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# Silicon Valley Bank Update

Below is our ongoing assessment of Silicon Valley Bank (SVB), Signature Bank (Signature), and the broader banking system as of the date of publication, March 14, 2023. We will continue to assess the situation as it evolves.

The general consensus thus far is that the issues leading to both banks' collapse were idiosyncratic to each organization. **Our sense is that the risk to the broader banking system remains relatively low, but the balance sheets and asset/liability mixes of regional and mid-sized banks are almost certain to face heightened scrutiny. In addition, banks whose defined contribution plans contain company stock could receive additional attention.** Opinions aside, these events have resulted in a large policy response from the Fed, the White House, and other elected officials in an attempt to prevent contagion within the financial system and allay investor fears.

## Background

On Wednesday, March 8th, Silicon Valley Bank announced that it had taken action to improve its financial position and that the firm had sold $21 billion of its most liquid investments at a loss of $1.8 billion.[1] SVB's liquidity had deteriorated due to declines in the bank's bond portfolio and increased withdrawals year-to-date due to near-term cash needs of SVB's clientele in the technology sector. The firm's stock traded down dramatically on the news and subsequently further the remainder of the week. The announcement also caused an immediate increase in withdrawal requests, following the textbook example of a bank run. These events culminated in the FDIC stepping in and assuming control over SVB's depositary assets on Friday, March 10th.

On Sunday, March 12th, Signature Bank, located in New York, was closed by the FDIC. Signature suffered from an asset and liability mismatch similar to SVB. The bank had begun to welcome cryptocurrency deposits against the advice of regulators and, similar to SVB, provided largely uninsured deposits to companies with high recent cash needs in the real estate and legal industries. That evening, the Fed announced that it would guarantee both insured and uninsured deposits at SVB and Signature in order to ease market concerns and move to isolate the challenges faced by the two institutions. The Fed will also provide additional liquidity through the Bank Term Funding Program (BTFP), offering loans to participants in the banking system.[2]

Regional bank stocks traded down sharply on Monday, March 13th, with mid-sized banking institutions touting the amount of liquidity on their balance sheets to the market. Around a dozen financial institution stocks were halted mid-day due to volatility. The broader market closed out the day relatively unchanged, after initial declines, as some investors became optimistic that the shock will slow the pace of Fed rate increases.

[1]Silicon Valley Bank Press Release, March 8, 2023. https://ir.svb.com/news-and-research/news/news-details/2023/SVB-Financial-Group-Announces-Proposed-Offerings-of-Common-Stock-and-Mandatory-Convertible-Preferred-Stock/default.aspx
[2]Federal Reserve Board Press Release, March 12, 2023. https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm

## Current Assessment

RVK's current sense is that the risk to the broader economy from these events remains relatively low thus far. SVB and Signature were small compared to the major national banks and both were more leveraged to the single industries and relied on a concentrated depositor base. For reference, SVB was America's 16th largest bank, with $209 billion in assets compared to JP Morgan's more than $3 trillion.[3] The policy response over the weekend was robust, with a guarantee of all deposits at SVB and Signature and the initiation of a large lending program. This should ease fears around deposit risk at mid-sized and smaller banks.

Early indications are that SVB's crisis was caused by mark-downs in the firm's bond portfolio as interest rates rose coupled with elevated withdrawals from the firm's technology sector borrowers, resulting in an increasingly illiquid balance sheet and declining balance sheet equity. The FDIC cited both inadequate liquidity (not enough cash on hand) and insolvency (liabilities exceeding assets). Both SVB's assets and liabilities ended up being adversely affected by increasing rates and the market and depositors' reaction to the news overwhelmed the bank's balance sheet and liquidity. Signature's issues appear to be similar.

The country's largest banks are more dependent on broad retail deposits and a much wider variety of lending and appear unlikely to face the same challenges in both assets and liabilities. We anticipate that regulators will continue to monitor bank balance sheets, with their efforts likely focused on regional banks.

## Potential Sources of Investor Exposure

RVK is working with the investment managers and general partners we cover to assess the potential damage or impacts to client portfolios. We expect that investors will have exposure to both SVB and SBNY equity and bond instruments in their liquid portfolios and as a service provider in private markets portfolios across venture capital and private equity. Direct exposure will, of course, vary by investment manager and portfolio construction; however, as of February 28, 2023, SVB and Signature comprised a small percentage—0.05% and 0.02% respectively—of the market cap-weighted S&P 500 Index.[4] As previously noted, the regional banking sector as a whole has also declined in value. This sector represented 1.15% of the broad index as of the same date.

With respect to client alternatives portfolios, we believe the most significant consequences will be felt in the operations of venture-backed portfolio companies that banked with SVB, with the second largest disruption in fund and firm operations for general partners that banked with SVB. The guarantee of the FDIC for all deposits on Sunday significantly eased concerns for all of these entities and we have heard early reports of funds and portfolio companies accessing SVB deposits on the afternoon of Monday, March 13th. Finally, we expect deal activity across private markets to decline substantially until markets normalize.

## Broader Lessons for Institutional Investors

While the exposure and impact will vary by client portfolio, below are some broader lessons all institutional investors should pay attention to:

1) **The form of security matters.** Businesses that held large deposits at SVB above the FDIC limits exposed themselves to the credit risk of a single financial institution. This is why we prefer diversified portfolios of securities for cash deposits (like government money market funds) rather than bank deposit products.

[3]Reuters, March 10, 2023. https://www.reuters.com/business/finance/global-markets-banks-wrapup-1-2023-03-10
[4]Morningstar Direct

2) **Asset / Liability mismatches can show up in unpleasant ways.** In this case, SVB owned longer-dated bonds and became a forced seller when depositors began demanding their assets back. This was, in hindsight, poor asset/liability management. It is worth noting that this is not a credit- or default-related event like Lehman Brothers—but occurred because of an asset/liability mismatch.

   In developing any portfolio's long-term strategic asset allocation, it is important to carefully consider the full liability profile, alongside with other important objectives and constraints. In the strategic asset allocation process, it is important to not overexpose portfolios to illiquidity, volatility, or longer-dated assets beyond what potential demands on the portfolio may require, such that the portfolio has little choice but to become a forced seller of assets at precisely the wrong time.

3) **Concentration is always a potential source of risk.** SVB held a premier position in the start-up and venture enterprise industry. That concentration can be beneficial when events unfold smoothly and become problematic when they don't. This is again why we adhere so fiercely to diversification as a foundational principle in client portfolio construction.

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