FINANCIAL MARKETS FLASH

BANKING STRESS, A SOURCE OF HIGH VOLATILITY IN THE MARKETS

16 MARCH 2023

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Wednesday 8 March: start of stress in the United States

On Wednesday 8 March and Thursday 9 March, an unprecedented withdrawal of $42bn of deposits led to the collapse of Silicon Valley Bank (SVB), the 16th-biggest bank in the US. The wave of panic was triggered by calls launched by major venture capital funds for their partners to flee SVB (a phenomenon known as a bank run), which was at risk of a liquidity shortfall after being forced to sell its $21bn portfolio of Treasury bonds, generating a loss of $1.8bn because of the rise in interest rates in recent quarters. In theory, this bank run phenomenon is an event marked by massive and simultaneous demands to withdraw money by the clients of a bank, which is at risk of becoming insolvent according to rumours heard by these same clients. It is because it is unable to honour these massive withdrawals that a bank becomes insolvent, explaining the self-perpetuating nature of this phenomenon.

• The collapse of SVB in detail

A specialist in the financing of start-ups and venture capital funds in the high-tech sector, SVB's success was based on its ability to aid the growth of these companies, which have raised massive amounts of capital over the past five years. As such, SVB had a very specific business model, with a balance-sheet structure quite unlike that of a typical regional bank. The structure of its deposits was concentrated on venture capital funds, not on retail clients. Its deposits had quadrupled from $44bn at end-2017 to $189bn at end-2021. Over the same period, its outstanding loans rose from $23bn to $66bn, enabling the bank to invest $128bn in assets with no counterparty risk, such as mortgage bonds or government bonds. The bank's assets therefore comprised a large share of bonds (mainly Treasuries and MBS), making it more sensitive than average to interest-rate fluctuations. But the $1.8bn capital increase following the loss mentioned above (without this being demanded by the regulator) should normally have been completed without generating any great emotion.

• Diagnosis

Despite its profitable long-term business model and adequate capital ratios, we have identified several factors explaining the company's difficulties:

- Lack of customer diversification (businesses and individuals working in Silicon Valley technology companies) in both geographical terms (vast majority of revenues generated in California) and, above all, in terms of sources of funding, as customer deposits represented 82% of liabilities and these deposits were thinly spread and concentrated on several big clients.
- Poor asset-liability management, mainly related to its disproportionate investment portfolio (representing 71% of assets in 2022). The lion's share of SVB's balance sheet was invested in US government bonds and MBS, both of which have fallen steeply in value because of the recent and rapid rise in interest rates in the US. To avoid recording these losses directly and to keep them unrealised, SVB had decided to record the vast majority of the portfolio at "amortised cost".

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Banks usually hedge (at least partially) the interest-rate risk of their investment portfolios with derivatives, but this was not the case here.

- Rumours of liquidity problems at SVB were shared by key Silicon Valley personalities (Peter Thiel, co-founder of Paypal, among others), leading to massive demands to withdraw liquidity in the middle of last week ($42bn of withdrawal demands in a single day, representing 20% of the bank's balance sheet).
- In view of the bank's modest size, the regulator was less demanding on several aspects, including on funding and liquidity (no requirement to publish the LCR or NSFR).

Sunday 12 March: regulators at work

The US Federal Reserve stepped in to forestall the risk of a systemic spillover through this bank run phenomenon.. In a bid to reassure the markets when they opened on Monday 13 March, it set up a deposit guarantee mechanism and provided banks with access to liquidity to avert deposit withdrawals.

• **Reactions by regulators**

In detail, US authorities in the form of the Treasury, the Fed and the Federal Deposit Insurance Corporation (FDIC) intervened with the following emergency measures to prevent any contagion:

- All deposits will be guaranteed, which means that the FDIC will make up the difference between the bank's deposits and those covered by asset sales (including deposits of more than $250,000).
- A bank term funding programme with less stringent collateral conditions was launched for banks to address a possible bank run type panic. Access conditions to the facility were loosened and collateral will be valued at par, which means that banks will be able to monetise securities above their market value if necessary.

Besides SVB, the US authorities are allowing access to all the deposits of another institution, Signature Bank, which was shut down by the regulator. This is a New York institution, the 21st-biggest US bank, whose assets are estimated at the Fed at $110bn. A third bank, Silvergate Bank, was also closed. This is far smaller but is known for its links to the cryptocurrency sector.

• **Short-term outlook**

These measures have reassured US banks in the short term, but the environment remains turbulent. US banks generally have L/D ratios of below 1, which means that they have an excess of deposits. On average, the proportion of bonds on US banks' balance sheets is far lower than that of SVB. As such, marked-to-market requirements potentially have less impact on their capital. Moreover, these bonds are intended to be held to maturity, implying that the any losses are virtual. They only materialise in the event of a fire sale, such as during a bank run, which was the case for SVB. What's more, the deposit base of traditional regional banks is far more inert and bank runs are less likely.

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In Europe, UK authorities announced on the morning of Monday 13 March that SVB's UK branch had been sold to HSBC, which said it had acquired it for a symbolic £1. SVB's customers in the UK could therefore access their deposits and banking services from market open on Monday. Eurozone banks do not have anything like the same profile as the aforementioned US regional banks. They are very liquid and have far more customer diversification.

Wednesday 15 March: Credit Suisse in turmoil

Credit Suisse's share price plunged by around 30% in a single day, taking it down 40% over one month and 80% over one year. Having been in difficulty for several months, the stock's sell-off followed the announcement by the principal shareholder, Saudi National Commercial Bank, that it would not inject fresh capital into Credit Suisse as it did at the capital increase last year in conjunction with the restructuring plan.

• **Concerns about Credit Suisse in detail**

Saudi National Commercial Bank currently holds a 9.88% stake in Credit Suisse and does not want to surpass the 10% threshold for regulatory reasons. This bad news adds to that last week from a long-term shareholder, Harris Associates, which announced the sale over recent months of its entire stake in Credit Suisse. The bank had also announced on 9 March the postponement of the publication of its annual report following the warning by the Stock Exchange Commission (SEC) about the publication of the 2022 report, with precise questions about its 2019 and 2020 cash flow tables. This annual report was finally published on Tuesday 14 March 2023.

• **Diagnosis**

The bank had been in difficulty for several months. Provisions recorded to cover various scandals (including the Archegos hedge fund fiasco and the collapse of fintech Greensill), losses on the investment bank's assets and withdrawals from the Wealth Management, Asset Management and Private Banking divisions had weakened the group's liquidity position. In this context, there is a risk that withdrawals of deposits will accelerate, generating additional losses on traditional activities, while the investment bank may have to divest assets in unfavourable conditions, deepening losses further.

The Swiss supervisor (FINMA) will play a key role in the group's rescue with the stated objective of ensuring the continuation of the group's Swiss activities to preserve the national financial ecosystem. Current conditions, the ongoing restructuring plan and losses to absorb on non-strategic assets and litigation necessitate a new recapitalisation of around CHF10bn. Because of market mistrust, Credit Suisse is no longer capable of organising a rescue plan through a merger with another bank or a recapitalisation. Other options are on the table to strengthen its solvency.

Morning of Thursday 16 March: Swiss regulators at work

The Swiss National Bank and FINMA announced overnight a CHF50bn collateralised credit facility to strengthen Credit Suisse's liquidity and allow it to launch a CHF3bn debt buyback.

• The reactions of regulators

With this facility, the SNB is attempting to neutralise systemic risk by providing implicit support to the sector. By injecting liquidity (in exchange for a deposit of high-quality securities), the SNB is limiting the erosion of Credit Suisse's capital caused by fire asset sales and is gaining time to implement a restructuring plan.

By authorising the repurchase of discounted debt, the SNB is implicitly recapitalising Credit Suisse without breaching bail-out rules and providing explicit support to the bank. Thanks to this reaction by the regulator, the risk of contagion seems contained for the time being.

• Short-term outlook

As expected, Swiss authorities, namely the Swiss National Bank and Finma, the banking supervisor, have intervened to reassure the markets and neutralise systemic risk. The challenge is to gain time to stabilise liquidity and limit the erosion of capital while studying various possible options.

Credit Suisse is a bank that has long been in a restructuring and the regulator has been in its offices in this regard for several weeks. The sell-off resulted from the combination of several factors: stress caused by the SVB affair, the postponed release of financial statements and the announcement by its reference shareholder. Other eurozone banks do not have the same risks to their fundamentals, but the stress remains since the situation is changing rapidly, particularly in terms of liquidity, where tensions can become self-perpetuating, explaining the importance of central bank interventions.

Once this is digested by the markets and volatility has eased, the impact of this phenomenon on company valuations in the financial sector may open up investment opportunities provided a selective approach is taken to the quality of fundamentals.

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