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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

INVESTMENT MANAGEMENT LESSONS LEARNED FROM THE MANAGEMENT AND MISMANAGEMENT OF IMPENDING BANK RUNS

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For years, Very Large VC (VLVC), the leading venture-capital firm in Silicon Valley, has exclusively banked with a prominent local community bank: The Bank. With more than $1 billion in liquid deposits, VLVC's account has significantly exceeded the $250,000 FDIC insurance limit. Nonetheless, having glided past the Financial Crisis of '07-'08 and successfully growing their collective assets under management (AUM) beyond $85 billion, Sarah and Jim—the founding managing partners at VLVC—have enjoyed well-earned comfort and celebrity status in Silicon Valley.

But now, Sarah and Jim are suddenly very worried. For months, they had been cognizant of rising interest rates as well as the elevated short interest on The Bank's holding company; yet they had largely ignored an alarming reality—namely, the practical and obvious disaster they would suffer under an increasingly probable bank failure given The Bank's asset-liability gap and insufficient capital adequacy ratio (CAR). Such a failure poses an evident and severe disaster for VLVC, as the firm not only stands to lose its $1 billion deposit but also faces repercussions on its investments. Specifically, since VLVC's portfolio companies also exclusively bank with The Bank, deposit losses suffered by these companies would prevent them from meeting their immediate financial obligations, thereby causing significant harm to VLVC's investments.

Faced with an urgent and difficult decision, Jim proposes that VLVC move swiftly not only to withdraw VLVC's own deposits but also to immediately contact and urge all of VLVC's portfolio companies to do the same, thereby proactively addressing the imminent bank run he suspects is

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a foregone conclusion. However, Sarah is unsure about this bold-faced and forceful approach. After all, any bank's de-facto asset-liability gap is not only impacted by fluctuations in interest rates but also by network-based contagion, which can either accelerate withdrawals or extend the duration of deposit liabilities.

With approximately $85 billion in assets under management (AUM), VLVC is renowned as the largest and most influential venture-capital firm in Silicon Valley. Thus, Sarah believes that VLCV has the clout and network centrality to proactively avert a bank run—that is, rather than incite its innermost circle to immediately withdraw deposits en masse, Sarah wishes to explore ways in which VLVC can successfully persuade its vast network to leave their deposits for the time being. While Jim acknowledges the merits of Sarah's arguments, he adamantly prefers the alert-and-retreat approach, given that this strategy ensures the preservation of cash deposits for VLVC and its portfolio companies, regardless of The Bank's survival or failure. Sarah counters, though, that the downfall of The Bank would likely have significant adverse effects on VLVC despite (or perhaps even due to) the pre-emptive preservation of deposit capital.

For one, The Bank consistently provides substantial debt capital to VLVC's later-stage portfolio companies. Moreover, Sarah is concerned about VLVC's extensive reliance on subscription lines of credit at concessionary rates from The Bank. Without these bridge loans, VLVC's funds would be forced to issue more frequent capital calls, also known as drawdowns, to its limited partners (LPs). That is, reduced access to an ongoing short-term credit facility would require the funds to request investors to deliver capital on a pro-rata basis upon each investment decision, and thereby, at an accelerated and unbalanced cadence. This, in turn, would negatively impact each fund's IRR and the ability to raise capital for subsequent funds under the VLVC umbrella.

Acutely aware that time is of the essence but unable to reach consensus, Sarah and Jim unhappily agree to flip a coin and hope for the best. With the decided outcome in place and with no further leeway to argue against a running clock, the other partners are mobilized to action.

Questions

- What are the pros and cons to VLVC of accelerating versus decelerating deposit withdrawals?
- How might network centrality and contagion work to exacerbate the asset-liability gap?
- What are other externalities to VLVC that may arise from accelerating a bank run?