Investment Insight
Our View on the Silicon Valley Bank Collapse: What's Next?

Key Takeaways
► The closure and wind-down of Silicon Valley Bank (ticker: SIVB) has led to some considerable stress in equity markets, particularly among shares of regional banks, as well as fear of contagion.
► There are unique elements to SVB that contributed to its demise, including its client base and risk controls.
► While we are likely not fully “out of the woods” yet, we view the regulatory response as appropriate and likely adequate, which should head off contagion fears.
► As long-term, fundamental, wisely-contrarian investors, we’re exploring ways to benefit from a potential dislocation in banking stocks, while being mindful of the risks.

What Happened?
Silicon Valley Bank (SVB), one of the 20 largest banks in the US in terms of assets, has collapsed. It was the second largest bank failure in U.S. history. As well, another (slightly) smaller bank, Signature Bank (ticker: SBNY) folded in similar fashion. In the case of both banks, the Federal Deposit Insurance Corporation (FDIC) — an independent agency of the U.S. government that provides insurance to bank depositors — was appointed as the receiver. Put simply, FDIC took over these troubled financial institutions, with the intention to create the best outcome for bank depositors.

The SVB/Signature story has a lot of moving parts, but ultimately boils down to an old-fashioned bank run. A flood of withdrawals from depositors destroyed these banks. How could this happen? Ultimately this type of situation, while complex-sounding, is fairly simple: there were not enough cash and liquid assets available that could be sold to fund deposit outflows, without wiping out their equity capital base. That’s in part because banks are not forced to carry enough cash to fund 100% of their deposits. According to regulations, they’re allowed to invest multiple dollars (think $10, in round numbers) for every dollar of deposits. These investments, which could be in the form of loans to customers or invested in marketable securities such as US Treasuries or Mortgage-Backed Securities (MBSs), are generally longer-term in nature, and are not always able to be sold or otherwise harvested at a profit.

Comparisons have been made to gym memberships; if every gym member showed up at the same time, not everybody can get a workout in. Banks are similar in this respect, if every depositor wants their money back at the same time, not everyone can get their money back.

Why is SVB Unique?
For SVB in particular, the growth trajectory of its deposit base, the concentration of its customers, the peculiarity of its portfolio, and the relative lack of risk controls around the portfolio are fairly unique...
factors. Per public filings, SVB’s deposit base jumped from $49 billion at the end of 2018 to $189 billion at the end of 2021. Venture capital funding was at all-time highs during this period and start-ups receiving funding were often putting the proceeds into SVB bank accounts. Putting that growth in perspective, SVB’s deposit base grew by approximately 57% per annum in this period while industry deposit growth was only 12% per annum, according to Morningstar’s research. As well, close to half its deposit base originated from technology companies, the majority of which was from early-stage technology companies. Traditional retail deposits, which tend to be stickier and tend to be smaller than the $250,000 insured by the FDIC, comprised a relatively small portion of SVB’s depositor base, making it more prone to a bank run.

As deposits grew rapidly at SVB, it increasingly purchased fixed-income investments. The bonds they purchased (predominantly mortgage-backed securities) were high-quality, but were long in duration, with the weighted average maturity over 10 years. Shortly after making these investments, the Federal Reserve began one of their most aggressive rate hiking periods in history. As interest rates rose, the value of these bonds fell. While in theory, the bond losses only existed on paper (if SVB held the bonds until maturity, they would get all their money back, plus interest), the “mark-to-market”, or unrealized, losses from these investments were significant, exceeding the company’s tangible equity capital. Observing this, depositors became skittish, started redeeming their money, and SVB became a forced seller of many of those bonds to meet redemptions. The paper losses turned into actual losses and laid the foundation for the rush to the exit by SVB’s depositors.

Exhibit 1 SVB’s losses were substantial relative to its capital base.

<table>
<thead>
<tr>
<th>Institution</th>
<th>Unrealized Losses/Tangible Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>SVB Financial Group</td>
<td>99%</td>
</tr>
<tr>
<td>Truist Financial Corporation</td>
<td>65%</td>
</tr>
<tr>
<td>Bank of America Corporation</td>
<td>55%</td>
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<tr>
<td>Comerica Incorporated</td>
<td>54%</td>
</tr>
<tr>
<td>KeyCorp</td>
<td>47%</td>
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<tr>
<td>Cullen/Frost Bankers, Inc.</td>
<td>47%</td>
</tr>
<tr>
<td>Huntington Bancshares</td>
<td>40%</td>
</tr>
<tr>
<td>Fifth Third Bancorp</td>
<td>40%</td>
</tr>
<tr>
<td>Wells Fargo &amp; Company</td>
<td>38%</td>
</tr>
<tr>
<td>Regions Financial Corporation</td>
<td>34%</td>
</tr>
<tr>
<td>Citizens Inc.</td>
<td>33%</td>
</tr>
<tr>
<td>First Republic Bank Co.</td>
<td>31%</td>
</tr>
<tr>
<td>J.P. Morgan Chase &amp; Co.</td>
<td>29%</td>
</tr>
<tr>
<td>NBT Bank Corporation</td>
<td>21%</td>
</tr>
<tr>
<td>Source: Morningstar, Inc. Figures quotes are Unrealized Losses (Tax-Adjusted)/Tangible Equity. Data as of March 10, 2023.</td>
<td></td>
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</table>

Is This a Lehman Moment?

While the collapse of another bank (Lehman Brothers) was at the epicenter of the Great Financial Crisis of 2008, we believe that the recent bank failures are significantly less likely to trigger a global banking crisis. The speculative excesses that caused the Global Financial Crisis of 2008/09 were rooted in an economy-wide bubble in real estate market, propelled by a large amounts of cheap debt funding that
flowed into real estate securities. These leveraged and insufficiently capitalized owners of real estate securities created a fault line in the financial system, causing a global banking crisis as the price of real estate assets started declining and levered investors faced margin calls.

This time around, the speculative excess appears to have been concentrated in niche segments of equities and alternative asset markets such as companies related to cryptocurrencies. Unlike the economy-wide debt binge that dominated the period leading up to the GFC, venture capital tends to be equity funded. Consequently, if venture companies fail, the loss typically ends with the investor, rather than being transmitted through the financial system as a bad debt. Additionally, bank balance sheets are, largely a function of the regulatory response to the GFC, significantly stronger than they were in the period leading up to 2008.

**Exhibit 2** Capitalization of Various U.S. Banks

![Exhibit 2 Capitalization of Various U.S. Banks](image)

Source: Morningstar, Inc. Figures are Common Equity (Tier 1) as % of Risk-Weighted Assets, After Selling Held-To-Maturity Portfolio. Data as of March 10, 2023.

We’d argue that while the rapid rise in treasury yields has caused some short-term losses for the banking industry that are substantive, industry capital levels are better positioned to weather the storm. We also believe the regulatory response from the Federal Reserve, the FDIC and the US Department of the Treasury has been quick, unified and substantive. The addressing of insured and uninsured depositors at SVB and Signature, as well as the opening of a borrowing window for short-term collateralized funding available at very attractive interest rates and terms should head off any concerns around systemic risk of a collective “run on the bank” moment.
So, What? Let’s Cover the Investment Implications
First, let’s cover portfolio exposure to Silicon Valley Bank, or SIVB. This stock was listed on the NASDAQ stock exchange so was held by many investors. Some indirect exposure is therefore likely for investors that hold a diverse portfolio using mutual funds or exchange-traded funds. In the case of Morningstar’s managed portfolio range, we expect the maximum exposure to be less than 0.5%, often far less, depending on the strategy used.

Regarding knock-on effects, in the short-term, we’d not be surprised to see market volatility remain elevated, reflecting the increased uncertainty around potential outcomes. In particular, the financial services sector, most notably regional banks, could remain under strain for some time. However, as long-term, valuation-driven, fundamental, and wisely-contrarian investors, this type of setup is one that we’d use to begin searching for opportunities. We’d be looking for our valuation work, coupled with our assessment of fundamental risk and investor expectations, to be our guide in determining whether, when and by how much to increase our investment in the banking industry, as well as other sectors that may potentially be impacted.

As it stands, we have a balanced viewpoint of U.S. financials, with a “medium” conviction rating assigned. From a valuation perspective, the sector looks relatively cheap (the second cheapest, behind communication services) but recent events have increased uncertainty, so careful portfolio construction is warranted. One issue is that the earnings can be quite volatile and cyclical, but bargain prices can present themselves as investors flee from the uncertainty. Armed with research, we stand ready to adapt in this regard and will be looking at both the opportunities and risks very closely.
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A debt security refers to money borrowed that must be repaid that has a fixed amount, a maturity date(s), and usually a specific rate of interest. Some debt securities are discounted in the original purchase price. Examples of debt securities are treasury bills, bonds, and commercial paper. The borrower pays interest for the use of the money and pays the principal amount on a specified date.

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