tra® Credit Services

Banking Sector Conditions and Outlook: 2023

CRE Banking Counterparty Risks | March 2023

Following the collapse of Silicon Valley Bank and Signature Bank, and the distressed First Republic Bank, commercial real estate companies throughout the U.S. and across asset classes suddenly see risks associated with both their own credit facilities and the health of their tenants and their tenants' banks. In this document, TRA provides insights to its clients and the industry to navigate the challenges in the new landscape.

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What happened to the global banking sector?

In short, there was a material degradation of confidence in the banking sector that started with the rapid collapse of Silicon Valley Bank (SVB), quickly spreading to other regional banks like Signature Bank and First Republic Bank. Deposit outflows at major regional banks was sparked by large balance personal and business accounts that wanted to find a safe harbor in the storm by opening accounts with global systemically important banks (G-SIBs), which are deemed too big to fail and will trigger broad central bank and local federal government support to preserve their solvency. Why now is explored in this report.

Inquiries

Visit us at our website:
www.tenantriskassessment.com

E-mail us at:
info@tenantriskassessment.com

SILICON VALLEY BANK POSTMORTEM

KEY POINTS

1. SVB saw net deposit outflows beginning in the second quarter of 2022, weakening its balance sheet, with net outflows continuing through year end.
2. SVB tapped into FHLB advances to improve its statutory and regulatory capital levels beginning in the second quarter of 2022.
3. SVB sold all its available for sale securities in March 2023, triggering a rapid loss in confidence leaving the bank insolvent.

Why SVB Collapsed

- Silicon Valley Financial (SVB) suffered a rapid loss of confidence, exacerbated by social media and other rapid communication, due to a highly concentrated customer group largely comprised of west coast technology companies, their owners, and their venture capital firms.
- The subsequent run on the bank starting on March 8, 2023 when SVB announced the sale of its available for sale securities resulting in a $1.8B loss, rapidly eroded its liquidity and marking its liquidity effectively to zero.
- The bank did not maintain sufficient interest rate hedges to protect it against its long-term holdings of agency backed mortgages and long-duration treasuries in a rising rate environment.
- SVB was unable to sell itself or raise additional capital, resulting in its receivership on March 10, 2023.

EXHIBIT 1

SVB Financial Group Available for Sale Securities Write Down

SVB FINANCIAL GROUP AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31,	
(Dollars in millions, except par value and share data)	**2022**	**2021**
Assets		
Cash and cash equivalents	$ 13,803	$ 14,586
Available-for-sale securities, at fair value (cost of $28,602 and $27,370, respectively, including $530 and $61 pledged as collateral, respectively)	26,069	27,221
Held-to-maturity securities, at amortized cost and net of allowance for credit losses of $6 and $7 (fair value of $76,169 and $97,227, respectively)	91,321	98,195
Non-marketable and other equity securities	2,664	2,543
Total investment securities	120,054	127,959

SVB Financial announced the sale of substantially all its available for sale securities on March 8, 2023 at a $1.8B after tax loss

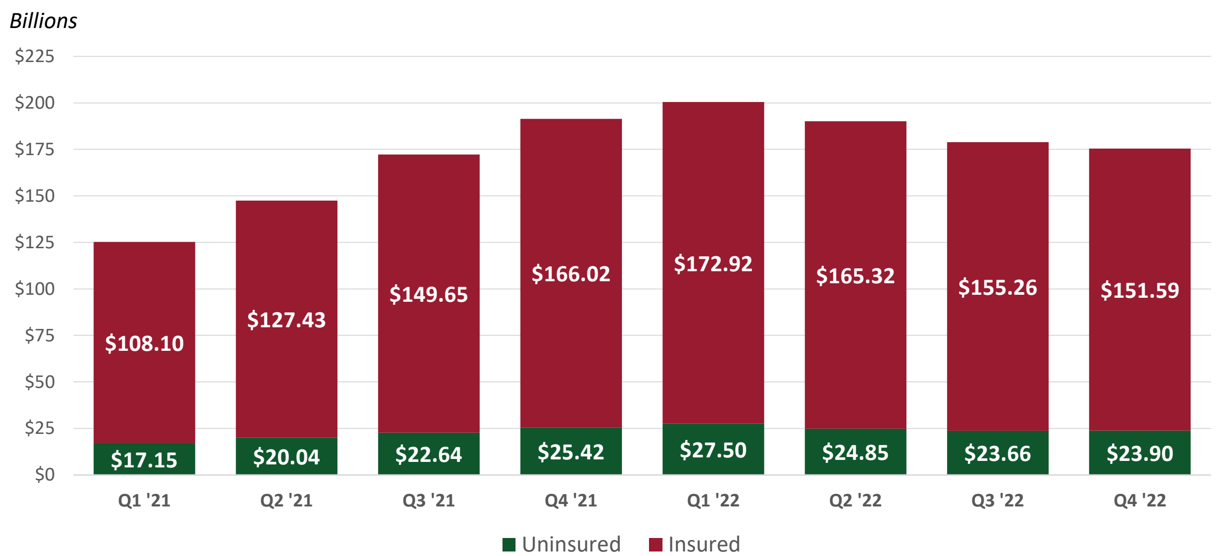
Source: SVB Financial Group

Markers of Pending Trouble

- The bank had substantial uninsured deposits, indicating that its deposit base was concentrated among high dollar accounts rather than widely diversified customers.
- Demand deposits comprised the majority of the company's funding, allowing potential banking customers to seamlessly withdraw cash and move to other bank's with little to no friction.
- The company also only had limited branches, reporting 17 branch locations in California and Massachusetts, giving the bank high regional concentration.

EXHIBIT 2

Silicon Valley Bank Deposit Balances by FDIC Insurance Status

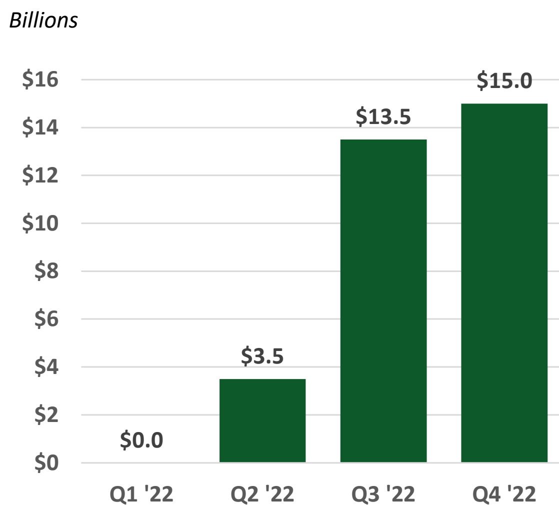


Source: FDIC

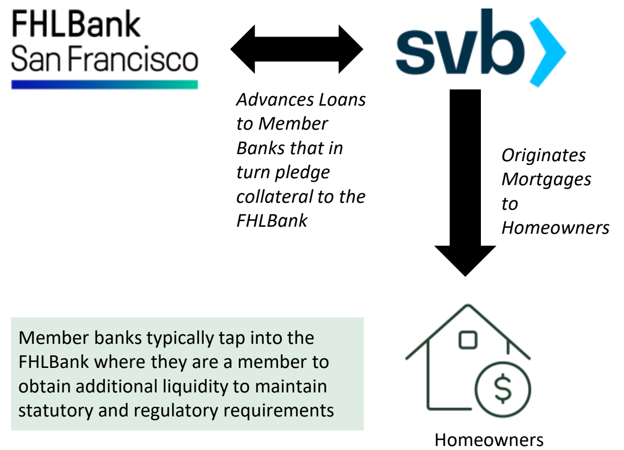
- In mid-2022, the, as deposit outflows continued, SVB tapped advances from the Federal Home Loan Bank of San Francisco (FHLBSF) to beef up its capital base.
- SVB's market to available for sale securities, which totaled $26.1 billion as of December 31, 2022, were comprised of $16.1 billion of U.S. Treasuries, $6.6 billion of agency issued mortgage-backed securities, and approximately $3.4 billion in a variety of other low risk, interest rate sensitive assets. These were held at a cost of $28.6 billion, indicating a paper loss of $2.6 billion.
- The bank did not have adequate hedges in place against rising interest rates, and thus as the U.S. Federal Reserve (Fed) continued to hike rates throughout 2022, the bank failed to protect its available for sale investments, which are marked to market, which became increasingly apparent on its year end 2022 earnings call.

EXHIBIT 3

Federal Home Loan Bank Advances to Silicon Valley Bank



Federal Home Loan Bank Liquidity Model to Support Stressed Member Banks



Source: Federal Home Loan Bank San Francisco

Commercial Real Estate Implications

- Landlords holding a letter of credit issued by SVB on behalf of a tenant should request the tenant replace its letter of credit with a new bank as quickly as possible.
- Landlords should inquire what new bank tenants will transition to (if applicable) to continue making rent payments.
- Landlords who have credit facilities or term loans with SVB should continue to make payments on the facilities or loans and on schedule per the terms of the original loan.

REGULATORY RESPONSE

Short-term U.S. Response

Investors and depositors were anxious about the strength and stability of smaller regional banks, and as a result, there was a pivot among some bank customers who moved deposits to larger G-SIBs like J.P. Morgan, Bank of America, Wells Fargo, and others, that are deemed "too big to fail." Bank regulators, including the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of Currency (OCC), and various state regulators coordinated to assure depositors that their money was safe, even beyond the FDIC limits of $250 thousand. The rational for this move was to limit outflows from regional banks and prevent contagion from spreading to other lenders. The Fed did this by increasing its balance sheet by $300 billion, about $143 billion of which went to SVB and Signature Bank's uninsured depositors, while the remaining went out to other banks through the Fed's long established Discount Window, known as the lender of last resort to prop up struggling financial institutions.

While bank regulators and supervisors do not appear blameless in our current environment, their initial steps are meant to instill any confidence the market lost during the early days following the collapse. In effect, the regulators, along with the other U.S. based G-SIBS and other private sector operators stepped in to stabilize the markets. It will now be incumbent on regulators and law makers to work in tandem with global central bank partners and law makers to do the hard work of re-calibrating the financial system for the rising rate environment.

Medium-Term Response

Following the Fed's quick injection of liquidity, it has worked with global central banks to facilitate U.S. dollar liquidity by enhancing U.S. dollar liquidity swap lines from weekly to daily. The Fed's partners in this plan include the European Central Bank, the Bank of Canada, the Bank of England, the Bank of Japan, and the Swiss National Bank. This is intended to ensure banks have sufficient capital to lend to businesses and households while remaining liquid with their respective counterparties.

The are also discussions around expanding FDIC insurance above the existing $250 thousand limits long-term, which is meant to assuage concerns around companies maintaining access to working capital at their preferred banking institutions.

The Fed also needs to remain responsive to inflation through ongoing rate hikes while preserving the integrity of the financial system. If inflation remains stubborn, rate hikes will be more likely to continue throughout 2023 unless the global financial system proves too fragile.

Conclusions

Financial crises are fast moving and while we appear to have put out most near-term fires, there remains considerable uncertainty around the future structure of the financial system and how it will operate, regulate, and supervise in light of the new challenges we face in both an inflationary environment with rising rates.

It's clear there are many parties at fault for the current crisis, from the banks themselves, the regulators and supervisors hinting at partial dereliction of their duties to properly oversee and enforce change on banking institutions (including measurement of banks regulatory capital) ratings agencies that did not adequately model the rapidly deteriorating balance sheet quality. It feels very much like the architecture of the financial system was not prepared for the new challenges that 15 years of low rates thrust upon us.

TRA is working to understand the evolving nature of the banking sector and how it can serve its clients needs around banking counterparty risks. To that end, we are updating our models to better capture insured and uninsured deposit balances, closer scrutiny of a bank’s available for sale securities, including holdings, unrealized losses, and duration, FHLBank activities, and others. We will also seek to understand how changing regulations and laws may impact the future banking climate and how it could impact the commercial real estate sector and our clients.

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