Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Is Silvergate solvent? Media coverage suggests it can stay in business based on the crypto bank's liquidity. Liquidity is, though, only a necessary condition for a bank to survive. For it actually to remain in business, a bank must also be solvent. For Silvergate and several other crypto-heavy banks this won't be easy.

The critical criterion determining whether regulators allow a bank to remain in business is the extent to which its capital meets or exceeds the rules and, when it doesn't, how much below these thresholds it falls and why. Ever since 1991, regulators are supposed to grant banks little leeway on these capital requirements – "prompt corrective action" provisions demand that regulators sanction banks as capital plummets and close them if they haven't already done so if ratio's sink to the "critical-capital" threshold.

Faced with a Lehman-like run, Silvergate has understandably focused on assuring stakeholders that it can continue to sell assets to handle all withdrawals. And so it may, but that's not its only problem. Even if it's liquid, Silvergate faces a grim future if its regulatory-capital ratios falter – and they might.

To survive, Silvergate must run a gauntlet between the amount of capital it holds on a shrinking pool of assets and the capital costs of losses taken as assets are sold to handle withdrawals. The bank entered the liquidity wringer with ample capital. According to its third-quarter call report, its leverage ratio was over ten percent. And, even when the bank dumped over $5 billion to absorb its initial run, the capital ratio remained relatively robust. This is because the bank's capital then backed only about two-thirds of the assets against which it scored so well the quarter before even though Silvergate also took a $718 million loss. After the sale and loss, the ratio was a bit under nine percent – still good.

However, this seeming resilience may evaporate if the assets were sold from Silvergate's hold-to-maturity (HTM) book. They likely were, meaning that the bank may have as little as $300 million or so in its capital base unless it can find something worth something to sell if it must meet still more withdrawal demand. This is because, in the third quarter, there was also a $520 million unrealized loss. If assets sold indeed came from the HTM book, then the bank's entire portfolio is "tainted" and the bank could be required to recognize unrealized losses when calculating its regulatory capital. Regulators could save Silvergate from this grim fate if they rule the HTM liquidation as necessary to address a rapid deterioration in the bank's condition. This they might do but then again they might not. Regardless, a waiver would be a glass no more than half-empty and not close to full enough given other likely losses on assets sold to meet continuing deposit withdrawal.

At the least, nothing will be easy for Silvergate. However, of all the banks with known crypto exposures, its resilience is distinguished by its low-risk portfolio. Banks that were both dependent

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on crypto depositors and heavily invested in crypto assets face potential runs combined with far less ready liquidity along with lower capital ratios ill-designed for acute stress.

There are a lot of moving parts here given the complexities of each crypto-exposed bank's balance sheet and those in the safety-and-soundness handbook. And, even if a bank is illiquid or insolvent, a troubled charter can be put out of its misery at relatively low cost to stakeholders if the FDIC decides to apport a third-party purchase rather than liquidating the company.

Typically, this is the path the FDIC prefers in contrast to receivership and liquidation. The law mandates stat the FDIC undertake resolutions that pose the "least cost" to taxpayers, allowing "purchase-and-assumption" transactions that sell a failing bank to the highest bidder. However, the FDIC under Chairman Gruenberg is well aware that purchases that meet this criterion also sharply increase moral hazard. If the FDIC assures itself that liquidation meets the least-cost test and poses no systemic risk, then it can and now surely will close any failing bank rather than offer it a graceful way out.