MARKET ANALYSIS

Silicon Valley Bank (SVB) - Update

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Overview:

Silicon Valley Bank (SVB), a significant financial lender servicing venture capital firms and tech companies was shut down by California regulators on March 10, 2023. At the time, SVB was the 16th largest bank in the U.S., with over $212 billion in assets. SVB specializes in venture capital funding. In fact, it apparently does business with nearly half of all Venture Capital backed startups in the US.[1]

Cause of the Collapse

In 2021, SVB saw a mass influx in deposits, which jumped from $61.76 billion at the end of 2019 to $189.20 billion at the end of 2021. As deposits grew and the interest rate environment remained low, SVB invested its deposits in treasury bonds and mortgage-backed securities (MBS) in attempts to generate higher yields (aka, higher profitability on the capital it held from depositors).

Two main issues that arose from this:

1. While Treasuries and MBS are very safe investments from a credit risk perspective, they pose substantial interest rate risk. The weighted average duration of these investments was about six years, implying that if interest rates rose by 100 basis points (1%), the value of those securities would decline by 6%.
2. These Treasury and MBS securities were held on a long-term “hold-to-maturity” basis. Meaning SVB did not have to mark-to-market those bonds until they were sold, leaving investors with a somewhat distorted view of its balance sheet, because as interest rose at their fastest pace in history, SVB was not marking these bonds at a significant loss.[2]

If SVB were able to hold those bonds for a number of years until they mature, then it would receive its capital back. However, as economic conditions soured over the last year, with tech companies particularly affected, many of the bank’s customers started drawing on their deposits. SVB didn’t have enough cash on hand, so it began selling some of its bonds at steep losses, spooking investors and customers.[3]

To fund the redemptions, Silicon Valley Bank sold on Wednesday a $21 billion bond portfolio consisting mostly of U.S. Treasuries. The portfolio was yielding an average of 1.79%, far below the current 10-year Treasury yield of around 3.9%. Forcing SVB to recognize a $1.8 billion loss, which it needed to fill through a capital raise.[4]

Compounding SVB’s problems was an apparent lack of risk management oversight by the board and risk management team. SVB was without their senior most risk officer for about eight months in 2022 and only in January 2023 brought a new Chief Risk Officer on board.[7]

Steps Taken by the Department of the Treasury and the Federal Reserve: [5]

1. Federal regulators, including U.S. Treasury Secretary Janet Yellen, Federal Reserve Board Chair Jerome Powell, and FDIC Chairman Martin Gruenberg on Mar. 12 announced "decisive actions" that would "fully protect depositors" at both Silicon Valley Bank and the now-shuttered Signature Bank. "Depositors will have access to all of their money starting Monday, March 13, 2023. No losses associated with the resolution of Silicon Valley Bank will be borne by the taxpayer," according to a joint statement from the regulators.

2. The Federal Reserve Board announced on March 12, 2023, a $25 billion Bank Term Funding Program (BTFP) that offers loans of up to one year to banks and "other eligible depository institutions" aimed at backstopping any liquidity issues they may face.

<u>Implications for the Economy:</u>

Silicon Valley Bank's failure is the largest since Washington Mutual went bust in 2008, a hallmark event that triggered a financial crisis that hobbled the economy for years.[6] Therefore, the question that everyone will be discussing this week is whether the SVB collapse will have a similar impact on the economy. Concerns over buildups of unrealized losses at many banks because of rapidly rising interest rates on fixed-income investments are legitimate in that a large bank run on SVB could be a catalyst for contagion effects where bank runs at other institutions with large unrealized losses then follow.[7] According to Fed data, small banks in the United States had $6.8 trillion in assets and $680 billion in equity as of February 2023. Considering this scenario, a failure on the tech bank could put in "risk of a run on thousands of small banks," further making the SBV situation a "main street problem,"[8]

We acknowledge that the SVB collapse will not be a one-off, as evidenced by the collapse of Signature Bank just days later. What is unique about SVB was the bank was a major service provider to the sorts of companies that have fallen out of market favor in the last year and struggled to continue funding themselves (startups and venture capital backed business) and now those companies have their own liquidity needs (cash burn is high for early stage, sometimes cash flow-negative companies, which means pulling money from their banks).[9] The fate of SVB may be a harbinger of tougher times for technology start-ups and companies in general, but does not cause significant concern for the banking system contagion seen during the Great Financial Crisis.

In a recent banking stress test issued by the Federal Reserve in June 2022, the nation's largest banks remained well-positioned to absorb a range of potential economic shocks while continuing to support their depositors. The test investigated a severely adverse scenario in which unemployment rises to 10%, GDP declines in tandem, commercial real estate prices drop 40%, home prices dip 28.5% and stock prices plummet 55%. All of the banks put to the test were forecasted to maintain their minimum capital ratios in spite of projected losses of $612 billion, propelled by $463 billion in loan losses and $100 billion in trading and counterparty losses. In such a scenario, the banks' aggregate common equity capital ratio would be expected to decline 2.7 percentage points to 9.7%. The Fed said that level would be more than double the minimum requirement of 4.5%.[10]

<u>Impact for Portfolios:</u>

In this environment, we could see a shift from momentum and growth stocks to stocks of higher quality, which should support active management as valuations and earnings become more important in security selection. Similarly, we believe that it is always prudent to position portfolios for volatility. Therefore, portfolios with shorter duration allocations in fixed income as well as allocations to liquid alternatives that should provide downside protection when stocks are under pressure.

Economic Definitions

Department of the Treasury: The Department of the Treasury is the national treasury and finance department of the federal government of the United States, where it serves as an executive department. The department oversees the Bureau of Engraving and Printing and the U.S. Mint.

Unemployment Rate: The unemployment rate tracks the number of unemployed persons as a percentage of the labor force (the total number of employed plus unemployed). These figures generally come from a household labor force survey.

Federal Reserve (Fed): The Federal Reserve System is the central banking system of the United States of America

Disclosures

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[1] Data Obtained from Bloomberg
[2] https://www.nytimes.com/2023/03/11/business/dealbook/silicon-valley-bank-collapse.html
[3] https://www.theguardian.com/business/2023/mar/13/silicon-valley-bank-why-did-it-collapse-and-is-this-the-start-of-a-banking-crisis
[4] https://www.reuters.com/business/finance/what-caused-silicon-valley-banks-failure-2023-03-10/
[5] https://cointelegraph.com/news/silicon-valley-bank-collapse-everything-that-s-happened-until-now
[6] https://www.reuters.com/business/finance/global-markets-banks-wrapup-1-2023-03-10/
[7] https://www.newswise.com/articles/op-ed-silicon-valley-bank-s-failure-in-risk-management
[8] https://cointelegraph.com/news/silicon-valley-bank-failure-could-trigger-run-on-u-s-regional-banks
[9] https://www.bloomberg.com/news/newsletters/2023-03-10/what-is-svb-and-does-it-pose-a-risk-to-your-portfolio
[10] https://www.bankingdive.com/news/big-banks-pass-muster-in-feds-annual-stress-test/626056/