Established in 2010, Summit Global Investments, LLC ("SGI") was founded to bring enhanced risk management to institutions, advisors, and families.

Monday, March 13, 2023

Venture Cash Crisis

The last few days have been a whirlwind for bank depositors, lenders, investors, and regulators. On Thursday, March 9, Silicon Valley Bank (SVB)—one of the 20 largest commercial banks in the country—experienced a steady stream of large withdrawals that led to having state and federal regulators taking over the bank. Over the weekend another large institution, the New York-based Signature Bank, also was closed by regulators.

I attribute this to very specific reasons.

1. Withdrawals for Better Yield – with rising rates, clients with cash accounts began moving money out of deposit accounts and into higher-paying money market funds and short-term bonds.
2. Venture Capital Deposits dried up – cash flows from venture capital investments into startup technology and cryptocurrency clients had less money to deposit.
3. Bank Run – The decrease in deposit amounts and rumors created worries among depositors, which in turn created excess withdrawals.

Due to such volatility in banks, and banking touches every investor, coupled with an explosion of media coverage, it's natural to feel concerned and on high alert. Is 2023 another 2008? There are several important differences between now and then. Understanding these differences can help investors be more confident in their financial decisions.

2023 "Venture Cash Crisis" vs. 2008 "Great Financial Crisis"

The Great Financial Crisis (GFC) of 2008 was caused by financial institutions investing in low-quality income securities. These low-quality securities created credit defaults, which is when people or institutions fail to make required repayments on a loan. Over 400 banks failed and were either forced to merge with higher quality banks (i.e., Washington Mutual merging with Wells Fargo) or were taken over by regulators.

The SVB liquidation, which was due to a reduction in bond values, was caused almost entirely by duration risk. In other words, the bonds that SVB invested in lost value not because of credit default—the prevailing cause of crisis in 2008—but because rising interest rates reduced the value of those bonds. The Federal Reserve created the conditions for this risk by increasing interest rates throughout 2022 and 2023.

2008 brought about bailouts, and during the GFC taxpayers paid much of the bill, whereas 2023 is more like a support program. This time, regulators seem to have (hopefully have) learned from previous mistakes and are intentionally avoiding repeating the same process. The regulators' focus has been on protecting bank clients, not investors or executives.

Specific to SVB

SVB served a highly concentrated group of clients, mostly in and connected to the venture capital community in California and even more specifically with technology startups. Over the last three years, total deposits at the bank tripled as its core clientele experienced a wellspring of new money, aided by easy monetary policy.

SVB invested deposits in high-quality bonds and held them on its balance sheet. As a rule, banks are funded with short-term liabilities—that is, deposits—and invest in longer duration assets. This can create a mismatch when short-term deposits are withdrawn, and that's what happened to SVB. But that was not half the problem.

Over the last year, the Federal Reserve has raised interest rates seeking to slow and reduce inflation. When interest rates rise, bond prices fall. As of late February 2023, SVB's long duration high-quality bond portfolio had unrealized losses—losses that didn't have to be realized and which the bank would normally continue to hold. Note that this is a common practice and is allowable by bank regulations. As long as deposits remain stable, banks can handle unrealized losses by simply NOT realizing them. But (maybe that should be *BUT!!!*) when clients withdraw their deposits at a rapid pace, the bank found itself short on capital and ended up selling long duration bonds and realizing the loss.

For SVB, the loss was in the billions. This realized loss impacted the book value and capital base of the bank, making it insolvent. Unrealized losses accounted for 120% of deposits and some calculations show that as high as 97% of deposits were above the FDIC limit of $250,000. Compare this to other banks where uninsured deposits are half that rate (i.e., Regions Financial at 47%).

In a letter addressed to bank depositors at another western regional bank it stated,

> *"Our deposits are held in 1.4 million accounts, and these accounts overwhelmingly tend to be smaller in size and operational in nature. Notably, the average balance of an account at Silicon Valley Bank was about 22 times the size of the average balance in a [xxxx] account, which made Silicon Valley Bank much more susceptible to the kinds of outflows they experienced last week. The situation was similar at Signature Bank.*
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> *"As an analyst at Bloomberg wrote over the weekend, 'In the wake of SVB and Signature's swift demise, it's important to view deposit granularity, or having lower balances per deposit, as a sign of more funding stability…'"*

In almost every major financial crisis throughout history, the banking system has been ground zero. This can lead investors to react emotionally to any potential warning flags.

Yet financial crises are almost always caused by systemic issues in the banking system, which is not the case today.

SVB's failure was caused by duration risk and by its exposure to particular industries, namely venture capital and the technology sector. Most other banks are much more diversified.

FDIC, Federal Reserve, & U.S. Treasury Intervention

On Sunday, March 12, the U.S. Treasury stepped in to protect SVB's depositors. As a reminder, the Federal Deposit Insurance Corporation (FDIC) already insures up to $250,000 per depositor, per insured bank, for each account ownership category. On top of this insurance, the U.S. Treasury agreed to serve as a backstop—a secondary source of support—for all SVB deposits, providing at least implicit coverage beyond the $250,000 FDIC insurance levels.

This is notable because the Treasury is effectively guaranteeing every bank deposit in the country! Is this a free market? Perhaps this is a question for another day. Many of the "market experts" or "influencers" who called for the government to step in and save the bank had a conflict of interest as depositors of SVB.

The newly created Bank Term Funding Program (BTFP), to help guard against excessive liquidity and withdrawal demands on banks, will offer loans of up to one year to banks, savings associations, credit unions, and other related institutions. In exchange, those institutions will need to pledge high-quality collateral, such as Treasury bonds. Because this is a loan program, taxpayer dollars are not at risk for now.

At the end of the day, all banks, and thus depositors, are only as safe as our confidence in them. A true bank run can cause any bank to fail. The moves over the weekend focused on increasing depositors' confidence across the banking sector regarding the safety of deposits.

What About My Cash?

Throughout the weekend, SGI worked hard to ensure a more complete understanding of this complex and fluid situation. The goal is always to better understand the scale and scope of all possible outcomes and to protect clients' assets.

We feel confident that client assets over which SGI has fiduciary responsibility are both safe and well-kept from bank runs. That doesn't mean the overall market will not decline nor that there are guarantees against experiencing losses. But the foundational support provided by the U.S. Treasury, FDIC, and Federal Reserve has already increased confidence regarding the safety of bank deposits, thereby reducing the risk of future bank runs.

Despite these increased protections, we would encourage clients to evaluate higher cash balances, especially those in excess of $250,000. SGI has agreements in place with several large custodians where SIPC insurance is double that of the FDIC. Furthermore, most individual T-Bills, Money Market Mutual

Funds, and short-term fixed income ETFs have higher yields than bank accounts and may provide more protection than simple FDIC insurance. We are not looking to contribute to the problem of bank runs, again we do not see further problems with other regional banks. We do believe you are better off knowing your options and believe investing excess balances can help to insulate against risks and may provide higher yields.

SGI is Committed to YOU!

Everyone at SGI is 100% committed to doing everything we can to ensure your investments perform as designed. Again, if you have any doubt or any questions, please do not hesitate to reach out to me directly or to the team collectively.

Sincerely,

David Harden, CEO

Summit Global Investments