

CREDIT RISK NEWSLETTER

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SILICON VALLEY BANK'S IMPACT ON THE BANKING SYSTEM

Before March 10, 2023, most might have said they'd never heard of Silicon Valley Bank (SVB). Now known for being the biggest U.S. bank failure since 2008 and the second largest in U.S. history, the failure of SVB is a reminder that banks are not immune to risk. We want to discuss how this happened, the overall health of the U.S. banking system, and the implications that this will have on credit conditions moving forward.

SVB was unique in that it catered to mostly tech startups, claiming to have banked for nearly half of all U.S. venture-backed startups since 2021. It was also a banking partner for quite a few of the venture capital firms that fund those startups. On March 8, two days before the failure, it signaled that it was facing a cash crunch as it sold \$21.5 billion of its portfolio to meet customer withdrawals, realizing a \$1.8 billion loss. While the bank was attempting to shore up its balance sheet, this spooked investors and depositors yanked \$42 billion from SVB on March 9 in a bank run. SVB was shut down by banking regulators the following day and the Federal Deposit Insurance Corporation (FDIC) was appointed receiver. Additionally, within days of SVB's failure, the New York state banking regulator seized Signature Bank of New York. On the other side of the Atlantic, Credit Suisse had to be rescued by UBS in a deal facilitated by the Swiss government.

These bank failures rattled markets and have changed the landscape. While initially causing fear of further bank runs, the recent Federal



Failed Bank

Reserve H.8 data shows that small banks, those most stressed by recent banking strains, gained some breathing room. Second, the largest banks in the U.S. still have large cushions of capital and ample pools of liquidity to see them through any further turmoil. The market avoided the domino effect and further financial incidents like these should remain isolated. Smaller U.S. banks with exposure to Commercial Real Estate (CRE) face the most risk. Higher borrowing costs and economic uncertainty have been a drag on the commercial real estate segment.

Understandably, banks will likely tighten lending standards moving forward, which will bring about more difficult credit conditions for borrowers. As explained best by Fitch Ratings, “Recent turbulences underlined difficulties in meeting large, unexpected, customer deposit outflows. This may drive closer oversight of deposit concentrations, particularly where there is high exposure to an industry or a type of client. SVB's failure also highlighted the importance of interest-rate risk management and liquidity policies in a rising rates environment.”

“Banks, especially regional ones, are not only looking at their deposit bases and whether their depositors will stick around but they’re also hearing from regulators calling for higher levels of liquidity at their institutions,” said Som-lok Leung, executive director of the International Association of Credit Portfolio Managers. “In response, banks will do what they have to do to preserve capital and one way to do that is to make fewer loans.” We note that heightened credit market volatility, tightening standards, and elevated interest rates will likely restrict the ability of higher-risk companies to raise debt capital.

CREDIT GUIDANCE: CUSTOMER LEGAL NAME

Credit professionals are tasked with analyzing a great deal of data during a customer credit review. One important and sometimes overlooked item is the customer’s legal name. Do you know your customer’s full legal name and address? This is especially important when it comes to security interests.

One measure creditors often take to secure additional protection is to file a Uniform Commercial Code (“UCC”) financing statement to solidify their security interest in a customer’s asset to facilitate a transaction. The financing statement describes the collateral that is secure.

DISTRESSED EXCHANGES ON THE RISE

According to S&P Global's Default, Transition, and Recovery data, distressed exchanges remain the preferred method of restructuring, accounting for five out of 14 defaults in March 2023.

The number of distressed exchanges has risen in recent years as distressed issuers view out-of-court restructuring more favorably than other options. With 16 distressed exchanges so far in 2023, the year-to-date total is nearly 50% higher than the 2009 and 2016 year-to-date tallies.

We note out-of-court restructurings differ from traditional bankruptcies because they are just that, they are a more informal process that does not require court supervision.

While most companies come out with healthier balance sheets and stronger liquidity, the company should be monitored closely. S&P reports that out-of-court restructurings have limited efficacy, with 37% of restructured entities either restructuring again or filing for bankruptcy.

Financially troubled companies cannot perpetually kick the can down the road, especially in cyclical business sectors. At some point, the company will reach its threshold for adding more debt, its liquidity will deteriorate, or some other negative risk event will occur.



Wolfson Bolton Kochis PLLC asks the question, is an abbreviation of a borrower's name fatal to perfecting a security interest? Does a trade name ("doing business as") hold up in court and would slightly altered or abbreviated names be misleading? A recent September decision by the United States Eleventh Circuit Court of Appeals has clarified some practice points about how to properly perfect a creditor's security interest.

A perfect example of this is shown in the case of 1944 Beach Boulevard, LLC v. Live Oak Banking Co., in which creditor Live Oak Banking had attempted to perfect its liens against 1944 Beach Boulevard by recording a UCC statement in the Florida lien registry. However, Live Oak Banking referred to the company as "1944 Beach Blvd., LLC" instead of its fully spelled legal name. 1944 Beach, a debtor in possession, sought to avoid Live Oak's blanket lien on all its assets. 1944 Beach argued that the error in the name rendered the UCCs seriously misleading and thus ineffective to perfect Live Oak's security interest.

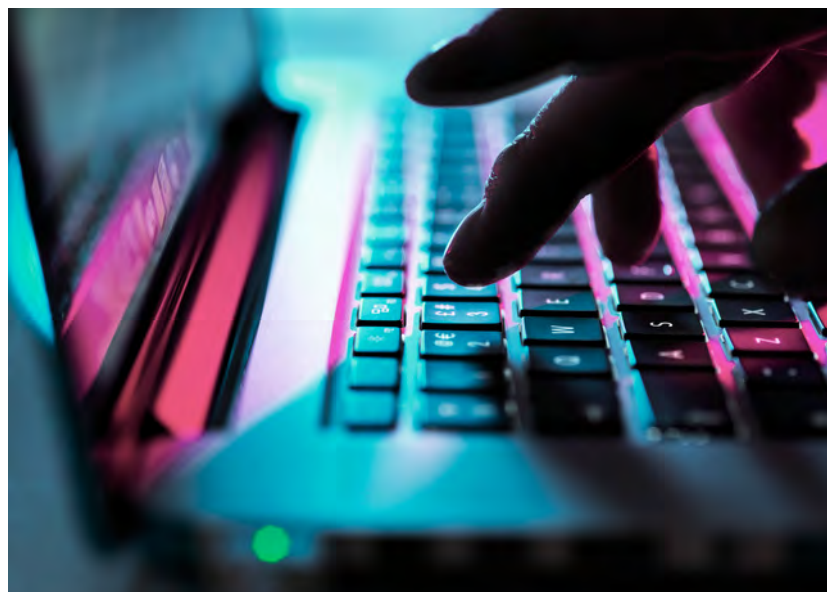
The Florida Supreme Court heard the issue from the Eleventh Circuit and concluded that the Florida lien registry does not, in fact, have any uniform search query logic or standard abbreviation terms. Therefore, the court held that even a slightly altered or abbreviated debtor name is seriously misleading under Florida law, rendering the attempt to perfect the lien insufficient and invalid.

With all this being said, it is always best practice not only to verify your customer's legal name and address, but also to be sure to update your credit file any time there is a name or address change. This will help alleviate potential headaches if legal action is necessary. A mere abbreviation may, in some states, invalidate your attempt to perfect a lien.

BEWARE OF VENDOR PAYMENT FRAUD

While this topic is not exactly credit risk related, we feel it is worth discussing with our readership. Over the past couple of years, PG clients have alerted us to several situations where either they or their suppliers were deceived by sophisticated cyber criminals, resulting in six-figure losses. Unfortunately, the legal system or your bank may offer little help.

It goes something like this, the hacker manages to install malware or a virus that allows them access to someone's email. They then send an email disguised as one from your company, often including a recent string of emails discussing a transaction that was legit. They then send a



message that says our ACH or bank information has changed, please remit payment here, often from the same commercial team or finance contact. They give new wire instructions. Companies that lack controls, such as making a quick call to the customer or supplier to verify the change, are often tricked into sending money to a cyber criminal's account. Later, as the invoice ages out, you get a call about a past due. You say we paid that, here are the details. Then the fraud comes to light, often too late.

With schemes getting increasingly sophisticated and realistic, a busy finance or credit professional can be easily tricked if unaware. Our advice is to get with your IT team to add safeguards, put a policy in place to always back-check a wire transfer before sending, and make good use of any and all virus or software protection to help prevent these attacks.

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