Never Let a Good Crisis Go to Waste

Due Diligence on the Sale of Silicon Valley Bridge Bank to Another Regional Lender

By Lance Pan, CFA®
Director of Investment Research and Strategy
lpan@capitaladvisors.com

Introduction

The acquisition of Silicon Valley Bridge Bank's (SVBB) loans and deposits from the FDIC by First Citizens Bank (FCB) resolved a major uncertainty for customers and depositors of the failed Silicon Valley Bank (SVB). The transaction allowed the FDIC to move on from the second largest bank failure in US history. SVB customers and depositors also gained clarity on the identity and capabilities of their new banking partner. And FDIC-assisted measures appear to provide some guardrails at the new bank in the near-term.

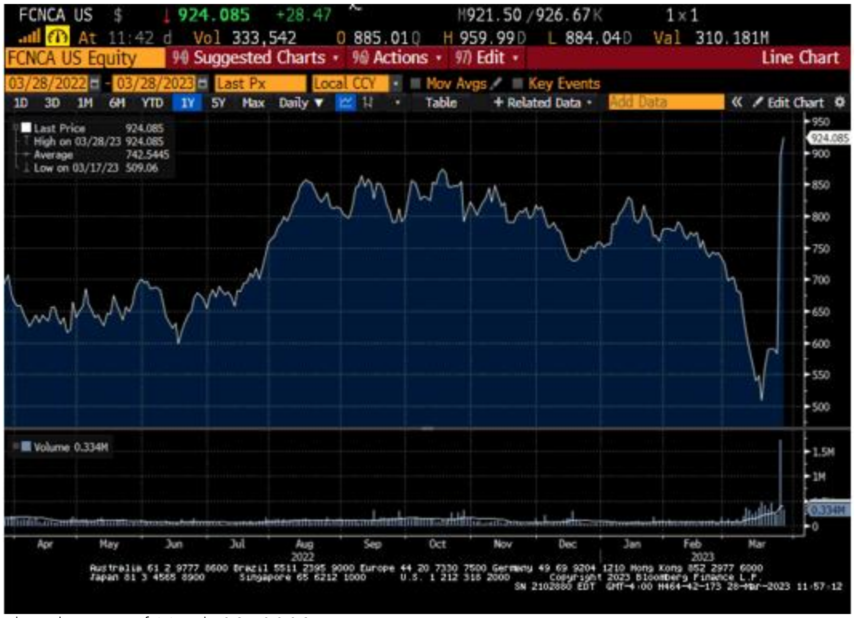
However, the "systemic exception" protection for deposits above $250,000 disappeared as soon as the bridge bank was absorbed by FCB. In addition, the curious selection of FCB as the acquirer deserves scrutiny as it shares some of the characteristics that contributed to SVB's failure. Due diligence on the risk culture and operational capabilities at FCB is thus imperative to protect against liquidity and solvency concerns in the future.

A Sweet Deal for the Newcomer[1]

After several rounds of unsuccessful attempts to dispose of the assets and liabilities of the failed bank, the FDIC agreed to sell substantially all of its loans and remaining deposits to FCB, the banking entity of Raileigh, NC-based First Citizens BancShares, Inc. (FCNCA). FCB received $110.1 billion of SVBB's assets, including $72.1 billion of loans at a discount of $16.5 billion. It assumed about $59.0 billion in liabilities, $56.5 billion of which were deposits, without a premium. About $90 billion in securities, which contained Treasury and government mortgage-backed securities that lost value due to higher interest rates, remained in FDIC receivership. On March 27, the 17 legacy SVBB branches began operating as Silicon Valley Bank, a division of First Citizens Bank.

The FDIC provided a five-year, $35 billion loan to help FCB close the deal. It also entered into a loss-sharing agreement with FCB to cover an estimated $60 billion of loans at 50% of losses after the initial $5 billion. FCB agreed to return to the FDIC 50% of recoveries. In addition, the FDIC provided a five-year, $70 billion line of credit that FCB can draw in the first two years against potential deposit flight. An equity rights agreement linked to FCNCA's stock entitles the FDIC to benefit from future share gains up to $500 million. The cost of SVB's failure to the government's deposit insurance fund is estimated to be around $20 billion.[2]

[1] See First Citizens' 8K filing with the SEC on March 26, 2023. ir.firstcitizens.com/financial-information/sec-filings/default.aspx.
[2] See the FDIC's press release on the transaction on March 26, 2023. www.fdic.gov/news/press-releases/2023/pr23023.html.



Bloomberg as of March 28, 2023.

The deal appears to be a boon to FCNCA's shareholders, demonstrated by the one-day 54% jump in the share price. It was somewhat of a surprise to bank analysts that the FDIC awarded the sale to a lesser-known regional lender, while larger banks such as PNC Financial and Royal Bank of Canada passed on the opportunity after expressing initial interest.[3] The only other bidder at the last round of auctions was Valley National Bank, a Wayne, NJ-based bank about half the size of FCB.

A possible explanation is that FCB has won and successfully managed FDIC-assisted acquisition of more than 20 other failed banks since 2009.[4]

A New Owner That Looks Like the Old[5]

First Citizens was the 30th-largest commercial bank in the US as of Dec. 31, 2022, with $109 billion in assets, $72 billion in loans and $56 billion in deposits.[6] Founded as the Bank of Smithfield in 1898, it operates about 530 branches in nearly 20 states, mainly in the southeastern and western US and some urban areas nationwide. In addition to traditional banking services, FCB offers investment management and operates as a broker-dealer of investment products. About 65% of its revenue comes from loan and lease payments, while no other business lines generate more than 5% of total revenue.[7]

With $220 billion in *pro forma* assets as of December 2022, the combined FCB/SVBB bank would have ranked the 14th largest commercial bank in the U.S., unseating First Republic Bank ($212 billion) and ahead of SVB ($209 billion) at No. 16.

[3] "Exclusive: PNC, RBC interest in SVB cools are regulators seek bids," Reuters, March 12, 2023. www.reuters.com/business/finance/pnc-rbc-interest-svb-cools-regulators-seek-rescue-bids-sources-2023-03-12/.
[4] "First citizens to buy SVB after biggest bank failure since 2008", by Ed Hammond and Matthew Monks, Bloomberg News, March 27, 2023. www.bloomberg.com/news/articles/2023-03-27/first-citizens-to-buy-silicon-valley-bank-after-run-on-lender.
[5] Financial data for FCB and SVB are from the respective holding companies' filings as of December 2022.
[6] See Federal Reserve Statistical Release, Large Commercial Banks, as of December 31, 2022. https://www.federalreserve.gov/releases/lbr/current/.
[7] Hoover's Inc. company descriptions, Bloomberg.

Rapid Growth of Assets and Deposits

Like SVB, FCB experienced rapid growth through mergers and acquisitions in recent years, acquiring 15 banks in the last decade and growing assets five-fold from $21 billion in 2013 to $109 billion in 2022.[8] The pace of growth quickened during the Covid-19 pandemic through acquisitions and organically. Between 2019 and 2022, its asset base grew 174% compared to a growth rate of 198% for SVB. Deposits grew 160% during this period, compared to 180% at SVB. Similarly, loans grew 145% vs. SVB's 124%. Companies going through a rapid growth phase are sometimes confronted with relaxed underwriting standards, missed regulatory warning signals, cultural clashes, operating systems challenges, communication and morale issues, and managerial capabilities in new and more complex businesses.

Venturing into Specialized Lending

The financial press tends to refer to SVB as a regional bank. A more accurate description may be a specialty lender to venture-backed technology and life science companies, a characteristic that exposed the bank to concentrated borrower and depositor profiles. FCB's 2022 merger with CIT, Inc., a national specialized middle market commercial lender, significantly altered its previous regional and retail-focused banking model. Much remains unknown as to how FCB management, representing 61% ownership in the new company, will manage CIT's specialized businesses in rail, maritime, energy and factoring. The addition of SVBB's tech and life science heavy specialty loan portfolio adds to this challenge, although the 50% FDIC loss-sharing arrangement will help cushion some credit losses.

Comparable Unrealized Losses in Securities Portfolios

SVB's $2.5 billion ($1.8 billion after-tax) loss from the sale of its available-for-sale (AFS) securities portfolio triggered runs on its deposits. As of December 2022, unrealized losses in the AFS and held-to-maturity (HTM) portfolios for both banks looked comparable to each other. Losses in FCB's AFS portfolio were 10%, compared to 9% at SVB. In the HTM portfolios, FCB had a loss of 14%, while SIVB's loss was 17%. For banks that do not experience liquidity issues, unrealized losses in the HTM portfolio are not a concern as the losses are reversed as securities mature at par value. Losses in AFS portfolios, however, remain an issue for federal financial regulators as a potential source of bank runs.

Lower Credit Ratings than SVB

As a small but rapidly growing regional bank, FCB's credit ratings reflect its relatively weak credit profile. Its parent company debt is rated Baa2 from Moody's and BBB from S&P. Deposits are rated A2 by Moody's and BBB by S&P' with a negative outlook. These ratings are indicative of small regional banks with good profitability and stable funding but less diversified sources of revenue and more interest income volatility. In comparison, prior to its March 8th asset sales, SVB's parent company debt was rated A3 from Moody's, two notches higher than FCB's, and BBB (same as FCB) from S&P. Deposits were rated Aa3 (also two notches higher) by Moody's and BBB+ (one notch higher) by S&P. As credit ratings are often influenced by a debt issuer's size and footprint, lower credit ratings on FCB relative to the large regional bank peers may suggest less resilience and fewer resources in an economic downturn or a market turmoil.

[8] See "First Citizens BancShares," Wikipedia, accessed on March 28, 2023. en.wikipedia.org/wiki/First_Citizens_BancShares.

Funding Stability from Lower Uninsured Deposits

A strong plus in FCB's corner is funding stability from its legacy retail and small business banking franchise. Compared to SVB's 86% concentration in uninsured deposits, the figure was much lower for FCB at 33% as of December 2022. What is less certain is how depositors on CIT's national online deposit platform respond to the Federal Reserve's rate hikes in chasing highest yielding banks. Online deposit volatility tends to impact not only interest income, but also the speed in loss of deposit funding. An encouraging data point is that, unlike SVB losing deposits in recent quarters, FCB said its deposits grew by $1.3 billion since the start of the year.

Unknown Regulatory Scrutiny in SVB's Wake

This last point of caution is not unique to FCB but to all regional banks in category III ($250 billion - $750 billion in assets) and category IV ($100 billion - 250 billion). These mid-size banks received what is known as the "tailoring rule" that rolled back capital and liquidity requirements as regulators thought they were less systemically important to the financial system.[9] The failure of SVB and the resulting runs at other banks dashed that assumption and evoked furious political blowbacks. A wave of tougher capital and liquidity requirements are already under review, including subjecting the banks to annual "stress tests" and reflecting AFS losses in regulatory capital ratios. While tighter regulations will generally result in stronger banks, FCB just reached the $100 billion category IV milestone recently and will have a long road ahead in navigating the incredibly complex web of systemic banking regulatory apparatus.

In summary, while FDIC-assisted credit and liquidity measures will provide some near-term clarity and safeguards against negative market sentiment, the combined FCB/SVBB presents multiple causes for concern for institutional cash managers. The deal appears to be a marriage of necessity with the FDIC's blessing and a generous gift to FCB shareholders. But for uninsured SVBB depositors and business clients, the ownership by a smaller and acquisitive regional bank still digesting its previous complex merger deal presents potential medium- and long-term challenges not unlike their previous bank.

Separately Managed Account Approach to Bank Risk Management

As an investment advisor of institutional liquidity portfolios, we consider uninsured corporate deposits as unsecured lending to banks. This undiversified credit risk needs to be managed and mitigated, especially for institutions that have routine balances above $250,000 FDIC insurance limits. On the other hand, maintaining dozens of operating banks to stay under the FDIC limit is impractical for institutions with large liquid balances. We believe a combination of an operating/custody account with low balances, a separately managed portfolio of government and high-quality liquid credit investments, and a daily-liquidity government money market fund may help reduce unnecessary exposure to undiversified bank credit risk.

Counterparty Due Diligence on Banks

While customers often consider lending relationships, banking services and location as the primary factors in selecting an operating bank, creditworthiness should be the first selection criterion for business accounts. Proximity bias exists in many forms, particularly when impressive buildings and marketing may portray a successful local bank as a strong and safe place to place one's deposits. Recent bank failures should be a stern warning against this mentality. In addition to financial statements, regulatory filings and rating agency reports, institutional depositors can get help from their investment managers with a dedicated credit research staff on the

[9] See "Rightsizing regulation: U.S. banking agencies releases "tailoring" proposals and regional banks are the winners", Cadwalader, November 5, 2018. www.cadwalader.com/resources/clients-friends-memos/rightsizing-regulation-us-banking-agencies-release-tailoring-proposals-and-regional-banks-are-the-winners.

counterparty strength of their operating banks. With multiple sources of concern stated above, First Citizens Bank may not represent the best of breed for uninsured deposits in their credit analysis and judgment.

No Unprotected Cash Balances in Operating Accounts

Industry surveys and regulatory reports indicate that institutional depositors routinely leave balances in their operating accounts well above $250,000. Operating accounts are business checking accounts for routine transactions such as payrolls, vendor payments and customer deposits. For businesses with large unpredictable daily cash flows, keeping a large balance is an unavoidable and accepted risk. Many institutions, however, choose to leave large sums of uninvested cash in their operating accounts as a habit of convenience and unwittingly expose their organizations to an unnecessary source of credit risk. This risk may be reduced by routinely sweeping unused funds out of operating accounts into investment accounts.

Risk Diversification Through Separately Managed Investment Accounts (SMAs)

A custody account at a bank with strong credit profile, coupled with a professionally managed portfolio of broadly diversified cash investments, may represent an optimal form of institutional liquidity management strategy for funds greater than $250,000. Unlike in an operating account, cash and securities in a bank custody account are not deposits but assets under custody, and thus are not subject to loss in a bank failure. A liquidity investment such as a government money market mutual fund provides price stability ($1.00 net asset value) and daily liquidity. A portfolio of high quality, short-duration instruments with properly laddered maturities helps to provide additional sources of liquidity (and higher market-based income potential). Professional managers can provide both interest rate and credit risk management guidance and help monitor changing economic and market conditions.

Conclusion

Winston Churchill was credited with the adage “never let a good crisis go to waste.” While Silicon Valley Bank’s concentration risk and imprudent interest rate management led to its failure, the changing of the guard to First Citizens Bank does not do away with undiversified credit risk for uninsured depositors. It remains to be seen whether FCB, another regional specialty lender, would meet the minimum credit standard for institutionally managed cash portfolios. With the expiration of FDIC unlimited insurance on large deposits, now may be the time to reevaluate the wisdom of leaving large sums of unused cash in an operating bank account. SMA strategies may help mitigate the risk while also producing higher income potential.

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Capital Advisors Group, Inc.
One Federal Street, Suite 2200
Boston, MA 02110
Tel: 617.630.8100 ~ Fax: 617.630.0023
www.capitaladvisors.com
info@capitaladvisors.com