



## Market Thoughts 3.13.2023

The last few days have been a whirlwind for bank depositors, lenders, investors, and regulators. On Thursday, March 9, Silicon Valley Bank (SVB)—one of the 20 largest commercial banks in the country—experienced a steady stream of large withdrawals that led to its almost-immediate failure. Three days later, on March 12, state regulators closed a second institution, the New York-based Signature Bank, citing systemic risk.

Following this and the corresponding explosion in media coverage, it's natural to feel alert. After all, it's difficult not to compare these events with those of the bank bailouts of 2008. Yet there are several important differences between now and then. Understanding these differences can help investors be more confident in their financial decisions.

### Recapping What Happened

SVB served a highly concentrated group of clients, mostly in and connected to the venture capital community in California. Over the last three years, total deposits at the bank tripled as its core clientele experienced a wellspring of new money, aided by easy monetary policy.

The bank had to do something with this influx of cash and there was little demand for loans, so SVB invested in high-quality bonds and held them on its balance sheet. As a rule, banks are funded with short-term liabilities—that is, deposits—and invest in longer duration assets. This can create a mismatch when short-term deposits are withdrawn, and that's what happened to SVB.

Over the last year, as interest rates rose, bond prices fell. As of late February 2023, SVB's long-term bond portfolio had unrealized losses of about 18 percent, which the bank would normally continue to

hold. Note that this is a common practice and is allowable by bank regulations. As long as deposits remain stable, banks can handle unrealized losses. And unrealized losses from high-quality bond portfolios are generally safe ones to have. But when clients began withdrawing their deposits at a rapid pace, the bank found itself short on capital.

This happened for three main reasons. First, many customers began shifting their money out of deposit accounts and into higher-paying money market funds and short-term bonds. Second, cash flows from venture capital investments began to slow down, so startup clients had less money to deposit. And third, the decrease in total deposit amounts began to create rumors and worries among depositors, which in turn created more withdrawals. This is what the industry calls a *bank run*.

To meet demand for client withdrawals, SVB had to sell bonds from its portfolio and did so at a loss of over \$1.8 billion. This realized loss impacted the book value and capital base of the bank, making it insolvent almost overnight. By the end of the day on Friday, March 10, California regulators took over the bank and began liquidating it, selling SVB's assets and pieces as quickly as possible.

## **The Response**

On Sunday, March 12, the U.S. Treasury stepped in to protect SVB's depositors. As a reminder, the Federal Deposit Insurance Corporation (FDIC) already insures up to \$250,000 per depositor, per insured bank. On top of this insurance, the U.S. Treasury agreed to serve as a *backstop*—a secondary source of support—for all SVB deposits, providing at least implicit coverage beyond the \$250,000 FDIC insurance levels. This is notable because the Treasury is effectively guaranteeing every bank deposit in the country.

The same day, the Federal Reserve created the new Bank Term Funding Program (BTFP) to help guard against excessive liquidity demands and withdraw demands on banks. To do this, BTFP will offer loans of up to one year to banks, savings associations, credit unions, and other related institutions. In exchange, those institutions will need to pledge high-quality collateral, such as Treasury bonds or mortgage-backed securities.

Banks are only as safe as their depositors' confidence in them. Both moves focused on increasing confidence across the banking sector regarding the safety of deposits.

## **How This Differs from 2008**

The global financial crisis of 2008 was caused by a massive amount of low-quality lending throughout the banking system. This led to a corresponding amount of *credit defaults*, which is when people or institutions fail to make required repayments on a bank loan. Markets are familiar with credit defaults and with poorly underwritten loans.

The SVB liquidation, which was due to a reduction in bond values, was caused almost entirely by *duration risk* instead. In other words, the bonds that SVB invested in lost value not because of credit default—the prevailing cause of crisis in 2008—but because rising interest rates reduced the value of



those bonds. The Federal Reserve created the conditions for this risk by increasing interest rates throughout 2022.

Additionally, the federal government's response has been far different from its response in 2008. Currently, the response feels less like a bailout and more like a support program. Throughout the global financial crisis, taxpayers paid much of the bill. This time, regulators seem to have learned from previous mistakes and are intentionally avoiding repeating the same process.

Here's how. To protect depositors, the FDIC will use money from an existing fund called the Deposit Insurance Fund (DIF). The DIF is funded by quarterly fees assessed on FDIC-insured financial institutions, plus interest earned through investments in government bonds. The DIF currently contains more than \$100 billion, which is enough to cover a huge number of depositors, including those at SVB and Signature Bank.

The BTFP will also play an important role, immediately safeguarding the banking institutions that are vulnerable to bank runs and market instability. Because BTFP is a loan program, taxpayer dollars are not at risk.

One additional, important difference: Although these measures protect bank depositors, they do not protect those who were invested in the failing banks. In other words, the individuals and institutions that invested in SVB or Signature Bank will take losses as previous owners of those banks. The regulators' focus has been on protecting bank clients, not investors or executives.

These differences are a direct result of the lessons learned from the bank bailouts of 2008. In addition to the swift actions taken by regulators over the weekend, significant regulatory reforms have been put in place since the global financial crisis that can protect depositors and taxpayers from similar consequences.

## **Going Forward**

Throughout the weekend, the CAPTRUST Investment Committee and Investment Group worked hard to understand this complex and fluid situation. As always, the goal was to better understand the scale and scope of all possible outcomes and to protect clients' assets.

At this time, both teams feel confident that the client assets over which CAPTRUST has fiduciary responsibility are both safe and well-kept due to the quick reactions of federal agencies and regulators. The foundational support provided by the U.S. Treasury, FDIC, and Federal Reserve has already increased confidence regarding the safety of deposits, thereby reducing the risk of bank runs.

Despite these increased protections, we would encourage clients to evaluate all cash balances, and stay below the \$250,000 FDIC-insured amount if possible. Investing excess balances in a standard money market fund or other direct investments can help to insulate against certain bank deposit risks and may provide higher yields.



In almost every major financial crisis throughout history, the banking system has been ground zero. This can lead investors to react emotionally to any potential warning flags. Yet financial crises are almost always caused by systemic issues in the banking system, which is not the case today. SVB's failure was caused by duration risk and by its exposure to particular industries, namely venture capital and the technology sector. Most other banks are more diversified.

When there is alarming financial news or market volatility, it can be difficult to remain levelheaded and resist emotional decision-making. In these cases, focus on what can be controlled. Staying invested and diversified can help guard against volatility. Also, remember not to conflate deposit risk with the risk to brokerage accounts. A financial advisor can be a helpful resource to help navigate uncertainty and risk.

CAPTRUST will continue carefully monitoring the situation as it evolves.

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