## Fintech:

We like to start out all of our discussions by telling investors who we are. We are FINTECH investors, and we define Fintech as *"anything utilizing technology to improve an established process."*

We realize that half of Fintech is financial, but we don't invest in traditional, credit sensitive banks. Having managed money during the Financial Crisis, we learned firsthand how certain opaque and balance sheet intensive financials could go bankrupt or insolvent.

We prefer transaction-based businesses, generating recurring revenue, with sustainable margins, and significant cash flow. From our perspective, the perfect example of a FINTECH business is the secularly growing payments industry. Names like Visa or Mastercard, that generate revenue and profit per swipe or transaction, without the underlying credit sensitivity or risk associated with that underlying line of credit.

## Banking 101:

Banks are quite different from our payment companies. To simplify a complicated business, banks make money by "borrowing short" from customers, in the form of demand deposits, checking accounts, and CDs. Then, bankers "lend long", presumably at a higher rate, with credit cards, auto loans, mortgages, etc.

In the event a bank doesn't lend these assets to clients, it can purchase "safe" securities and hopefully earn a higher yield. The way-too-simple goal of any bank is to profit by earning the interest rate spread in an upwardly sloping yield curve environment.

However, we've been dealing with an inverted yield since October of last year, as the Fed has raised rates 7x in 2022, with more on the way and just another 25 basis points announced by the Fed last week. These types of large rate swings can catch certain banks unprepared and ill-equipped to handle withdrawals and volatility. That's really where we were 2 weeks ago, before this banking crisis.

## The Banking Crisis of March 2023:

How did we get here? I think we need to start in early November, when FTX collapsed. That was on November 8th and 9th. More and more information has come out, but clearly the risk management systems in place and regulatory scrutiny was lacking. Risk management is the takeaway from that failure, and we'll hit on that point again in a little bit.

Then, earlier this month, Silvergate collapsed. As a crypto custodian and digital currency intermediary, Silvergate was supposed to be a safe exchange between various counterparties. It is down (92%) this year and clearly was not the stabilizing force it claimed to be.

Afterwards, the banking crisis kicked off with the sudden and almost shocking failure of Silicon Valley Bank, which we'll shorten to SVB for the rest of this discussion.

SVB was the 16th largest bank in the country, but it now has the notorious ranking as the 2nd largest bank failure in history, just behind Washington Mutual in 2008 (as this chart shows). In our opinion, SVB was a risk management failure coupled with a a classic "bank run", and not similar to the credit problems the market dealt with during the Financial Crisis.

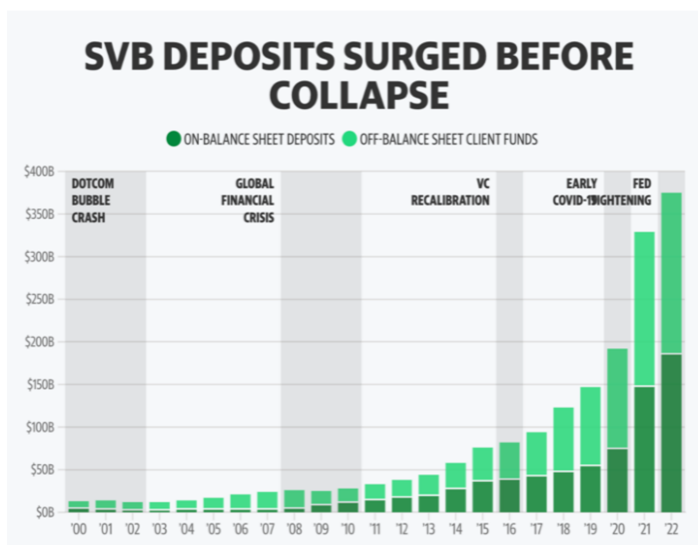
Now, we'll review five key points that led to SVB's downfall.

## Point #1 is Clients:

First of all, SVB had a concentrated client base of mostly money losing VC backed entities, that were constantly drawing down their balances. Last year, as the market fell (18%), many money losing companies found the environment much more challenging to raise funds. These companies and depositors used SVB as a traditional bank, some at the recommendation of their private equity sponsors. SVB was known to be the bank of choice for start-ups, and it actually relished that reputation. These weren't small "mom and pop" retail banking accounts, that fell under the $250,000 FDIC insured protection level. Some of these firms had millions of dollars at SVB and had material risk to their firm's longevity if something were to happen to their cash.

SVB had significant client cash concentrations, with Roku at $487 million, Rocket Lab at $380 million, Block Fi at $227 million, Ginkgo Bioworks at $740 million and Circle with $3.3 billion of cash deposited with the bank. If SVB didn't provide liquidity to them, there was no way these firms could make payroll. So, there was too much client concentration at SVB, with specific clients that weren't FCF positive and were probably, on average, too large.

## Point #2 is Investments:




The second key point leading to SVB's collapse was related to their investment portfolio. Many of SVB's depositors experienced large inflows of capital into their business during 2020 and 2021, when times were good, and the market was positive. As this SVB investor slide shows, its deposits, and assets balloon by over 300% to over $150 billion.

At that time, interest rates were still close to zero. SVB was unable to generate much in terms of a rate spread and wasn't much of a traditional bank lender, so it conservatively invested these client assets in US Treasuries.

We want to emphasize a key point. We have no problem with SVB safely purchasing these assets, as Treasuries are a much safer choice than investing in 30-yr fixed mortgages, 10-yr commercial proprieties, auto loans or even unsecured credit cards. The timing wasn't ideal, but the choice was sound and fairly conservative.

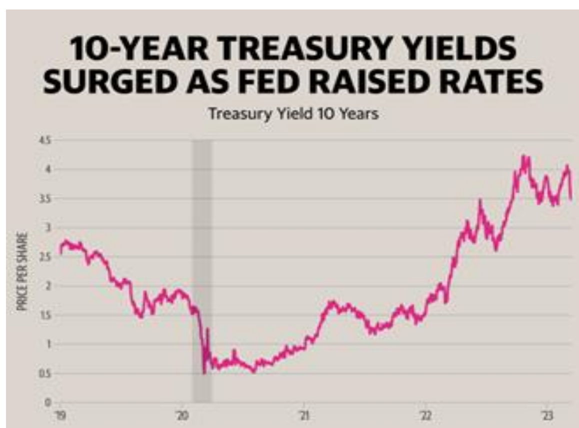
With over $120 billion of depositor money into US notes, SVB was earning less than a couple of hundred basis points for its credit and duration risk. As that point in time, SVB probably thought it was perfectly situated. However, the problem for SVB comes when the Fed decides to hike interest rates 7x in 2022.

## Point #3 is Accounting:

Banks can classify their investment portfolios multiple ways. They can be HTM or held to maturity. They can be trading assets and even be in a bucket called AVS or available for sale securities. In simple terms, SVB held bonds that they classified as HTM, which lost money on paper as interest rates rose. Under current accounting rules, bonds that are HTM are not required to be measured at fair value on the balance sheet. Therefore, if a bank has a lot of unrealized losses, investors would not have been aware of the extent of those losses because the balance sheet would not show them. For accounting purposes, HTM bonds are carried at their original interest rate when issued, typically called the amortized cost. Even though the real-world value has changed, as interest rates climbed, accounting treatment ignores these changes. Some call this "ostrich accounting" and simply burying one's head in the sand.

From an accounting perspective, the logic goes: If temporary market value movements reflect circumstances that do not impact the amounts expected to be collected in the future, it should not directly impact the carrying value of those assets on the financial statements, whether positive or negative. These bonds are worth less than what SVB paid for them, but they still have obvious value. If a bank sells "more than an insignificant proportion" of its HTM investments before maturity, it must classify all remaining HTM assets as AVS and consider the portfolio "tainted".

This 100% legal, accounting technique permits the bank to keep these investments at par and not mark them to market. If they were trading assets or available for sale investments, the bank would take the price movements, both up and down, into their quarterly income statements. With HTM investments, the accounting treatment essentially smoothes out the gains and losses, as long as the assets are actually "held to maturity". The investment can be kept at par, regardless of its true and current valuation, as long as the bank plans on holding the security through its maturity.




As yields climbed (as this chart shows), the next question is what does SVB's management and risk teams do?

As of the end of last year, SVB had roughly $120 billion in investments, versus $74 billion of loans to borrowers. Of the $120 billion in bond investments, $91 billion was classified in HTM investments (at its amortized cost). There is an opportunity for the bank to classify some of these assets as CECL or current expected credit losses, but it looks SVB did not establish any reserves for credit losses on these investments. Considering they were Treasuries, guaranteed by the US government, this isn't surprising. On this portfolio, SVB was truly underwater by $15.6 billion, but had only a $6 million reserve. This is a critical accounting aspect to understand, and it had a large impact on SVB's eventual collapse.

Following the SVB debacle, there is renewed interest in having the FASB (Financial Accounting Standards Board) change its accounting rules for HTM. Seven years ago, this was a topic in accounting circles, but nothing arose from those talks.

Two FASB members (Harold Schroeder and Thomas Linsmeier) dissented and stated that the board's *"decision to retain existing classification and measurement guidance represents a significant lost opportunity to provide users with the information necessary to understand the potential risks in financial instruments that have caused significant issues in past economic crises."* Both also said existing accounting rules failed *"to require additional disclosures that provide users with a better understanding of the duration risk, interest-rate risk, and liquidity risk of financial instruments, which they believe have led to significant market uncertainty in past financial crises".* Both were spot on but were unfortunately overruled.

## Point #4 is Risk Management:

As everybody knows, higher rates have an inverse impact on bond prices, so this Fed tightening should cause a large downward revision to SVB's investment portfolio. That's just simple mark-to-market accounting. However, as we just mentioned, SVB doesn't need to mark this portfolio down, as it is classified as HTM.

As this volatility is occurring in the market, we don't have a clear picture of what SVB is doing. Most banks and financial institutions have a defined risk management program and team in place, that adjusts and adapts to a changing environment. When rates skyrocket, like they did in 2022, banks can hedge their rate exposure with exchanges like the CME, which we have owned for over 2 decades. In fact, as this email notification from the CME shows, it just hit record interest rate volumes last week, as this banking crisis intensified. Not all financials are

**CME Group Hits Daily Trading Volume Record of More Than 66 Million Contracts**

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sensitive to interest rates in the same way. Derivative exchanges actually benefit from volatility, and some can handle this volatility much, much better. Now, some banks complain that the cost to hedge is too expensive. However, in our opinion, this is a "necessary evil", when one has a well-functioning risk management program.

So, what did SVB's risk management team do during 2022, as rates were continuously raised? Well, we have heard that it not only didn't have the necessary hedges in place, but it apparently didn't have anybody even sitting in that key risk management role.

Dating back to 2021, the Federal Reserve Bank of San Francisco began issuing SVB citations for how it was handling risk. It was negatively flagged for not having enough cash on hand - in the event of a crisis. Last summer, the San Francisco Fed put SVB in "full supervisory review", for what it called "deficient risk controls". We believe their failure to have a risk manager in place or any kind of adequate hedges, likely was the key aspect of its ultimate failure.

## Point #5 is Liquidity:

That's leads to our last point that led to SVB's failure. Many of SVB's large clients got worried a couple of weeks ago and began to withdrawal money. Or maybe they just drew down balances to cover bi-monthly payroll. Either way, there was a call for liquidity by SVB's depositors and this is what led to this "bank run".

As we discussed, SVB didn't have that cash in their bank vault, as it was invested in US government paper. Since SVB suddenly needed capital to repay its depositors, it sought advice from Goldman Sachs. GS purchased over $50 billion of investments from SVB, which led SVB to record a $2.1 billion loss. To put "some lipstick on this pig", SVB claimed that it was only an after-tax loss of $1.8 billion. Once GS purchased SVB's investment portfolio (at a material discount), the portfolio became "tainted".

The transaction provided SVB needed liquidity, but it also alerted Wall Street of a potential problem. After the purchase, GS then tried to raise $2.25 billion of additional capital for SVB, but there was already too much "blood in the water". Should GS have reversed timing of the portfolio sale and capital raise? Would SVB still be around if they tried to raise capital first and then sell some assets to GS? We'll never really know. When no "white knight" appeared, the stock cratered, left a massive capital hole, and led to its demise.

In our opinion, SVB failed because:

- Its client base was too concentrated, especially with money losing, VC-backed companies.
- SVB had a large asset / liability mismatch and a massively mis-constructed balance sheet.
- It was borrowing short (heavy deposit weighting) and lending long (purchasing long duration securities).
- This mismatch came to light as rates rose in 2022, but SVB didn't hedge or perform adequate risk mgmt.
- When a drawdown of deposits and withdrawals occurred, it forced the bank to sell its investment portfolio.
- This forced them into a negative and unrealized net equity position, a capital deficit and led to a spiraling of additional outflows and additional losses.

## Changes Are Coming:

Did this banking crisis need to happen? Are there other issues still lurking underneath these headlines? What are some of the key takeaways, from our perspective?

We attribute much of this as a company specific problem, that has unfortunately cascaded to other players. We believe one of the longer-term impacts will be lower bank profitability moving forward.

## Profits Are Going Down!

Right now, the average bank generates a profit margin of roughly 16%. We wouldn't be surprised to see that permanently get lowered to say 12% or 13%. The headwinds on profitability will likely come from several issues. We anticipate significantly higher FDIC premiums, especially if the insurance cap gets lifted above $250,000. How do we know this is coming? Well, FDIC Chairman Martin Gruenberg just hinted at it during his Senate testimony. He said that the FDIC will likely propose a new rule that assesses a special fee on banks because it guaranteed all deposits at failed SVB and Signature Bank.

In addition, we believe banks will likely tighten their lending standards. If you were running a bank today, we imagine you'd likely hold onto your capital a little tighter in this type of volatile environment, right? We can't quantify this headwind, but we have to guess that banks will add additional risk management procedures.

In addition, costly compliance burdens are absolutely on the rise. Finally, we expect banks to keep a more liquid balance sheet, which will pressure their profitability. All of these issues will pressure margins and drive bank profitability lower.

## M&A:

In addition to lower profits, we expect some changes to banking M&A. In the short-term, the only M&A will probably be just distressed deals, like the First Citizens deal mentioned above. Most banks will choose to "hunker down" and focus on specific, internal issues right now.

Over the intermediate term, it will be challenging to do deals, if one doesn't fully understand the regulatory environment. Will regulators choose to alter how banks classify their investment portfolios. With regulatory scrutiny on interest rate marks, whether banks have investments in the HTM or AVS bucket, we believe it makes merger math more difficult.

Longer-term, we think bank M&A will increase. Any expected increase in regulatory burdens will disproportionally burden smaller banks. Some will simply choose to sell out and make life easier on themselves. Finally, there are still too many banks in the US. On a per capita basis, there are 12.8 financial institutions per 1 million US citizens, which ranks 6th in the world. For comparison purposes, Canada only has 5 large banks (Toronto Dominion (TD), Royal Bank of Canada (RBC), Bank of Nova Scotia, Bank of Montreal, and Canadian Imperial Bank of Commerce (CIBC).

Over the past decade, the banking industry has seen an average of about 228 deals per year. We would not be surprised to see that number rise to perhaps 350 per year. Longer-term, we wouldn't be surprised to see the total number of banks, credit unions, thrifts, community banks here in the US fall by 20% from today's bloated levels.

## Regulatory Changes:

After the Financial Crisis, the market received thousands of pages of new regulations, in the form of Dodd-Frank reforms. We expect this crisis will lead Washington to act. Never underestimate regulators taking advantage of a crisis by instituting more powerful controls over an industry.

Will regulatory changes impact how banks account for their bank security portfolios? Will HTM continue to ignore mark-to-mark accounting? Will all bank investments be forced to run through the income statement and bring heightened volatility and fluctuations to earnings? Can regulators force banks into solid risk management procedures? We aren't sure, but we won't be surprised to see these type of valuation and accounting changes come out of this crisis.

In the camp of "you can't make this stuff up", the co-author of Dodd-Frank was Massachusetts Congressman Barney Frank. Following 32 years of service, Barney retired. What was he recently up to? Well, Barney was on the Board of Directors for NY-based Signature Bank, which was seized by regulators just days after SVB.

## Other Challenges:

SVB isn't the only troubled financial institution right now. For example, First Republic seems to be gaining significant market attention. Its recent turmoil reminds us of Long-Term Capital Management in 1998. Back then, Long-Term Capital Management blew up almost overnight. They had tremendous leverage, which became exposed by an emerging market crisis. There would have been an enormous dislocation in the fixed income market, risking serious contagion to others, if there wasn't a strong market response. The Fed got the biggest investment banks together and essentially told them to fix "their problem", by each contributing capital to stabilize the situation, without taxpayer capital. This was enough to placate the situation and a large potential problem was averted.

Fast forward to today and we see similar actions by the Fed. A week or so ago, the Fed "not so politely" asked big banks like JPM, Citi, Wells Fargo, Goldman Sachs, Morgan Stanley, and others to infuse $30 billion of capital into First Republic to fortify their equity base. Sounds familiar, right?

Another Financial Crisis tactic was forcing certain entities to acquire weaker participants. JP Morgan acquired Bear Stearns in March of 2008 for $1.4 billion (with $30 billion of Federal Reserve backstops), as well as WaMu for $1.9 billion. Eventually, JP Morgan came to regret those deals. Years after it helped save those two companies, government regulators slapped $19 billion of fines against JP Morgan. So much for helping out the industry. It is no wonder Jaime Dimon, CEO and Chairman of JPM, isn't interested in doing any more "shotgun weddings".

During the Financial Crisis, the Fed and Treasury were forced to create programs to prevent mass contagion. Our regulators placed significant reforms on the investment banks and had the investment brokers convert into banks overnight. In 2010, Dodd-Frank rules were enacted that fortified capital requirements and instituted many rules (like the Volker rule) that prohibited proprietary trading.

Now that we have seen SVB and Signature Bank collapse, there are contagion problems affecting other regional banks. Initially, the Fed, Treasury and FDIC came out and backstopped that key $250,000 depositor guarantee. That was their first priority and they successfully provided that level of stability.

Then, it created a new vehicle, called BTFP or bank term funding program. This essentially gives a bank a 1-year loan or liquidity with the pledging of US Treasuries, agency debt, mortgage-backed securities, and other qualifying assets as collateral. The key for us was that all of these assets will be valued at par, which clearly isn't mark-to-market accounting, right? The BTFP is key source of liquidity that banks can utilize on their "high-quality securities", eliminating their need to quickly sell those securities in times of stress. Just like SVB had to do. This was right out of Paulson's and Bernanke's playbook in 2007 and 2008.

Will these recent actions do enough to stabilize the market? Will there be additional actions taken? Will the government institute additional regulatory protections and rules? We believe more is coming, but a key takeaway, from our perspective, is that banking margins will head lower. The key for us is that the US will continue to backstop the banking industry, as it is way too systemically important to allow to falter. It touches every aspect of consumer and business life, and the government cannot risk ***not*** having a strong and resilient US banking system. Period, end of story.

## Unintended Consequences:

We started this discussion by mentioning how FTX and Silvergate's collapse had some impact on banking problems this month. It is quite interesting to see what has happened to digital currencies since March 10th and this wave of banking volatility. Bitcoin is up nearly 70% this year. Coinbase, the dominant digital currency exchange is up a whopping 80% this year, although it received a Wells notice last Friday.

A Bernstein analyst called recent banking sector jitters *"the perfect setting for Bitcoin, Ethereum and the rest of the decentralized-financial system, to stand apart from the centralized banking system."* Others have said that crypto is a solution to this banking failure, and that our current system is too opaque and fraught with continuous regulatory lapses.

Could Bitcoin actually be a "flight to quality" asset, as banks struggle? We aren't going to make that statement, but we are fascinated to see it rallying in the midst of this banking turmoil.

## Conclusion:

We never bring politics into our research and aren't going to start now. We simply want to highlight a key point that President Biden made, right as SVB failed. He said, *"Investors in the banks will not be protected. They knowingly took a risk and when the risk didn't pay off, investors lose their money. That's how capitalism works."* Now, we agree with his point, but it was interesting timing to say right as the banking industry just experienced its 2nd largest failure in US history and regulators were providing assurances that the banking system was resilient and safe. We simply find it interesting that he felt compelled to mention that the government would not bail out investors in this failed bank and to tell the public exactly how capitalism really works.

Our takeaway is that more regulation is coming, and it will pressure bank profitability. Instead of regional or smaller credit unions or community banks thriving, we anticipate that the big banks will only get bigger. The goal with Dodd-Frank was to limit how the market was susceptible to systemically important financials and prevent any banks from becoming "too big to fail." Following this bout of banking volatility, universal banks like JP Morgan Chase, Bank of America, Citi, Wells Fargo, and Schwab gained assets and got bigger at expense of weaker regionals banks.

Two weeks post SVB's collapse, deposit concerns for regional banks remain a key focus. For example, the top 25 domestically chartered banks saw their market share increase to 66.4%. These large financial institutions garnered over $108 billion of new inflows, at the expense of the next largest 850 banks. This is unfortunate and exactly what the regulators do not want to happen, but it appears to be what is occurring. The big are getting bigger and becoming "too big to fail".

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