March 14, 2023

A Comment on Charles Schwab

A bank run (described below) is a slight risk for Banyan's custodian, Charles Schwab (or "Schwab"), who owns TD Ameritrade. Schwab operates mainly as a bank. Its deposits are custodial clients' cash balances. These balances are insured up to $250,000 by FDIC or SIPC. All securities, including Treasury Bills, are segregated and thus unavailable to Schwab's creditors.

As of Tuesday, March 14, no Banyan client had cash balances in excess of $250,000. If your account shows more than $250,000, it is because our purchase of Treasury Bills at today's auction will not show in your account until the end of today. Thus, in the unlikely event Schwab suffers a bank run, Banyan's clients are fully protected. A statement from Schwab is here.

A Short Essay on Bank Runs

After the market closed on March 8, Silicon Valley Bank (or "SIVB") announced it would raise $2.25 billion of new capital after losing $1.8 billion on the sale of its $21 billion "available for sale" bond portfolio. SIVB's stock fell 60.4% on the 9th. A bank run ensued. By lunch on the East Coast the following day, the bank was in receivership. The well-regarded bank was dead.

It is worth exploring how this happened. Banks pay customers for deposits and then lend deposits to borrowers at interest. The difference, or "net interest income," is a bank's primary profit source. To juice net interest income, banks lend more money than they have on deposit. This is fine if deposits are stable (and loans do not default in mass, as happened in 2008-09).

Problems arise when deposits become unstable. Loans are made for months if not years while deposits can be withdrawn on demand. This creates a liquidity mismatch. Furthermore, banks buy bonds if deposit inflows exceed customer demand for credit. This happened during the pandemic as the trillions of dollars created by the Federal Reserve became deposits at banks.

The types of bonds many banks bought with excess deposits is important. Rather than buy short-dated bonds like 6-month Treasuries, many bought long-dated bonds like 30-year Treasuries. The longer the maturity, the more sensitive a bond's price is to interest rate moves. As interest rates rose, banks' long-dated bonds suffered huge losses, thereby impairing their capital positions.

Unfortunately, much of the impairment could be found only in the footnotes of banks' financial statements. Losses were not counted against reported "book value," or equity, due to an accounting quirk. If a bank designates a bond "held to maturity," meaning it does not *intend* to sell before maturity, the bank can ignore changes to the bond's market price. Economic reality is ignored.

Tom Gayner, the CEO of Markel, was asked about this very issue on Markel's Q1 2022 earnings call. Seeing that Markel has a sizeable bond portfolio suffering from higher interest rates, a hopeful analyst asked why Markel did not switch the accounting treatment of its bonds from "available for sale" to "held to maturity." Doing so would allow Markel to stop reporting losses on its bonds.

Tom responded,

> "[H]ow many legs does a dog have if you call a tail a leg? The answer is four. So calling a tail a leg doesn't make it a leg . . . . [T]he mark-to-market value is a real economic number . . . . We think about things in real economic terms. So we really don't expect to have any changes in what we are doing or the way that we label the accounting [of our bond portfolio]."

Few CEOs are this principled. By simply switching bonds' accounting treatment, as if by magic losses stop flowing through the income statement to impact reported equity, of "book value." That is very tempting for CEOs obsessed with meeting Wall Street's quarterly earnings estimates. Tom and Markel deserve to be recognized for their principled adherence to economic reality.

Back to the banks. Due to higher interest rates, people are moving their money out of bank deposits and into higher yielding alternatives like government bonds. If pronounced, this "cash sorting" can create a liquidity crunch for banks. No matter how genuine its original intensions, a jeopardized bank may have to sell its "held to maturity" bonds and realize losses to meet deposit outflows.

In a nutshell, this is what happened to SIVB. First, SIVB had to sell "available for sale" bonds, whose losses were already reported in "book value." This still required an equity raise, thereby spooking more depositors. A bank run ensued. SIVB's "held to maturity" bonds were then needed to meet deposit outflows. SIVB could no longer hid from economic reality. It was insolvent.

There are lessons here. First, accounting practices can differ from economic reality. In most cases, the difference does not threaten a company's viability. For financial companies, on the other hand, it can be the difference between life or death. The fact that accountants can ignore a reality does not mean management or investors can. Second, always read the financial footnotes.

Sincerely,

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