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Capital Management, LLC

A Crisis of Confidence

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The banking sector has been engulfed by a crisis of confidence. In just a few weeks, numerous events have shaken the market and banking industry. These include the failures of Silicon Valley Bank and Signature Bank, which were the second and third largest U.S. bank failures, respectively; the wind down and liquidation of Silvergate Bank; the sale of Credit Suisse to UBS in a Swiss government-brokered and backstopped weekend sale; and a significant sell-off in U.S. regional bank stocks, particularly in First Republic Bank.

While depositor outflows, or bank runs, were the proximate cause of each bank's crisis, the preconditions at each bank preceding the bank runs were relative outliers compared to the broader banking and financial sector. Understanding these preconditions helps us understand why these banks failed and what other banks or financial institutions may or may not be at risk.

Silicon Valley Bank (SIVB): The roots of Silicon Valley Bank's failure were a concentrated client (deposit) base, a severe asset-liability mismatch exacerbated by the rapid rise in interest rates, and the fact that more than 95% of deposits exceeded the Federal Deposit Insurance Corporation (FDIC) coverage limit of \$250,000.

- SIVB catered to tech and venture capital (VC) backed companies, creating a highly concentrated depositor base where many clients knew each other. As these companies received funding, they would deposit the funds in a SIVB operating account. Before 2022, these clients would often receive regular funding through new investment rounds, or new companies would be funded, providing SIVB with a consistent flow of new deposits.
- Post-pandemic, VC funding surged, and cash deposited in SIVB accounts nearly tripled. SIVB invested a large portion of the new deposits in medium-term Treasuries and longer-dated mortgage-backed securities (MBS) to earn income for the bank. At the time, SIVB did not think the funds would be needed by its depositors anytime soon (they would receive new funding) and believed the ~1.75% interest rate the bank was earning on the investments to be attractive.
- In early-2022, the Federal Reserve began raising interest rates leading to two critical issues for SIVB: 1) the VC market cooled, existing companies stopped receiving new funding and fewer new

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VC-backed companies were launched, and 2) the Treasury and MBS bonds SIVB purchased began to decline in value. The losses on the MBS investments were so large that had SIVB sold them, the bank would have realized losses large enough that it would become insolvent.

- Without additional funding from VCs, SIVB's clients began to draw down their accounts leading to deposit losses for SIVB. Additionally, the declining value of SIVB's bond investments meant that it was hesitant to sell its bonds to raise cash to fund these withdrawals.
- This situation was untenable and eventually led to SIVB announcing it sold \$20 billion worth of medium-term Treasury bonds to raise cash and that it intended to raise over \$2 billion in new capital by selling new shares. However, the combination of the bond sale and capital raise spooked the market, and a VC-stoked bank run began the next day – many of SIVB's clients knew each other or were backed by the same VC firm and many transferred their money out en masse.
- The bank was closed by regulators less than 48 hours later on March 10th. Just over two weeks later, most of Silicon Valley Bank was sold to First Citizens Bank and Trust.

The speed of the Silicon Valley Bank collapse is unprecedented and shocked the market. Investors quickly grew anxious about the financial stability of other regional banks, including First Republic Bank (see below).

Signature Bank and Silvergate Bank: Much like Silicon Valley Bank, these banks had a concentrated depositor base. Their downfall was linked to their focus on cryptocurrency clients. Many crypto exchanges would keep their customer's cash in accounts at these banks. As cryptocurrencies collapsed in 2022, many investors sold their crypto investments and left the market, withdrawing their money from the exchanges, which in turn withdrew money from these banks. The process was slower than the 48-hour collapse of SIVB, but the mechanism was largely the same – a concentrated depositor base withdrawing all their money from the bank at the same time.

Credit Suisse: Credit Suisse was a poorly run bank. The bank consistently recorded losses, even when other banks were achieving record profits, and regularly incurred massive fines for violating various laws and financial regulations. The failure of SIVB merely accelerated the deposit flight that Credit Suisse was already experiencing. To stave off a bank run and ultimate failure of Credit Suisse, the Swiss government organized an acquisition of Credit Suisse by its compatriot bank and primary

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competitor UBS.

First Republic: In the aftermath of the SIVB failure, investors turned their attention to other regional banks that may also be unstable. Focusing on banks with a high percentage of uninsured deposits and unrealized losses on their investments, zeroing in on First Republic Bank (FRC). First Republic's stock has declined nearly 90% over the past two weeks.

- Two similarities to SIVB that initially drew investor concerns were the fact that 80% of FRC's deposits exceeded the FDIC's \$250,000 insurance limit and that the bank had \$5 billion in unrealized losses in its mortgage portfolio.
- However, contrary to SIVB, First Republic's deposit base is much more diversified. Roughly 40% of deposits are from retail clients, which tend to be stickier, with the balance being from corporate clients. Additionally, no one industry comprises a disproportionate share of clients. And finally, unlike SIVB, FRC had been seeing double-digit deposit growth.
- Again, in contrast to SIVB, the \$5 billion of unrealized losses in FRC's mortgage portfolio, while not ideal, would not render FRC insolvent if the bonds had to be sold.
- Since the crisis started, FRC has received substantial liquidity support. First, with a line of credit from JP Morgan and the Federal Home Loan Banks, and later, by the unprecedented \$30 billion deposit in FRC by the 11 largest U.S. banks.
- While FRC began this crisis in a much stronger position than SIVB and has received substantial support, the situation now appears to have become an unfortunate, self-fulfilling prophecy. The initial stock price decline led to nervous depositors withdrawing funds, leading to more negative news/rumors about deposit outflows, leading to further stock declines, etc.

The fate of First Republic Bank remains in the balance. Various media reports have indicated that the Fed, the U.S. Treasury, and the largest U.S. banks are working together to find a way to either stabilize or sell First Republic. At the time of this writing, it does not appear that First Republic will be allowed to fail as SIVB did.

Charles Schwab: Charles Schwab (SCHW) has also been caught up in this crisis. Schwab's stock price is down 25% since the crisis began, though it has rebounded from its lows and the CEO is

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personally buying stock. However, for the reasons detailed below, Schwab is not like SIVB, FRC, or the other regional banks that are under pressure.

- Schwab has a healthy and diverse customer base. SCHW is the largest brokerage firm in the U.S. with \$7.5 trillion in assets. Schwab bank has \$366 billion in deposits, of which 80% are below the FDIC insurance limit. Additionally, client investment assets are insured by Securities Investor Protection Corporation (SIPC) which provides insurance in the rare event that a brokerage fails (bankruptcy), and client assets are missing due to fraud or other causes.
- From a liquidity perspective, SCHW is in a considerably stronger position with ample liquidity.
 - ◇ Schwab's loan-to-deposit ratio is only 10%, meaning it has a very liquid portfolio should it need to access funds for deposit outflows.
 - ◇ It has \$20 billion in cash and another \$40 billion in available-for-sale securities it could sell without incurring any losses.
 - ◇ Its securities portfolio is expected to generate \$95 billion in cash from interest and maturities this year.
 - ◇ Bank Term Funding Program: After the failure of SIVB, the Fed created a new funding program to provide bank liquidity. With this program, SCHW could tap 85% of its \$320 billion securities portfolio (or over \$270 billion) of liquidity if needed.
 - ◇ Overall, it is estimated that Schwab could access \$275 billion of liquidity immediately and roughly \$375 billion over the next 12-month time span which fully covers their \$366 billion of bank deposits.
- Finally, Schwab customer securities are kept segregated from the bank's own balance sheet assets. This means Schwab's bank assets and Schwab's client assets are not commingled. As such, in the unlikely event of failure or bankruptcy, client assets would not be available to bank creditors. The client assets would be safely segregated and would be transferred to a new custodian elsewhere.



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As a firm, we remain confident in Charles Schwab as a custodian and continue to have full faith that Schwab will survive this crisis much as it did the dot-com bubble and the global financial crisis previously.

Where does this leave us?

Confidence is the cornerstone of the banking system. Today, the Federal Reserve, the Treasury, and the largest U.S. banks are working fervently to ensure the public maintains confidence in the soundness and stability of the U.S. and global banking system. In the near term, we expect the crisis at First Republic to be resolved shortly. Treasury Secretary Yellen has indicated that no customer will suffer losses on their deposits. Longer-term, we expect regulatory changes to better manage and monitor the risks inherent in banking and a potential rethink of FDIC insurance and its limits to maintain the public's confidence in, and willingness to do business with, regional and local banks.

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