How SVB 'Profited' From Interest-Rate Risk

By William L. Silber

How did three top officers of Silicon Valley Bank earn a combined $18 million in salary and bonus while sitting on a powder keg? The answer lies in the peculiar accounting treatment of bond investments that encourages reckless risk taking with depositor money—a form of legal subterfuge that still threatens the financial system.

SVB held tens of billions of dollars in long-term government bonds. On its face, this may seem like a prudent investment for a bank, but Treasury securities are riskless only when held to maturity. If you have to sell before then, you can easily lose money if market rates have risen since you first purchased the bond. For example, buying a 10-year U.S. Treasury bond with a 2% coupon at par and holding it for 10 years earns you 2% per annum. But if you sell early and rates have jumped—say, 4% since you bought the bond—then the price will have declined to about $838 per $1,000 face value, meaning you incur a loss of $162 per $1,000 bond.

Though that risk is implicit in every bond purchase, accounting and regulatory frameworks can obscure it in a way that results in big bonuses for bank officers. When a bank like SVB buys a Treasury bond, it can declare its intention to hold it to maturity. The bond then goes into a "held to maturity" investment account where capital gains and losses are ignored because the bond pays par at maturity. The income from the bond, however, goes into the bank's income statement, adding to the institution's apparent profitability. In the short run, this lets bank officers collect hefty checks, but if rates are rising in the background, a mounting risk is going unaccounted.

An accounting rule created an incentive for the collapse.

That's more or less what happened to SVB, which held about $90 billion of its $120 billion bond portfolio in its held-to-maturity investment account. As interest rates rose over the past few years, SVB did little to hedge against its exposure to rate hikes. So when depositors came demanding cash, the bank had far less than its books showed.

This was all legal under current regulatory and accounting frameworks. Other banks that bought long-dated bonds before the Fed started hiking rates could face similar uncounted losses. The rules create an incentive for risk taking with Treasury bonds by allowing bank management to create a short-run asymmetric payoff: If interest rates hold steady or decline, the bank's profitability increases because of the coupon payment, but if rates rise, the capital losses are deferred to accounting footnotes. This means higher profitability in the short term and more money in the hands of bank officers. But it introduces immense hidden risk into the financial system to the detriment of creditors—and in the case of a bailout taxpayers.

Regulators should have raised a red flag about SVB's behavior before things got to this point. Now that they have, the government should take the opportunity to change accounting rules so that banks don't take on such careless risk for personal profit. Otherwise, SVB may be the tip of the iceberg.

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