FLASH NOTE

Bank bankruptcies in the USA and the next dominoes to fall: financial markets are not looking in the right direction

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1/ What happened?

a) A story of shadow banking exposure and depositor concentration

The US banking system is made up of more than 4,000 credit institutions, the overwhelming majority of which holds less than $10bn of assets. Regulatory oversight obviously differs whether you are JPMorgan Chase (more than $3,600bn of assets as at the end of 2022) or a small regional bank. Capital requirements are set at lower levels for smaller banks and they do not have to fulfill several liquidity constraints. Yet, this story is not about regulatory failure.

This is a story about fast growth and depositor concentration that ends badly for three banks:

- ***Silvergate Bank (SI)***: assets grew from $2bn to $16bn between 2019 and 2021, then dwindled back to $11bn as at the end of 2022. This crypto-centric bank announced on Thursday that it was winding down its operations and liquidating the bank, which has been in financial turmoil since the collapse of crypto exchange FTX. Following a bank run in the fourth quarter, Silvergate leaned on the Federal Home Loan Bank of San Francisco for a $4.3 billion cash injection, which by the end of the quarter made up nearly all of its total assets.

- ***Signature Bank (SBNY)***: its assets went from $50bn to $118bn between 2019 and 2021 and was much bigger than now-defunct Silvergate Bank. In the wake of the demise of SVB and SI, Signature Bank, the bank was closed on Sunday by its chartering authority. All depositors of this institution will be made whole. As with the resolution of Silicon Valley Bank, no losses will be borne by the taxpayer.

- ***Silicon Valley Bank (SIVB)***: assets went from $71bn to $211bn between 2019 and 2021 and were stable until the end of 2022. As its name suggests, SVB was lending to companies mostly based in the Silicon Valley, with a focus on lending to technology companies, providing services to venture capital and private equity firms. It rapidly grew to become the 18th largest bank holding company in the US. During the 2019-2021 phase, SVB received significant inflows of deposits from venture capital firms that it needed to cover from an asset standpoint. As such, management sought to chase yield by buying long-duration bonds (Treasuries, MBS…). The bank started to lose deposits as VCs pulled cash through operating capital, which pressured management to sell some of its long-term assets. It seems like these assets were not really properly hedged, but we lack sufficient information thus far.

On March 9, 2023, shares of SVB Financial plunged more than 62% after the company proposed a share sale to shore up its balance sheet which had suffered fleeing deposits and a $1.8bn realized loss on the securities sale. According to a regulatory filing published on Friday, investors and depositors tried to pull $42bn from SVB on Thursday… A good old fashioned "bank run". Despite being in sound financial condition prior to Thursday, the California watchdog said the run "caused the bank to be incapable of paying its obligations as they come due," and it was now insolvent. The bank was then closed by the California Department of Financial Protection & Innovation and placed into FDIC receivership, marking the biggest failure of a US bank since the financial crisis.

On Sunday evening, a joint statement by the US Treasury, the Fed and the FDIC announced that "no losses associated with the resolution of Silicon Valley Bank will be borne by the taxpayer". In other words, all deposits (even those that are uninsured by the FDIC above $250k) will be guaranteed. Any losses to the Deposit Insurance Fund to support uninsured depositors will be recovered by a special assessment on banks. Subordinated debtholders and equity holders will very likely be wiped out, while senior unsecured creditors may recover part of their holdings (bonds were trading at c. 40 cents on the dollar at Friday close, but this is not a trustworthy indication of their final recovery).

In order to contain the fallout from these bank failures, the Fed said it would create a new lending program for banks: the Bank Term Funding Program, or BTFP. The facility will allow banks to take advances from the Fed for up to a year by pledging Treasuries, MBSs and other debt as collateral. By allowing banks to pledge their bonds, they can meet customer withdrawals without having to sell their bonds at a loss, which is what SVB did last week. Banks can borrow funds equal to the par value of the collateral they pledge, which means that the Fed will not be looking at the potential unrealized losses on the bonds.

This mechanism, along with the guarantee that all depositors will be made whole, are very significant steps to ensure the safety of the US banking system.

b) How can a bank die that fast?

This is the textbook definition of a "bank run". SVB had merely announced on Wednesday evening that they were looking to raise some fresh capital to cover their net loss (which was far from significant from a balance sheet standpoint), but it was coming on the heels of the collapse of Silvergate, thus inducing more panic from VC companies. According to CNBC, several prominent funds instructed their startups to pull funds out of SVB in recent days on concerns of a bank run. The highly interconnected nature of the tech investing community, along with the echo chamber of social media are key reasons for the rapid demise of the bank.

We have seen that before, and we do not need to get back to the Great Financial Crisis (GFC) of 2007-2008 to gain hindsight. In Europe, Banco Popular Español collapsed from a bank run allegedly induced by local authorities in June 2017, which advised communities and municipalities to withdraw funds from the bank, as its financial soundness was being put into question.

No amount of capital and liquid securities can save you from a "bank run". This will always be the Achille's heel of the banking industry, which relies on trust from its customers at the end of the day. Banks are by nature a leveraged industry, where short-term deposits finance long term lending. Regulations since the GFC have forced banks to hold way more capital than before and to deleverage to a large extent, while forcing them to hold large amounts of so-called "High Quality Liquid Assets" to satisfy newly-conceived liquidity requirements. But this regulatory oversight is mainly targeted to global and systemic banks, rather than regional players.

c) Canaries in the coalmine?

Why did these two banks in particular got liquidated during the same week? Panic is of course a self-fulfilling prophecy to achieve the worst outcome, but Silvergate, Signature Bank and SVB shared one distinct feature: they lacked depositor diversification.

To put it into simple words: when a bank caters to only one group of people, and these people begin to suffer from cash outflows themselves, the bank becomes subject to the woes of the people they are financing. Silvergate was the bank of the crypto industry and SVB was the bank of VCs, which came under scrutiny and pressure in 2022. With US rates stuck at higher levels, needless to say that funding for these industries has become more difficult over the course of the last 15 months.

Is it the only lesson to draw from here? We are witnessing a lot of focus on the natural asset-liability management (ALM) mismatch that a bank encounters when it buys long-duration bonds to cover short-term deposits. Usually, a bank swaps its fixed-rate assets to a variable basis in order to avoid such an ALM mismatch, as deposits are mostly remunerated on a floating basis. Moreover, a bank can decide to hold its securities until maturity, which has the beneficial effect of not having any impact on its P&L, as long as it does not have to sell them. Most of the bonds bought by SVB during its expansion phase were running with elevated unrealized losses, but again, it should not become a hot topic, unless the bank is forced to unwind them to cover its fleeing deposits AND if they do not benefit from interest-rate hedging. An inverted US yield curve is negative for bank net interest margins, as banks need to remunerate deposits while earning somewhat less on the asset side, but this is not that worrisome at the moment, in our opinion, as US bank profitability remains on high grounds.

While this is always interesting to discuss bank accounting and profitability metrics, this should not be the topic here. What matters is that banks which have a lack of depositor diversification and that lend to volatile/risky activities will always be more prone to "bank runs", especially if they do not have proper risk management of their exposures nor a high degree of regulatory oversight.

2/ Contagion? This is not a banking crisis. This is a shadow banking crisis.

a) US Banks : the equity price contagion has no fundamental ground

A study published on Friday by independent research provider CreditSights highlights that SVB is a unique case among US regional banks, as its loan portfolio is 79% directed to the Technology and VC fund sectors, while peers such as PNC, CFG, RF, FITB, TFC, CMA, USB, KEY have an exposure that ranges between 1% and 4%. We do not see any fundamental ground for the equity price contagion that happened this week, as these banks do not look to be suffering from any worrisome deposit outflows, nor do they show any sign of asset quality deterioration.

Moreover, big banks in the US are subject to two liquidity ratios designed under Basel III rules: the Liquidity Coverage Ratio and the Net Stable Funding Ratio, contrary to smaller banks such as SVB. Finally, the US economy is still benefiting from a positive macroeconomic backdrop, which should sustain balance sheet and P&L metrics for the quarters to come.

It also seems like SVB did not have a proper hedging policy for their long-dated bond exposures, which should have prevented the bank from recording a significant loss when unwinding their positions. While this is quite surprising and suspicious to us, we need to stress that all big US banks do have such policies. Moreover, according to Autonomous Research, unrealized losses on held-to-maturity securities represented close to 80% of SVB's tangible book value, while other US banks are much less exposed to this (between 5% to 50% of their tangible book value, according to this independent research provider).

b) Banks outside of the US: Credit Suisse in the eye of the storm

The most obvious risk is for Credit Suisse, which has been suffering for a while from its own woes. Its equity price is trading at all-time lows and has lost c. 70% in value since the beginning of 2022.

Credit Suisse is struggling to regain trust from its clients after an abysmal Q4 earnings announcement and a 2022 full year net loss of CHF7.3bn. The bank is struggling to stabilize deposit and AuM outflows, which were very elevated in Q4 (CHF93bn in Wealth management, CHF8bn in Swiss Bank and CHF12bn in Asset Management), and CS was also loss-making in virtually all of its business segments. According to Bloomberg, CS has recently raised the interest rate on deposits of new money from $5m and above in Asia, in order to stabilize outflows and retain existing clients. Moreover, the Chairman from CS is being probed by Swiss regulator FINMA, which seeks to establish "the extent to which Lehmann (the Chairman; no pun intended with Lehman Brothers), and
other Credit Suisse representatives, were aware that clients were still withdrawing funds when he said in media interviews that outflows had stopped".

This is relevant because Credit Suisse has been suffering from deposit outflows and has a client base that is largely made-up of sophisticated individuals and companies, which are considered as less sticky depositors than retail clients. These next few months will be key for Credit Suisse, which absolutely needs to stabilize its deposit base, even at the cost of its profitability, that is already severely hampered anyway.

Our base case is that Credit Suisse may end up being more or less split, with its Investment Banking franchise being partly or entirely sold, while retaining its Swiss retail arm and part of its Wealth management franchise overseas. However, this case revolves around its ability to counter deposit ouflows in the short to medium term.

It is worth remembering that the Swiss capital regulation framework for UBS and Credit Suisse is called the "Too big to fail" regime. As such, should Credit Suisse fail because of sustained deposit outflows, the FINMA would be ready to act very quickly to safeguard the interest of depositors, while breaking down the rest of the bank, at the expense of shareholders and subordinated bondholders. Again, the closest case that has been encountered lately was that of Banco Popular in Spain, which had been sold for €1 to Santander in order to safeguard deposit holders and senior bondholders.

As such, we steer clear from investing in Credit Suisse. Even though such an event is a far-remote tail risk, the current fear of contagion and pressure from markets is very unhelpful for the Swiss bank.

What about other banks outside of the US? We do not see any fundamental ground for any concern here. While bonds from "higher beta" banks such as Deutsche Bank tend to overreact to some extent from such newsflow, there is nothing to see here, in our opinion. Credit fundamentals for European banks have never been so positive, with stable deposit metrics, low non-performing loan ratios and elevated capital buffers. We also assume that, in a very negative scenario, senior and subordinated bondholders would be shielded by a potential ban on dividend distributions and other protective measures (unlimited access to central bank liquidity, etc.), as what happened during the Covid19 crisis in 2020.

Moreover, unrealized losses on held-to-maturity securities portfolios are much less significant for European banks (usually between 0% and 20% of their tangible book value), when compared to US banks. And again, let us stress here that is absolutely no cause for concern, as banks hedge these exposures, which do not even need to be unwound, unless huge deposit outflows arise.

c) The true contagion risk: shadow banking

We have been arguing for years that Basel III and subsequent banking regulations worldwide have forced banks to deleverage to a large extent and to forbid them from running riskier activities, such as private equity, private lending, owning shares of companies, etc. These activities have been transferred to the so-called "shadow banking industry", which operates with unregulated or under-regulated companies.

Years and years of low rates, non-conventional monetary policies and fiscal stimulus have fueled the shadow banking industry to become a juggernaut with many areas that are difficult, if not impossible, to monitor. The future of this industry lies in the macroeconomic and inflation prospects for the quarters to come, and it is impossible at this stage to say which domino may fall next.

In our opinion, financial markets and regulators should pay more attention to these players, rather than US and European banks, which are adequately capitalized and regulated already. The demise of Silvergate and SVB could well be the canaries in the coalmine of this industry, along with the soft gates being imposed by Blackstone on its private real estate fund, for instance.

Of course, higher defaults on the shadow banking industry will have consequences for banks from all over the world, but credit institutions are robust enough to withstand such consequences, thanks to the regulatory tailwinds that they benefit from. The consequences of a theoretical full-fledged crisis on the shadow banking industry – again, not our base case – would impact all cyclical sectors of the economy, among which banks, but their over-regulated nature should protect them to a large extent.

Conclusion: The failures of SVB, Signature and Silvergate are not a danger for the US nor the global banking system. However, they clearly show the lack of regulatory oversight on the shadow banking industry and the dangers of banks which are reliant on a fragile deposit basis. The current inflation and rate outlook is posing a clear threat on the shadow banking industry, which has grown rapidly at the expense of the banking sector. While the banking sector cannot escape macro- and micro-economic misfortunes of the shadow banking industry, it is not responsible for the excess that have spread out this past years and should not suffer that much from these defaults, thanks to (i) their balance sheet robustness, (ii) high amounts of liquid assets, and (iii) potential regulatory forbearance, as was the case during the Covid19 pandemic.

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