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PERSPECTIVES ON THE CURRENT BANKING SITUATION

Over the past few days, US regulators seized two sizeable banks, Silicon Valley Bank ("SVB") and Signature Bank. These actions have been heavily followed in the media (with varying accuracy) and raised questions and concerns among our clients and friends. This note seeks to provide a brief (and therefore over simplified) explanation and analysis of the situation.

WHAT HAPPENED?

In the narrowest sense, the SVB crisis is traceable to the combination of SVB'S rapid deposit growth, the bank's poor investment management and the recent rapid rise in interest rates. SVB was the banker of choice for venture capitalists and start up companies and it grew very quickly to become one of the 20 largest banks in the US. SVB also had subsidiaries in other countries with emerging tech sectors. The deposit growth out paced the bank's ability to prudently lend the funds to its commercial customers. To deploy the excess funds, the US entity bought US government and federally guaranteed mortgage backed securities. With short term interest rates at historic lows, SVB sought to earn greater revenue by buying longer term, fixed rate securities that offered a higher yield. As the Fed started aggressively raising rates, the longer term fixed rate assets lost value and SVB began reporting losses. That started a classic run on the bank, forcing more securities sales and causing bigger losses. The concern about the safety of SVB then spread to other smaller banks, notably Signature Bank and First Republic. Over the weekend of March 10th, US banking regulators seized both SVB and Signature Bank and issued guarantees for both insured and uninsured deposits. Equity and bondholders of both banks were wiped out. First Republic survived the weekend and announced $70 billion in additional liquidity facilities from the Federal Reserve and JP Morgan. On March 16, a group of the largest US banks announced that they would collectively deposit $30 billion in First Republic to further enhance its liquidity.

ANOMOLIES

There are several aspects of these events that are unusual in the banking world. First, bank runs are usually motivated by concerns about a bank's asset quality. That was not the problem with either SVB or Signature and there has been little indication of credit problems at First Republic. Forty percent of SVB's assets were in high quality securities that were intended to be held to maturity. However, SVB's asset-liability management strategy assumed low credit risk but high interest rate risk. That proved fatal when rates started to rise quickly. Signature Bank's balance sheet was more traditional with only 10% of its assets in securities. But its lending was more aggressive with heavy concentrations in loans to private equity ventures and New York City commercial real estate (which was greatly stressed by the pandemic). Signature also provided extensive services to the crypto industry although it did not have any crypto denominated loans or deposits. Importantly, SVB, Signature and First Republic all had very high proportions of uninsured deposits. When SVB started reporting losses, the uninsured depositors reacted quickly by withdrawing

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more than $40 billion in a few days. The fear spread to Signature's depositors and the regulators seized both banks to stem the contagion. The contagion also affected First Republic but the bank was not seized. Rather extraordinary efforts as described above were taken by the regulators and other banks to stabilize First Republic. It is not yet clear if these efforts will be sufficient.

Another unusual aspect of this situation is the regulatory response. When a small or regional bank becomes insolvent, the normal course is for the FDIC to assume control and merge the troubled bank into a stronger one. Typically, the assuming bank honors all the deposits (insured and uninsured) and agrees to accept certain assets. The FDIC retains the other assets and liquidates them over time. Equity and bondholders of the troubled bank suffer up to 100% losses. Any losses the FDIC incurs are borne by its trust fund which is funded through assessments on member banks. In the current crisis, this regulatory response was unsuccessful. The FDIC attempted to auction SVB over the weekend, but no banks submitted bids. Similarly, there was no reported interest in acquiring Signature. Analysts have cited various factors for the lack of interest in these banks including their large uninsured deposit bases, Signature's aggressive business mix, and the regulators' harsh treatment of banks after earlier auctions. Another auction for SVB is expected to be held in the next few days.

After the 2008-09 financial crisis, the US enacted the Dodd-Frank Act that created a framework for dealing with crises in "systemically important" financial institutions. Such institutions are subject to enhanced regulation and stress tests. Regulators have broader authority to deal with crises in such institutions, including guaranteeing non-insured deposits. In 2018, legislation was enacted that raised the minimum size for a bank to be classified as systemically important. None of SVB, Signature or First Republic met the higher minimum. When the US auction for SVB failed, the US regulators used arcane provisions of the 2008-09 law to treat both SVB and Signature as systemically important and guarantee the insured and uninsured deposits of both banks.

UK'S EFFECTIVE RESPONSE

The resolution process was more successful with SVB's UK subsidiary which had approximately £7 billion of deposits. As with the SVB US, only a small fraction of the UK deposit bases was insured. The UK insurance program is much more limited than the FDIC program, protecting only £85,000 of deposits (a little more than $100,000). The demise of SVB UK threatened a broad swath of the UK's start-up sector and there was intense political pressure for a government supported resolution. SVB UK was seized by the UK regulators late last week and a sale to HSBC Bank for £1 was announced early Monday morning. All deposits will become liabilities of HSBC and are likely to be available soon. But the transition is uneven and the delays are causing some SVB UK's customers to miss payrolls and other payments to creditors. While the situation is likely to work out for these firms over the long term, there is considerable disruption to their current operations.

IMPLICATIONS OF FDIC'S RESPONSE

When the US regulators were unable to accomplish a quick merger of the seized banks into healthier institutions, they faced a difficult tradeoff. On the one hand, not protecting uninsured depositors could create a panic and cause runs on a number of small and regional banks leading to a broad financial crisis. On the other hand, protecting all depositors creates a "moral hazard" – complacency among uninsured depositors that the government will protect them and absolve them of the need to monitor the safety and soundness of their banks. The regulators opted to protect all insured depositors which should defuse the crisis in the short term but may create a moral hazard problem for the long term.

The regulators have been harshly criticized for protecting uninsured depositors and encouraged to force depositors to be more diligent. In practical terms, there are significant barriers to this. With an insurance limit of $250,000, even small firms and institutions require operating account balances in excess of the limit. Banks are large and opaque institutions, and few customers are capable of assessing their total risk when they make a deposit. The more likely result is additional regulatory oversight of all banks with more focus on non-credit risk. Bills to restore the standards that were eased in 2018 will likely be drafted but their outlook is uncertain in the divided Congress.

IMPACT ON THE BROADLY SYNDICATED LOAN MARKET

The recent travails of these regional banks have had minimal effect on the broadly syndicated loan market and the funds and programs that hold them (e.g. the Saranac CLOs and Canaras Liquid Asset Strategies). The companies that were threatened by recent events primarily were very small, with limited liquidity and all their funds in one of the seized banks. In contrast, the companies that Canaras programs lend to are very large with EBITDAs of $600 million to $1+ billion. They have more sophisticated treasury management processes that include diversified bank deposits and liquidity borrowing facilities.

Of greater concern is the situation at Credit Suisse which is a major player in the syndicated loan market and acts as the agent bank for a large number of loans. There are market mechanisms for replacing troubled agents, but some transitional dislocations and uncertainty are likely until the Credit Suisse situation is resolved. Fortunately, the larger US and international banks who play key roles in the syndicated loan market as underwriters, agents, market makers and trustees have not yet been affected by the current turmoil. Canaras has intensified its monitoring of both borrowers and market participants and is taking defensive action when warranted.

LESSONS TO BE DRAWN

The primary lesson we draw from this situation is the need for all individuals and entities to protect their liquidity through diligence and diversification. In the case of SVB, a fatally flawed asset-liability management strategy escaped reaction by the regulators, the rating agencies, and SVB's auditors (who gave

the bank a clean opinion shortly before the crisis). To date, assuming that the government will protect uninsured depositors has been a reasonably successful strategy, but it cannot be relied on in perpetuity and substantial short term disruption can be encountered in a crisis. For high net worth individuals, family offices, and commercial enterprises, exceeding FDIC limits on operating accounts may be a practical necessity, but liquidity in excess of daily operating needs should be tiered and diversified across several banks and broadly diversified investment funds rather than concentrated in a single counterparty.

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