Banking & Finance News Alert

SVB Bank Collapse and Credit Suisse crisis

Bank regulation and supervision in simple terms

These past 10 days headlines have been dominated by the regional banking crisis in the United States. Although most EU banks did not have a meaningful exposure to Silicon Valley Bank (SVB), the prospect of a collapsing Credit Suisse (CS), a Global Systemically Important Institution (G-SII) caused turbulence in the Banking sector's market prices. In this article, we are exploring the main reasons behind the collapse of SVB, CS' threatened cessation of business and how these crises, although very different to each other, may expose systemic vulnerabilities of the international Banking system.

WHY BANKS ARE SUBJECT TO LIQUIDITY RISK

Archetypically, banks take in deposits and give out loans. A bank acts as an intermediary between positive and negative savers, i.e. it lends out the money collected by depositors to businesses and individuals requesting financing. Since a bank must be in a position to pay back deposits, profits are generated from the difference between the interest paid to depositors and that which is levied from the borrowers. In the contemporary fractional reserve banking model, only a certain amount of all deposits actually sits with the bank, the rest being transformed into loans to finance the economy. While generally deposits must be paid on demand, loans have different maturity periods that generally span over years. As a result, if a significant number of depositors demand their money back at once (bank run), a bank may not be able to pay them all back. Things get a lot more complicated when banks don't just invest in loans, but also in government and corporate bonds, derivatives and a series of other financial instruments.

This is called 'liquidity risk' and constitutes a structural risk to the operation of all credit Institutions.

HOW HAS LIQUIDITY RISK BEEN ADDRESSED

In the wake of the 2008 Great Financial Crisis, the G20 members committed to implementing the Basel III risk management framework, produced by the Basel Committee on Banking Supervision **(BCBS),** constituting best practices to banking supervision. That framework addresses, among others, liquidity risk by requiring that banks respect two main liquidity ratios: the Liquidity Coverage Ratio **(LCR),** representing a bank's capacity to finance its liabilities in the short term, a form of runaway countdown meter, and the Net Stable Funding Ratio **(NSFR),** mandating that banks diversify their sources of funding for those short-term liabilities.

WHY SVB WAS ESPECIALLY VULNERABLE TO LIQUIDITY RISK

Insufficient risk management and a piecemeal implementation of Basel III framework

SVB, the 16th largest bank in the US (a Tier-I Bank by EU's standards), reached a peak in available deposits by the end of the pandemic. It used available funds not only to finance a significant part of the FinTech and innovation sector, but also to cover its position by purchasing highly rated assets in the form of medium-term US (government) bonds. However, a lot has changed since 2020 in the economic and finance sector, most notably the US Central Bank's interest rates hikes, to tackle surging inflation. This spike in interest rates meant that SVB's otherwise safe investment would cease to be sufficiently profitable, because the yield of 2020 US bonds was substantially lower than those of e.g. 2022 or 2023. When concerns over SVB's solvency caused several large corporate depositors to withdraw, SVB had to liquidate its position of US bonds in the secondary market. This move created even more losses because the lower yield on 2020 bonds meant that investors would buy them at a discount compared to their nominal price. This provoked public fear that SVB would fail and so more depositors rushed to withdraw their deposits. On March 10, the US Regulator withdrew SVB's authorization activating at the same time the Federal Deposit Insurance Scheme.

An over-exposure to the interest rate risk and duration mismatch between its assets and liabilities, coupled with the absence of any hedging position, resulted in the rapid collapse of SVB.

This may have been the result of poor risk management by SVB; however, it indicates gaps in the regulatory policy applied. In fact, the US regulator has implemented the full set of Basel III liquidity management arrangements solely to the country's largest Institutions. SVB didn't fall within the scope of application of said prudential framework and as such, no backstop was in place to cater for improper risk management by the Bank.

WHY CREDIT SUISSE WAS DIFFERENT

The way from investor distrust to the Lender of last resort

Both the Swiss and the EU regulators have implemented the full set of Basel III prudential regime, to which all credit institutions are subject.

After the US regional banking crisis, many investors felt uneasy, fearing a greater de-stabilization of the global banking sector. When the main shareholder of Credit Suisse, a G-SII already experiencing the negative effects of its involvement in nefarious cases, categorically shut down the possibility of any future involvement in the bank's share capital, CS' share price collapsed, bringing down with it share prices across the EU banking sector. Fear caused depositors to withdraw their money en masse; in a bank run situation, fear of a potential insolvency, even if unfounded, may easily turn into a self-fulfilling prophecy

Faced with an outflow of deposits at a rapid pace, CS requested assistance by the Swiss National Bank **(SNB),** which came in the form of a significant liquidity injection. The activation of the Emergency Liquidity Assistance **(ELA)** mechanism is only reserved for otherwise solvent Institutions that face an extraordinary liquidity shock, evidencing that at the time the turbulence started, CS' balance sheet was reportedly in good order.

This represents a major difference of CS' crisis to that which occurred across the Atlantic; CS was subject to the full set of Basel III rules implemented by the Swiss Regulator and as such was in a much better state to wither the initial shock.

However, CS' reputation has been further damaged, to a point where improvement seemed unlikely, and the provision of liquidity assistance does not help to restore client trust in a Bank. CS would remain vulnerable to a potential run which could be further exacerbated by speculative positions against its survival.

That is why the Swiss Regulator concluded that the best outcome would be the acquisition of CS by its competitor, UBS, paired with a liquidity stand-by facility and state guarantees. Otherwise, losses would have been borne by the Swiss taxpayers, as the majority of CS' liabilities would have to be guaranteed by the Swiss State: essentially a complete bail-out. Contrary to what was expected, the SNB and FINMA announced that the government support will still trigger a complete write-down of the nominal value of all AT1 debt of CS. This decision of the Swiss Regulators has shocked the market because it went against the usual hierarchy of losses, whereby the holders of common equity – and not of AT1 – are the first to absorb losses. The repercussions of that Swiss regulatory policy may be broader, as it is expected to affect internationally the AT1 market, making the raising of AT1 for banks more expensive and difficult in the future. This led to ECB and SRB making publicly clear that they will not follow the CS pattern in future crisis interventions.

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However different the Silicon Valley Bank from the Credit Suisse case may be, a collapse came, or could have come, as a result of the liquidity risk materializing.

Basel III main Liquidity Ratios are by no means a panacea, but their full application to all Credit Institutions serves to safeguard financial stability and minimize the effect on taxpayers. In addition, the provision of ELA to a stressed bank remains the prerogative of the national Regulator, as a tool necessary in cases where an immediate lifeline is required to preserve financial stability.

Authors:

Dimitris Passas, Associate

Nikos Askotiris, Senior Counsel