MARCH 13, 2023

Recent Bank Failures and Fed Action

What happened?

On Friday, Silicon Valley Bank (SVB) became the largest bank to fail in over a decade, and the first to fail since 2020. The California Department of Financial Protection and Innovation (DFPI), SVB's primary regulator, took possession of the bank and appointed the FDIC as the receiver of the bank's assets. Following a turbulent weekend, the Federal Reserve, Department of Treasury, and FDIC announced Sunday evening that they were taking actions to protect depositors and the economy by covering all depositors of Silicon Valley, including uninsured depositors. They also announced a lending facility to banks to ensure they have access to liquidity without having to sell securities. New York bank regulators also announced the closure and takeover of Signature Bank.

SVB's issues started late Wednesday after the bank announced it intended to launch a $2.25 billion share offering. The share offering was announced alongside the bank disclosing it had sold $21 billion in securities. However, the security sales resulted in an after-tax loss of $1.8 billion and necessitated SVB raise capital to ensure the bank's regulatory capital levels stayed above minimums.

The news of SVB's balance sheet restructuring made waves Thursday and led both Moody's and S&P to downgrade the bank's ratings. As nervousness spread throughout the day and the bank's stock price fell, many prominent SVB clients including venture capitalists began advising their portfolio companies to withdraw their deposits from the bank. Eventually, SVB abandoned the share sale and looked for potential suitors to sell themselves to. On Friday morning, trading in the bank's shares was halted pending news, and shortly before noon, news broke the bank had been closed.

WHY DID THIS HAPPEN?

SVB's failure was due to a combination of rapidly rising interest rates and its unique, concentrated client base of tech startups and venture capital firms. Robust venture capital funding in 2020 and 2021 put lots of cash into startups' hands. Those startups turned to SVB for banking services, and SVB's deposits tripled to nearly $200 billion in just over two years. Loan growth didn't keep pace with the extraordinary deposit growth, so they invested the funds in fixed-income securities, majorly agency mortgage-backed securities and treasuries. As interest rates moved higher starting in late 2021 through 2023, SVB's investment portfolio lost market value.

Simultaneously, the Federal Reserve's restrictive monetary policy led to a slowdown of venture capital funding, which in turn led to SVB's clients withdrawing deposits. Unlike most other banks, the vast majority of SVB's deposits appear to have been uninsured as startups had large deposits at the bank. SVB experienced approximately $33 billion in deposit outflows since September 2022.

Banks account for their investment portfolios in one of three ways, with the primary two being either available-for-sale (AFS) or held-to-maturity (HTM). Most banks' investment securities are HTM, meaning they are carried at amortized cost. AFS portfolios are generally smaller and are carried at fair value with unrealized gains and losses reported as changes in accumulated other comprehensive income (AOCI). For banks with less than $700 million in assets, changes in AOCI do not affect regulatory capital. SVB's sale of $21 billion of AFS securities made a previously unrealized loss a realized loss.

WHAT IS NEXT?

The FDIC announced that all depositors of SVB and Signature Bank will have access to their funds Monday. The ultimate timing of the sale of SVB and Signature Bank's assets is still unknown as of this morning.

The Federal Reserve announced the Bank Term Funding Program to alleviate liquidity pressure in the banking system. Specifically, eligible depository institutions, including banks and credit unions, can borrow from the program for up to one year. Eligible collateral for the loans includes treasuries, MBS, and agency debt, and the collateral is valued at par, not the securities' market value. By valuing the collateral at par, banks should be disincentivized to sell their securities and can avoid realizing losses.

HOW ARE MARKETS REACTING?

The two bank failures have driven investors into a "flight to quality" trade, putting downward pressure on rates and rate hike expectations. As of early this morning, the 2 Year Treasury briefly traded below 4%, down over 1% from 5.07% on Wednesday. Similarly, the 5 Year Treasury and 10 Year Treasury are down 0.7% and 0.53%. Likewise, market expectations for rate hikes have changed dramatically, with the terminal rate priced at 4.73% now, down from 5.7% on Wednesday.

WHAT THIS MEANS FOR YOU

Other regional banks saw their stock prices move lower last week, and we are monitoring markets for broader implications. We expect some increase in market volatility as news is digested, and we will continue to stay diligent.

If you have questions, or would like to talk about your individual situation, please reach out to your investment professional at Meeder by calling 866.633.3371 or visit us online at meederinvestment.com.

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