Bank Instability — Important Considerations for Private Equity Investors

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Since inflation and rising rates were not exciting enough, "Mr. Market" thought destabilizing the US banking sector should get investors' attention. Just weeks ago, Silicon Valley Bank ("SVB"), a 40-year-old $220bn commercial bank experienced one of the fastest bank runs in the history of the US. The result was an FDIC takeover followed by the bank being designated as a systemic risk. Signature Bank quickly followed the same path. Other regional banks have seen their stock prices decline and Credit Suisse has been thrust into a forced marriage with UBS by Swiss regulators. Bank regulators are now contemplating actions to restore confidence, and we discuss two options below. As they say, there are weeks when decades happen.

While every market crisis has unique characteristics, we have seen plenty of rhymes given Adams Street's 50-year history of investing in private markets. Investors are asking us two key questions — "What happened?" and "Does bank instability create risk (or opportunity) in my private equity portfolio?"

Bank Instability — What Happened?

In a nutshell, SVB's asset/liability duration was mismatched. They were reaching for yield but were left exposed as rates rose dramatically all while deposits were declining.

SVB clients include many venture-backed companies. During 2020-2021, hedge funds and corporate venture funds invested unprecedented amounts into rapidly growing but cash-burning pre-IPO venture deals, a cyclical phenomenon we call "venture tourism". A healthy portion of the cash raised by these companies found its way to commercial deposit accounts at SVB. By year-end 2021, SVB's deposits had risen to $148bn, nearly double the $75bn from the prior year.

If SVB had concluded this cash surge was cyclical with risk of reversal, they might have invested into short duration assets which could be sold quickly with little impairment. Instead, SVB invested in longer-dated fixed income instruments which offer more yield but can decline in value if left unhedged during a rising rate environment. This is exactly what happened.

Concerns surfaced about SVB's deposit erosion as commercial client burn rates exceeded new fundraising. Management was unable to raise capital before its stock price fell and clients attempted to pull $42bn on March 9 alone, tripping the FDIC seizure trigger.

The FDIC receivership playbook is straight forward — immediate access to insured deposits ($250k per depositor, per ownership category) with uninsured deposits typically getting most, if not all, of their money back over time as the FDIC sells the bank's assets. This playbook generally works well for retail and small business banks where most deposits are small.

However, the FDIC playbook can be a problem for a bank with large commercial clients that cannot wait months to access their cash. As any CFO of a company with several hundred employees or more will admit, it is nearly impossible to run their business on less than $250k in deposit accounts. By necessity, these companies have bank accounts with sizable uninsured balances that fluctuate as wires are received from customers and money is wired to suppliers and employee payroll providers.

According to *The Wall Street Journal*[1] SVB's uninsured deposits represented ~90% of total deposits. However, Bank of New York and State Street, two banks active in custody and clearing for hedge funds and other trading outfits were also ~90%. Citibank hovered at ~80%, while JPMorgan Chase and Bank of America were at ~60%. Some of these banks offer sweep policies that move uninsured deposits nightly into uninsured but diversified money market accounts. But practices vary, and during banking hours uninsured balances are largely exposed.

The FDIC receivership playbook would be a problem for commercial clients at any of the above-named banks and countless others. That is making regional commercial bank shareholders and clients nervous. CFOs across the country seem to be concluding, "the federal government won't let a huge bank go to FDIC receivership, so I better move my uninsured deposits there." This is dangerous sentiment for well-run regional commercial banks that provide valuable operational services that larger banks cannot or will not match.

Is My Private Equity Portfolio at Risk?

Under the systemic risk designation, SVB and Signature deposits are fully insured and pose no risk to private equity investors. However, absent a systemic risk designation, other banks' uninsured commercial deposits could become inaccessible under FDIC receivership.

This liquidity trap appeared in the FDIC seizure of SVB, forcing many companies to seek emergency funding and prepare for mass layoffs. Had it not been for the systemic risk designation, venture capital and private equity returns would likely have been harmed by underlying company disruptions/closures due to acute liquidity needs.

The SVB experience has undoubtedly spooked CFOs of every operating company and private equity firm. We expect that all commercial enterprises are actively diversifying their bank relationships, which can reduce liquidity trap risk, but not eliminate it. We think if regulators were to either increase FDIC commercial deposit insurance at regional banks or modify the FDIC receivership playbook to grant immediate access to a significant portion of uninsured commercial deposits, that either move will likely calm CFOs, getting them comfortable keeping commercial deposits at well-run regional banks. Regulators must thread the needle of restoring confidence while not creating moral hazard risk.

In terms of opportunity, private equity tends to thrive in times of dislocation. While traditional banking is a small part of private equity portfolios, we expect private equity firms with deep domain expertise and experience investing across cycles to find compelling opportunities in this dislocation. That includes partnering with management teams of well-run financial institutions suffering a short-term confidence crisis as well as working with venture-backed CEOs looking to disrupt the industry.

Regardless, investors will likely welcome returning to the ho-hum worries of inflation and rising rates. ■

1. Source: *The Wall Street Journal* "The Banking Sector Turmoil in Charts" March 18, 2023.

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