James Investment Research, Inc.

SVB's Demise

Navigating Turbulent Markets

In this brief presentation, we aim to provide clarity on the recent default of Silicon Valley Bank (SVB), the nation's 16th-largest bank, and its impact on savings and financial markets, which have raised significant concerns among many.

SVB's primary focus is on providing financial services to venture capital firms and startups, especially in the Technology Sector. As a bank, SVB accepted deposits and made loans to these high-tech start-ups. Bloomberg News reported that nearly 50% of all US startups backed by venture capital worked with SVB, along with 44% of US venture-backed technology and healthcare companies that went public last year. However, the recent and unprecedented rate hikes implemented by the Federal Reserve (Fed) to address inflation made it more difficult to find profitable projects in these sectors. (One reason why the technology-heavy NASDAQ dropped over 30% in 2022.)

From the end of 2020 to March 31, 2021, SVB's total deposits increased by 94%, as reported by FactSet. Since Venture Capital (VC) funds usually invest large sums that exceed $250,000, only a fraction of these deposits is insured by the Federal Deposit Insurance Corporation (FDIC). In this regard, SVB is an outlier, with 97% of its deposits held in accounts that exceed the FDIC insurance limit of $250,000.

As there were limited profitable lending opportunities available, the bank opted to invest the majority of the increased deposits in longer-term government securities to achieve higher yields. While these government bonds carry no default risk, their values decline as interest rates rise. (When interest rates rise, bond prices decline). When some depositors began to search for higher yielding money market options, they withdrew their funds from the bank, prompting the bank to sell some of these securities at a heavy loss.

In summary, SVB's demise was due to its heavily concentrated deposit base and substantial unrealized losses on Treasuries and mortgage bonds. No other publicly traded US banks have balance sheets resembling SVB's.

The FDIC assumed control of the bank when attempts to find a buyer failed in order to safeguard the depositors. Following the collapse of Signature Bank in New York due to similar issues, and the subsequent sharp drop in bank share prices, the Treasury, Federal Reserve, and FDIC issued a joint announcement on March 12th. The announcement declared that all depositors at SVB Financial and Signature Bank would receive full compensation regardless of the amount deposited, and a new liquidity facility would be established.

The Federal Reserve's new lending facility, backed by the US Treasury Department will assist other banks in meeting the demands of their depositors. The Bank Term Funding Program will provide advances up to the value of pledged collateral, with collateral valued at par and priced at the one-year overnight index swap rate plus 10 basis points.

Lenders can pledge collateral such as government bonds to draw on the Fed's lending facilities for up to a year. These credit lines were extensively used during the Covid-19 crisis and have been the preferred tool to stabilize markets since the 2008 financial crisis.

The extended deposit guarantee is intended to prevent runs on banks by assuring customers that they will be protected even if another bank fails. The Fed's offer to lend against high-quality bonds at par is aimed at assisting banks in meeting withdrawals without selling securities at a loss. This helps boost confidence among depositors at other banks, reducing the risk of a similar panic.

This move addresses a specific problem faced by SVB and other large institutions, as many have billions of dollars invested in securities that currently can only be sold for less than their purchase price. If held until maturity, these securities would be worth par. The Fed's lending program reduces the risk that paper losses on bank portfolios, estimated to be over $600 billion at the end of 2022, will turn into actual losses.

In a broader sense, the possibility of depositors losing money at a major US bank would have shaken confidence in the financial system and increased the likelihood of a widespread run on banks.

Unlike the complex securities and bad loans that caused the 2008 financial crisis, SVB's losses were only paper losses on government bonds. The sale of SVB's broker-dealer and investment banking arm may also generate funds to repay the federal assistance. US officials stated that any losses to the deposit insurance fund supporting uninsured depositors would be recovered through a special assessment on banks. However, investors holding SVB and Signature's shares and bonds will lose their money if there are no excess funds after repaying depositors.

This rescue may alleviate the recent crisis of confidence, but even sound banks are likely to face tougher regulations and higher costs. Analysts predict that banks will either offer higher interest rates for depositors or tap into wholesale money markets to strengthen their funding position, resulting in smaller interest margins.

SVB and Silvergate are specialized banks that focus on serving high-risk market segments, particularly in the Venture Capital and Crypto industries. While these banks have failed, the broader banking system has consistently undergone stress tests, maintained sufficient liquidity and ample capital, and had less asset-liability mismatches. As such, it is unlikely that the recent bank failures will have a significant and negative impact on the broader economy.

However, the instability in financial markets due to these bank failures may prompt the Fed to reconsider its planned interest rate hikes. As the Fed prioritizes Financial System Stability over its Inflation fight, the widely anticipated 50 basis points (0.5 %) interest rate hike on March 22 is now in doubt, and expectations for subsequent tightening moves later this Spring have been revised downward. However, the insurance policy that the FED has just written for the banking system with its new lending facility may give it more flexibility in raising interest rates later this year.

Sincerely,

The James Research Team

P.O. Box 8 Alpha OH 45301 | (888) 426-7640 | info@jamesinvestment.com

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