The SVB Bank Collapse and Implications for Business

Last week, Silicon Valley Bank (SVB) was shuttered by US regulators after an insolvency scare prompted a run by depositors. At the time of publication, regulators are actively facilitating timely sales of SVB’s assets to other financial institutions with stronger balance sheets and liquidity. Federal regulators have said that all depositors of Silicon Valley Bank be able to access all of their money, as will a second bank, Signature Bank, was also closed. Additionally, the Fed said it would make additional funding available to banks to ensure they have “the ability to meet the needs of all depositors” through a new “Bank Term Funding Program.” This facility will offer loans of up to one year to banks that pledge U.S. Treasury securities, mortgage-backed securities, and other collateral.1

While the Federal Deposit Insurance Corporation (FDIC) may be able to contain the fallout from these two failures, will this lead to a US or even global financial crisis? The failures are far short of the 2008 crisis that hit the core of the banking system. However, we posit that contagion risks remain material, and that further action to restore confidence by regulators to safeguard the financial system and companies to protect themselves from financial harm may be warranted to avoid a broader crisis.

Insights for What’s Ahead

- **Regulators must continue to reassure confidence in the US banking system.** Regulators must communicate to the public three points:
  - (1) there is constant monitoring of the financial system and the health of financial firms;
  - (2) regulators will take action when necessary, as exemplified by the steps being taken to contain the two bank failures; and
  - (3) regulators must continue to provide any extra liquidity that is needed in the market.

- **Regulators must also continue provide adequate support to the financial system.** We suggest that regulators take specific actions to underpin the financial system including:
  - **Transparency** – Describing the new policy decisions put in place, including the new facility, and the seemingly unlimited protection of depositors by the FDIC.
  - **Risk assessment** – Evaluating the implications of these decisions for the banking system as a whole and the risks these decisions may have on the governance of financial institutions.
  - **Duration** – How long these emergency policies will remain in place to avoid creating other systemic risks.

- **Venture Capital (VC) backed companies should take measures to protect clients.** Actions include:
  - Speaking with investors and reassuring them of the transparency and robustness of your capital structure and banking relationships.
  - Exercising due diligence on your counterparty risk exposure.
  - Diversifying deposits across institutions.
  - Asking investors to provide emergency liquidity backstops.
  - Communicating with suppliers to ensure their liquidity as well as consistency of supply.
  - Look to raise equity in the near future.

- **Banking institutions must take immediate steps to ensure liquidity, but also plan for future crises.**
  - **Immediately**
    - Take whatever action that is needed to ensure liquidity and customer confidence, including reiterating what Treasury and the Fed have done to support financial markets.
    - Communicate transparently with all clients about liquidity sufficiency.

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• Review Asset-Liability Committee (ALCO) strategy with a focus on both tenor matching (i.e., having the assets and deposits with the same time profile (e.g., 10-year assets paired with 10-year deposits)) and liquidity pool depth (i.e., diversifying sources of funding including commercial paper, repos, tri-party agreements, etc.).
• Review counterparty risks for rehypothecation (i.e., when assets your institution lends are lent again to third parties, which makes your bank an unsecured creditor to that third party).
• Carry a deeper buffer of cash liquidity than historic business practice might suggest.

Future steps
- Lower leverage ratios.
- Reduce investments in risky assets.
- Ensure operating familiarity with the Federal Reserve’s discount window. Consider using it during times of low volatility to guarantee that processes work and that your institution has established a good relationship with the Fed window.

Non-Bank Firms must take steps to protect their assets and clients from harm. Important actions include:
- Reviewing the flexibility of operating accounts with your banking institution.
- Raising liquidity in an abundance of caution.
- Checking the liquidity status of all vendors and suppliers.
- Draw down revolvers – a short-term credit facility from a bank – if needed, to backstop working capital needs.
- Reassure all stakeholders – customers, employees, and owners – by verifying and reporting on the depth of your company’s liquidity and banking sources.

What to expect next? While capital tests may be useful to judge robustness of banks in some scenarios, we posit that the issue surrounding SBV’s failure concerned liquidity. Hence, the focus should be on ensuring that there is sufficient liquidity in the US (and by extension the global) financial system.
- More shoes may drop. The US banking system is indeed generally healthy and well capitalized, but even with emergency decisions just announced, financial institutions should evaluate their ALCO models. There possibly are other institutions that have replicated SVB’s asset-liability model. Consequently, additional institutions may come under liquidity stress and choose to (1) be absorbed by a larger institution; (2) partner with other more liquid institutions to create a more robust entity or consortium; or (3) dissolve.
- Possible contagion to Europe There are clear concerns about international contagion given SVB’s operations in the UK. Firms abroad may have similar ALCO models to SVB’s.
- Potential Stablecoin spillover There could be spillover between stablecoin markets as some of their assets may be intertwined in SVB’s assets.
- Fed pause possible In addition to key economic data reports, this week’s activity in the banking sector and financial markets will be critical for determining if the Fed pauses its interest rate hiking cycle. While inflation remains the most important threat to the real economy, and this week’s CPI and retail sales reports may further underscore this fact, this financial crisis might prompt the Fed to not raise interest rates at the March 22nd meeting. Instead, the Fed might state that it is pausing its campaign in order to wait for financial market volatility to die down and then resume tightening as appropriate once it feels confident that there will be no dislocations caused by its actions. Even with a pause, we believe several more interest rate hikes are in store before the Fed completes the cycle. However, if financial markets calm over the next few days, the Fed may proceed with an increase this month.
What happened to SVB?

During the week of March 3, SVB experienced a massive bank run – where depositors withdrew deposits at a scale that overwhelmed the bank. SVB lacked sufficient cash to meet depositor demands, and on Friday, March 10, the FDIC seized the bank. Individuals and corporations are insured by the FDIC up to $250,000 per bank for all assets held at an individual bank.

SVB was the US' 16th largest bank, mainly serving corporations and high-net-worth individuals linked to the tech sector. However, at the core, the FDIC’s guarantees are intended to protect retail (consumer) investors. Hence, there are grave concerns about whether depositors – many of which are businesses – will be made whole enough to continue operating and pay workers.

While US banks generally are well capitalized and possess high quality assets, SVB’s woes centered primarily around liquidity, which were exacerbated by downshifts in deposits and net interest margins at the bank linked to weakness in the tech sector more broadly and rising interest rates. Three factors likely led to the illiquidity of the institution, with the first being the most critical:

1. **Tenor mismatch**: SVB may have accepted short-term deposits from clients but matched them by purchasing very long-term fixed-rate assets. Ideally, deposit tenor should match asset tenor. The fault in this strategy is that a) when interest rates rise, the value of long-term deposits fall; b) long-term assets can take time to sell; c) selling those assets create a cash shortfall such that an institution has less depositor money to return to the client; and d) when assets are sold en masse in a “fire sale” the bank may not receive the best pricing for those assets. We posit that SVB’s capital and capital management may have been sound, but its cash and ALCO management was not. Capital provides reporting information, but cash provides liquidity.

2. **Decline in deposit base**: Following the pandemic-era boon, the tech industry is now experiencing a swoon as consumer demand is shifting away from tech equipment and services with the return to the office. Interest rates have also risen precipitously as the Fed is tightening monetary policy to curb inflation, making debt more expensive for highly leveraged firms in the tech sector. Meanwhile, input costs, including labor, are on the rise. Consequently, tech firms have been forced to burn through more cash, as evident in reduced free cash flow and shrinking margins. IPOs are infrequent and VCs are unable to raise capital through subsequent funding rounds. If VCs deploy less cash, then companies are unable to keep more cash in bank accounts. Together, these dynamics potentially reduced SVB’s deposit base. Additionally, if SVB possessed a revolving credit facility (i.e., a bank line or credit card for clients), then companies likely drew on those bank lines to stay liquid.

3. **Shrinking net interest margin**: Given the type of clients SVB hosted, shrinking net interest margin may also have weakened the bank. Net interest margin is the earnings banks make from paying less in interest on deposits than the interest charged on loans. SVB’s clients were corporations and high net worth individuals, both of which tend to be more sophisticated investors. Moreover, these clients are believed to have possessed billions of dollars in holdings at SVB, and thereby the leverage to ask for greater returns on their deposits as interest rates rose.

What are the contagion risks?

Small bank failures are common and rarely lead to contagion, but the size of SVB and the interconnectedness of the global financial market suggest that the risk of contagion is material. Those risks include the following:

- **Indiscriminate runs on other banks.**
  - Banks with similar lending and liquidity profiles as SVB may come under severe stress.
  - The Fed and Treasury’s actions notwithstanding, there could still be future runs on more traditional banks by institutional (i.e., firms) and retail (consumers) customers. These other banks
may not be low on liquidity or have mismatches in the time horizons of their assets vs. liabilities, but still come under pressure.

- **Extensive reviews will be triggered.**
  - Regulators should review the implications of their emergency actions to address the current crisis.
  - Banks should conduct extensive reviews of the banking relationships with their financial institution clients, including operating accounts, trading counterparty activity, and other transactions such, as letters of credit.\(^2\)
  - Banks should conduct extensive reviews of their corporate and retail clients for the same product sets.

- **Seizing up of individual asset markets could occur.** Large institutional depositors may choose to hold back their available funds from the short-term lending market (e.g., commercial paper) while they wait for greater market clarity. This seizing up occurred during prior financial crises of 1991, 2000 and 2008.

- **Foreign contagion is at risk.** There could be spread of the US crisis to the UK given SVB’s operations in that economy’s banking system. This could lead to suspicion of other foreign firms with similar operating models.

- **A further cascade of failures in the opaque crypto market is possible.** The stablecoin market may become unstable given statements by some of the larger entities operating in this space that their assets are tethered to US currency and Treasury assets held at SVB. This reinforces concerns that, without safety nets for stablecoins, losses could emerge even where there are verifiable deposits.

- **Broader contagion to financial markets and to the real economy.** The thus far orderly slowdown in the US economy and layoffs limited to the most impacted sectors could rapidly become disorderly and flareup into another financial crisis and deep recession. Bank runs by ordinary consumers could cause a panic leading to a nosedive in consumer spending and massive job losses as firms react to the cratering of demand. Hence, the importance of regulators and financial institutions to continue to reassure Americans that the financial system is sound.

![Graph: US Bank failures are common, but contagion is not](image)

Sources: Federal Deposit Insurance Corporation and The Conference Board.

### Additional Ripple Effects

In addition to some degree of contagion, SVB’s demise probably will cause other ripple effects through banking and financial markets:

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\(^2\) A letter of credit is a document sent from a bank or financial institution that guarantees that a seller will receive a buyer’s payment on time and for the full amount – Source: Investopedia.com.
• **A hole in a major funding market.** The dissolution of SVB may gut an important source of funding for tech firms. SVB might have provided bespoke capital options and complex lending packages that tech customers often require. Indeed, the complexity of the lending products might enhance the difficulty of selling off SBV’s assets. Tactically, without customized capital it probably will be difficult for capital intensive startups to launch and remain solvent.

• **Flight to safety.** SVB’s failure may result in its customers, and others like them to, seek traditional banks that are more liquid, better capitalized, and less complex, but less willing to offer customized capital. The largest US and global banks have the greatest opportunity to benefit in this tenuous environment.

• **Fire sales of assets.** The current crisis creates a buying opportunities for Private Equity and VC funds. Those with capital can potentially create an entirely new ecosystem for liquidity provision.

• **Distressed sales.** A few banks or even firms may sell themselves, look for partners with deep pockets, or even close in reaction to the scrutiny the SVB episode will bring.

• **Unknown externalities.** The FDIC’s systemic risk exemption for the two banks in crisis will have important, as of yet, unknown knock-on effects on the banking structure and governance.

### What are the US government’s next steps?

The SVB event is an “old-school” run on a bank, but by an unusual set of depositors – particularly large corporations and wealthy individuals instead of SMEs and consumers. Per policy, the FDIC closed SVB and seized its assets. Once the initial dust settles, a critical question will remain: what will be the order of priority for those with claims on SVB’s assets? The following order is possible:

1. Depositors will be made whole in excess of the prior $250,000 cap.
2. Shareholders and certain unsecured debt holders will not be protected (i.e., equity holders could lose the entire value of their holdings; bond holders may suffer either a partial or total loss).
3. For traders and counterparties, qualified financial contracts (QFCs) may be honored whether in the money or out of the money.\(^3\)
4. Letters of credit will be honored.

### Concluding Thoughts

Regulator-mandated stress testing is paramount, but internal controls are critical. In this instance, capital and high-quality assets do not appear to be at the root of the events leading to SVB’s failure, but a dearth of liquidity. Opacity regarding internal operations and a lack of consideration of the more extraordinary needs of SVB’s clients might have also contributed to the blind sighting of regulators and SVB’s ultimate demise.


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\(^3\) Calls are in the money when the security’s price is above the strike price, and out of the money when the security’s price is below the strike price. Put options are in the money when the security’s price is below the strike price, and out of the money when the security’s price is above the strike price. – Source: TheBalance.com