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ODLUM BROWN
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The Anatomy of a Run

2023, which started with such promise, has hit its first major roadblock. Silicon Valley Bank (SVB) was put into receivership last week when their client base all rushed for the exits at the same time. This particular event is significant enough to bring my typing fingers out of their (longer-than-expected) sabbatical, as its implications may be *widespread* but not necessarily *far-reaching*. First, let us discuss banking.

Banking Overview

At its core, the banking business is one of borrowing short and lending long (from the bank's perspective). You and I deposit our savings at a bank and typically receive the benefit of a little interest on our money to make it worth our while. The bank, in turn, will take your money and try to earn a certain percentage "spread" above the amount they pay us to have our deposits. This can be done by either lending these dollars to someone as a loan (i.e., mortgage, home equity line of credit (HELOC), regular line of credit (LOC), etc.) or placing these dollars in some investment, which is typically lower volatility and very liquid (i.e., U.S. Treasuries and Government of Canada Bonds). In both cases, the lent amount is generally secured against some asset of value and that value will fluctuate depending on its market.

By nature, there is always a mismatch on timing between the depositor base and the lending base. You can pull your money from a bank account on demand, and at whatever frequency you choose. The money that has been lent or invested, however, is usually secured for longer time intervals. As a bank, you can do a few things to try to bridge this gap:

- Have some variability in your depositor base
- Have some variability in your lending base
- Try to match the duration on your depositor side with your lending side as closely as possible

As stated before, there is always a timing mismatch between depositors and lenders. However, it is more common to have deposited dollars largely stay put than it is to have them fully withdrawn on an irregular basis. This general expectation, combined with the measures above, provide enough consistency for banks to make a business of the practice of lending. Ignoring any of these measures increases the risk of being caught offside. So, what happened to Silicon Valley Bank?

Silicon Valley Bank – A Tale of Two Sides

Silicon Valley Bank (SVB) is a lending institution situated in California that catered almost exclusively to the **venture capital (VC) crowd**, providing them with depositor services, cash management solutions and wealth management solutions. The venture capital space is a fickle one, but for the past 10–15 years it has been a lucrative one to be in. As interest rates remained depressed in the aftermath of the financial crisis of 2007-08, the "easy" money environment created significant wealth for VCs. That money, naturally, found its way to a regional institution (SVB) and created the conditions for the bank's success and subsequent demise.

Let's think about the VC space as a depositor base. The VC business is one of boom/bust, raising equity and using the cash from those raises to fund operations, payroll and expansion. The hope for any VC is to continue raising equity at successively higher valuations (generating more cash), being bought out by another business (generating more cash) or going public (generating more cash). So essentially it is a business of going from one watering hole in the desert to the next until you find the oasis. The length of time between watering holes increases the likelihood of not surviving (i.e., spending all your cash).

The ultra-low interest rate environment of the past decade created more watering holes, on average, so much so that businesses that would not otherwise have survived were able to do so. The market was awash with cash, and that cash was deposited with SVB. That environment changed drastically in 2022 as central banks across the globe began raising rates in order to combat inflation. Suddenly, the watering holes started drying up and cash for equity raises became scarce. VC businesses that did not have consistent cash flow generation from their operations began to rely more heavily on their cash deposits in order to keep things afloat. This is the Tale of the VC side.

Silicon Valley Bank, over the past decade, benefitted greatly from the deposits being made to them. Like any good bank, they looked for ways to make those deposits earn something in order to generate a spread. Unlike your typical bank that would underwrite mortgages and other loan-type businesses, SVB had a focus on investments (i.e., buying treasuries and government bonds, etc.) which, in fairness, made more sense for them given their depositor base. Deposits were rolled into investments with varying maturities to match the duration on the depositor side as best they could. These investments are interest rate sensitive by nature, and the price of said investments move in the opposite direction from interest rates with varying severity based on a) when they mature and b) what they pay via coupon.

As 2022 rolled on and interest rates across the globe increased, the "price" of these investments consequently moved in the opposite direction, creating a paper loss for these holdings. This usually is not an issue for most banks, so long as there is no reason for them to have to liquidate their investments to meet a wave of deposit redemptions. This is the Tale of the SVB side, and you can probably see where this is headed.

Perfect Storm and Contagion

Although the SVB scenario exhibits characteristics of improper banking risk management, this environment is indicative of a broader theme of certain interest rate sensitive investments coming under pressure due to rate hikes. As noted at the top, the implications will be widespread but not necessarily far-reaching, at least not yet. SVB's unique position had been exacerbated by a series of other factors, including having a high percentage of deposits over the Federal Deposit Insurance Corporation (FDIC) insured threshold of US$250,000, which is not the norm for most of the major banks. I would argue that they had the conditions for a perfect storm, and while it is disconcerting to read about, it still stands out as more of a unique situation than a structural issue.

What does this mean for contagion? This remains to be seen, but regulators in the U.S. have already stepped in to shore up other potential risky lenders to prevent fear from spreading across the lending space. This is the first step of many to calm both depositors and lenders and create more certainty around depositor security and bank stability. In both an ironic and sad twist of fate, the past few days of volatility has shifted market sentiment around interest rates and has likely moved the value of investment assets (like what SVB sold off) upwards. Consequently, this would make every other lending institution in a similar environment slightly better off.

Conclusion – Stay Vigilant

We knew that the rate hikes of 2022 would lead to something breaking, and now we're getting a little more clarity on what that weak link is. I suspect, when all is said and done, the events of last week and this upcoming week will benefit those in the market that have the varied depositor base, a more robust investing/asset base and higher capital requirements and more rigorous underwriting standards (like the U.S. major banks and most Canadian banks). This is not a given, however, and as such we will stay vigilant. The opportunities will continue to pop up throughout this year, and we aim to stay ready for when they do.

Happy to chat further,

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