Spectrum Asset Management

Principal Asset Management℠

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Silicon Valley Bank: What Happened. Lessons Learned.

Silicon Valley Bank (SVB) and its parent SVB Financial Group (SIVB) were a top 20 banking group, and successful, long-term financial leaders focused on the 'innovation economy,' including venture capital (VC) start-ups and their VC sponsors, technology companies, and senior personnel in those sectors. SVB, whose senior debt was rated A3/BBB by S&P and Moody's days before its collapse, was the 'house bank' for many firms in those sectors, with close, long-term relationships. Reflecting the focus of the bank, SVB's funding base was dominated by business clients, which typically kept large, above-FDIC-insurance-limit, deposits at the bank. It was an acknowledged leader in important, large, growing sectors of the US economy, and becoming increasingly diverse, with expansion in investment banking and wealth management. These characteristics made SIVB's preferred stock an attractive investment.

That said, in the past year we took note of the volatility of the VC/tech sectors, current soft VC/tech conditions, and the concentration of SVB's client and deposit base. In addition, rapidly rising interest rates were squeezing SVB's net interest margins, and the market value of its high-quality investment securities portfolio. However, SVB continued to be profitable, with healthy loan quality and a sound capital base. The bank recorded net income of $1.5B in 2022.

Silicon Valley Bank still failed suddenly on Friday March 10, and the Federal Deposit Insurance Corporation (FDIC) took over as receiver the same day. The proximate cause was a run on the bank by its corporate clients. The drivers of this run were several:

- Stress on its net interest margins and the market value of its high-quality securities portfolio

- A soft VC/tech sector including constrained funding causing many clients to withdraw deposits to cover their operations

- And importantly, the run was triggered by the company's ill-timed and surprising announcement on March 9 of the liquidation of its available-for-sale securities at a loss of $1.8 billion, followed by a planned (but never completed) recap consisting of $2.25 billion of common and preferred stock. **The sudden announcement of a large loss booked prior to completing capital funding was an impairment signal to the market.**

This sudden bank collapse further underscores that concentrations can have inherent risks which can appear suddenly and severely, even if many other safety metrics are sound. It also re-emphasizes the cost of poor management decisions. SVB's failure was a major shock, and we expect substantial regulatory changes regarding deposit structure and liquidity to emerge that should be supportive of banks' creditworthiness. In addition, the VC/tech space will come under more pressure, boosting the likelihood of a recession. Finally, the Federal Reserve could rethink its interest rate hiking plans, given the stress it has put on the financial system.

Yesterday it was announced the FDIC will cover all deposits at SVB and Signature Bank (the investment of which we don't own) and the Fed will provide additional liquidity to eligible US banks.

These US government backstop actions significantly support banks' funding and operations and should help to stem US market volatility. Spectrum believes that SVB's failure will not prove to be a systemic event in the US or Europe.

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