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MEMORANDUM REGARDING A MARKET UPDATE ON SILICON VALLEY BANK 3.13.2023

As you have most likely learned, Silicon Valley Bank (SVB) and Signature Bank, two large regional banking institutions, experienced a material deterioration in solvency last week that ultimately drove them to failure. Both banks' customer bases are dominated by members of the venture capital and private equity communities.

While the situation remains fluid and details are still uncertain, we would like to provide you with a brief update on recent developments and measures taken thus far, and how financial markets are currently reacting to and pricing the related risks.

Although recent events have been alarming, we believe the developments over the weekend related to support from the Federal Reserve and others is a significant step in stabilizing markets. As in the past, we highlight in these times of uncertainty that staying the course and relying on the benefits of having a diversified portfolio is the best course of action.

Key Takeaways

→ Silicon Valley Bank and Signature Bank were taken over by the Federal Deposit Insurance Company (FDIC) due to significant outflows that were largely driven by their unique deposit bases.

→ Actions taken over the weekend to ensure depositors could maintain access to funds quelled a rising concern over contagion.

→ Despite relief driven by the announcement of support by the Fed and others, pressures remain in parts of the equity market, especially for regional banks.

→ In the short run, market volatility could remain high as the Fed tries to balance bringing down still elevated inflation while maintaining stability in the financial system.

Background

Banking institutions around the globe perform the critical task of making loans and seeking deposits. Often, these institutions maintain a significant number of diversified lending and deposit relationships, allowing their business to sustain itself over different economic cycles. Banks who are focused on or have built their business through a specific segment of the economy (e.g., agriculture, oil, real estate, or in this case, venture capital) may have a concentrated customer base that presents a unique risk to their balance sheet.

Both SVB and Signature were well known and deeply engrained in the venture capital (VC) and private market ecosystem, leading to a concentrated customer base. The last several years had been very strong for the VC industry, so deposits and lending swelled within this community. This continued until the sharp increase in interest rates of 2022, which resulted in a slowdown in the VC industry.

Additionally, many startup companies increasingly burned through their cash throughout 2022. This led to shrinking deposits at SVB and Signature. As the pace of deposits continued to fall, SVB had to sell a portion of its investment portfolio to raise capital to meet demands for cash. SVB's deposits were often invested in the perceived safety of US Treasuries and mortgage-backed securities that were intended to be held until maturity. The sharply rising interest rates of 2022 meant that these assets would have to be sold at a loss to meet redemptions.

SVB, perceiving the need to raise additional capital in order to be able to meet withdrawal requests, tried to issue equity. This information (i.e., the dire cash situation and potential for a stock sale) became public, which accelerated the pace of withdrawals as one depositor after another decided that it was safer to withdraw their cash from SVB than to risk not being able to get it out. This resulted in a "bank run" and led to the ultimate intervention of the FDIC.

The Government Response Thus Far

Measures taken by the US government, and government-related entities has been swift and focused. The FDIC placed SVB into receivership on Friday March 10th and immediately began the search for a buyer. Signature Bank, which faced similar challenges, was placed into receivership on Sunday March 12. Further, the FDIC announced over the weekend that all deposits would be made available to customers by today (March 13, 2023). The full return of deposits is unusual, as the FDIC only guarantees up to $250,000 of deposits, and many customers had balances well in excess of that amount.

Also occurring over the weekend, the Federal Reserve Board, with approval of the US Treasury Secretary, announced a new funding program to support any banks facing similar risks. The lending program, termed the Bank Term Funding Program (BTFP), will provide eligible depository institutions with loans of up to one year in length, pledged against US Treasuries, agency debt, agency mortgage-backed securities, and other qualifying assets.

The program is similar in design to emergency measures taken during the 2008 financial crisis, which were positively received by the market and helped ease related risks over the months that followed. Lastly, the Federal Home Loan Banking system announced on Monday that it was raising $64 billion to provide liquidity and additional support to regional banks and related entities.

As a whole, these measures appear to be designed to stem a broader run on regional banks and/or contagion that leads to a wider financial crisis. While some regional banks have suffered steep losses, broader market pricing appears to imply that the market is satisfied with these measures, at least for now.

Public Market Reaction

Public markets saw significant changes across both equities and interest rates. The focus remained on regional banking securities and on interest rate expectations. The KBW Regional Bank Index has declined over 20% in recent days. Interest rates saw a meaningful repricing. Interest rates fell globally, almost regardless of maturity. Expectations for US monetary policy have also been dramatically repricing. Prior to the SVB crisis, recent comments on the continued strength of the economy by Federal Reserve Chair, Jerome Powell, drove expectations higher on the terminal federal funds rate. As of this writing, the market is pricing in a terminal rate below 5.0% compared to the recent peak of over 5.5%.

Primary Risk Considerations

In the short run, market volatility could remain high as the Fed tries to balance bringing down current elevated inflation while maintaining stability in the financial system. Regional US banks could remain under particular pressure on contagion fears despite policy support. Venture capital funds could also experience pressure given the bank failures and the overall slowdown of the economy.

Monetary policy remains an important topic as well. The interest rate markets have moved from anticipating more tightening for a long period of time to anticipating only one more fed funds increase followed by rate cuts before the end of 2023. Inflation pressures remain top of mind per Chairman Powell's March 7th testimony, but the market reaction given the actions taken by the Fed, Treasury, and the FDIC imply something altogether different.

Implications for Private Equity Portfolios

SVB was widely used by venture capital investment firms for traditional banking services, both at their firm level and fund level. Via these relationships, deposits of their firms, of the funds they manage, and of the portfolio companies they invest within the funds, were at risk of loss. Further, each of these entities faced the immediate operational need to establish alternate banking relationships. Now it seems that depositors will be able to access their deposits today. As of late last week, many firms using SVB reported switching banking relationships. On Friday, many issued instructions to discontinue sending capital calls to SVB.

Switching banks for these day-to-day services should be a relatively minor operational challenge.

However, SVB has also provided specialized lending services to firms, funds (subscription lines) and portfolio companies (loans). Here, new sources of credit will be needed. This could come at a higher cost to these organizations. Many venture capital firms have indicated that they will step in to fill funding gaps for their portfolio companies, but today this remains to be seen.

A separate division of SVB is SVB Capital, which manages a fund-of-funds series. Investors here face additional uncertainties regarding the future of the team and network advantages it may have enjoyed at the center of the venture capital ecosystem. Meketa has a call scheduled with SVB Capital today to learn more about their future. SVB Capital confirmed that the bank did not provide financing to the funds they manage, but in each, did make investments in the range of <1% to 3% of total fund capital. Note that the fund of fund Limited Partner Agreement permits limited partners to suspend the investment period for the funds in the event of a change of control at SVB Capital.

The implications for the venture capital industry are hard to determine today. However, the biggest area of uncertainty is who will step in as a banking partner to startups, as SVB was considered uniquely able to work with entrepreneurs.

Summary

The current situation is rapidly developing. Fortunately, many institutional investors have very small direct exposures to regional banks, but the second order effects are still evolving. We recognize that the range of potential outcomes is broad. We will continue to diligently monitor it and provide updates as needed.

If you have any questions, please contact your client team.

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