SVB Collapse Highlights Importance of Bank Resiliency

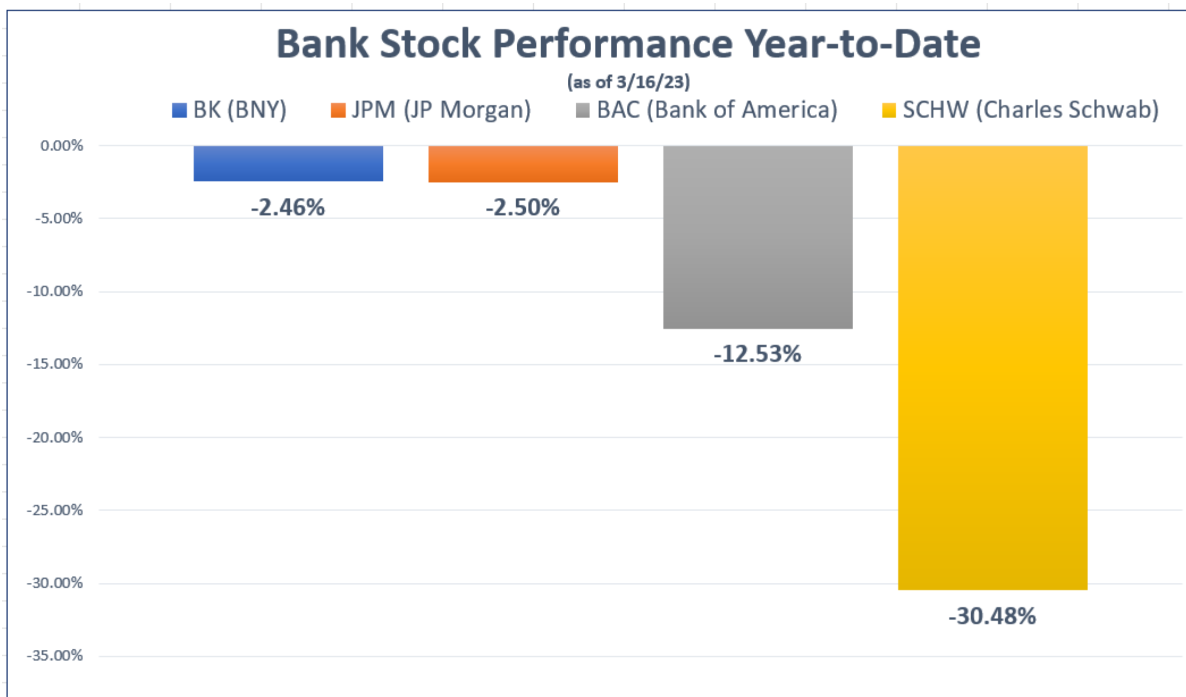
The sudden collapse of Silicon Valley Bank (SVB) has roiled the markets, panicked investors, and left many observers wondering whether we are on the precipice of another financial crisis. The Federal Government has taken the unprecedented step of ensuring all depositors of SVB will be able to receive the full value of their accounts, beyond the standard $250,000 FDIC insurance, in hopes of stopping panic and preventing further bank runs. While it remains to be seen how far-reaching the fallout from SVB's collapse will be, we thought it would be helpful to examine what caused the problem and how Hanover's custodial partner is working to limit risk and safeguard client assets.

There is sure to be a great deal of discussion in the coming days and weeks over what led to SVB's collapse and whether misguided corporate policies were to blame, or if the bank's poor risk management was indicative of moral hazard. However, the financial collapse of the bank was relatively straightforward. Ultimately, SVB was brought down by a combination of its highly concentrated deposit base and very large unrealized losses on Treasuries and mortgage bonds. The bank saw a massive influx of deposits amid the pandemic-era tech boom, fueled by IPOs and SPACs. To ensure liquidity, banking regulations require banks to hold a reserve of high-quality liquid assets, most commonly in the form of Treasuries, but also mortgage-backed securities and some corporate bonds. This introduces a great deal of interest risk, particularly in an environment of rapidly rising interest rates. Banks can manage risk through credit swaps and other means of hedging. Not only did SVB apparently not hedge its interest risk by any means, but the bank did not even have a risk manager in place for several months prior to its collapse, exposing its investors and depositors to a massive amount of risk.

According to an analysis from The Macro Compass, SVB's $120 billion bond portfolio had an average non-hedged duration of 5.6 years. This means that a 10-basis point increase in the 5-year interest rate cost the bank about $700 million. A 200-basis point increase meant a $14 billion economic loss, effectively wiping out the bank's entire capital. Of course, these losses are unrealized, and only materialized when depositors started taking money away from the bank, forcing SVB to realize this huge loss by selling its holdings to provide cash for fleeing depositors. The highly concentrated depositor base and poor risk management caused

SVB to collapse quickly.

Luckily, a Bloomberg analysis found that there are no other publicly traded banks in the U.S. that have balance sheets similar to SVB's. However, investors are growing more nervous about the massive amount of unrealized losses banks are sitting on in their bond portfolios. According to the FDIC, at the end of 2022, U.S. banks were sitting on $620 billion in unrealized losses on their bond assets. Banks poured billions into U.S. Treasuries when interest rates were much lower. Because rates have soared over the past year, these bonds have significantly declined in value, and in the event that banks need to sell them, they could realize massive losses that could wipe out shareholder equity, which is the amount due to investors after a company's debts and liabilities are paid off. Much of the panic selling has focused on smaller niche banks. First Republic, for example, has seen its value plummet a staggering 78.53% year-to-date. However, investors are realizing that even some larger financial institutions may be ticking time bombs. Charles Schwab's stock has tumbled more than 30% year-to-date, as investors reconsider the potential losses facing the bank. According to its annual 10-K report, Charles Schwab is sitting on $27.9 billion in unrealized losses. The bulk of Schwab's bond holdings across both its available-for-sale and held-to-maturity securities have a duration of more than 10 years with a weighted-average yield significantly lower than today's yields. Schwab's available-for-sale securities totaled nearly $150 billion with an average-weighted yield of 2.13%, while its held-to-maturity securities totaled $159 billion with an average-weighted yield of 1.74%. Because investors today can easily buy a 2-year Treasury note with a yield that is nearly triple that, Schwab's bond holdings would have to be sold at a significant loss if it were forced to liquidate a significant portion. Schwab has assured investors that depositor in-flows remain positive, so it is unlikely that they will be forced to realize all of these potential losses, but the recent downturn in their stock price reflects the lack of trust that investors have in the bank.



By contrast, Hanover's custodial partner, BNY Mellon, has seen its stock fall just 2.5% year-to-date. Much of banking sector has seen losses in recent weeks as panicked investors flee the entire sector, but BNY's strong performance relative to other financial institutions is a testament to the strength that investors see in the bank. Hanover chose to work with BNY, and their brokerage subsidiary Pershing, in part because of the size and stability of the bank and its proven track record with safeguarding client assets. BNY has been in operation for more than two centuries and has navigated depressions, recessions, and financial crises, and was named the custodian overseeing the government's Troubled Asset Relief Program (TARP) during the 2008 financial crisis. BNY oversees more than $44 trillion in assets under custody, and its designation as a Globally Systematically Important Bank (GSIB) means it is subject to stringent capital and liquidity requirements and undergoes regular stress tests and audits from independent auditors. GSIBs are designated by the Financial Stability Board, an international group that monitors the global financial system. While these banks are usually referred to as "too big to fail," size alone is not a determining factor. Some huge banks, such as Charles Schwab, are not deemed to be integral to the stability of the global economy and are thus not subject to the same level of scrutiny.

These are uncertain times, and while the Federal Reserve has stepped in to limit any potential fallout from the collapse of SVB, it remains possible that we will see further bank runs and deterioration of the financial system. The entire global financial system is rife with mismanagement, so it is more important than ever to carefully vet your financial institutions to ensure that you are not adding more risk to an already risky investing environment. We believe that the aggregate wisdom of the markets has demonstrated the resiliency of BNY and their commitment to securing the assets of Hanover clients. For more information on how the fallout of SVB is impacting the markets and broader economy, be sure to keep an eye out for upcoming Investment Commentary and Q1 review video in the coming weeks. If you have any questions or concerns, please contact us today.

The Protection of Client Assets Remains at the Center of Our Focus

FINANCIAL STRENGTH—DECEMBER 31, 2022

BNY MELLON'S PERSHING

- Over $2.0 trillion in global client assets
- Net capital of over $2.0 billion—well above the minimum requirement

THE BANK OF NEW YORK MELLON CORPORATION

- $44.3 trillion in assets under custody and/or administration
- $1.8 trillion in assets under management