

Spectrum Asset Management

March 13, 2023

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.

This material is provided by and reflects the current views and opinions of Spectrum Asset Management, Inc., an affiliate of Principal Global Investors.

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal.

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. Information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

This material may contain 'forward-looking' information that is not purely historical in nature and may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader. This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation. This document is intent for use in:

- The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
 - Europe by Principal Global Investors (EU) Limited, Sobo Works, Windmill Lane, Dublin D02 K156, Ireland. Principal Global Investors (EU) Limited is regulated by the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). The contents of the document have been approved by the relevant entity. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (EU) Limited ("PGI EU") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGI EU, PGIE or PGI EU may delegate management authority to affiliates that are not authorized and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland.
 - United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorised and regulated by the Financial Conduct Authority ("FCA").
 - United Arab Emirates by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organization.
 - Singapore by Principal Global Investors (Singapore) Limited (ACRAReg.No.199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
 - Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission. This document is intended for sophisticated institutional investors only.
 - This document is marketing material and is issued in Switzerland by Principal Global Investors (Switzerland) GmbH.
 - Hong Kong SAR (China) by Principal Asset Management Company (Asia) Limited which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance
 - Other APAC Countries, this material is issued for institutional investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.
- Principal Funds are distributed by Principal Funds Distributor, Inc

© 2023 Principal Financial Services, Inc. Principal®, Principal Financial Group®, Principal Asset Management, and Principal and the logomark design are registered trademarks and service marks of Principal Financial Services, Inc., a Principal Financial Group company, in various countries around the world and may be used only with the permission of Principal Financial Services, Inc.

Principal Asset ManagementSM is a trade name of Principal Global Investors, LLC.