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A Q&A ON SVB AND CUSTODIANS

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Introduction

It's been a hair raising few days in the markets as we've once again been inundated with headlines about bank failures, bailouts, and emergency lending facilities. Within the last couple weeks three banks have gone under prompting flashbacks to at least the COVID crisis in early 2020, if not the financial crisis of late 2008 and early 2009. But what is going on today is distinctly different from those prior two episodes with very different causes and effects. We wrote about the problems at Silicon Valley Bank (SVB) in our ***weekly commentary last Friday***. But since then, there have been new developments that we address below.

Q&A

Why is the market so volatile?

It's all about the banks. On March 8th, Silvergate Capital (SGC) closed its doors. This firm catered largely to the crypto industry, and weakness in the sector plus regulatory pressure led to their closure. However, this was quickly followed by SVB's collapse on Friday. SVB was more like a traditional bank, but as the name implies, it catered to the venture capital and start-up industries in Silicon Valley. What made SVB particularly worrisome was that 1) it was large, and 2) the vast majority of its deposits exceeded the FDIC mandated $250K cap. Many large companies and individuals stood to lose tens of millions from SVB's demise, and to make matters worse, Signature Bank (SB) was seized by banking regulators on Sunday. SB also catered to the crypto industry, and like SVB, a large portion of its depositors were uninsured. There was a real concern on Sunday afternoon that there would be a deposit run on other banks when business resumed on Monday, March 13th.

What did the regulators do to calm fears?

If the authorities learned anything from the financial crisis of 2008/2009 it is to move quickly during times of stress and not hold anything back. On Sunday afternoon the Federal Reserve, FDIC, and Treasury Department issued a joint statement basically stating two things:

1) All deposits at SVB and SB would be guaranteed, regardless of the size. Cash would be available Monday morning and no losses would be borne by the taxpayer.

2) The Federal Reserve also created a new lending facility which will allow other banks to pledge liquid assets as collateral for loans with maturities up to one year.

Both steps are significant. By guaranteeing all deposits at SVB and SB the authorities have taken a major step to prevent further bank runs. Before this announcement there was a real risk that depositors would move 'en masse' to the four large "too big to fail" banks. This disintermediation could put dozens if not hundreds of smaller banks at risk of deposit flight. While the current plan applies only to deposits at SVB and SB, the implication is that it could be extended to other banks if necessary.

Secondly, by providing longer-term loans the Fed is alleviating the need of banks to sell impaired assets in a weak market. This is significant because many banks are sitting on unrealized losses in their investment portfolios that they would much rather not liquidate in a down market. It's worth stressing that this is a very different scenario from the financial crisis. Back then the credit quality of bank loans was severely impaired. This time around the credit quality of the Treasury and Agency bonds is unquestioned – they are simply selling at a discount to par due to the increase in interest rates. The new lending facility allows banks to access liquidity without selling assets that have temporarily depreciated but are "money good."

Is there a common theme?

Without question. In the case of SGC and SB it's crypto. Both institutions have grown rapidly the last few years servicing the needs of the crypto industry and acting as a gateway between them and the traditional financial world. As the crypto industry ran into trouble, so did these two institutions. Additionally, regulators have decided to make it very difficult for the traditional financial world to utilize cryptocurrencies in any way. The business model of both SGC and SB has been growing more and more untenable the last few months. However, the good news is that both institutions are special cases. Few other banks or custodians deal in crypto, so the fallout from both SGC and SB should be contained.

SVB is a different matter altogether, but still a special case. As we noted earlier, the bank's niche is catering to the venture capital and start-up industries. Upwards of 60% of their deposit base (or more depending on how you measure it) could be traced back to these two sectors. SVB has publicly stated that nearly half of all U.S. backed venture-backed-startups were customers. As this sector boomed in the 2010's and early 2020's SVB's balance sheet exploded. Much of the deposit inflow was then invested in longer-term government bonds. However, when the venture and startup sectors ran into headwinds in 2022, deposits started to flow out. This forced SVB to sell assets at a loss, which then raised questions about their capital adequacy, which then fed back into further deposit withdrawals. This all came to a head on Friday last week. But SVB is unique in that they had such a high concentration to a very narrow industry sector. Few other banks in the U.S. have such an exposure.

Will the problems be contained?

It's too soon to say if other banks are at risk of failing, but what's important to stress is that depositors are likely to be made whole regardless. Also, the ability to pledge depreciated assets at the Fed and receive par value back is a big deal and is likely to take the pressure off many banks. But no one can be sure that there isn't another shoe to drop. However, it's hard to see another failure turning into a systemic problem given the actions of the authorities. We suspect that the actions of the Fed, FDIC, and Treasury will serve to 'ringfence' any new failures and not lead to an infamous 'Lehman moment.'

But what about my custodian?

If you have an investment portfolio it's likely not kept at a traditional bank – it's at Schwab, Fidelity, TD Ameritrade, etc. These businesses work very differently from a bank. At a traditional bank your deposits are comingled with all the other depositors. At Schwab, Fidelity, TD., etc., accounts are held in the investors' name, not the name of the custodian. This is a critical difference. Now it doesn't mean your account won't fluctuate in value depending on what the markets do, but the risk of waking up one day and not being able to access your assets is exceptionally small. All of us at Gemmer hold the bulk of our liquid net-worths at custodians like Charles Schwab.

Schwab published a useful piece today along the same lines. It's worth a read if you are concerned - https://www.aboutschwab.com/perspective-on-recent-industry-events.

What are the market implications?

It is really too soon to say. Markets rallied on Monday in response to the forceful actions on the part of the Fed, FDIC, and Treasury. Whether this proves to be a durable recovery or not will depend on at least three factors:

- Do other problems materialize in the coming days? It's almost impossible to know what other issues are out there. As we said earlier, though, we do take some comfort in the fact that the new lending facility combined with a possible expansion of deposit insurance could prevent further panic deposit outflows.

- We shouldn't forget about inflation. There are a couple inflation reports this week that could tilt things one way or the other.

- How will the Fed balance financial sector weakness with underlying inflationary pressures? This time last week the betting was the Fed would hike rates by half-a-point on Wednesday March 22nd. This is looking less and less likely, but the Fed will be in a tough spot if the inflation data comes in hot and many regional bank stocks remain under pressure. We suspect the Fed will take a pause soon and see how the financial vulnerabilities play out, but we will learn much more next week.

Finally, if you have any further questions or simply want to talk things through, don't hesitate to contact your financial advisor.

The Team at Gemmer Asset Management

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