NASHVILLE NOTES

It Is Never Good to Be a Forced Seller

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By Jeff K. Davis

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In early 2010, I had the opportunity to visit a former Bear Stearns executive about a business prospect. I told him I was not going to ask about the past other than one question: What happened?

He said that after the two Bear Stearns-sponsored hedge funds imploded in summer 2007, liquidity was an issue. The company's treasurer reportedly was adamant about the need to aggressively sell assets to increase liquidity because funding issues were beginning to spread, especially among heavily levered institutions such as Bear Stearns. The company had $13 billion of equity supporting $423 billion of assets for the quarter ended May 31, 2007.

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He was right, but other executives and the board reportedly did not want to incur a sizable loss when the company would report earnings in September for the quarter ended Aug. 31, 2007. Whatever securities and other assets Bear Stearns sold in fall 2007 and early 2008 to build liquidity were not enough. The board was ultimately forced to sell the company to JPMorgan Chase & Co. in March 2008 for what was viewed as a fire sale price.

Silvergate Bank, the Federal Deposit Insurance Corp.-insured wholly-owned subsidiary of Silvergate Capital Corp., could be approaching an existential capital crisis that has been brought about by a liquidity crunch that Bear Stearns faced. Last week, Silvergate filed a notice that it was delaying its Form 10-K and reported that additional securities were sold to repay $4.3 billion of Federal Home Loan Bank advances. Also, the company disclosed that it was shutting down its Silvergate Exchange Network that allowed funds to flow between the bank and cryptocurrency exchanges, a platform that provided rapid deposit growth in recent years.

The release did not mention $2.4 billion of brokered deposits that were onboarded in 2022. These funds were used in conjunction with Federal Home Loan Bank advances and security sales to fund the massive outflow of deposits in 2022. Presumably, many of these depositors or the brokers who supplied the deposits will look to pull their funds in 2023, too, given the flow of bad news.

Unlike Bear Stearns, Silvergate is less significant, with about $11 billion of assets as of year-end that were funded with deposits, Federal Home Loan Bank advances and $572 million of equity. The parent company is unremarkable, in that its only material assets were the investment in the bank and $47 million of cash that was funded with preferred and common equity, plus a sliver of trust preferred securities. As an aside, the parent company issued $200 million of 5.375% noncumulative preferred stock in mid-2021. Only five dividend payments were declared, with the last issued Oct. 11, 2022.

The release notes that the additional losses incurred may result in the "company and bank being less than adequately capitalized." As of year-end, the company's and bank's respective leverage ratios were 5.4% and 5.1%. I read the release as the bank's leverage ratio could decline below the minimum 4.0% threshold but remain importantly above the 2.0% "critically undercapitalized" threshold that starts the FDIC resolution clock.

It is unknown as to how much, if any, of the parent company's cash has been injected into the bank to shore up its capital position. The parent company, aside from being required to be a "source of strength" for its depository subsidiary, needs boatloads of cash to pay lawyers and other professionals as its legal woes mount.

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There are a couple of takeaways for investors in financial stocks.

One is that regulatory risk is at the intersection of reputational and liquidity risks. While thinnish capital at an institution can be tolerated for a while, I think liquidity is nonnegotiable for regulators. Liquidity issues cannot be allowed to fester because illiquidity can infect the system, and an infected system raises solvency issues.

Another is that regulators, in my view, have fired a warning shot at banks as it relates to conducting cryptocurrency business notwithstanding the "moneyness" attributes of cryptocurrencies. FTX Trading Ltd. and Alameda Research LLC morphed into a giant fraud, unbeknownst to Silvergate management, until it was too late. Banks regularly get burned by customers who conduct frauds, as seen with the Allen Stanford Ponzi litigation that resulted in significant fines being paid by Toronto-Dominion Bank, Independent Bank Group Inc. and Trustmark Corp. However, the frontier nature of the cryptocurrency ecosphere may make it a regulatory no-go zone either explicitly in time or via an expectation that boards steer their institutions away from the business.

The final is obvious: Being a forced seller is almost always a very bad position for a bank and all of its stakeholders. No doubt Silvergate management laments not investing deposit inflows into ultra-short-term securities and avoiding FTX altogether. The same is true for the Bear Stearns board, though the financial implications for Bear Stearns and markets were much more impactful than what I think is the case for Silvergate and cryptocurrencies.

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