26th April 2023

You can't bank on it

Silicon Valley Bank (SVB)

Based in Santa Clara, California, SVB was the 17th biggest bank by assets in the US. It was officially shut down in March 2023 by the California Department of Financial Protection and Innovation. SVB was closed owing to a run on the bank, caused by depositors withdrawing large amounts of money. This was due to a loss of trust in the bank, following the realisation of a part loss on its investment portfolio of government treasuries due to rising interest rates.

Started in 1983, SVB was a pioneer of what is known as venture debt: A type of loan offered by banks and non-bank lenders specifically designed for early-stage, high-growth companies with venture capital (*VC*) backing. By 2021, SVB had built up a significant deposit base: It held $288 billion in client funds, 67% of which were non-interest bearing deposits with an average cost of just 5 basis points — well below that of most large banks. Most of these deposits came from companies in the technology, health care and life sciences industries. Although VC firms did park funds with SVB that haven't yet been deployed, most of these deposits were invested in US government treasury bonds and other long-term debt.

Generally, these treasuries are considered defensive, providing low risk adjusted returns. However, as the US Federal Reserve (the *Fed)* aggressively hiked interest rates though 2022/2023 to tame rising inflation, bond valuations declined. This led to a decline in the value of SVB's bond portfolio. As this was happening, some of SVB's customers were drawing funds from their accounts as tech companies faced cash flow problems and the inability to raise capital via issuing shares. To address these withdrawals, SVB had to sell some of their investments at a loss of $1,8 billion setting its failure into motion. View the timeline below:

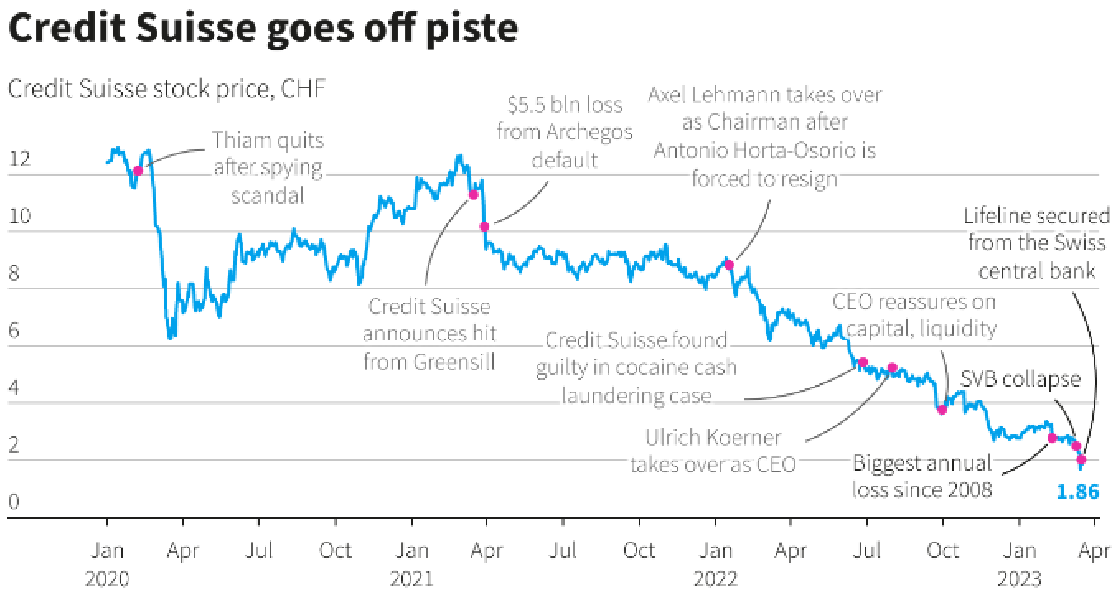
- **March 8**: Silicon Valley Bank announced its $1.8 billion loss on its bond portfolio, along with plans to sell both common and preferred stocks to raise $2.25 billion. In the aftermath of this announcement, Moody's downgraded Silicon Valley Bank's long-term local currency bank deposit and issuer ratings.
- **March 9**: The stock for Silicon Valley Bank's holding company, SVB Financial Group, crashed at the market opening. Other major banks also saw their stock prices take a hit. Additionally, more SVB customers began withdrawing their money, bringing total attempted withdrawals to $42 billion.
- **March 10**: Trading was halted for SVB Financial Group stock. Before the bank could open for the day, federal regulators announced they would take it over. After regulators were unable to find a buyer for the bank, deposits were moved to a bridge bank created and operated by

the Federal Deposit Insurance Corporation (FDIC), with a promise that insured deposits would be available by Monday, March 13.

- **March 12**: Federal regulators announce emergency measures in response to the Silicon Valley Bank failure, allowing customers to recover all funds, including those that were uninsured.
- **March 17**: Silicon Valley Bank's parent company, SVB Financial Group, filed for bankruptcy.

Credit Suisse

Credit Suisse dropped 61,95% on Monday the 13th of March. This was owing to a string of scandals, top management changes, multi-billion-dollar losses and an uninspiring strategy. The bank confirmed in February that clients had pulled 110 billion Swiss Francs in the fourth quarter of 2022, while the bank suffered its biggest annual loss of 7,29 billion Swiss Francs. Recently, the Saudi National Bank (the bank's top shareholder) told reporters it would not give any more capital to the bank, as it was constrained by regulatory hurdles.



Credit Suisse ranked amongst the world's largest wealth managers. Crucially, it was one of 30 global systemically important banks, whose failure would have caused ripples throughout the global financial system. After a run on deposits, the Swiss government had turned to UBS, which agreed to buy Credit Suisse for 3 billion Swiss Francs ($3.3 billion), while the Alpine state put up more than 200 billion Francs of support and guarantees.

However, as part of this deal, the Swiss Financial Market Supervisory Authority (FINMA) announced a clean-out of 16 billion Swiss Francs worth of Credit Suisse additional tier 1 (AT1) bonds. Some investors believe that this may cause further spill-overs of risk globally.

AT1 bonds were introduced in Europe after the global financial crisis to serve as shock absorbers when banks start to fail. They are designed to impose permanent losses on bondholders or be converted into equity if a bank's capital ratios fall below a predetermined level, effectively propping up its balance sheet and allowing it to stay in business. According to the Swiss bail-out regime, AT1 debt is above equity in the loss absorption waterfall.

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Credit Suisse's entire AT1 tranche of bonds were written down to zero, which is an interesting development and raises questions about the real value of contingent convertible bonds.

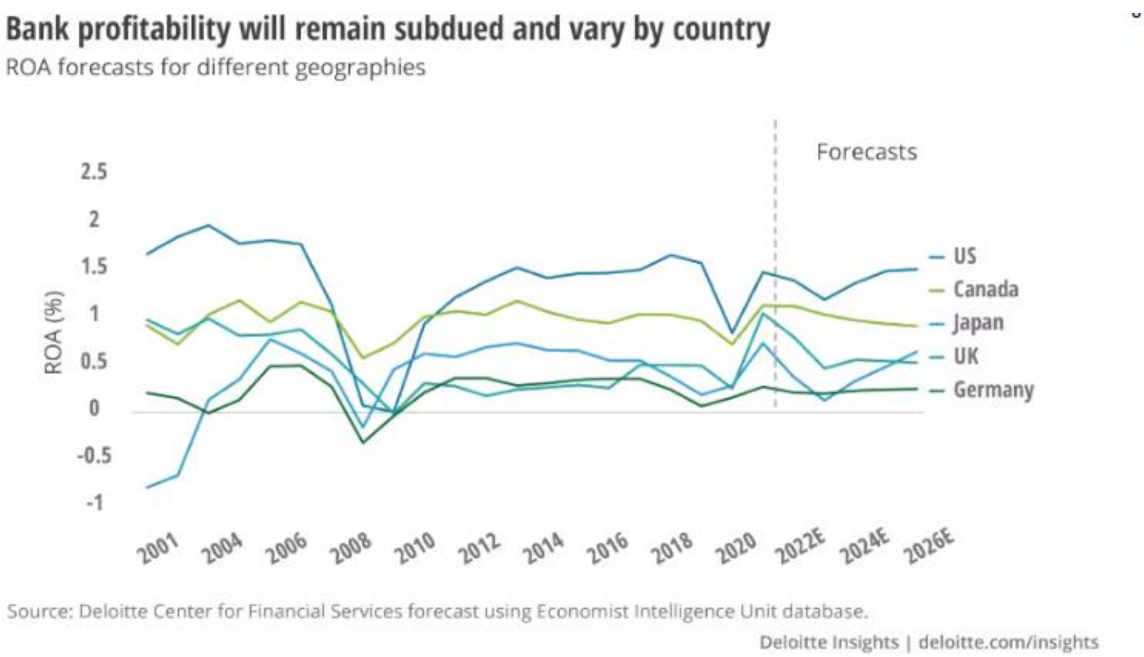
Financial impact

The long-term financial impact this will have on the markets remains unclear. However, since the 2008 banking crisis, banks have endeavoured to ensure to place increased capital buffers to withstand systematic risks.

The cost to the banking system ultimately is a socialised cost, as it takes capital out of the banking system that could otherwise be put to work in the economy. How big is this cost? To put SVB into context: A bank with $212bn in assets failed and society ended up on the hook for less than 10 per cent of that; that is less than the 17 percent of assets the FDIC had to absorb from bank failures in the great financial crisis.

Another cost to be considered is the implicit guarantees offered to all uninsured depositors in all US banks when the authorities stepped in so quickly to guarantee all SVB depositors. Depositor risk aversion imposes discipline on banks to manage their balance sheets prudently (unlike SVB) to attract depositors. It is worth noting that US uninsured depositors have been consistently bailed out for decades and it will probably always be that way, owing to the historically destructive nature of bank failures.

Significantly, the problems at SVB started with profitability. Falling profitability led to the depositor run and thereafter the solvency problem (coupled with the inability of tech startups to raise additional capital). The profitability problem, in turn, came down to a bad business model: Taking a flood of deposits from a single highly cyclical industry, without a plan for profitably deploying that capital, except for buying long duration bonds.



Rockman’s view on the banking sector

As a house we remain neutral towards the finance sector. It is important to note that investing in the banking sector does come with its own risks, including changing regulation, interest rate fluctuations, credit risk and market volatility etc.

We have spoken at length about the current high interest rates, which currently sits at 5% in the US. This is considered as positive for the banking sector, as lending institutions are finally able to earn a margin via the endowment effect and net interest margin (*NIM*) (NIM is the margin between the cost of the bank’s capital and the rate at which they are lending money to customers). Overall, this leads to increased profitability. However, higher NIM must be balanced with rising provisions for bad debts, due to a slowdown in economic activity.

Whilst the recent tremor through the banking sector reduced the prices of all banking shares alike, we took this as an opportunity to increase client exposures to banks. With the recent 2023 Q1 reporting cycle, share prices have recovered, with most big banks reporting strong NIM growth.

We currently hold limited exposures to US & European banks but are still positive about the insurance sector, which we will cover in our next newsletter and the underlying reasons .

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