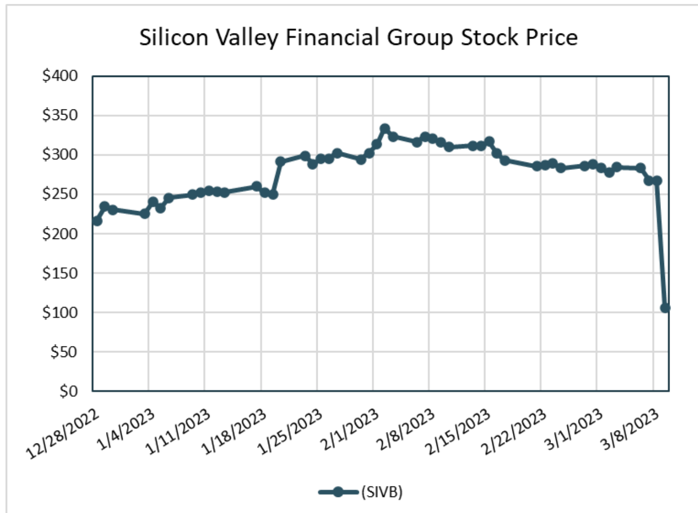
Executive Highlights – What Caused the Silicon Valley Bank Closure and How Should Business Owners Respond?

On Friday, March 10th, Silicon Valley Bank was closed by regulators and put into receivership. This is the largest bank failure since Washington Mutual in 2008. On Sunday March 12th, a second institution - Signature Bank - was also shut down. Many business owners are now concerned about their bank and the financial system overall.



Source: S&P Capital IQ

Our advice at this point is simple:

1. **<u>Don't panic</u>**: SVB and Signature Bank had uniquely risky loan and deposit portfolios because of concentration with startup companies and cryptocurrency. Additionally, multiple regulatory actions have been taken to reduce the risk to other banks.
2. **<u>Two banks are better than one</u>**: If you have business accounts at a second bank, there's no harm in moving some cash there to temporarily diversify and maximize your FDIC coverage. If you don't have a second banking relationship, this is a good opportunity to set one up.
3. **<u>Assess your exposure to startup companies</u>**: If your customers or vendors are startups, many of them banked with SVB. You should expect payment disruptions and may need to update information for electronic payments.
4. **<u>Don't fall for payment scams</u>**: Criminals will try to take advantage of this event. We expect to see fake emails from "vendors" with "new" account information, emails or texts that impersonate your executives and tell your payables staff to make "emergency" payments to new vendors. Tell your staff to be on alert and always get a second confirmation before changing payment information.

Banking Overview

Let's begin by saying that the banking sector is healthy in the aggregate. Comparisons to 2008 are misplaced because of balance sheet health and the stronger framework for government intervention that exists today. Moving quickly to prevent panic elsewhere, the FDIC announced on Sunday that it would extend FDIC insurance above the $250K limit for depositors at SVB. More importantly, the Federal Reserve just created the Bank Term Funding Program (BTFP) that will allow banks to borrow from the Fed directly to payback depositors if they face a run.

Still, no bank will ever be completely safe from a run on its deposits, which is ultimately what killed SVB. It only takes a panic amongst ~10-15% of depositors to put one into jeopardy. In 2008, Washington Mutual was destroyed by withdrawals of ~$16B over a 10-day period (versus prior year-end deposits totaling ~$188B). Last week, Silicon Valley Bank was facing withdrawals of $42B - approximately 25% of deposits as of March 9th.[1] The vast majority of its depositors had balances over the $250K FDIC insurance limit, which contributed to the panic. Before we go into more detail on SVB's collapse, a quick overview of the banking business is necessary.

[1] California State Department of Financial Protection and Innovation. *Order Taking Possession*. San Francisco, CA. March 10, 2023. https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/03/DFPI-Orders-Silicon-Valley-Bank-03102023.pdf?emrc=bedc09

Banks hold deposits for businesses and individuals (checking, savings accounts, CDs). Banks then lend those deposits to other businesses and individuals (mortgages, lines of credit, term loans, credit cards). Deposits represent a liability for the bank (they owe it to the depositor). Loans made to others represent an asset for the bank (they can collect from the borrower).

Except for CDs and similar instruments, as a depositor you can spend or transfer your balance any time. However, a loan portfolio can't be converted into cash at will. For example, your bank can't demand that you repay your mortgage early. This tension between the long-term loans a bank makes (less liquid) and the ability of its depositors to spend the cash in their accounts or ask for it back (very liquid) creates a balancing act for the bank and its regulators. They need to ensure that the bank has enough cash, available credit with financial institutions, and liquid securities to meet the needs of its depositors in the short term. In a situation where deposits fall extremely fast, the firm will need to liquidate more of its assets to create the cash to repay depositors.

Silicon Valley Bank

Liquidating available for sale securities is what SVB tried to do last week. However, it had to sell many of these securities at a loss because rates were lower when SVB purchased those bonds. A 1% paying bond that was purchased in 2021 will sell at a discount today if bonds with similar maturities are now paying 2% or 3% (or more). As interest rates rise, old fixed-rate bonds lose value. At the end of 2022, SVB had a $26B portfolio of available for sale securities with $2.5B of unrealized losses for that reason.[2] It also reported $91.3B of held until maturity investments (not intended to be sold) carrying a significant $15.2B of unrealized losses concentrated in mortgage-backed securities and collateralized mortgage obligations.[3]

While its loan portfolio was declining in value, its deposits were shrinking to $166.4B, down from $187.4B in 2021.[4] SVBs depositors were mostly startup companies that have been burning through cash quickly. The banking industry focuses on the risks surrounding loan and securities portfolios but gives much less attention to deposits. In its 2022 annual filing, SVB provided a little color on deposit outflow and concentration:

"Our level of deposits also depends on whether clients determine to keep proceeds from liquidity events and other funds in deposit products with us (as opposed to off-balance sheet products, such as third-party money market funds). Although clients have historically retained a significant portion of their funds on our balance sheet, clients began to move more funds off balance sheet in the second half of 2022."

"Our focus on certain markets or segments, including those by client industry, life-cycle stage, size and geography, increases the potential for significant losses due to concentration of risk."[5]

With its deposits declining, SVB borrowed $15B from the Federal Home Loan Bank of San Francisco towards the end of 2022.[6] The bank would see its deposits decrease by a further $8B during the first two months of 2023 and it was forced to increase its borrowings from the FHLB by an additional $15B while selling those available for sale securities.[7] This spooked its depositors (mostly uninsured by the FDIC), who began to panic. With both liquidity and regulatory ratios under pressure, the company tried to raise approximately $2.25B of equity but fell short.[8] As a last resort, it attempted to find a buyer for the company before regulators stepped in.

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[2] SVB Financial Group. *Form 10-K 2022.* Santa Clara, CA. 2023. https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/f36fc4d7-9459-41d7-9e3d-2c468971b386.pdf

[3] SVB Financial Group. *Form 10-K 2022.*

[4] SVB Financial Group. *Form 10-K 2022.*

[5] SVB Financial Group. *Form 10-K 2022.*

[6] SVB Financial Group. *Form 10-K 2022.*

[7] SVB Financial Group. *Form 10-K 2022.*

[8] SVB Financial Group. *Form 8-K March 8, 2023.* Santa Clara, CA. 2023. https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/eede72d3-1cc6-45ee-89cf-3dc4f59469ad.pdf

The government now guarantees that all SVB *depositors* will be made whole. Whether unsecured creditors of the bank or its shareholders will get their money back is an open question. According to the FDIC, the bank had $209 billion in assets and $175.4 billion in deposits when it failed. Read the full FDIC press release here and see additional resources here.

What Should You Expect Next?

1. **Banks Compete for Client Deposits, Tighten Credit Standards**

Over the next few months, expect well capitalized national and regional banks to try and woo former SVB clients. In the next week or two, regional banks will be focused on communicating their solvency and distancing themselves from the issues that impacted SVB. Most of these companies have already issued statements with information on their depositor base and available credit. They will also be able to access the new Federal Reserve programs. We think competition for depositors and competition on rates paid for various term deposit products may tighten because of SVBs failure. This will put pressure on net interest margins and bank profits. Expect banks overall to be stricter with new loans or extensions of existing agreements.

2. **Bay Area Tech Service Providers & Investors Navigate Uncertainty**

Financial institutions and service providers (law firms, accountants, consultancies, venture capital and angel investors) who worked closely with SVB or who focus on startup companies will be negatively impacted and experience turbulence in the short run. SVB was a major part of the VC ecosystem, and it will take a while for market participants to replace the liquidity it provided.

3. **Wall Street Analysts, Investors, and Regulators Scrutinize all Financial Institutions for Deposit Flight Risk, Unrealized Losses, and Net Interest Margin Erosion**

Meanwhile, institutional investors and Wall Street analysts will be taking a much closer look at the industry concentration, deposit base and unrealized losses of smaller and midsize banks. These companies are often more thinly traded and less closely covered by the analyst community, so it is possible other banks have issues that have not yet come to light. All other financial institutions who “borrow short and lend long” will get a second look to analyze the impact of higher rates.

4. **The Federal Reserve Moderates its Rate Hikes**

Before the SVB meltdown, the “higher for longer” Fed seemed ready to increase rates by as much as 50 basis points again. After SVB, 25 basis points is much more likely, and some analysts are even predicting no rate hike in March. The Feds final decision will depend on inflation data this month, but a 50-basis point hike seems unlikely.

Other Questions We’re Being Asked:

Q: How much and how fast would the FDIC pay out if something were to happen to my bank?

A: Fast. Within the $250K FDIC limit you can expect payment within a few business days, if not the next business day after the closure of a bank. Banks are required to prepare contingency plans with regulators to ensure they can step in quickly and get liquidity to depositors. As a side note, SVB just submitted its new plan at the end of 2022. All SVB depositors are being told they will have access starting on Monday.

Q: I also bank with a credit union, is my account insured?

A: Almost all credit unions are insured for $250K by the NCUA.

Q: My personal investment account is also through my bank, am I covered there?

A: The SIPC applies to securities held at most brokerages and covers investors for $500K. FDIC is for deposit accounts.

Q: My business has two checking accounts at our bank, does that mean I am FDIC insured for $500K?

A: No. FDIC insurance is based on account owners in specific ownership categories at an institution. Your business is the owner of both accounts and so they share the $250K coverage.

Q: My operating business leases its facility from another company that I also own. Both have the same bank. Do these businesses share the same FDIC limit?

A: No. Two different entities at the same bank would each have separate $250K FDIC coverage – even though they have joint ownership.

Q: I bank with ABC Hypothetical Bancorp – should I be worried?

A: Right now, probably not. There is a lot of stock market volatility, but banks now have access to significant new resources from the Federal Reserve to pay depositors. Moreover, the FDIC has created a bit of a precedent that depositors should be made whole regardless of $250K FDIC limits. If another bank fails and they don't rescue all the depositors, it will look like Silicon Valley customers got preferential treatment. If another bank fails, we think they would step in for everyone, again.

Still, we encourage business owners and executives who are concerned to contact their relationship manager to discuss their banks financial position.

Q: I have accounts at two different banks, does this increase my FDIC coverage?

A: Yes. As an example, if you have checking accounts at two separate banks you will have $250K of FDIC coverage at both institutions. Opening an account with a second bank is a sound financial decision for all businesses, even during normal circumstances.

Q: What happens if I have more than $250K in my checking account and something happens to my bank?

A: You'll get $250K back because it is FDIC insured. We think in this specific situation the FDIC will cover deposits over $250K because of their actions with SVB. If they decide not to guarantee amounts over $250K, you'll receive periodic payments from the regulator as it sells the assets of the banks and pays depositors. Whether your deposits in excess of $250K are returned to you will depend on how much money the bank loses as its assets are sold. It is rare that depositors lose money when a bank fails because shareholders and other creditors take the losses first, but it can happen.

About ClearPath Business Advisors:

ClearPath Business Advisors is a multi-faceted, high-end consulting & advisory firm delivering on our perspective that business owners should create a healthy, sellable business whether they plan to sell or not. Everything that builds a sellable business, creates a stronger business and a more balanced life for its leaders and teams.

We are a team of seasoned, multi-disciplinary business executives with finance, accounting, operations, sales, and legal expertise. We strive to become a part of our client's teams, working closely and alongside business owners and their management.

We are also a firm with a heart, guided by our core values in creating high value for our clients while delivering on our promise of being a different type of consulting and advisory firm. We lead with our core values of Integration, Convergence, Service, and Every|One, and we donate 25% of our M&A transaction success fees to charity.

Ultimately, we just want to work with good people who could use our help.

If you have concerns about your short-term cashflow, or are worried about your banking relationship, please reach out to us.

Contact Our Team

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