The Corporate Finance Crisis: The Dangers of Counterparty and Regulatory Risk

Counterparty risk is an ever-present problem that is becoming more acute. The warning signs are hiding in plain sight. Non-regulated corporate financial advisors and non-regulated "institutions" such as FTX have crashed right before our eyes. Founder-led equity offerings, such as with Theranos and their "advisors," are recent glaring examples of the problem. Where counterparty risk becomes extremely dangerous and damaging is when it shows up where we least expect it, in spheres we assume to be regulated and safe, because the participants are regulated banking institutions. **Jeffrey Sweeney**, CEO and Chairman at **US Capital Global**, explains why it pays to be vigilant and always apply the highest standards of risk management.

The Implosion of Silicon Valley Bank and Rescue of Credit Suisse

With the collapse of California-based **Silicon Valley Bank** (SVB) and the emergency rescue of **Credit Suisse**, the banking sector remains on edge and global markets are rattled. The FDIC, the Fed, and the US Treasury Department have been taking swift measures to avoid contagion across the financial sector. This is the biggest banking challenge since 2008, with SVB's failure leaving billions of dollars belonging to companies and investors stranded. Sadly, more vigilant risk oversight could have prevented this but now we are faced with a more expensive solution in both cost and institutional reputation.

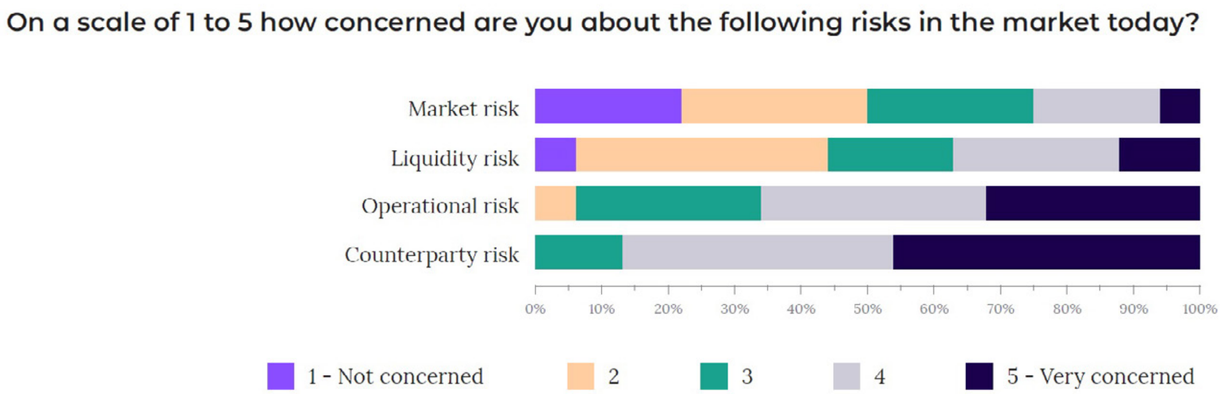
We have weathered—and even flourished—during the 2008 crisis and remember many previous financial storms, from the savings and loan crisis beginning in the 1980s and the dot-com crash of the late 1990s. One of the key elements to a financial crisis has almost always been, "If it looks too good to be true, it probably isn't true." For example, in the private equity arena, Theranos, with its exponential valuation growth, non-expert celebrity board, miraculous but unsubstantiated technology, and lack of any regulated investment bank leading the raise, was loaded with red flags. These are all examples of ignored counterparty risk. The root cause of the recent bank failures was lack of experience and care in portfolio management and lending. Lack of careful regulatory oversight is a contributing factor, but if the investment and risk thesis is unprofessional and weak, we cannot blame it all on the regulators. Seasoned leaders in risk and credit, as well as a clear articulation of strategy and risk, should be reviewed before committing to depositing or investing in banking institutions.

Counterparty risk is the probability that one of the parties in an investment, credit, or trading transaction might default on either their contractual obligations or fiduciary responsibilities. These failure can be attributed to either inexperience or fraud, or both, as appears to be the case with FTX. While lenders and investors know they are exposed to default risk in virtually all forms of credit, it may come as a rude awakening for depositors to discover that they face such risk too within standard banking relationships. Before SVB's collapse, its CEO, Gregory Becker, had been telling investors, Wall Street analysts, and technology executives in his usual bombastic style **that the future of the tech industry was sparkling and so was SVB's place within it**. Of course, what he failed to disclose was that about a week earlier the rating agency Moody's had called to inform him that SVB's financial health was in jeopardy and that its bonds were at risk of being downgraded to junk. SVB had failed to pay attention to risk management. Indeed, in early 2022, BlackRock's consulting arm had warned the bank that **its risk controls were "substantially below" its peers**. The report found that the bank trailed similar banks on 11 of 11 factors considered and was "substantially below" them on 10 out of 11.

FTX, Silvergate Bank, and Signature Bank

Sometimes we can fail to appreciate counterparty risk because of the participants involved, such as reputable commercial banks or high-profile individuals such as Elizabeth Holmes and Bernie Madoff. At other times, it may be the asset category itself that lulls one into a false sense of safety. Physical gold and silver themselves carry no counterparty risk but the custodians of your assets certainly do. Until recently many of the modestly informed assumed that the digital monetary system, with seemingly reliable blockchain networks, was outside the realm of counterparty risk as well. Sadly, hacking, skirting regulations, and unreliable custodians have demonstrated how counterparty risk is still present in many aspects of the cryptocurrency industry.

FTX suffered a crippling devaluation after a surge of client withdrawals, following news that in the US the SEC had been investigating the firm's handling of client funds and crypto-lending practices. FTX founder Sam Bankman-Fried lost roughly 94% of his estimated $15 billion+ fortune. FTX's spectacular collapse, and the looming prosecution of its founder has undermined confidence in the institutional crypto ecosystem and brought on accelerated regulatory oversight and the potential shutdown of other crypto trading platforms. Silvergate Bank, a key custodian for crypto entities, recently announced plans to wind down and liquidate. Meanwhile, regulators close crypto-focused Signature Bank, citing systemic risk.



Source: Acuiti, Crypto Derivates Management Insight Report, Q1 2023

According to a recent report by Acuiti, the first institutional study on the response to the collapse of FTX, counterparty risk is now the top concern for the crypto derivatives market, with 47% of survey participants saying that they were concerned with this risk factor compared to 31% for operational risk, 13% for liquidity risk, and only 6% for market risk. Importantly, more than three-quarters of respondents believed there would be a permanent separation of exchange and custody functions as investors look to reduce concentration risk. After all, FTX had been actively trading using client deposits, according to various reports.

One of the problems is that the term "Decentralized Finance" (or "DeFi") has been incorrectly applied to companies like FTX – which are not decentralized at all. These are clearly "Centralized Finance" (or "CeFi") enterprises. To be sure, if FTX was decentralized, it would not have been able to drain its accounts of client funds. Bitcoin and other digital currencies were created in the wake of the 2008 financial crisis as an alternative to government-issued money. Based on a "trustless protocol," the blockchain, they were designed to have no credit risk or counterparty risk. As crypto became increasingly mainstream, however, a large number of companies were formed to help individuals navigate the crypto world. For example, just setting up a cryptocurrency wallet with a crypto exchange almost certainly involves establishing a relationship with new counterparties. Anyone transacting with those companies was on some level trusting them. The lesson is that counterparty risk is always a critical consideration for treasurers – and cryptocurrency management is no exception.

How We Limit Counterparty Risk

Regarding financial institutions, at US Capital Global we strongly focus on limiting counterparty risk both for our borrowers and for our investors. Our treasury operations are always with banks that have the highest Tier 1 capital, such as JPMorgan Chase and Bank of America. We avoid smaller regional banks for our deposit operations. Larger banking institutions offer ICS® (Insured Cash Sweep) and CDARS® (Certificate of Deposit Registry Service) for our accounts, extending FDIC protection across the full value of deposits.

Our FINRA-regulated securities subsidiary, US Capital Global Securities LLC, is very careful to investigate and perform extensive due diligence on our debt or equity capital raise clients. This involves verifying representations about their business model, financial statements, supply chain, and sales orders and channels. Additionally, we examine prior investors on their capitalization chart and management organization to assure there are no "bad actors" that could spell trouble from regulators down the line. To the best of our ability, we examine counterparty risk as part of our business model before presenting any opportunity to the investor community of institutions and individuals.

Jeffrey Sweeney is a fund manager with years of experience in corporate finance and asset management. He is Chairman and CEO at US Capital Global (www.uscapital.com), a full-service global private financial group headquartered in San Francisco with primary offices in Dallas, Philadelphia, New York, Miami, London, Milan, Zurich, and Dubai.