Key Take-Aways for Credit Unions from Silicon Valley Bank's Collapse

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DISCUSSION POINTS

Overview of SVB financial condition and related weaknesses in their balance sheet.

Accounting issue related to “intent and ability” to hold securities to maturity.

High level review of CU AFS and HTM “losses” as of 12/31/22.

A few “governance” takeaways.

ECONOMY | CAPITAL ACCOUNT

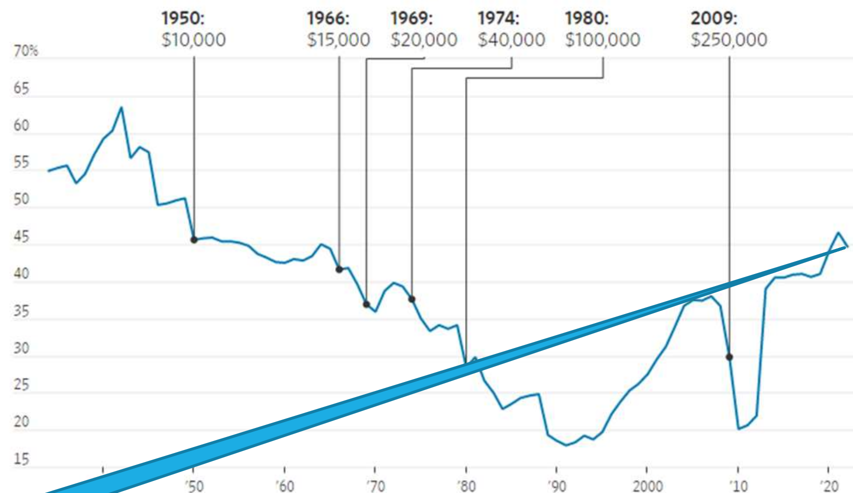
SVB-Fueled Turmoil Junks Lessons of the Global Financial Crisis

Fed, Congress thought smaller banks, deposits and bonds were boring and safe; instead, they are the source of new fragility

By Greg Ip Following
Updated March 21, 2023 1:25 pm ET

The global financial crisis originated with "shadow banks"—lightly regulated finance companies, securities dealers and off-balance-sheet vehicles (some of them subsidiaries of bank holding companies). They invested in subprime mortgages and related derivatives, financed with skittish wholesale funding—asset-backed commercial paper, prime brokerage customer accounts and repos.

Banks' uninsured deposits as % of total domestic deposits, and dates of new insurance limits



Note: From 2008 to 2010, the FDIC guaranteed all non-interest bearing accounts. Some deposits categorized as uninsured may be insured because they are held on behalf of multiple beneficiaries.
Source: Federal Deposit Insurance Corp.

SVB had 94% uninsured deposits!

By contrast, SVB was pursuing the epitome of safe, boring banking: taking in deposits, which are usually stickier than wholesale funding, and investing them in Treasurys and federally backed mortgage securities. Such securities have no risk of default, unlike the emerging market, commercial real estate and subprime loans that drove previous crises.

SVB RED FLAGS

- Significant concentration of HTM vs. AFS securities
- Escalating losses and deterioration in fair value of HTM securities
- Significant increase in S/T and L/T borrowings
- 94% uninsured deposit accounts
- Deposit shrinkage already visible as of 12/31/22

SVB BALANCE SHEET

SVB FINANCIAL GROUP AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in millions, except par value and share data)	December 31, 2022	2021
Assets		
Cash and cash equivalents	$ 13,803	$ 14,586
Available-for-sale securities, at fair value (cost of $28,602 and $27,370, respectively, including $530 and $61 pledged as collateral, respectively)	26,069	27,221
Held-to-maturity securities, at amortized cost and net of allowance for credit losses of $6 and $7 (fair value of $76,169 and $97,227, respectively)	91,321	98,195
Non-marketable and other equity securities	2,664	2,543
Total investment securities	120,054	127,959
Loans, amortized cost	74,250	66,276
Allowance for credit losses: loans	(636)	(422)
Net loans	73,614	65,854
Premises and equipment, net of accumulated depreciation and amortization	394	270
Goodwill	375	375
Other intangible assets, net	136	160
Lease right-of-use assets	335	313
Accrued interest receivable and other assets	3,082	1,791
Total assets	$ 211,793	$ 211,308
Liabilities and total equity		
Liabilities:		
Noninterest-bearing demand deposits	$ 80,753	$ 125,851
Interest-bearing deposits	92,356	63,352
Total deposits	173,109	189,203
Short-term borrowings	13,565	71
Lease liabilities	413	388
Other liabilities	3,041	2,467
Long-term debt	5,370	2,570
Total liabilities	195,498	194,699
Commitments and contingencies (Note 21 and Note 26)		
SVBFG stockholders' equity:		
Preferred stock, $0.001 par value, 20,000,000 shares authorized; 383,500 and 383,500 shares issued and outstanding, respectively	3,646	3,646
Common stock, $0.001 par value, 150,000,000 shares authorized; 59,171,883 and 58,748,469 shares issued and outstanding, respectively	—	—
Additional paid-in capital	5,318	5,157
Retained earnings	8,951	7,442
Accumulated other comprehensive income (loss)	(1,911)	(9)
Total SVBFG stockholders' equity	16,004	16,236
Noncontrolling interests	291	373
Total equity	16,295	16,609
Total liabilities and total equity	$ 211,793	$ 211,308

Approx. 6% cash seems okay on surface, right? Not in light of other negative trends!

Eye-Popping Issues

1. Extraordinarily high concentration of HTM securities
   - 75% of Investments
   - 43% of Assets
2. Huge increase in and amount of Unrealized HTM losses
   - What were NEV and NII stress indicators telling them?
3. Investments/Assets reflects low loan demand
4. Declining deposit balances
5. Demand deposits transition to "interest bearing" deposits
6. Huge increase in total debt

SVB MOUNTING HTM LOSSES

Summary of SVB Unrealized Investment Gains/Losses		
	In Millions	
	12/31/2022	12/31/2021
HTM Investments		
HTM Book Value	$ 91,321	$ 98,195
HTM FV	$ 76,169	$ 97,227
Unrealized Gain/(Loss)	$ (15,152)	$ (968)
Total Net Equity	$ 16,295	$ 16,609
Gain/Loss % of Equity	93.0%	5.8%
AFS Investments		
AFS Cost	$ 28,602	$ 27,370
AFS Book (Fair) Value	$ 26,069	$ 27,221
Unrealized Losses	$ (2,533)	$ (149)

Huge HTM Losses Caused by Excess Concentration in HTM and Rising Rate Environment:

- HTM losses equate to 93% of net worth
- HTM losses increasing to unmanageable levels

HTM SECURITIES FOOTNOTE

HTM Securities

During the year ended December 31, 2021, we re-designated certain securities from the classification of AFS to HTM. The securities re-designated consisted of agency-issued CMO's, CMBS', MBS' and U.S. agency debentures with a total carrying value of $8.8 billion. At the time of re-designation the securities included $132 million of pretax net unrealized losses in other comprehensive income and are being amortized over the life of the securities in a manner consistent with the amortization of a premium or discount. Our decision to re-designate the securities was based on our ability and intent to hold these securities to maturity. Factors used in assessing the ability to hold these securities to maturity were future liquidity needs and sources of funding. HTM securities are carried on the balance sheet at amortized cost and the changes in the value of these securities, other than an ACL, are not reported on the financial statements. There were no re-designations during 2022.

PWC Guidance

3.3.1 Classification: held-to-maturity debt securities

ASC 320-10-25-1(c) describes held-to-maturity securities.

> **Excerpt from ASC 320-10-25-1(c)**
>
> Held-to-maturity securities. Investments in debt securities shall be classified as held-to-maturity only if the reporting entity has the positive intent and ability to hold those securities to maturity.

The positive intent and ability to hold debt securities to maturity is different from not having an intent to sell. If a reporting entity's intention is uncertain, the security should not be classified as held to maturity. A reporting entity's intent and ability to hold a debt security to maturity is typically evidenced through written representation, as well as other evidence, such as historical experience, board and investment committee minutes, documented investment strategies, instructions to portfolio managers, future business plans, and projections of liquidity and capital adequacy. The intent and ability to hold a debt security to maturity should be reassessed at each reporting period.

The held-to-maturity classification is restrictive. ASC 320-10-25-4 and ASC 320-10-25-5 include specific circumstances and scenarios that preclude a reporting entity from classifying securities as held to maturity. For example, a security may not be classified as held to maturity if it can be contractually prepaid or otherwise settled in such a way that the holder will not recover substantially all of its recorded investment. Securities that a reporting entity may sell based on changes in interest rates, prepayment risk, foreign exchange rates, the entity's liquidity or funding sources/terms, or the availability of yield on other investments should also not be classified as held to maturity.

FAS 91 SIMILARITIES?

1. Before SFAS 91, deferred fees (points on loans) accounted for on "cash basis."
   - In other words, front load revenue with points on mortgage loans, and burden future earnings with below market rate income stream.
   - S&L postmortem led to FASB issuing FAS 91
2. Will FASB recognize the very questionable impacts of HTM accounting and move to F/V model for securities held for investment?
3. And even if FASB doesn't change guidance, will banking regulators (FDIC, NCUA, etc.) require consideration of equity impaired by HTM losses?
4. All credit unions should be evaluating "net worth" both in accordance with current accounting rules, and also in accordance with financial repercussions of impaired investments!!!

SVB INCREASING DEBT

SVB FINANCIAL GROUP AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

(Dollars in millions)	Maturity	Principal value at December 31, 2022	Carrying Value December 31, 2022	Carrying Value December 31, 2021
Short-term borrowings:				
Securities sold under agreements to repurchase	(1)	$ 525	$ 525	$ 61
Other short-term borrowings	(2)	40	40	10
FHLB advances		13,000	13,000	—
Total short-term borrowings			$ 13,565	$ 71
Long-term debt:				
3.50% Senior Notes	January 29, 2025	350	349	$ 349
3.125% Senior Notes	June 5, 2030	500	496	496
1.800% Senior Notes	February 2, 2031	500	495	494
2.100% Senior Notes	May 15, 2028	500	497	496
1.800% Senior Notes	October 28, 2026	650	646	645
4.345% Senior Fixed Rate/Floating Rate Notes	April 29, 2028	350	348	—
4.570% Senior Fixed Rate/Floating Rate Notes	April 29, 2033	450	448	—
Junior subordinated debentures	Various	100	91	90
FHLB advances	Various	2,000	2,000	—
Total long-term debt			$ 5,370	$ 2,570

Borrowing Trend Implying Tightening Liquidity

- Huge increase in FHLB Advances
- Huge increase in Long Term Debt

SVB NEGATIVE DEPOSIT TRENDS

14. Deposits

The following table presents the composition of our deposits as of December 31, 2022, and December 31, 2021:

	December 31,	
(Dollars in millions)	**2022**	**2021**
Noninterest-bearing demand	$ 80,753	$ 125,851
Interest-bearing checking and savings accounts	32,916	5,106
Money market	52,032	54,842
Money market deposits in foreign offices	51	696
Sweep deposits in foreign offices	664	969
Time	6,693	1,739
Total deposits	$ 173,109	$ 189,203

The aggregate amount of time deposit accounts individually equal to or greater than $250,000 totaled $6.6 billion and $1.6 billion at December 31, 2022, and December 31, 2021, respectively. At December 31, 2022, time deposit accounts individually equal to or greater than $250,000 totaling $6.6 billion were scheduled to mature within one year.

Deposit Trend Portraying Negative Liquidity Impacts

- Total deposits are shrinking
- Interest bearing deposits growing rapidly
- Time CD’s growing rapidly
- Customers behaving rationally in a rising rate environment

SVB UNINSURED DEPOSITS

14 Mar, 2023

SVB, Signature racked up some high rates of uninsured deposits

Silicon Valley Bank and Signature Bank had some of the highest proportions of estimated uninsured domestic deposits across the entire industry.

Silicon Valley Bank ranked first among banks with more than $50 billion in assets, with 93.8% of its total deposits being uninsured, while Signature Bank ranked fourth, according to S&P Global Market Intelligence data as of year-end 2022.

Credit Union Insured Shares
Based on NCUSIF data, 91% of total shares are insured by NCUSIF

SVB 94% Uninsured Deposits
How was this allowed in a federally insured institution?

SVB POSTMORTEM

GROSS NEGLIGENCE

- *Management?*
- *Board?*
- *Regulator?*
- *Auditor?*

How did management allow the very obvious liquidity crisis to go unresolved?

- Failure to understand the exposure?
- Understood but ignored the exposure?

Where were the Board of Directors?

We know the Chief Risk Officer position was vacant far too long.

How did KPMG issue a "clean opinion" on 2/24/2023? The audited f/s combined with post balance sheet events clearly reflect the lack of ability to hold HTM securities!

It has been reported that SVB had ~94% of their deposits uninsured.

- Sophisticated investors and depositors should have evaluated the risk and exercised appropriate caution much sooner.

What are the ramifications of all deposits being covered by FDIC, even those that exceed FDIC insurance limits.

Regulators should have taken aggressive action which could have diminished the continual damage that was occurring!

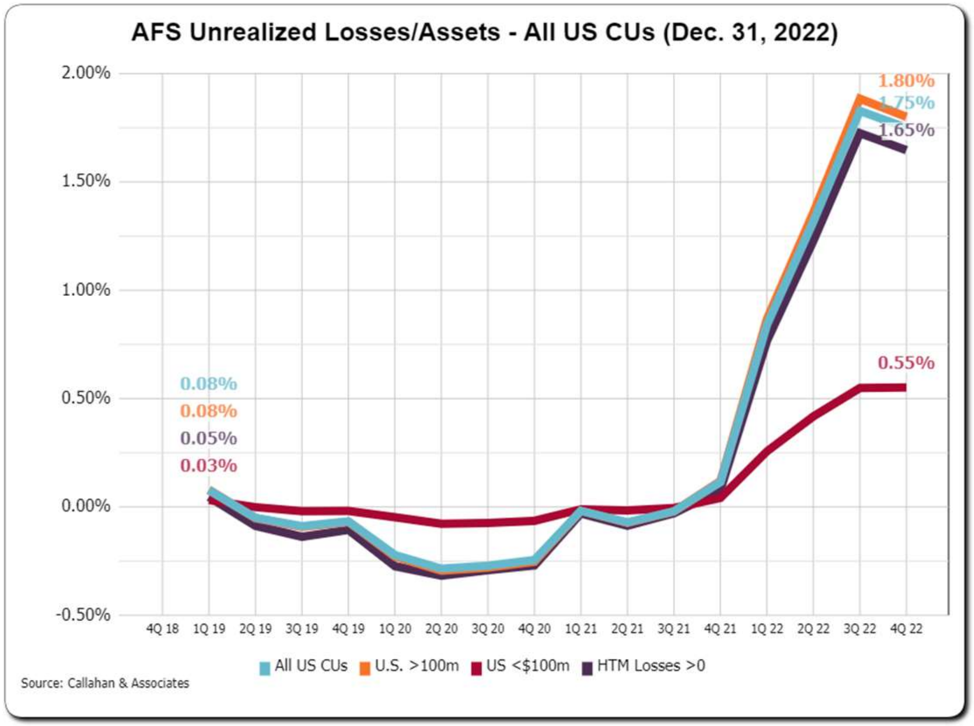
FASB Impacts

CREDIT UNION IMPACTS

SOME CU STRESS INDICATORS

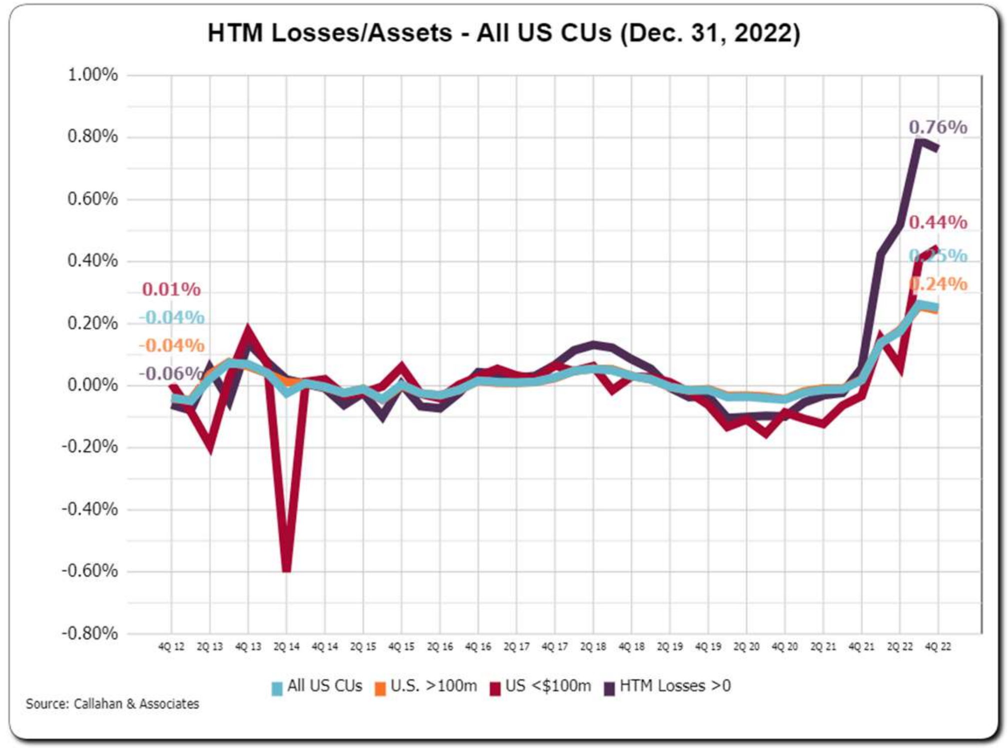
- Unrealized losses on AFS rising
- HTM losses also rising, but not as problematic given smaller allocation to HTM
- Increasing levels of borrowings to compensate for liquidity constraints.
- Declining levels of deposit growth
- Lowest liquidity levels in more than 10 years
- Significant declines in MMA balances and increasing CD balances

CREDIT UNION AFS UNREALIZED LOSSES



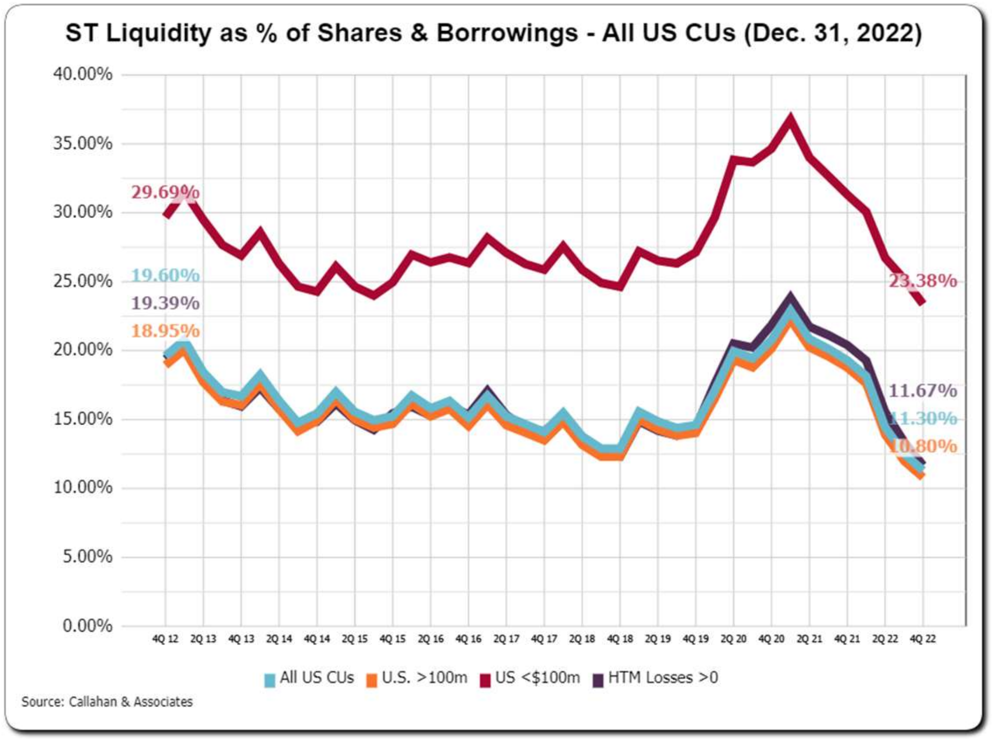
- Smaller CU's relatively benign impact.
- Larger CU's larger impact, but more than adequate capital to absorb.
- But…Some CU's have very significant AFS losses which significantly impairs net worth.
- These losses NOT embedded in NCUA's NWR.

HTM UNREALIZED LOSSES



- HTM losses are a MINOR problem for credit unions!

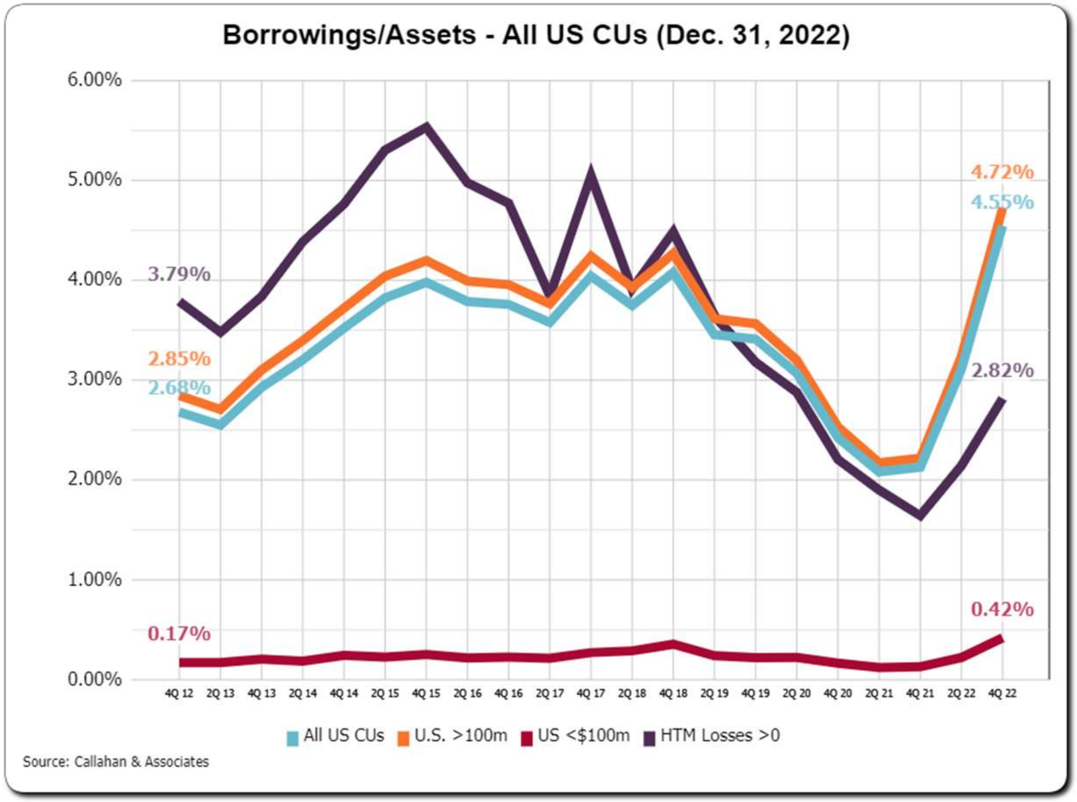
S/T LIQUIDITY DECLINING



<u>CU Liquidity is declining</u>

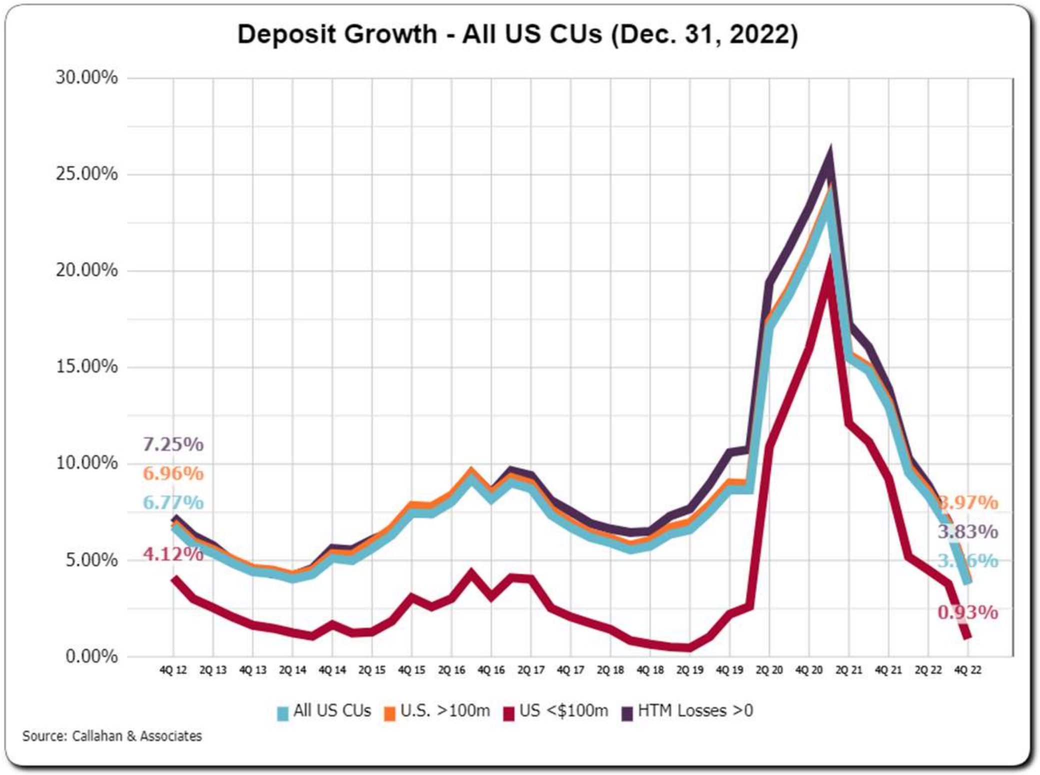
- Borrowings are rising
- Deposit growth is declining

BORROWINGS RAPIDLY INCREASING



- Increased borrowings and declining rates of deposit growth (next slide) a reflection of tightening liquidity!

DEPOSIT GROWTH DECLINING



<u>Sacher Opinion:</u>

- CU's have been slow/reluctant to offer higher, more competitive rates on various deposit products.
- CD promos can only go so far.

CALIF CU'S WITH "MODIFIED" NWR <6%

AFS Investments - Calif-All							
State	Name	AFS, Amort Cost	Available for Sale Securities FV	Accumulated Unrealized Gains (Losses) on Available for Sale Debt Securities	Net Worth Ratio	Net Worth x Accum Gain/Losses on AFS/Assets	assets
CA	1	$28,307,747	$23,649,327	-$4,658,420	8.52%	-1.23%	Under $100m
CA	2	$346,223,231	$291,329,636	-$54,893,595	7.78%	0.73%	$500m-$1b
CA	3	$119,164,865	$107,899,872	-$11,264,993	7.73%	0.91%	$100m-$250m
CA	4	$293,249,621	$257,424,541	-$35,825,080	10.86%	1.60%	$250m-$500m
CA	5	$130,580,998	$114,193,317	-$16,387,681	8.88%	2.03%	$100m-$250m
CA	6	$160,587,922	$137,431,902	-$23,156,020	7.94%	2.35%	$250m-$500m
CA	8	$70,227,276	$61,884,455	-$8,342,821	7.13%	2.66%	$100m-$250m
CA	7	$16,671,241	$11,618,482	-$5,052,759	7.08%	2.66%	$100m-$250m
CA	9	$2,298,345,166	$2,034,631,496	-$263,713,670	8.16%	3.49%	>$1b
CA	10	$52,026,946	$46,865,999	-$5,160,947	7.55%	3.61%	$100m-$250m
CA	11	$128,927,344	$110,459,347	-$18,467,997	7.86%	3.80%	$250m-$500m
CA	12	$13,359,241	$11,457,825	-$1,901,416	7.37%	3.81%	Under $100m
CA	13	$271,587,091	$235,056,046	-$36,531,045	7.99%	4.06%	$500m-$1b
CA	14	$484,600,756	$414,460,924	-$70,139,832	7.98%	4.14%	>$1b
CA	15	$79,431,802	$70,434,386	-$8,997,416	8.49%	4.24%	$100m-$250m
CA	16	$38,639,710	$35,149,898	-$3,489,812	6.77%	4.38%	$100m-$250m
CA	17	$144,633,124	$127,048,648	-$17,584,476	10.38%	4.40%	$250m-$500m
CA	18	$66,147,000	$61,090,783	-$5,056,217	10.05%	4.72%	Under $100m
CA	19	$21,453,307	$17,041,085	-$4,412,222	9.48%	4.72%	Under $100m
CA	20	$106,152,399	$96,808,634	-$9,343,765	8.36%	4.79%	$250m-$500m
CA	21	$891,892,776	$730,765,634	-$161,127,142	11.12%	4.88%	>$1b
CA	22	$749,096,753	$677,898,917	-$71,197,836	9.48%	4.90%	>$1b
CA	23	$14,521,000	$13,702,704	-$818,296	7.26%	4.94%	Under $100m
CA	24	$53,267,897	$42,960,088	-$10,307,809	8.03%	4.98%	$250m-$500m
CA	25	$1,141,621,447	$1,031,647,101	-$109,974,346	10.64%	5.06%	>$1b
CA	26	$807,889,041	$707,080,911	-$100,808,130	9.31%	5.22%	>$1b
CA	27	$23,154,800	$21,501,433	-$1,653,367	6.46%	5.25%	$100m-$250m
CA	28	$1,475,211,129	$1,276,603,860	-$198,607,269	9.66%	5.30%	>$1b
CA	29	$450,026	$305,823	-$144,203	6.70%	5.50%	Under $100m
CA	30	$144,639,185	$131,697,404	-$12,941,781	8.72%	5.52%	$250m-$500m
CA	31	$391,801,339	$361,488,093	-$30,313,246	8.80%	5.65%	$500m-$1b
CA	32	$466,118,487	$405,150,642	-$60,967,845	12.63%	5.75%	$500m-$1b
CA	33	$137,278,713	$122,075,875	-$15,202,838	7.87%	5.76%	$500m-$1b
CA	34	$590,725,639	$528,403,553	-$62,322,086	8.76%	5.80%	>$1b
CA	35	$85,567,041	$72,566,115	-$13,000,926	7.30%	5.83%	$500m-$1b
CA	36	$251,739,824	$219,547,406	-$32,192,418	8.85%	5.88%	>$1b
CA	37	$615,068,728	$550,810,714	-$64,258,014	10.34%	5.91%	>$1b

Total Assets	$34,633,052,950
Avg. Assets	$936,028,458
Avg. NWR x AFS	4.65%

- "Modified" = NWR minus unrealized losses on AFS
- 37 CU's in Calif. with "modified" NWR <6%
- Avg. Modified NWR 4.65 %
- Total assets of "modified" group is $34billion
- Avg. assets of "modified" group is $936 million.

This is simply an indication of the impact that rising rates and AFS concentrations have on the industry

ALCO & GENERAL GOVERNANCE TAKEAWAYS

1. Does your credit union have competitive rates on deposits at various maturity stages?
   - Creative MMA equivalent product needed to retain/attract larger account balances without repricing entire existing MMA portfolio.
   - Shouldn't rely exclusively on CD's to drive deposit growth.
   - Are IRA products competitively priced?
2. Has your credit union identified members with relatively large deposit balances (say over $100,000) and ensured those members have competitively priced products so as to alleviate the need for withdrawal to another institution?
3. Does your credit union actively reach out to members with upcoming CD maturities for the purpose of promoting competitively priced products and perhaps offering an early withdrawal without penalty if the proceeds are immediately rolled over to a new CD?
4. Do your MSR's have the authority to match deposit rates of other institutions in order to avoid a potential withdrawal?
5. Are appropriate steps taken to ensure loan pricing is appropriate and not too low based on current market conditions?
6. Has your credit union confirmed LOC borrowing limits, and "tested" execution of borrowing transactions?
7. Does Management and the Board monitor net worth both with and without AFS/HTM losses?
8. Re: AFS & HTM: Is both "intent" and "ability" factored into the classification of investment securities? Are HTM losses properly disclosed in internal financial reporting?
9. Re: Borrowing to avoid realized AFS losses, in calculation performed to compare NPV of holding vs. selling AFS securities?
10. Does your CU's liquidity stress testing include "worst case" deposit withdrawal assumptions which take into consideration uninsured deposit concentrations?

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