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A Traditional Bank

Banks like most industries are composed of firms who take very different paths to achieve profitability.

The traditional banking model is taking consumer and commercial deposits and lending those deposits out as loans, typically mortgages and commercial loans.

The bank pays a fee for those deposits (interest on a checking or savings account) while receiving a fee (interest) on the underlying loan. The difference between these fees is referred to as the net interest margin or the interest received from borrowers minus the interest paid to deposit holders.

In addition, banks do not loan out all deposits and keep a portion as cash and/or very liquid investments. This permits the bank to provide cash to any deposit holder who may need their respective funds on any given day.

Silicon Valley Bank (SIVB)

SIVB might be a bank, but it stood in stark contrast to the traditional banking model. While I cannot ensure the link will stay active much longer, SIVB prided itself as more than a bank:

https://www.svb.com/how-we-help-clients/startup-banking-b

Specifically, SIVB wanted to be a bank for startups in technology, healthcare, and life sciences. This desire mutated a traditional banks balance sheet of consumer deposits and home mortgages to venture capital (VC) fundraising and VC debt.

This "banking model" lead to a lot of success post 2008 as overnight interest rates remained near 0% and technological startups found very little resistance in raising capital.

Where It Went Wrong

Remember that a traditional bank makes the bulk of its profit by earning more interest on loans and investments than the interest it pays out on deposits. The main risk with this model is that checking and savings accounts provide daily liquidity while a 30-year mortgage can be tied up for 30 years. This creates a mismatch in liquidity (or duration) that a bank must invest a portion of the deposits into secure short term investments to offset the duration.

SIVB did the opposite……..SIVB saw its deposits balloon from $62B in 2019 to $173B in 2022. The bulk of these deposits were put into US Treasury Bonds. While Treasury Bonds are considered risk free from a credit perspective, they are still susceptible to interest rate risk.

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This has been a reoccurring theme Titan has been harping on, but it all comes down to duration risk. A year ago any investor could have bought a 10-year US Treasury paying ~2%. Fast forward to today, and a 10-year US Treasury is paying ~3.50%. The only way the investor who bought the 2% yielding Treasury could sell that bond is at a steep discount. Otherwise, the investor would have to hold this bond to maturity to avoid any capital loss (remember this would be 10 years).

Because interest rates have meaningfully risen over the past 2 years, SIVB had a significant unrealized loss.

The other show that dropped was the lack of liquidity for VCs. Because interest rates rose, VCs began to drawdown deposits rather than pay a higher and higher interest rate. This drawdown in deposits now forced SIVB to sell those Treasury Bonds to make deposits whole. **This climaxed last Thursday as SIVB sold $21B worth of investments (which was the bulk of their liquid investments) at a $1.8B loss.**

As a result, deposit holders panicked and began to pull more and more deposits from SIVB. This only forced more selling on SIVB's behalf and created a downward spiral that lead to regulators closing the bank on Friday.

<u>What Happens from Here</u>

First, Titan Investments does not own SIVB, Signature Bank, or Silvergate Capital Bank (the latter two are also under regulator control for deposit and crypto risk).

Second, the FDIC and Fed enacted three measures to contain any potential fallout:

1) The FDIC will make all deposit holders at SIVB full.
    a. This stands in stark contrast to the FDIC only covering up to $250K/business or person.
2) The Fed announced a new Bank Term Funding Program that would provide par value of any Treasury, Agency, or mortgage-backed security.
    a. In other words, a bank may own a $100M 10-year Treasury Bond that is currently worth $90M on the market. However, the Fed will provide $100M to the underlying bank if deposits are withdrawn.
3) The Fed relaxed terms for lending through its discount window.

Thirdly, small, regional banks are going to come under fire, especially those that have taken the route of SIVB. Companies to watch will be First Republic Bank (FRC), Bank of Hawaii (BOH), East West Bancorp (EWBC), Western Alliance Bancorp (WAL), PacWest Bancorp (PACW), Zions Bancorp (ZION), etc.

Larger, money center banks will also face some stress, but will have a significant opportunity. A company such as JP Morgan Chase (JPM) not only has cash, but the bandwidth to swoop in buy SIVB loans at pennies on the dollar. Thus, the JPM's of the world stand to benefit in this scenario and only emerge as larger more powerful institutions going forward.

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Lastly, this will severely limit the FOMC's ability to raise interest rates going forward. In addition, the shock and awe of the scenario will limit hiring as well as spending. Economic data tends to be stale in the sense of reflecting today, but the fear from SIVB will most likely lead to significant disinflation.

We will provide more information as this plays out, but the T-Bills Titan has leaned into will be a safe haven in this time of volatility.

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