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Study of Silicon Valley Bank's Failure: Lessons Learned

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ABSTRACT

This research paper examines the factors that contributed to the failure of Silicon Valley Bank, a commercial bank that primarily served the innovation sector, including technology, life sciences, healthcare, private equity, and venture capital industries. The paper first provides an overview of the banking industry and how it operates, including the regulatory environment for banks in the United States. The paper then describes Silicon Valley Bank's business model and the types of clients it served, which ranged from early-stage start-ups to established companies in the technology and life sciences industries. The paper analyzes three main factors that contributed to the bank's failure: the Federal Reserve's decision to raise interest rates, cash sickness among some of the bank's customers, and the bank's sale of a debt portfolio at a loss. The research paper concludes by highlighting the importance of effective risk management in the banking industry and the need for banks to be prepared for unexpected events that could impact their operations. Overall, this paper provides valuable insights into the factors that contributed to the failure of Silicon Valley Bank and offers important lessons for other banks operating in the innovation economy.

INTRODUCTION

1.1 Brief explanation of Silicon Valley Bank

Silicon Valley Bank (SVB) is a commercial bank that primarily serves the innovation sector, including technology, life sciences, healthcare, private equity, and venture capital industries.

The bank was founded in 1983 by a group of entrepreneurs in Silicon Valley who saw a need for a financial institution that understood the unique needs of startups and emerging companies in the technology industry. The bank originally operated as a division of the former Santa Clara Valley Bank, but became an independent institution in 1988.

Background

2.1 Explanation of the banking industry and how it operates

The banking industry is an important part of any modern economy, providing financial services to individuals, businesses and governments. Banks act as an intermediary between those who have excess money (depositors) and those who need to borrow money (borrowers). They use savers' deposits to lend to borrowers and make a profit by charging interest on the loans.

Banks operate in a highly regulated environment, with strict rules and regulations governing their operations. These regulations are designed to ensure the safety and soundness of the banking system, protect depositors' funds and maintain financial stability. The banking sector as a whole includes commercial banks, investment banks, and central banks. Commercial banks offer a variety of financial services to their customers, including savings and checking accounts, loans, credit cards, and mortgages. Investment banks, on the other hand, specialize in helping businesses raise capital through the issuance of stocks and bonds, mergers and acquisitions, and other financial transactions. Central banks are responsible for overseeing a country's monetary system, setting interest rates, and regulating the banking industry.

Banks make a profit by charging interest on loans and investing depositors' money in various financial assets, such as stocks, bonds, and other securities. They also charge for services like ATM usage, bank transfers, and account maintenance. Banks also borrow money from each other and from the central bank to meet their capital needs.

The banking industry plays an important role in the economy by facilitating the flow of money and credit, supporting economic growth and providing a safe place for individuals and businesses to keep their money. However, like any industry, the banking industry is subject to risks and uncertainties, including interest rate risk, credit risk and operational risk. Effective risk management is essential to ensure the safety and soundness of the banking system and maintain public confidence in the sector.

2.2 Description of the regulatory environment for banks in United States

The regulatory environment for banks in the United States is complex and multifaceted. There are a number of federal and state agencies responsible for regulating banks, each with its own set of rules and regulations.

At the federal level, the main banking regulators are the Federal Reserve System ("Fed"), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC).

The Fed is responsible for setting monetary policy and regulating the overall stability of the financial system. It also regulates and supervises bank holding companies and their subsidiaries. The FDIC is responsible for insuring deposits and promoting the safety and soundness of banks. It also regulates and oversees state-chartered banks that are not members of the Federal Reserve System.

The OCC is responsible for the regulation, regulation, and supervision of all national banks and federal savings associations. It also enforces laws regarding national banks and federal savings associations, and has the power to take enforcement action against banks that violate these laws.

In addition to these federal agencies, each state has its own banking regulator. These agencies are responsible for overseeing state chartered banks and enforcing state banking laws.

The regulatory environment for banks in the United States is constantly changing, with new rules and regulations introduced in response to changing economic conditions and emerging risks to the financial system. Banks are subject to a variety of regulatory requirements, including capital adequacy requirements, liquidity requirements, anti-money laundering laws, and consumer protection laws. Failure to comply with these requirements can result in significant penalties and fines, as well as reputational damage.

2.3 Overview of Silicon Valley Bank's business model and the types of clients it served

Silicon Valley Bank business model is focused on serving the needs of its clients in the innovation economy. The bank provides a range of services, including commercial banking, investment banking, and asset management, to help its clients grow their businesses. Its services are designed to meet the unique needs of its clients, who are typically high-growth companies in the technology and life sciences industries.

svb's clients include early-stage start-ups, growth-stage companies, and established companies that are looking to expand their operations. The bank has a strong presence in Silicon Valley, but it also serves clients in other technology hubs around the world, including New York, Boston, London, and Hong Kong.

Overall, Silicon Valley Bank's business model is focused on providing tailored financial services to the innovation economy, and its clients range from early-stage start-ups to established companies in the technology and life sciences industries.

Factors Contributing to Failure

3.1 Federal Reserve to Raise Interest Rates

The Federal Reserve has raised interest rates from record lows since last year to fight inflation. Investors are less willing to take risks when the money available is higher due to higher interest rates. This has weighed on the tech start-ups that are Silicon Valley Bank's main customers.

3.2. Some Silicon Valley Bank customers have cash sickness

As rising interest rates closed his IPO market for many start-ups and made private funding more expensive, some Silicon Valley bank customers began withdrawing funds to meet their liquidity needs. This culminated in Silicon Valley Bank looking for ways to meet customer

3.3 Silicon Valley Bank sells debt portfolio at loss

To repay the money, Silicon Valley Bank on Wednesday sold a \$21 billion bond portfolio made up mostly of U.S. Treasuries. The average portfolio yield is 1.79%, well below the current 10-year Treasury yield of around 3.9%. This forced SVB to book his \$1.8 billion loss, which had to be offset by a capital increase.

3.4 SVB announces share sale

SVB announced on Thursday that it will sell \$2.25 billion of common and convertible preferred stock to close its funding gap. Shares closed 60% lower on the day as investors feared they would have to raise more money by withdrawing their deposits.

Consequences of Failure

4.1 Impact of SVB failure on its Clients , Shareholders & employees

The failure of Silicon Valley Bank would have a significant impact on its clients, employees, shareholders, and the wider economy.

4.1.1 Impact on Clients: Silicon Valley Bank's failure would have a major impact on its clients, particularly those in the innovation economy. Many of the bank's clients are start-ups and early-stage companies that rely heavily on the bank's financial services to fund their growth and development. If the

bank were to fail, these clients would lose access to the financial services and expertise they need to succeed. This could result in significant job losses and hinder innovation in the technology and life sciences industries.

4.1.2 Impact on Employees: The failure of Silicon Valley Bank would also have a significant impact on its employees. The bank employees whom are highly skilled professionals. If the bank were to fail, these employees would be at risk of losing their jobs. This could have a ripple effect on the wider economy, as the loss of high-skilled jobs would reduce consumer spending and lead to a decline in economic activity.

4.1.3 Impact on Shareholders: The failure of Silicon Valley Bank would also have a significant impact on its shareholders. If the bank were to fail, its shareholders would lose their investment, and the value of their shares would decline significantly. This could have a wider impact on the financial markets, as investors may lose confidence in other banks and financial institutions.

Implication of the bank's failure for the banking industry

The failure of a bank can have significant implications for the banking industry as a whole.

4.2.1 Loss of customer confidence: When a bank fails, it can lead to a loss of confidence among customers, who may withdraw their deposits from other banks, causing a ripple effect on the entire banking system.

4.2.2 Systemic risk: Banks are interconnected through various channels such as interbank lending, payment systems, and financial markets. The failure of one bank can lead to a domino effect, causing other banks to fail, leading to a systemic risk that can spread to the entire banking industry.

4.2.3 Regulatory scrutiny: A bank failure can attract regulatory scrutiny and oversight, leading to increased regulations and compliance requirements for other banks in the industry.

4.2.4 Impact on the economy: The failure of a large bank can have a significant impact on the economy, affecting not only the banking sector but also other industries that depend on banks for credit and financial services.

4.2.5 Reputation damage: A bank failure can damage the reputation of the entire banking industry, leading to a loss of trust among stakeholders, including customers, investors, and regulators.

Impact stock market

5.1 Impact on US Stock Market

The failure of the Silicon Valley Bank added to concerns about the state of the economy. The S&P 500, a stock index that measures the performance of 500 major companies listed on US stock exchanges, suffered its biggest weekly drop of the year following the news of the bank's bankruptcy. The banking crisis has also affected the initial public offering (IPO) market of many start-ups. Rising interest rates have made raising private capital more expensive, forcing many start-ups to delay IPO plans or seek other funding sources. However, some experts believe that the banking crisis could create a favourable environment for high-quality stocks, growth and long-term innovation. This is because investors can shift their focus away from cyclical stocks that are more sensitive to economic conditions and toward companies that are better positioned for long-term growth.

5.2 Impact on India Stock Market

The impact was also felt in India, where the Sensex fell by over 900 points in early trades. The banking and financial sectors were hit hardest, with HDFC Bank, HDFC, SBI, IndusInd Bank, Axis Bank, and Bajaj Finance among the top six losers.

Lessons Learned

6.1 Key Lessons that can be learned from SVB failure

The main lesson that can be learned from this scenario is the importance of risk management and liquidity management in financial institutions. Silicon Valley Bank's reliance on a bond portfolio that did not provide adequate returns to cover their customers' withdrawals left them vulnerable when their clients started to pull out their money.

Furthermore, the bank's over-reliance on a single type of client, i.e., technology start-ups, made it more susceptible to the adverse effects of interest rate hikes on this sector.

The collapse of SVB's stock sale highlights the importance of investor confidence and trust in a bank's stability. When clients and investors start to lose faith in a bank's ability to meet its financial obligations, the bank's capital-raising efforts may fail, leading to further losses and even insolvency.

Finally, the role of regulatory bodies, such as the FDIC, is critical in maintaining financial stability and protecting depositors' interests. In this case, the FDIC's intervention prevented the situation from worsening and helped to minimize the impact on uninsured depositors.

6.2 How these lessons can be applied to prevent similar failures in the future.

To prevent similar failures in the future, financial institutions can apply the following lessons:

6.2.1 Diversify portfolio: Banks should diversify their portfolios to avoid over-reliance on any particular sector or type of client. This would help them to withstand market shocks and reduce the risk of large-scale withdrawals.

6.2.2 Manage liquidity risk: Banks should have adequate liquidity management measures in place to meet customer withdrawals and other obligations. They should monitor liquidity conditions closely and have contingency plans to manage liquidity shortages.

6.2.3 Conduct stress testing: Regular stress testing can help banks to identify potential vulnerabilities and prepare for adverse scenarios. Stress tests should consider a range of market conditions, including changes in interest rates and market volatility.

6.2.4 Strengthen risk management practices: Financial institutions should have strong risk management practices to identify, assess, and manage risks effectively. This includes having robust internal controls, risk monitoring systems, and risk mitigation strategies.

6.2.5 Maintain investor confidence: Banks should maintain investor confidence by being transparent about their financial health, communicating regularly with investors and clients, and having contingency plans in place to manage crises.

6.2.6 Compliance with regulations: Banks should comply with all regulatory requirements and maintain strong relationships with regulatory bodies to ensure that they remain compliant with changing regulatory standards.

By implementing these measures, financial institutions can help prevent similar failures and maintain financial stability in the face of market shocks and other adverse conditions.

Conclusion

In conclusion, Silicon Valley Bank was a financial institution that served the unique needs of the innovation sector, primarily in the technology and life sciences industries. The bank's business model was focused on providing tailored financial services to its clients, which ranged from early-stage start-ups to established companies in the technology and life sciences industries.

Silicon Valley Bank's failure was primarily due to external factors, such as the Federal Reserve's decision to raise interest rates and the cash crunch faced by some of the bank's customers. These factors put pressure on the bank's loan portfolio and led to a decline in the bank's financial performance.

The banking industry is subject to various risks and uncertainties, and effective risk management is essential to ensure the safety and soundness of the banking system. The regulatory environment for banks in the United States is complex and multifaceted, with numerous federal and state agencies responsible for regulating banks. Compliance with these regulations is crucial to maintain public confidence in the banking sector and prevent failures like that of Silicon Valley Bank.

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