

# Silicon Valley Bank's failure and its impact on markets

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## Silicon Valley Bank: a brief company overview

SVB Financial Group (SIVB US) is a diversified financial services company, which provides personalized financial solutions to private equity/venture capital professionals and executives of innovation companies. *Silicon Valley Bank* (SIVB) is the company's principal core business, offering traditional commercial loan and deposit products, as well as credit cards. The global fund banking division of SVB primarily provided PE/VC call lines of credit secured by LP capital commitments, representing 56% of the loan book.

The other core businesses are as follows: (2) *SVB Private*, which provides personalized financial solutions to PE/VC professionals, such as mortgages, (3) *SVB Securities*, which is the investment bank and (4) *SVB Capital*, which is the VC investment arm.

## What sparked SIVB's problems?

SIVB largely banked start-ups and venture companies and was never a big lender. The start-up would get their seed capital and put it into SIVB where it would receive little to no interest. The start-up would then use the money to fund its operations, and additional rounds of funding would replenish their account. SIVB would take the deposits and largely invest in securities, things like Treasuries to capture a yield. What occurred is the investments in that securities book had a yield of <1.8% and a duration at ~4 years so those securities had unrealized losses following the recent increase in bond yields. These don't impact the bank's capital and/or liquidity as long as they are held, as the unrealized losses go away as the bonds mature. Problems arise when assets in the investment portfolio need to be sold, because it then crystallizes the loss, impairing capital.

As venture activity slowed last year the start-ups, not getting additional financing, had to draw on their deposits at a faster rate. This impacted both SIVB's top-line and bottom-line and there was not much visibility to when VC activity would return and how it would return. SIVB reset guidance a few times on back of this dynamic.

Fast forward to last week, the company was still facing pressures related to cash-burn of the VCs. In response, the company decided to get some degree of earnings buffer by selling part of their investment portfolio and repositioning their balance sheet. The company raised equity to offset the capital loss caused by realizing the losses on the investment portfolio. Although this was not a liquidity issue, it created confusion in the market, particularly with SIVB customers. Customers of SIVB took the equity raised and the security realized loss on their sale as the bank being in trouble, creating a typical bank run.

## What is a bank run?

The banking system is highly dependent on customer confidence. All bank deposits in the U.S. are insured by the Federal Deposit Insurance Corporation (FDIC), but only up to \$250,000 (a similar insurance system exists in Canada, under the CDIC). Deposits above that cap are uninsured. Bank customers have no upside of staying with a bank that is rumored to have problems, especially if their deposits at the bank are above the FDIC cap. This creates a strong incentive for depositors to move their capital to an institution that is perceived as safer, which amplifies the problems of the institution they are departing from.

On Thursday March 9<sup>th</sup>, following the rumors of problems at the bank, SIVB was hit by very rapid and substantial outflows, reported to be \$42 billion USD. That likely created liquidity mismatches and forced the FDIC to step in and declare the institution insolvent.

## **Will there be a contagion effect?**

SIVB's client base and operations were quite different from other U.S. banks, including smaller regional banks. Because most of its accounts were VCs and tech startups, it appears that over 90% of its deposit accounts were above the FDIC cap. Moreover, SIVB had one of the biggest investment portfolios relative to its capital base. All this makes it likely that the bank's problems are localized.

That being said, U.S. government officials and the FDIC must handle the uninsured depositors carefully. Since the Global Financial Crisis (GFC), a lot of regulatory pressure has been applied to a small group of too-big-to-fail institutions, making them much safer than before the crisis. If depositors fear that their money is not safe if held in a smaller institution, it is likely that some will choose to migrate to the banking giants, leaving the smaller U.S. banks in a more difficult position. Maintaining confidence in the banking system is important, and regulators and officials know that.

In an effort to stabilize the market, on Sunday March 12<sup>th</sup>, the Fed backstopped all deposits at SVB Financial and Signature Bank and established the Bank Term Funding Program (BTFP). The BTFP provides liquidity to the banking system and would allow a bank to use their assets as collateral and receive funds at par value. The initial read is this essentially removes liquidity risks any regional bank might face if deposits were redeemed and the hope was to stymie further runs on banks. U.S. futures reacted positively and the expectation was that would continue the morning of March 13<sup>th</sup>. However, this did not stabilize confidence and the regional banking group continued to sell off.

The concerns for the group have turned to 1) earnings falling; as net interest income abating faster if deposits did not stabilize, 2) risks around eventual regulatory ramifications to the group, 3) questions if the Fed can support its existing quantitative tightening program in this environment and what happens after BTFP expires in a year, and 4) questions around franchise values that could be impaired by current events i.e. will customers continue to originate with their existing bank or will we see outflows of deposits that don't create a liquidity event but change the growth trajectory of the bank.

On a more macro level, stress appearing in the banking system is not good for risk sentiment, even if it turns out to be limited solely to SIVB. On the flip side, it will appear on the Fed's radar as they consider the next step on the monetary policy front and probably reduces the likelihood that they will aggressively hike rates from here. That is what makes markets difficult: there are a lot of intertwined dynamics.

Sources: CI Global Asset Management as of March 14, 2023.

For more information, please visit [ci.com](https://www.ci.com).

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## GLOSSARY OF TERMS

**Contagion:** A contagion is the spread of an economic crisis from one market or region to another and can occur at both a domestic or international level.

**Duration:** A measure of the sensitivity of the price of a fixed income investment to a change in interest rates. Duration is expressed as number of years. The price of a bond with a longer duration would be expected to rise (fall) more than the price of a bond with lower duration when interest rates fall (rise).

**Liquidity:** The degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price. Cash is considered to be the most liquid asset, while things like fine art or rare books would be relatively illiquid.

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