



COINDESK RESEARCH NOTE

Silvergate Bank: How Deep Is Its Moat?

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While not often in the limelight, Silvergate Bank serves as an integral part of the cryptocurrency ecosystem. It's often claimed by crypto enthusiasts that bitcoin will eventually displace the financial system as we know it. As it stands today, however, banks still play the pivotal role of fiat on/off ramps for exchanges and investors.

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INTRODUCTION

Silvergate competes with a handful of U.S. crypto-friendly banks. What sets it apart, however, is its growing customer list of well-established digital asset businesses (such as Coinbase, Bitstamp, Gemini, Genesis Capital) and its unique product offering specifically tailored for its crypto-native audience.

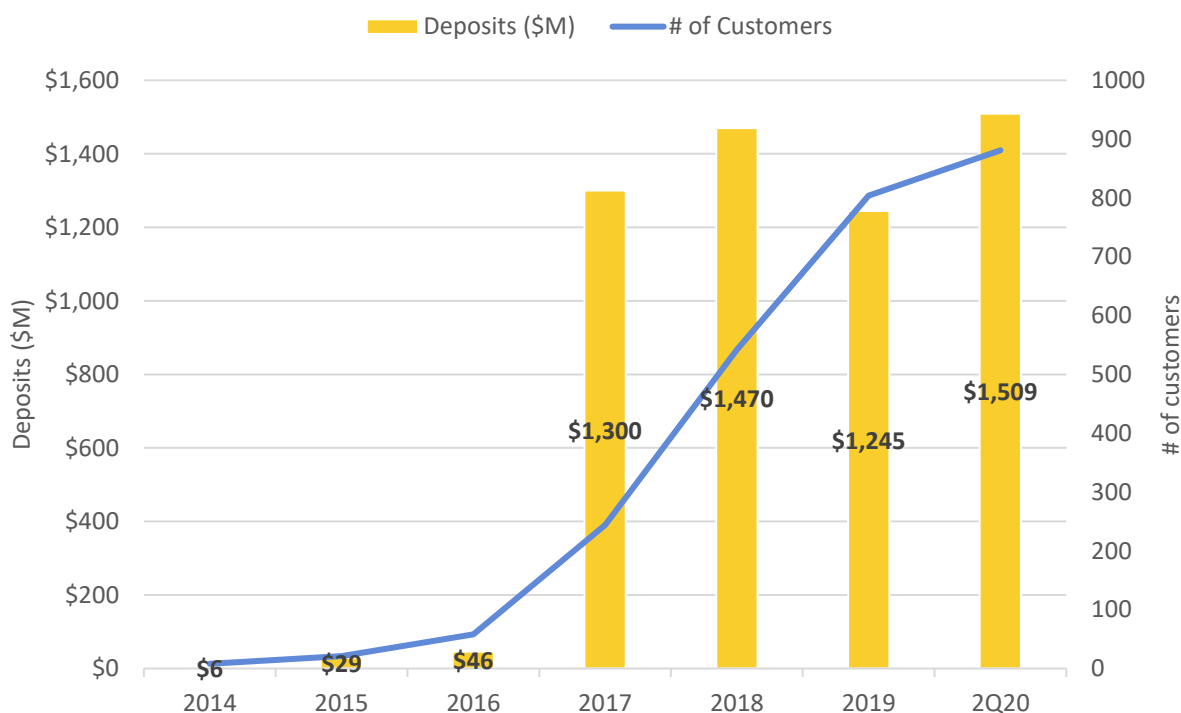
From a broader perspective, the cryptocurrency industry is a niche market. Silvergate estimates that the total addressable market of U.S. dollar deposits related to digital currencies to be around \$30- \$40 billion. However, Silvergate feels it is well-positioned to capitalize on this potential growth market as one of the leading banking providers of the industry with its growing near-instant payment network, SEN.

With that being said, Silvergate may experience increased competition as the digital asset space matures which could in turn be detrimental to Silvergate's growth. The bank is also not impervious to the effects of the ever-changing macro environment with low interest rates and coronavirus-induced economic uncertainty serving as potential overhangs for the banking industry.

HISTORY

Founded in 1988, California-based Silvergate Bank initially served as a traditional commercial bank. The company began pursuing digital currency customers in 2013, and soon thereafter made servicing the crypto-related companies its core focus after achieving early success. As of June 30, Silvergate has expanded its digital currency customer base to 881 clients with aggregate deposits of \$1.5 billion (which accounts for 94% of the bank's total deposits).

Silvergate's digital currency initiative



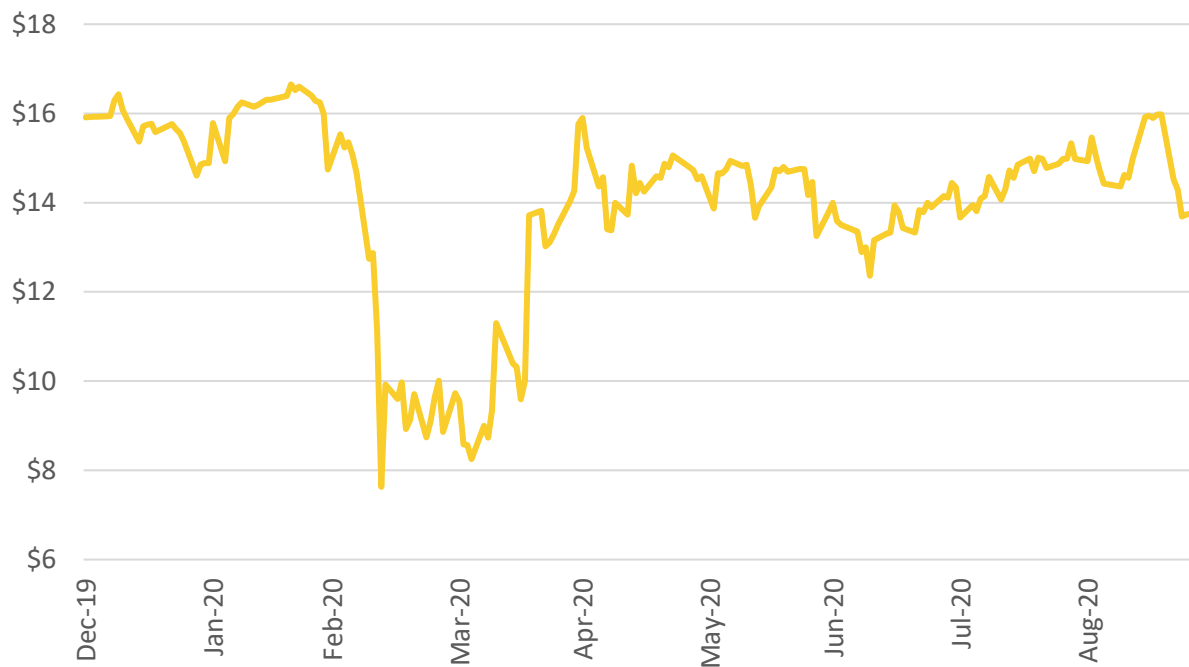
Source: Silvergate, FactSet, CoinDesk

The complexities of navigating this fast-paced environment require the banks servicing this market to need specialized compliance capabilities with management teams knowledgeable in both the cryptocurrency and financial services industries. As a result, Silvergate competes with only a handful of crypto-friendly banks in the U.S. including Signature Bank, JPMorgan Chase, SVB Financial, and Metropolitan Bank.

What sets Silvergate apart from its competition, however, is its wide network of established cryptocurrency-related companies and its unique product offering such as its Silvergate Exchange Network, or SEN (a payment network that allows Silvergate's customers to exchange U.S. dollars amongst one another 24/7).

Silvergate currently trades on the NYSE under the ticker SI, with a market capitalization (at time of writing) of approximately \$257 million.

Silvergate (\$SI) stock performance



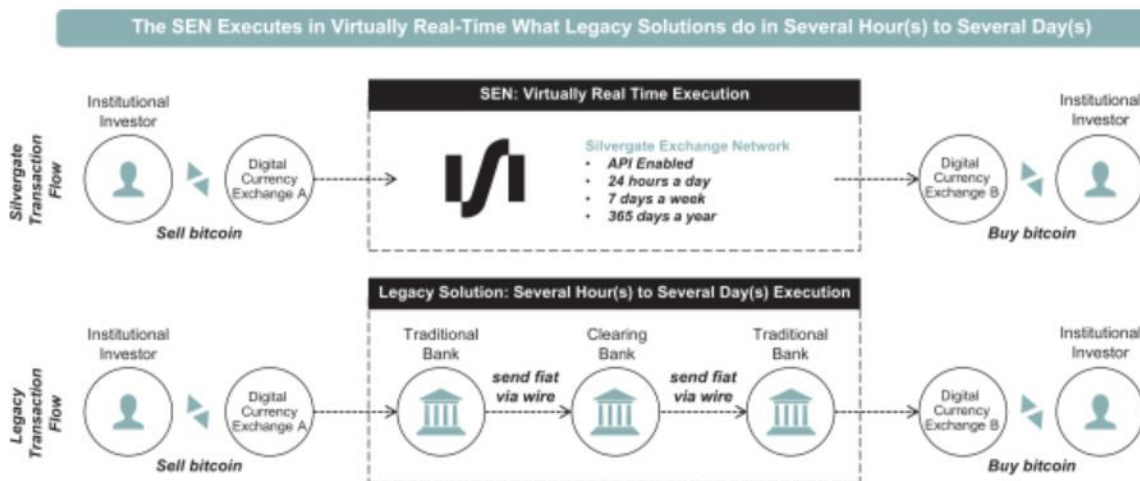
Source: Yahoo Finance, CoinDesk, Data as of September 25, 2020

SILVERGATE EXCHANGE NETWORK (SEN)

The backbone behind Silvergate's strategy revolves around its unique product offering to its digital asset customers, which management believes creates a competitive moat for itself.

The most notable of these products is its real-time payment network, the Silvergate Exchange Network (SEN).

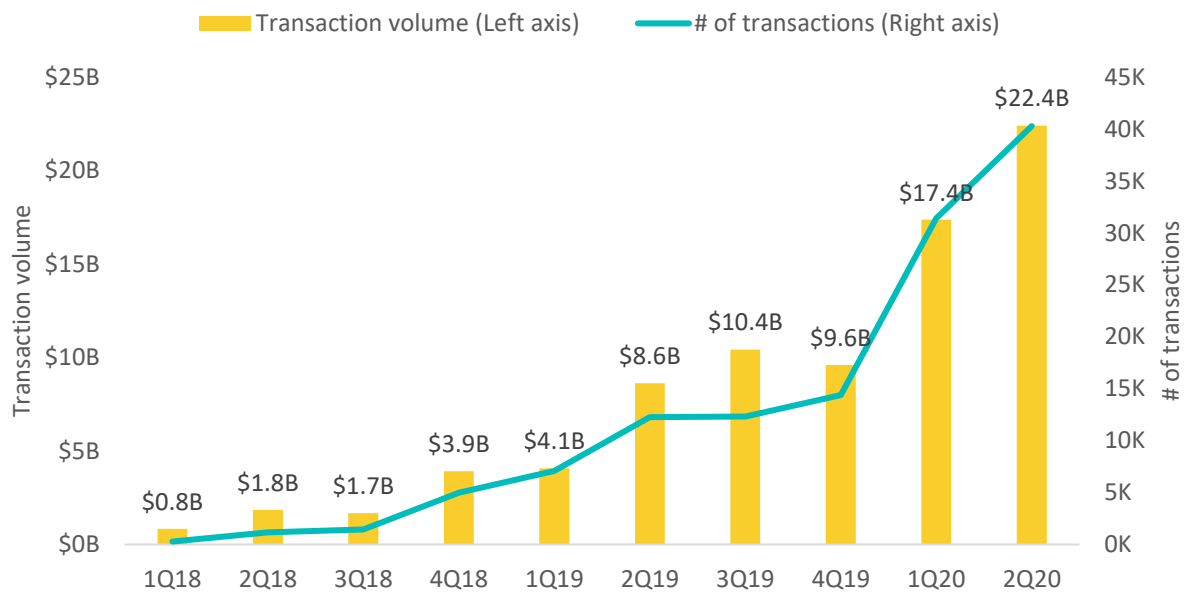
SEN transaction flow vs. legacy wire transfers



Source: Silvergate

The SEN is a closed network available 24/7 that allows for real-time transfers of U.S. dollars between Silvergate's institutional investor and digital asset exchange customers. Unlike traditional wire transfers which can take days to settle, the SEN allows users to send transfers to each other nearly instantly.

SEN transfer volume



Source: Silvergate, FactSet, CoinDesk

Since its launch in early 2018, both the number of transactions and transaction volume have increased dramatically. In 2Q20, the SEN had over \$22 billion in transfer volume which was 29% more than the previous quarter. Management attributes its increased use to the growing network effects as more customers get introduced to the platform.

To reduce any possible friction, Silvergate does not charge fees on its SEN transfers. The company believes that by improving the utility of SEN, this will in turn deepen the bank's competitive moat. Instead, Silvergate plans on driving revenue through complimentary products that build on the SEN.

Competing against the SEN is Signature Bank's payment network, [SigNet](#), which launched in early 2019. SigNet bears many similarities to the SEN. Both are fee-less closed-off systems that allow real-time U.S. dollar transfers. Unlike Silvergate, Signature does not disclose the amount of activity that takes place on SigNet. However, Signature's management does frequently mention it as one of the main drivers behind its deposit growth on quarterly earnings calls.

FINANCIALS

Balance sheet

(YE 31-Dec, \$USDM)	4Q18A	1Q19A*	2Q19A	3Q19A	4Q19A	1Q20A	2Q20A
Assets							
Cash & cash equivalents	674	533	341	160	134	166	199
Securities	357	462	921	910	898	964	951
Loans	943	845	920	1,003	1,041	1,114	1,115
Other	29	51	60	63	56	66	75
Total assets	2,004	1,891	2,242	2,137	2,128	2,311	2,341
Liabilities & Shareholders equity							
Deposits from digital asset customers	1,470	1,320	1,463	1,297	1,245	1,693	1,509
Other deposits	313	279	475	551	570	310	162
Total Deposits	1,783	1,599	1,939	1,848	1,815	2,003	1,671
Other liabilities	30	91	89	58	82	63	402
Total liabilities	1,813	1,690	2,027	1,906	1,897	2,066	2,073
Shareholders equity	191	201	215	231	231	245	268
Key ratios							
Return on avg. assets (ROAA)	1.37%	1.13%	1.03%	1.20%	0.67%	0.79%	1.02%
Return on avg. equity (ROAE)	16.9%	11.4%	10.0%	11.8%	6.1%	7.1%	8.7%
Loans/Deposits	52.9%	52.9%	47.5%	54.3%	57.3%	55.6%	66.8%
Net interest margin (NIM)	3.59%	4.01%	3.56%	3.39%	2.97%	2.86%	3.14%
Efficiency Ratio	61.1%	62.2%	64.5%	59.9%	72.8%	68.0%	65.0%
Net charge-offs/Average loans	1.40%	0.00%	0.01%	0.01%	0.01%	0.00%	0.00%
Tier 1 Leverage ratio	8.5%	11.1%	11.1%	10.4%	11.2%	11.0%	11.6%

Source: Silvergate, FactSet, CoinDesk

Low-cost deposit base

Historically, one of the most attractive aspects of Silvergate's business model is its low-cost deposit base. By catering to a market which has traditionally struggled to find banking partners, Silvergate manages to keep its cost on deposits close to zero. As of period-end 2Q20, nearly 94% of its \$1.7 billion in deposits were non-interest bearing with its digital asset customer base accounting for the vast majority of that.

Like any other bank, Silvergate utilizes its deposits to earn yield on its asset base. Silvergate uses what it calls a "low-risk asset strategy" by limiting the size of its loan book and deploying a significant portion of its assets into liquid securities. While these securities don't earn the same level of yield as that of its loan book, management believes this strategy gives them ample liquidity given its volatile deposit base.

Income statement

(YE 31-Dec, \$USDm)	4Q18A	1Q19A*	2Q19A	3Q19A	4Q19A	1Q20A	2Q20A
Net interest income	20.9	19.3	17.6	18.4	15.6	15.5	16.1
Provision for loan losses	(1.7)	0.3	0.2	(0.9)	--	0.4	0.2
Net interest income after provision	22.5	19.0	17.4	19.3	15.6	15.1	15.8
Fee income from digital asset customers	0.7	0.9	1.1	1.6	1.4	1.7	2.4
Other fee income	1.3	1.5	1.1	1.0	1.8	3.2	3.0
Total fee income	2.0	2.4	2.2	2.6	3.1	4.9	5.4
Noninterest expense	14.0	13.5	12.7	12.6	13.7	13.9	14.0
Pre-tax income	10.6	7.9	6.8	9.3	5.1	6.2	7.3
Income tax expense	2.5	2.4	1.7	2.6	1.5	1.8	1.8
Net income (loss)	8.0	5.5	5.2	6.7	3.6	4.4	5.5
Diluted EPS	\$ 0.44	\$ 0.30	\$ 0.28	\$ 0.36	\$ 0.19	\$ 0.23	\$ 0.29

*1Q19 adjusted for one-time gain on sale of San Marcos branch and associated tax effect

Source: Silvergate, FactSet, CoinDesk

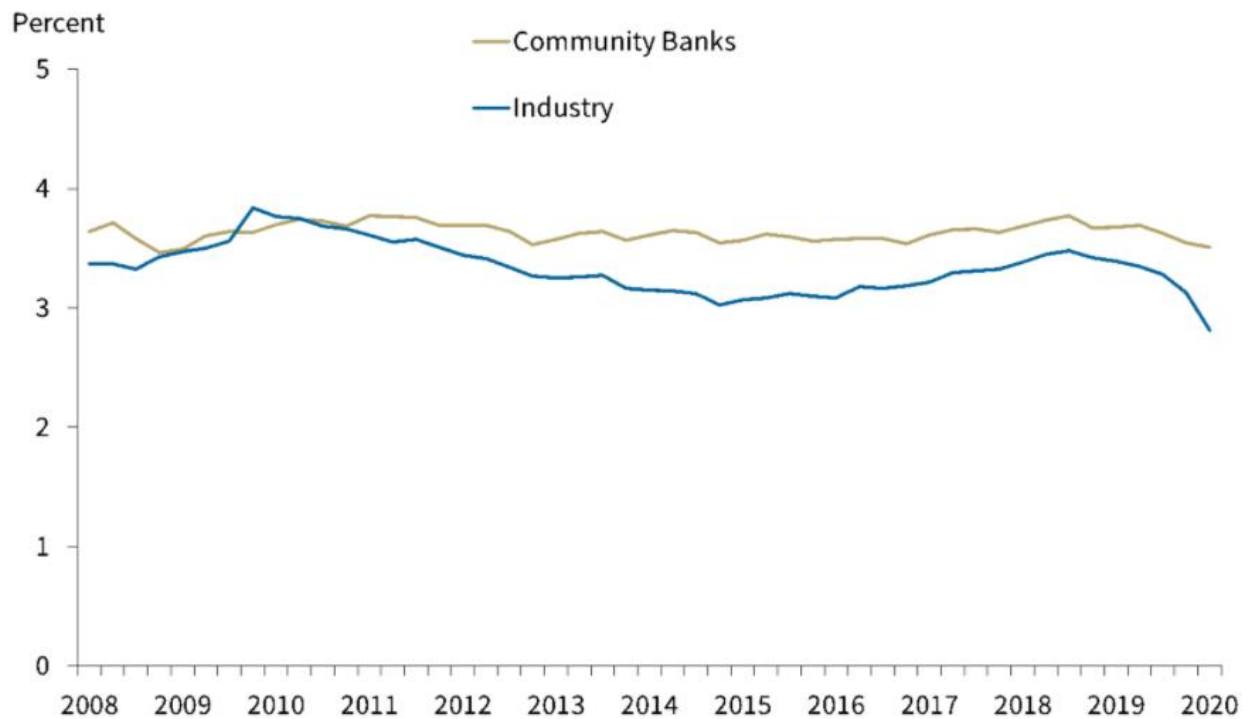
Lack of deposit growth and near-zero interest rate environment limiting net interest income

Over the past year and a half, Silvergate has experienced a decline in net interest income (the difference between the yield earned on assets less the cost of its liabilities). This is primarily due to two reasons:

- Decreases in the Fed Funds rate
- Lack of deposit growth

Since July 2019, the Federal Reserve has decreased the federal funds rate four times. The low-interest rate environment has had negative impact on the entire banking industry with the average net interest margin declining 58 basis points sequentially to 2.81% in 2Q20 as asset yields declined more rapidly than funding costs, according to the FDIC.

Banks' quarterly average net interest margin (NIM)



Source: [FDIC](#)

Like many other banks, Silvergate has experienced a decline in its net interest margin as the yield on its assets decreased. It's worth noting that beginning in 2Q19, the company issued callable brokered CDs as part of a rate hedging strategy which temporarily caused an increase in its cost of funds.

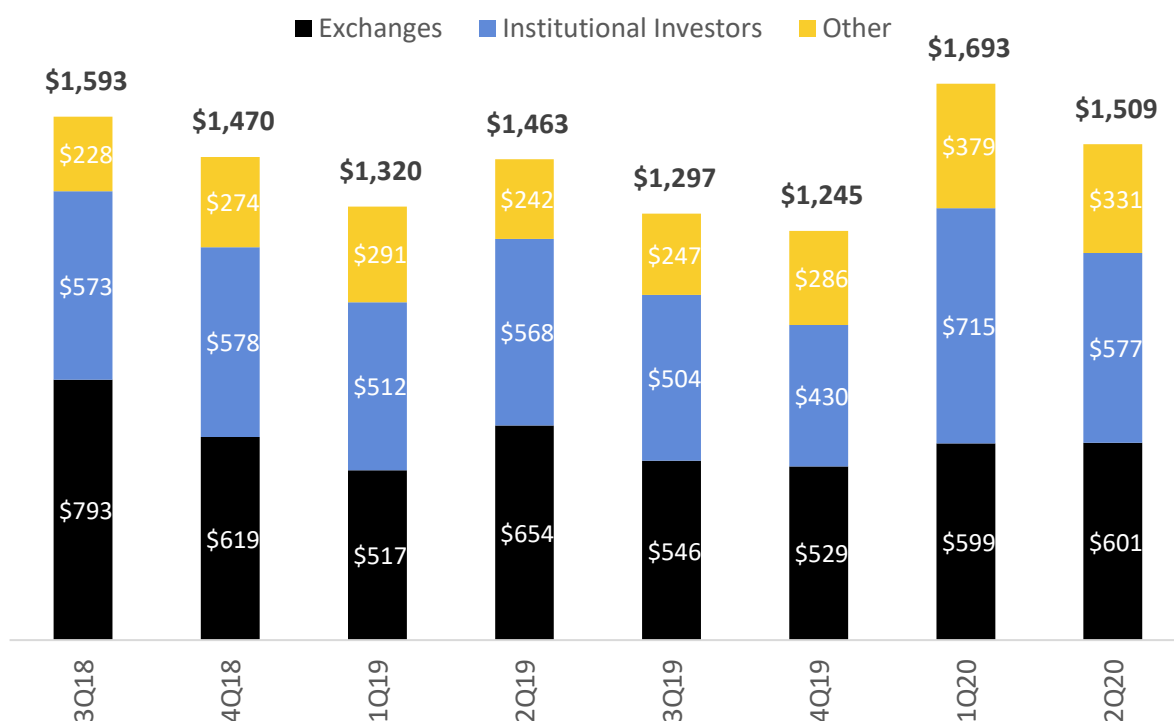
Silvergate net interest margin trends



Source: [Silvergate](#)

Besides lower net interest margin, another limiting factor for Silvergate's profitability is the lack of deposit growth (which in turn limits its ability to grow its asset base).

Silvergate digital currency customer deposits (\$mm)



Source: Silvergate, FactSet, CoinDesk

Despite the bank consistently growing the number of its digital asset customers, the aggregate deposit balance fluctuates around \$1.5 billion. Management has noted that the bank has experienced deposit outflows (primarily from Silvergate's institutional investor customers) to its competitors offering yield.

It's possible some of those outflows went to its fellow crypto-friendly bank, Signature Bank, who has offered yield on deposits to at least some of its digital asset clients. Although Signature does not normally disclose the size of its digital-asset related deposit portfolio, it did mention that its digital asset team grew deposits by [\\$1 billion](#) sequentially in 2Q20 (vs. the \$184 million sequential deposit decline from Silvergate's digital asset customer base).

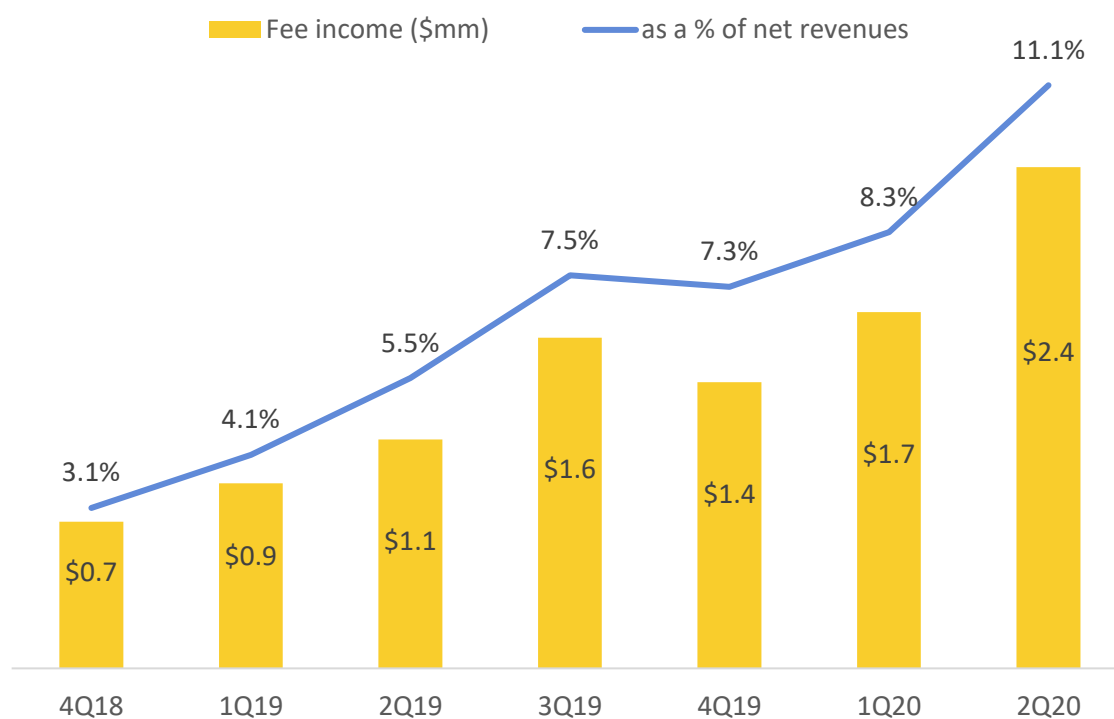
Non-interest income growing but still a small contributor

Due to the volatility in its deposits, management has put a greater focus on building out its fee income (income from charging fees on services), which it believes will be a more consistent revenue stream.

Historically, Silvergate's fee income has only been a small contributor to the bank's overall revenue. However, fees related to its digital asset customer base have risen dramatically thanks to the SEN.

As mentioned previously, Silvergate does not charge fees on SEN transfers. The increased usage of the SEN, on the other hand, has spurred demand for its cash management services (namely wire transfers from its cryptocurrency exchange customers), on which it does earn revenue.

Silvergate fee income from digital currency customers



Source: Silvergate, FactSet, CoinDesk

As of 2Q20, fee income related to its digital currency customer base has grown to \$2.4 million, which is still only 11% of Silvergate's net revenues (sum of fee income and net interest income). Nonetheless, management feels confident that this segment will have a more material impact as SEN use expands.

HEADWINDS

Economic uncertainty

Industry-wide, banks are bracing themselves for potential loan losses as the coronavirus continues to cause economic uncertainty. Silvergate has been actively working with some of its borrowers to avoid default by granting payment deferrals for those financially impacted by the virus.

COVID-19 related loan modifications

Loan Segments at June 30, 2020					COVID-19 Loan Modifications				
(\$ in millions)									
Loan Segment	#	Loan Balance	WA LTV	% of Total Loans HFI	Completed Modifications	#	Loan Balance	% of Loan Balance	% Resumed Payments
Real estate loans:					Real estate loans:				
One-to-four family	505	\$ 216	55%	27%	One-to-four family	19	\$ 12	6%	25%
Multi-family	58	72	50%	9%	Multi-family	-	-	-	-
Commercial:					Commercial:				
Retail	33	83	54%	10%	Retail	13	52	63%	15%
Hospitality	13	46	44%	6%	Hospitality	8	39	85%	0%
Office	13	58	63%	7%	Office	4	21	37%	90%
Industrial	23	87	60%	11%	Industrial	1	5	6%	0%
Other	20	43	47%	5%	Other	2	6	13%	100%
Total commercial	102	317	55%	40%	Total commercial	28	123	39%	27%
Construction	6	11	51%	1%	Construction	-	-	-	-
Commercial and Industrial	14	25	58%	3%	Commercial and Industrial	2	1	6%	100%
Other	15	2	88%	0%	Other	-	-	-	-
Mortgage warehouse	n/a	155	n/a	19%	Mortgage warehouse	-	-	-	-
Total gross loans HFI	694	\$ 797	n/a	100%	Total modifications	49	\$ 137	17%	27%

Source: [Silvergate](#)

As of June 30, the bank had modified 49 of its 694 loans (7% of all loans) with an aggregate outstanding balance of \$137 million (17% of Silvergate's total loan balance). As of July 15, 27% of the 49 modified loans have resumed payments.

Despite the uncertainty, management remains optimistic as shown by CFO Antonio Martino's comments on the 2Q20 earnings call from late-July:

"Although there is significant uncertainty in the current economic environment due to the impact of COVID-19 pandemic, we believe that our relatively low loan-to-value ratios along with only modest exposure to the retail and hospitality sectors provides low probability of loss in the event of default in our portfolio."

New entrants taking market share

Over the past few months, we have seen signs that the world of banking may be getting more comfortable in providing services to the cryptocurrency industry as it matures:

- In May, it was [reported](#) that JPMorgan Chase had accepted both Coinbase and Gemini as its first clients from the cryptocurrency industry.
- In July, the OCC released a [letter](#) that allowed nationally chartered banks in the U.S. to provide custody services for cryptocurrencies and also reaffirmed its position that national banks can provide banking services to cryptocurrency businesses (as long as they effectively manage the risk and comply with the law).

Although this is positive for the cryptocurrency industry as a whole, this could be detrimental to Silvergate's market share of crypto-related deposits as more banks enter this niche market. If that happens, it will become even more important for Silvergate to build out its competitive moat with its unique product offering.

As mentioned previously, Silvergate has in the past experienced deposit fluctuations as customers moved funds to institutions offering yield (unlike Silvergate's deposits which are almost exclusively non-interest bearing), which calls into question how deep Silvergate's moat really is.

With that being said, Silvergate consistently has a robust pipeline of prospective customers (often 200+ pending applications every quarter) and continues to invest in R&D to further enhance its product offering.

TAILWINDS

Potential acquisition target

As banks become more comfortable with the cryptocurrency market, it is possible Silvergate becomes a prime candidate for an acquisition target. Rather than build the compliance capabilities internally, we may see larger banks looking to purchase companies like Silvergate who already have the built-in capabilities as well as the industry familiarity.

During a [virtual conference](#) with Canaccord Genuity back in July, Silvergate CEO Alan Lane hinted at his willingness to eventually be acquired:

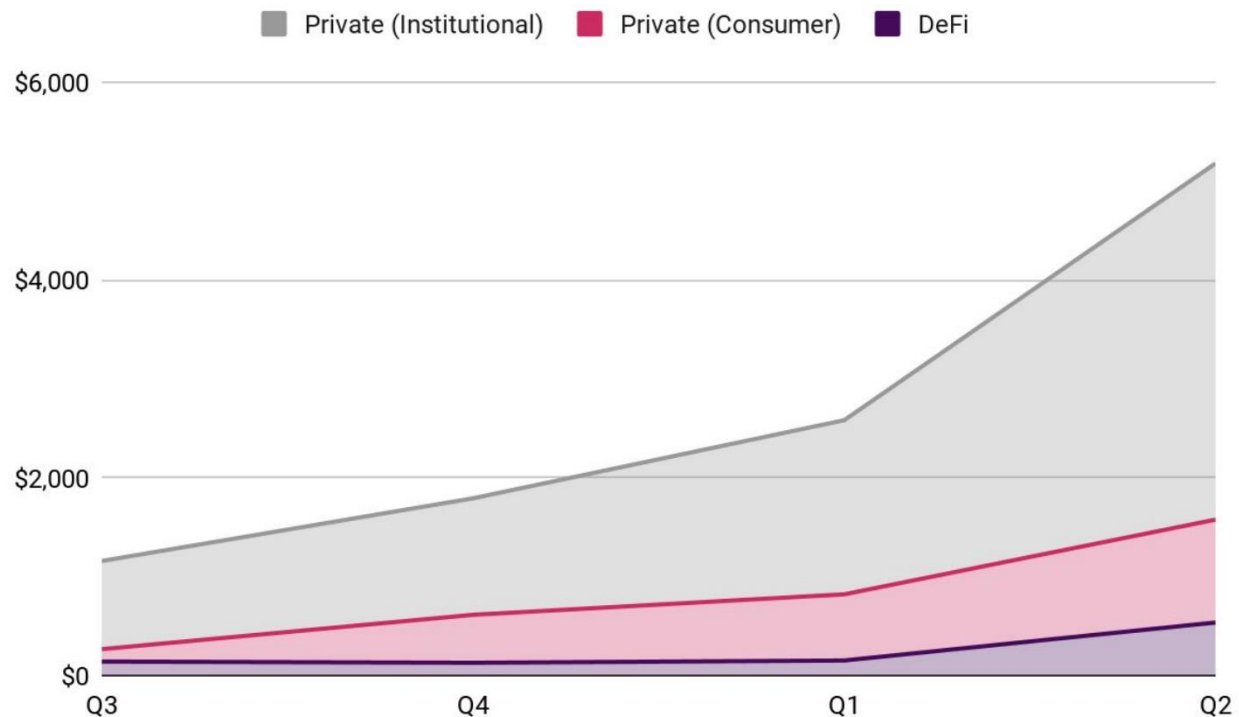
"I've been in banking for almost 40 years. I have sold just about every bank that I have been a part of. Our strategy at Silvergate is always we run it like we are going to own it forever, add value to shareholders, and at some point in time we are likely going to be an attractive target for someone who wants to get into this business."

For the time being, however, COVID-19 has slowed [bank M&A activity](#) as larger banks build their capital positions to better withstand possible loan defaults.

SEN Leverage

Over the past year, crypto-backed lending, in which customers deposit crypto holdings as collateral for fiat loans, has been one of the fastest-growing segments within the cryptocurrency industry. Competing in this market are mostly crypto-native private lenders ("CeFi") such as BlockFi and Genesis Capital as well as decentralized lending platforms built on smart contracts ("DeFi") such as Maker and Compound.

Loans outstanding of crypto lending institutions (\$mm)



Source: [Credmark](#)

According to research by Credmark, crypto lending has continued to show robust growth in loans outstanding over the past year. Of the crypto lending firms that Credmark surveyed, the aggregate amount of active debt from these institutions doubled from \$2.6 billion to \$5.2 billion between period-end 1Q20 and 2Q20.

Silvergate hopes to capture some of this market by providing bitcoin-collateralized loans to its institutional clients through its product called SEN Leverage which launched in 1Q20.

The bank is currently trying to establish a subsidiary that can serve as a qualified bitcoin custodian. However, the subsidiary's application to become a New York State licensed trust company is still under review from regulators. In the meantime, Silvergate is content with partnering with third-party financial institutions such as Bitstamp and Anchorage (who are also customers of Silvergate) to manage the bitcoin collateral for SEN Leverage.

As of June 30, Silvergate had \$20 million in loans outstanding from this product, which equates to less than 2% of the bank's total loans. As it stands today, Silvergate's cryptocurrency-backed lending platform is not nearly as robust as those of its non-bank competitors. Genesis Capital, for example, offers collateralized loans denominated in various cryptocurrencies (not just bitcoin).

Genesis loan portfolio composition

Asset	9/30/2019	12/31/2019	3/31/2020	6/30/2020
BTC	50.2%	47.3%	44.8%	51.2%
BCH	0.3%	3.4%	5.8%	4.5%
ETH	7.5%	5.0%	5.6%	7.4%
ETC	3.0%	2.7%	2.1%	1.7%
XRP	3.6%	2.7%	2.3%	1.9%
LTC	2.0%	0.9%	0.7%	0.3%
USD & Equivalents	31.2%	37.2%	36.6%	32.0%
Other	2.2%	0.9%	2.1%	1.0%

Source: [Genesis](#)

Crypto bull run

Silvergate grew its deposit base significantly in 2017 in large part due to the crypto bull run that year. As it stands today, the digital asset industry is still a niche community. However, if the industry expands significantly like it did in 2017, Silvergate could be well-positioned to capture some of the upside given its unique products for digital asset customers.

CONCLUSION

Silvergate is one of a handful of banks that service the niche cryptocurrency community. Although its client base continues to expand, the size of its deposit portfolio has not grown for nearly the last two years. Offering no yield on deposits has helped sustain the bank's margins, but at the same time has made it susceptible to losses in market share as competitors offer yield.

Silvergate has built a unique set of products geared towards its cryptocurrency client base. Should cryptocurrency markets experience a bull run similar to that of 2017, Silvergate may face increased levels of competition from new entrants. Despite this, however, management believes it is well positioned to capture upside given its competitive moat and the increased network effects from its payment platform, SEN, and complimentary products.



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