Observations on the Banking Crisis of 2023

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The unprecedented events of the last two weeks in the banking industry have been breathtaking. As the banking and capital markets turn their focus to the Federal Reserve and Washington, the crisis of confidence that has ping-ponged between California, New York and Switzerland has caused many clients and investors to change their relationships in the banking world.

Let's review in a nutshell what has happened:

First, two American banks – Silicon Valley Bank ("SVB") and Signature Bank of New York – ran out of cash. The FDIC swooped in within 48 hours to protect all depositors. Most of SVB was acquired by First Citizens Bank which greatly expanded its presence in California. Most of Signature Bank of New York was acquired by the Flagstar Bank subsidiary of New York Community Bancorp.

Second, 167 year-old Credit Suisse bank – an institution larger than Lehman Brothers – merged with its cross-town rival Union Bank of Switzerland – UBS.

The cause of the crisis is now crystal clear. After the Great Recession, which was caused by the collapse of a speculative real-estate boom in the United States, the Federal Reserve flooded the economy with dollars and cut interest rates to basically zero.

Faced with a flood of cash inflows that exceeded its working loan balances, some bank managers opted to buy the same securities the Federal Reserve was buying in its "quantitative easing" program: Treasury securities and mortgage-backed securities ("MBS"), as well as state and local government backed municipal bonds. Safe.

But short-term Treasury bills were paying near 0% interest, while longer-term Treasury securities, MBS and municipal bonds were paying 3-5%. Then, interest rates spiked to 5% devaluing all bonds yielding less held by the banks, regardless of credit quality.

Bank runs by large depositors drained the cash coffers of SVB, Credit Suisse, Signature Bank and First Republic Bank as large depositors feared bank failures in a world where the FDIC guarantees deposits only up to $250,000. The $250,000 FDIC insurance cap was established by Congress in July 2010. See generally, https://www.investopedia.com/articles/economics/09/fdic-history.asp

SVB of Santa Clara, California was taken over by the FDIC then largely sold to First Citizens Bank, at the conclusion of an auction of its assets. The FDIC has continued to operate SVB in the interim and has guaranteed all its deposits. Its UK assets were sold to HSBC with the assistance of the British Government. It is unclear whether the FDIC Deposit Insurance Fund will lose any money on SVB.

Signature Bank in New York was also closed and its branches were sold by the FDIC to Flagstar Bank of New York Community Bank. Again, the FDIC stepped in to guarantee all customer deposits and expects to lose $2.5 billion.

Credit Suisse was forced into a merger with Union Bank of Switzerland (UBS) in Switzerland with similar assurances from the Swiss regulators as to the safety of customer deposits and a multi-billion Swiss franc backstop to UBS from the Swiss government, which also made available a one hundred billion Swiss franc ($109 billion) line of credit to assist the transaction between Credit Suisse and UBS.

Here are some key takeaways from these events.

1. A spike in interest rates can have devastating and unexpected financial consequences for even well-capitalized banks that have not been hurt by loan defaults. The Great Recession of 2008 was precipitated by a collapse in real estate prices that caused many bank loan defaults. To the contrary, SVB and Signature Bank had very few non-performing loans.
2. The banking crisis of 2023 is costing investors and multiple governments billions of dollars. It is unclear how much the waiver of the $250,000 FDIC insurance limit is going to cost. Perhaps it is time to consider raising the $250,000 cap rather than waiving it entirely.
3. There are probably other banks with similar issues. A widely publicized study has noted that almost 190 banks are at risk under certain circumstances. See generally: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4387676; https://www.usatoday.com/story/money/personalfinance/real-estate/2023/03/19/svb-collapse-new-banks-could-fail/11504269002/

It is widely anticipated that federal and state regulators will soon roll out additional measures to stabilize the banking industry in the near term. Although it is unclear how much damage will be done to the FDIC Deposit Insurance Fund from all of these events, in a press release dated March 19, 2023, and updated March 20, 2023, the FDIC estimated the cost of the failure of Signature Bank to it Deposit Insurance Fund to be $2.5 billion. The FDIC recently estimated that SVB may cost some $20 billion to the Deposit Insurance Fund. The FDIC Deposit Insurance Fund is currently estimated to contain approximately $130 billion.

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