Bank Contagion Appears Limited, but Failures Create Key Risks

Heightened liquidity constraints and disruption require deft investing touch.

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KEY INSIGHTS

- Recent regional bank failures appear to have been due to unique factors. But many banks have ample liquidity and strong deposit bases.
- The venture capital and private-equity community remains on solid ground, but the start-up ecosystem has been disrupted.
- Tighter credit conditions may create a headwind for the economy, making close monitoring of the situation essential across industries and regions.

Matt Snowling
Portfolio Manager,
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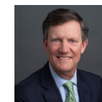

David DiPietro
Head of the Centralized Private Equity Team

The collapse of Silicon Valley Bank (SVB), followed two days later by that of Signature Bank, sent shock waves through equity and fixed income markets. The events also carry important implications for the banking industry, economy, and private-equity markets.

Matt Snowling, portfolio manager for the Financial Services Equity Strategy in the U.S. Equity Division, shares his view on the banking industry and how he and his team are trying to separate the wheat from the chaff as they seek to manage risk and uncover opportunities. David DiPietro, head of the firm's Centralized Private Equity Team (CPET), discusses how SVB's failure may influence venture capital (VC) and the start-up ecosystem.

"Extreme" Cases Carry Some Risk of Broader Contagion

"For many banks," Matt notes, "the risks appear manageable and likely to pose more of a challenge to earnings and margins, as opposed to an existential threat." He believes that the U.S. banking industry is generally well capitalized and that many regional banks have ample liquidity and strong deposit franchises.

Against this backdrop, the collapse of SVB looks like "an extreme case," says Matt. The risk factors that felled the bank appear unique in their magnitude:

- **Deposit Concentration:** An extraordinarily high percentage of the deposit balances at SVB were above the USD 250,000 threshold for insurance from the Federal Deposit Insurance Corporation (FDIC). The company also catered to technology and life science start-ups, with its website claiming that "nearly half" the VC-backed companies banked with the firm. When concerns about the bank emerged, prominent VC firms encouraged portfolio companies to withdraw their cash,

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reportedly resulting in USD 42 billion worth of requested withdrawals on March 9 alone.[1]

- **Duration Mismatch:** Unrealized losses in the company's sizable securities portfolio caused by rising interest rates would have wiped out the bank's equity as these holdings were liquidated to meet deposit withdrawals. These plain-vanilla assets included an unusually large weighting in longer-duration mortgage bonds and U.S. Treasuries.

Signature Bank's weakness appeared to reflect similar concerns about its securities portfolio and deposit concentration. And in the wake of tech-focused SVB's collapse, worries about Signature Bank's exposure to companies involved in cryptocurrency and other digital assets may have contributed to deposits leaving the bank. Some of the regional bank stocks that have come under the most pressure also have meaningful deposit exposure to the VC community.

The regulatory actions taken thus far have helped to address critical concerns, in Matt's view.

He points to the emergency lending facility established by the Fed, which should help to alleviate worries about strained banks being forced to sell portions of their securities portfolios at a loss. These loans would last up to one year and, critically, would value the pledged collateral at par, as opposed to its current market value.

Matt believes that the FDIC's decision to make all SVB's and Signature Bank's depositors whole was a step in the right direction.

However, whether regulators' actions will be enough to prevent additional bank failures remains to be seen. Matt believes that the industry might not be out of the woods yet because of the deposit flight that comes with fears of contagion. "Capital is not the problem this time. It's liquidity—and fear is what matters most. When the local news is talking about bank deposits being at risk, you know it has entered the psyche."

He says the financials team has been spending a lot of time on banks' liquidity profiles, especially the amount of cash lenders have at hand as well as the type of customer and concentration of its deposit base. Retail and operational accounts, for example, tend to be much stickier than larger corporate ones. "With sticky, low-cost funding," Matt says, "a bank doesn't have to take as much risk to earn the same return on a loan."

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A New Headwind for the Global Economy

The aftereffects of the first bank failures of this cycle could also have important implications across the economy. "Think about the natural response from banks," Matt counsels. "They're likely to become more conservative and selective in their lending to preserve liquidity. The cost of credit going up and the availability of credit going down would not be good for the economy."

Reports on the stresses at European banking giant Credit Suisse have added to fears of contagion in international markets. Our analysts in Asia, Europe, and emerging markets are monitoring deposit trends more closely and scrutinizing the companies they cover for potential weaknesses related to the economic and rate environment.

A Challenging but Manageable Impact on the Private-Equity Market

Some growth-oriented T. Rowe Price strategies have small positions in "privates"—young companies that we expect to eventually conduct an initial public offering. These positions also allow us greater insight into important

[1] Source: State of California—Department of Financial Protection and Innovation.

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new developments in the tech sector and other industries that impact our publicly traded holdings.

When SVB Financial Group's stock was frozen, and it became clear that the bank would be taken into receivership, David's team began contacting the privates held in the firm's portfolios and received inbound updates related to their exposure to SVB.

About 15% of the companies David's team initially connected with had deposits at SVB that were material to their balance sheets. The guarantee of SVB's uninsured deposits should solve the short-term funding problems for these firms, allowing them to make their payrolls and pay other expenses. "For the time being, it feels like we are in pretty good shape," David says.

A Lasting Disruption to the Start-Up Ecosystem

Nevertheless, David warns that the SVB failure will prove disruptive to the tech ecosystem, where SVB held a unique position. Venture capital and private-equity funds will have to find other lenders, as they will no longer be able to turn to SVB for subscription lines, or lines of credit that backed the assets of the funds' investors or partners. The lines of credit allowed VC funds to reduce the number of capital calls they made on their limited partners.

SVB also served as the unofficial start-up financial and business connector, making introductions between investors and companies. SVB's decision to loan to a company was often seen as a source of legitimacy for a start-up. SVB also served companies that struggled to get financial support from more traditional lenders. VC-backed companies that are seeking loans, especially those without substantial assets to use as collateral, are likely now to find it tougher to get loans, in David's view.

David doubts that any one bank will step in to fill SVB's shoes—even over the longer term. Community banks or banking giants will likely step in to pick up different pieces of SVB's business, he says. But he also warns that may not happen immediately. For one thing, it always takes time to establish a new credit relationship, and hundreds of companies are now likely crowding banks' phone lines in their attempt to establish credit facilities. Investors are also now likely to devote more time to examining a company's banking relationships and advise management to diversify that exposure before making an investment in that company.

Our Private Investing Strategy and Strict Due Diligence Remain Unchanged

The collapse of SVB has not changed T. Rowe Price's strategy in private markets, however. As a "crossover" investor that seeks to invest in companies both shortly before and then after they go public, T. Rowe Price operates in the so-called late-stage market. While the potential returns from a private investment are not as great as they are for the earlier-stage "A, B, and C" investors, one advantage of late-stage and crossover investors is the ability to get greater clarity on the viability of a company's business model, the strength of its management team, and myriad other factors that might determine how successful it might be as a public company.

Over the past year, the number of companies seeking financing has moderated from its rapid pace during the pandemic. As the Fed has raised rates and financing has grown more expensive, David explains, late-stage financing has nearly ground to a halt, with a few notable exceptions. "Our investment division's risk appetite in private markets has been somewhat lower for the past year just because we see so many opportunities in the public market. So many quality companies are trading at attractive valuations, in our opinion."

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Despite the current turbulence, David says that some of the most successful venture-backed companies have launched during times of previous market and financial stress. CPET, our analysts, and our portfolio managers are continuing to keep an eye out for the private companies that we think have the best potential to be durable compounders. "While our pace of investing has slowed in the past year," David notes, "we have maintained a healthy pace of travel to research and meet with the managements of promising new companies."

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