BANKING SECTOR TURMOIL

WHAT HAPPENED AND WHAT'S NEXT?

MARCH 2023

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Introduction

The events of the past week have led to the ghosts of 2008 making a sudden reappearance. Turmoil started with the collapse of Silicon Valley Bank ("SVB"), a regional US bank, continued with the failure of another regional lender, Signature Bank, and then appeared to spread to Europe with Credit Suisse ("CS"), a globally systemic institution, coming under severe pressure.

Many other banks have seen their share prices drop sharply and market conditions have deteriorated. A group of large US banks orchestrated a deal to save First Republic, a third US regional bank coming under pressure.

Worries about the health of bank balance sheets are fuelling turmoil in global markets among fears that this could be the start of the next global financial crisis ("GFC").

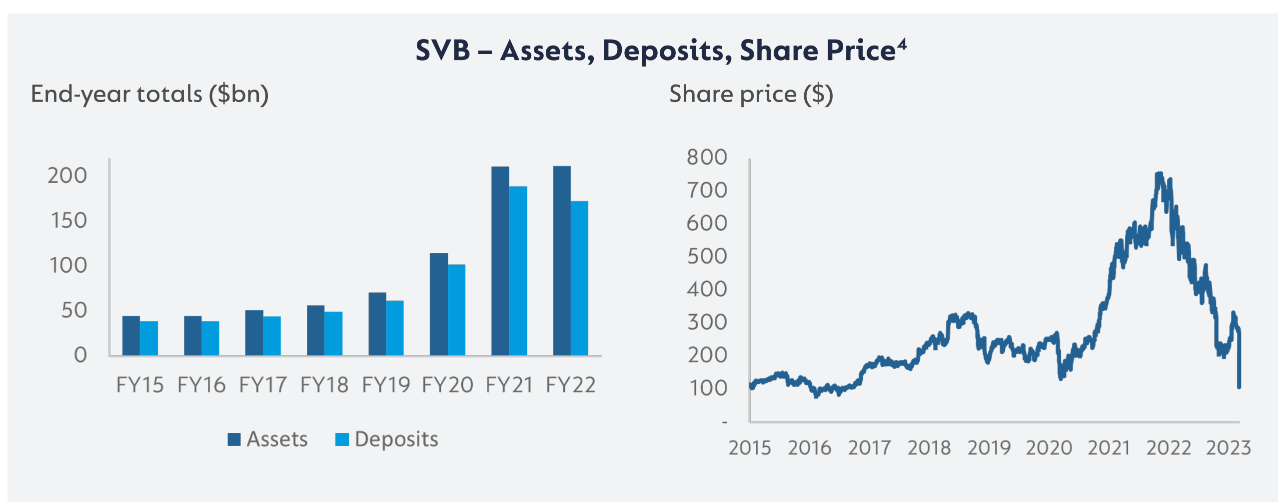
In this paper we explain what happened to each of these banks, how the situation differs from 2008, and what the major risks are going forwards.

What happened to Silicon Valley Bank?

Background

California-based SVB was the 16th largest bank in the US[1]. The institution had become the go-to bank for about half of all venture-backed tech and life science companies in the US[2]. This enabled the bank to enjoy massive growth in deposits and assets starting from 2020, driven by the post-Covid tech boom.

Searching for yield in an era of ultra-low interest rates, it ramped up investment in a $120bn portfolio of highly rated government-backed securities, $91bn of these in fixed-rate mortgage bonds carrying an average interest rate of just 1.6%[3]. The investments locked the cash for a decade and exposed it to losses if interest rates rose quickly.



Bank Run Triggers

- **Capital raise:** The bank launched a $2.25bn capital raise on March 8th to shore up its capital base after suffering a $1.8bn loss on the sale of a portfolio of long-dated securities[5]. The sale of long-dated assets was to meet deposit withdrawals by customers, either affected by the worsening economic conditions as the tech bubble burst, or moving cash to other institutions in search of higher yields.
- By being forced to sell assets to meet withdrawals, the bank crystallised the unrealised losses on its portfolio. Moreover, it drew investors' attention to the fact that the $91bn of held to maturity ("HTM") financial instruments had a fair value of only $76bn[5]. The c. $15bn loss if the assets were to be sold in the current market would have wiped out the bank's equity almost entirely – though the bank should have been able to make depositors whole[5].

1 Federal Reserve Statistical Release, 31/12/2022: https://www.federalreserve.gov/releases/lbr/current/
2 FT: SVB's cardinal sin; https://www.ft.com/content/926dd6a2-7982-4d52-93b4-84b66954292f
3 FT: Silicon Valley Bank, the spectacular unravelling of the tech industry's banker; https://www.ft.com/content/b556badb-8e98-42fa-b88e-6e7e0ca758b8
4 Data from Bloomberg as of 17 March 2023
5 Risk.net: Missing Basel metric could have revealed SVB risks; https://www.risk.net/regulation/7956250/missing-basel-metric-could-have-shone-light-on-svb-risks

- The share price fell more than 60% the day after the announcement and led to a bank run.

Regulators' Intervention

10th March

The US banking regulators assumed control of SVB and put it into receivership.

12th March

US government announced it would guarantee all deposits held at SVB and crypto lender Signature Bank, which was also shut down by regulators at the weekend[6].

The Federal Reserve announced a new lending facility (Bank Term Funding Program, "BTFP") which will offer loans of up to 1 year to lenders that pledge collateral including US Treasuries and other "qualifying assets", which will be valued at par[7].

13th March

The UK division of SVB was acquired by HSBC for £1 in a transaction facilitated by the UK Government and the Bank of England[8].

SVB Peculiarities

We believe what happened to SVB was a combination of idiosyncratic features of the bank, poor management and lack of regulation:

Asset-liability mismatch: Our view is that the key underlying problem for SVB was an asset-liability mismatch: short-term assets (cash and available for sale ("AFS") securities) were $40bn as of December 2022. Deposits due within a year were $173bn at the same date[9]. This resulted from poor risk management and created terminal issues for the bank when clients started withdrawing money.

Concentrated client base with uninsured deposits: The vast majority of SVB deposits were uninsured, partly because its client base is dominated by big deposit customers such as venture capital firms and the start-ups they backed. Around 96% of SVB deposits were not covered by the FDIC insurance policy (which guarantees deposits up to $250k). This compares to 38% at Bank of America[10]. Uninsured depositors are seen as "flighty" and more prone to quickly withdraw at the first sign of stress compared with customers with insured capital, who are seen as more "sticky". Additionally, the fact that most clients operate in the same close-knit sector led to herd-like behaviours and exacerbated the bank run[10].

Poor management: The concentration of investments in long-dated fixed-rate assets represented a shift in strategy for SVB, which until 2018 had kept the vast majority of its excess cash in mortgage bonds maturing within one year[11].

This has been attributed to a change in the leadership of the finance function, and turned out to be a short-sighted decision[12]. Moreover, only one member of SVB's board had investment banking[13] experience, highlighting the lack of skills needed to manage the institution at times of crisis.

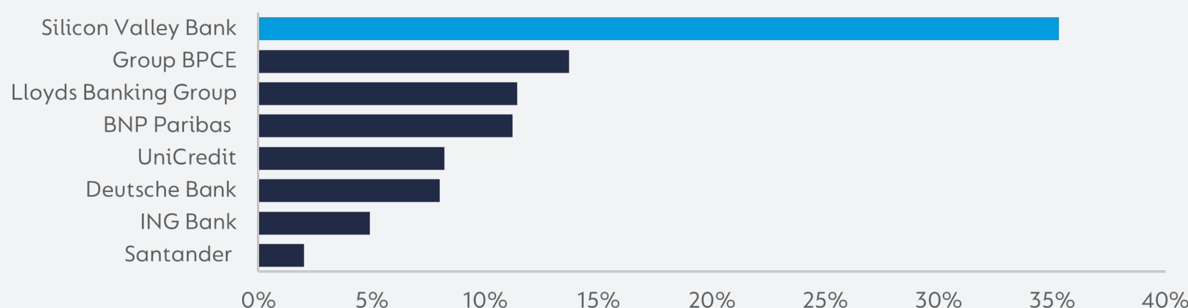
Lack of regulation: SVB's interest rate risk exposure would have triggered supervisory intervention under rules that are enforced in Europe, but not applied in the US for smaller

6 https://www.fdic.gov/news/press-releases/2023/pr23016.html
7 https://www.federalreserve.gov/monetarypolicy/bank-term-funding-program.htm#:~:text=The%20Bank%20Term%20Funding%20Program,needs%20of%20all%20their%20depositors.
8 https://www.hsbc.com/news-and-media/media-releases/2023/hsbc-acquires-silicon-valley-bank-uk-limited
9 https://blogs.cfainstitute.org/marketintegrity/2023/03/13/the-svb-collapse-fasb-should-eliminate-hide-til-maturity-accounting
10 FT: Silicon Valley Bank's failure shines light on dangers lurking in higher interest rates; https://www.ft.com/content/19fd9a50-ced4-460d-85a1-f5faad6b86c6
11 SVB annual report
12 FT: Silicon Valley Bank: the spectacular unravelling of the tech industry's banker; https://www.ft.com/content/b556badb-8e98-42fa-b88e-6e7e0ca758b8
13 https://www.dailymail.co.uk/news/article-11859379/Only-ONE-member-failed-SVBs-board-experience-investment-banking.html

sized banks. A specific framework of the Basel rules requires banks to measure their economic value of equity ("EVE") and assess their sensitivity to a set of interest rate shock scenarios. Banks are required to disclose the EVE impact assuming a change in rates of up to 200bps and compare it to their Tier 1 capital. If EVE decline is >15% of Tier 1 capital, a bank would be deemed at risk and would receive supervisory scrutiny[14]. The US has not implemented these rules for banks with <$700bn in assets, among which is SVB. Nonetheless, SVB has disclosed this measure until 2021, and it showed a significant decline. At end of 2021, the bank reported a decline in its EVE of 27.7% should rates increase by 200bps, equivalent to 35.3% of its Tier 1 capital[14]. The Fed increased key interest rate by 450bps between March 2022 and February 2023, leading to a much bigger impact than shown in the below projections.

SVB – Interest Rate vs European Banks[14]

Economic value of equity decline as % of T1 capital in 200bp rate rise



What happened to Signature Bank?

On 12th March, US regulators announced that Signature Bank, a New York-based regional bank that became a leader in cryptocurrency lending, was being taken over to protect its depositors and the stability of the US financial system[15].

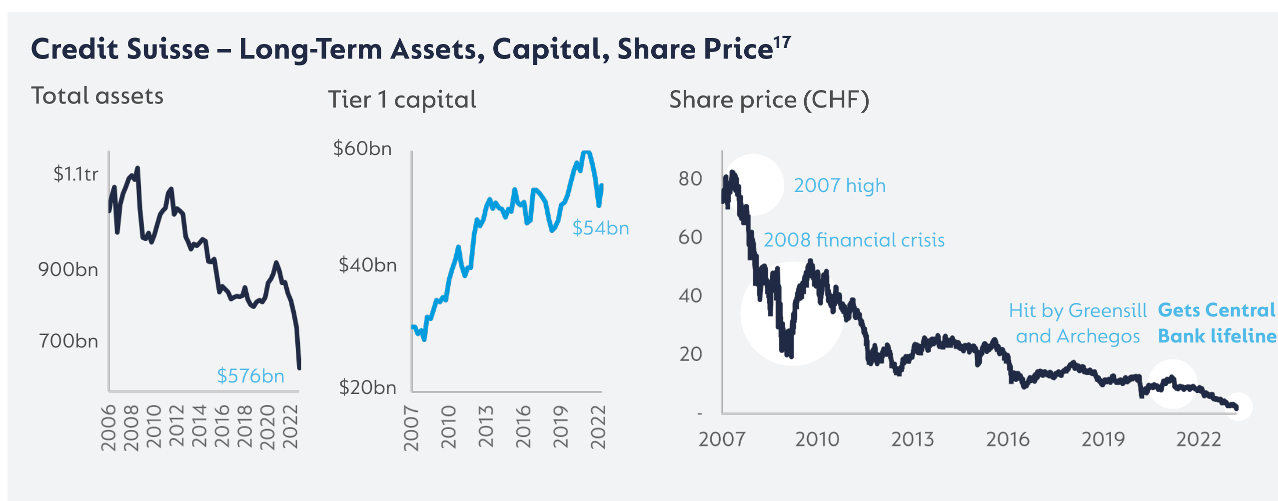
The move came on Friday after Signature Bank customers, spooked by the sudden collapse of SVB, withdrew more than $10bn in deposits. Like SVB, Signature Bank had high levels of uninsured deposits (i.e. deposits higher than $250k), which exacerbated the bank run and forced regulators to step in[16].

14 Risk.net: Missing Basel metric could have revealed SVB risks; https://www.risk.net/regulation/7956250/missing-basel-metric-could-have-shone-light-on-svb-risks
15 https://www.fdic.gov/news/press-releases/2023/pr23018.html
16 FT: SVB was only a little bit insolvent, luckily; https://www.ft.com/content/9ee5edda-a038-4992-863f-242bd69c8b79

What happened to Credit Suisse?

Background

Long-Term Decline: CS has been underperforming for a long time. The bank has been hit by a series of scandals in recent years, including the biggest trading loss in its 167-year history following the implosion of Archegos Capital[18] and the closure of $10bn of investment funds linked to collapsed finance firm Greensill.



Q4-22 results: CS reported a 33%[17] fall in revenues, largely down to a 74%[17] decline in investment banking fees, while wealth management revenues fell 17%[17] and asset management income dropped 28%[17]:

Wealth Management AuM fell by 27% in 2022[17];

- Deposits fell by 37% in Q4-22 alone[17].
- Fellow Swiss wealth managers UBS and Julius Baer reported an influx of wealth management assets at the end of last year – this does not appear to be a loss of confidence in Swiss banking as a whole[18].

Sell-off Triggers

2022 annual report: A number of issues surrounded the publication of CS accounts on Tuesday 14th March:

- CS forced to delay the release of its annual report after the Securities and Exchange Commission ("SEC") raised last-minute queries on cash-flow statements from 2019 and 2020, discussions which have now concluded. CS said "management did not design and maintain an effective risk assessment process to identify and analyse the risk of material misstatements in its financial statements" and that it found "material weaknesses" in its reporting and control procedures for the past two years, after questions from US regulators[19];
- In a separate statement, PwC said that "management did not design and maintain effective controls over the completeness and the classification and presentation of non-cash items in the consolidated statements of cash flows"[17].

17 Bloomberg
18 FT: Credit Suisse slumps to biggest annual loss since financial crisis; https://www.ft.com/content/f0893fa5-6ae4-413a-81f1-f3352967dc59
19 FT: Credit Suisse finds 'material weaknesses' in financial reporting controls; https://www.ft.com/content/3605c3fb-973d-440d-88e3-9ddf367bbef2

Shareholder support: on 15th March, asked whether the Saudi National Bank, the largest CS shareholder at 9.9%, would inject further capital, the Saudi National Bank chairman said: "The answer is absolutely not, for many reasons outside the simplest reason which is regulatory and statutory". SNB is underwater on the stake it bought in October. Not only would SNB raising its holding above 10 per cent bring regulatory complications, but it would also be unpopular with minority shareholders who felt blindsided by the initial investment[20].

SVB: this came days after SVB was taken over by the US government. We discuss the relationship between SVB and CS below but in short – in our view there does not appear to be a direct channel by which the SVB collapse materially affects CS.

Sell-off, Government Support, and Merger

15th March sell-off: CS share price fell by c. 25%. Other European banks also fell, but their declines were in the 5-10%[21] range;

15th March government support: At 8pm Zurich time, the statement came that the Swiss National Bank ("SNB") "if necessary ... will provide CS with liquidity";

Six hours later, CS said it was "taking decisive action to pre-emptively strengthen its liquidity by intending to exercise its option to borrow from the SNB up to CHF 50 billion under a Covered Loan Facility as well as a short-term liquidity facility, which are fully collateralised by high quality assets";

The bank also announced it would buy back SFr3bn ($3.2bn) in senior debt securities. This was seen as CS signalling to markets that it has the financial strength to buy back its distressed debt. The message is: taking liquidity from the SNB is not just a last-ditch effort to save the bank; CS are planning for the future[22];

16th March ECB rate hike: A 50bps rate hike by the ECB did not impact CS share price. Shares closed on CHF2.30 on 16th March, the same level as immediately before the ECB announcement, vs CHF2.50 at close of 14th March and 31%[23] above the CHF1.76 trough on 15th March. Christine Lagarde noted that there is a large arsenal of tools to fight financial stress in Europe that will be used if necessary, but also that the ECB does not see a trade-off between monetary and financial stability[24].

UBS merger: over the weekend of the 18th March, it was announced that rival Swiss bank UBS had agreed to acquire CS. While ostensibly voluntary, this was in fact imposed by the Swiss authorities to shore up confidence in the financial system. The price of SFr 0.76 per share is a 59% discount to the price as at the Friday close. The deal was not a surprise per se – it was always one of the probable outcomes – but nonetheless this is a seismic change to the European banking landscape[25]. As a result of the merger, CS's Additional Tier 1 ("AT1") bonds were written down to zero, while the shareholders retained value. This unusual ranking of the capital structure led to uproar from the CS bondholders and sent jitters through the market. EU authorities were quick to reassure investors that this ranking is not usual and that bondholders should only bear losses after the equity[26].

20 BBG: Credit Suisse Reels After Top Shareholder Rules Out Raising Stake; https://www.bloomberg.com/news/articles/2023-03-15/credit-suisse-top-shareholder-rules-out-more-assistance-to-bank-lf9gfhbr?sref=bc0CwN0E

21 Bloomberg

22 World News Era: Credit Suisse under siege; https://worldnewsera.com/news/finance/stock-market/credit-suisse-under-siege/

23 Bloomberg

24 ECB Governing Council Press Conference, 10 March 2022; https://www.youtube.com/watch?v=qdQYkgS-SoE&ab_channel=EuropeanCentralBank

25 Capital Economics: UBS takeover of Credit Suisse (March 2023); https://www.capitaleconomics.com/publications/euro-zone-rapid-response/ubs-takeover-credit-suisse-march-2023

26 Bloomberg: EU Authorities Say Holders of Risky Bonds Should Bear Losses Only After Equity; https://www.bloomberg.com/news/articles/2023-03-20/eu-authorities-say-at1s-should-bear-losses-only-after-equity?sref=bc0CwN0E

Why are CS and SVB different, and what does this tell us about the US and European systems?

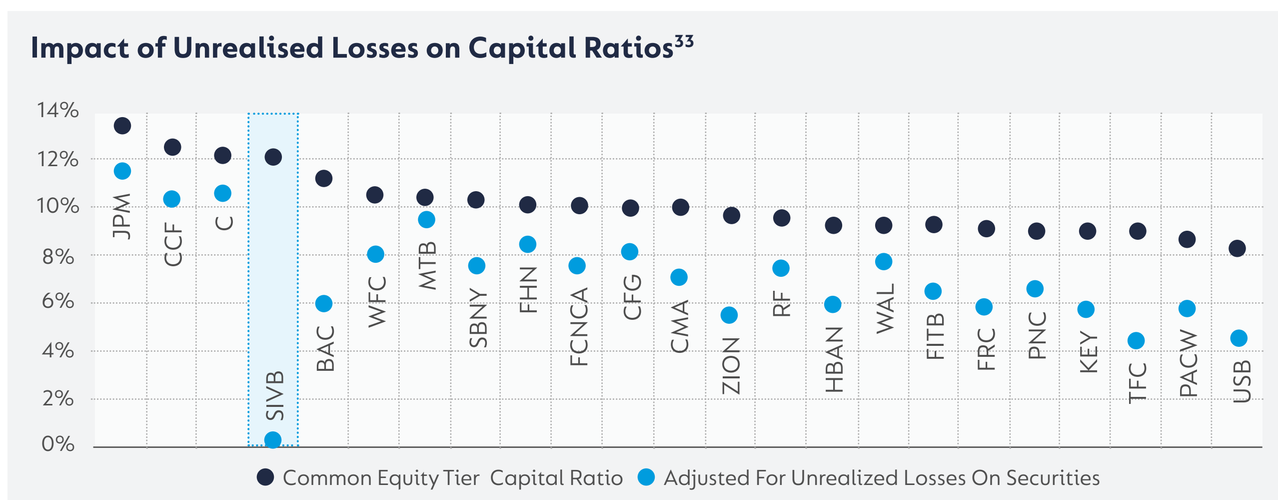
CS and SVB are very different businesses, and the losses in long-term securities / maturity mismatch that brought down SVB are not a problem for CS. CS is a bank with a profitability problem but is capitalised in line with other European peers and with similar levels of liquidity[27]. If you anonymised the banks and put their key risk metrics alongside one another – CET1 ratios, liquidity etc – it would be difficult to distinguish between them. The differences between CS and SVB therefore underline a divergence between the European and US regulatory systems.

Hold-to-Maturity ("HTM") Securities: SVB held 43% of its assets in HTM securities, and due to US rules, accounted for them at amortised cost, not fair value, as at December 2022[27]. HTM securities represent 4% of CS assets[27]. European regulation sets limits on the share of assets held as HTM, with the remainder being marked to market. Even the HTM securities need to be maturity-matched.

CET1 Ratios: CS has a 2022 CET1 ratio of 14.1%[28]. DB=13.3% (Q3-22)[29], UBS=14.2%[30], Euro GSIB average 13.9% (Q3-22)[31]. See US banks below.

Unrealised losses: At SVB, unrealised losses amounted to c. 12% of assets, i.e. the entire CET1 ratio[32]. The allowance for credit losses at CS was 1% of assets[33]. Of CS' total SFr 5.5bn allowance for credit losses, SFr 1.4bn was related to loans, or 0.5% of its loan book (rest of allowance relates to brokerage receivables)[34]. In Europe, the average unrealised loss impact is 30bps – see US impact below. Therefore, European banks in general are much better capitalised than their US counterparts. This capitalisation has come at the expense of global competitiveness / RoE over the post-GFC period versus US peers.

Impact of Unrealised Losses on Capital Ratios[33]



27 CFA: The SVB Collapse: FASB Should Eliminate "Hide-'Til-Maturity" Accounting; https://blogs.cfainstitute.org/marketintegrity/2023/03/13/the-svb-collapse-fasb-should-eliminate-hide-til-maturity-accounting/

28 FT: Now even its cornerstone investor is kicking Credit Suisse; https://www.ft.com/content/e4602e40-463d-4408-8d1d-e682b86d1859

29 DB: https://www.db.com/news/detail/20221230-deutsche-bank-publishes-2023-srep-requirements?language_id=1

30 UBS: Ad hoc announcement pursuant to Article 53 of the SIX Exchange Regulation Listing Rules

31 https://www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html

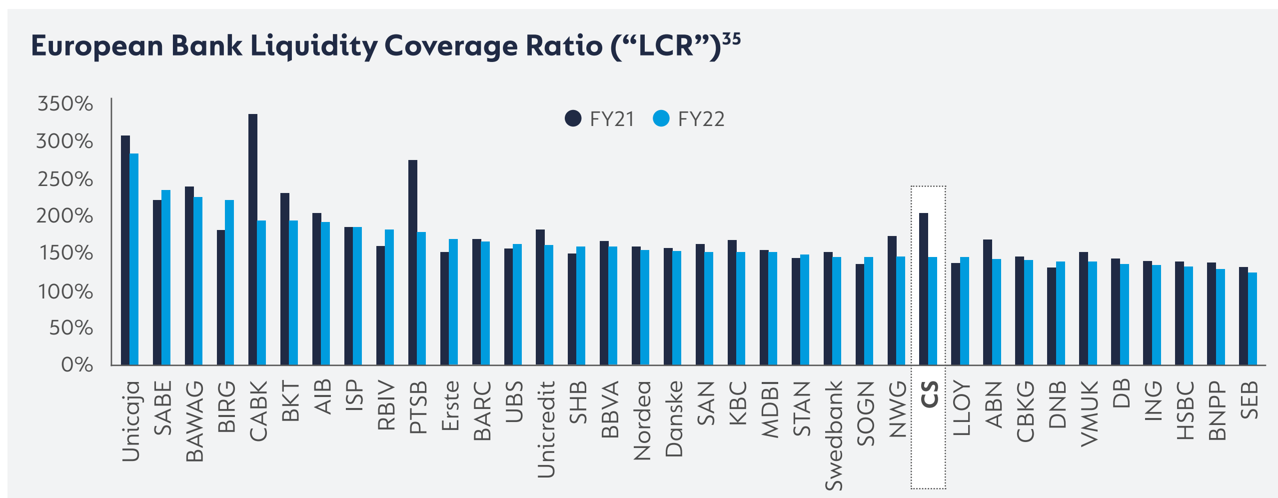
32 FT: SVB was only a little bit insolvent, luckily; https://www.ft.com/content/9ee5edda-a038-4992-863f-242bd69c8b79

33 CS Annual Accounts 2022

34 Credit Suisse Annual Report

Liquidity: the Liquidity Coverage Ratio ("LCR") measures the stock of High Quality Liquid Assets ("HQLA") to total net cash outflows over the next 30 days – a key statistic used by regulators to monitor liquidity. CS has a LCR largely in line with peers – it does by no means stand out[35].

European Bank Liquidity Coverage Ratio ("LCR")[35]



Interest rate stress testing: as mentioned earlier, all European banks are regulated such that if a 200bps stress leads to a >15% equity decline, it is placed under additional scrutiny[36]. Smaller US banks do not have this test as a result to Trump-era deregulation[37]. Going forward, these regional banks will likely be much more closely scrutinised by regulators and consumers alike.

What happens now? What are the risks going forwards?

Thisremains a very fluid and fast moving situation. The actions taken by the Fed and other authorities rovided some calm for markets, but material volatility persists.

There are a number of ways these stresses can escalate more broadly:

- **More banks struggling with unrealised losses.** Unrealised losses across US financial institutions stood at $620bn at the end of 2022 according to FDIC[37]. If depositors displayed the same behaviours as with SVB, banks could use the BTFP to avoid realising losses, or policymakers might need to step in again to insure deposits. This is already happening:

- US banks borrowed $165bn in aggregate from the Fed in the week to March 15, a record high, up from $4.6bn the previous week. The prior all-time high was $111bn during the GFC[38].

35 FT: A Suisse twist; https://www.ft.com/content/983f7f7d-5429-4f54-a93a-1f079794e409

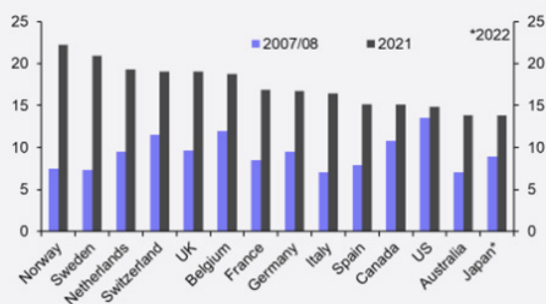
36 Risk.net: Missing Basel metric could have revealed SVB risks; https://www.risk.net/regulation/7956250/missing-basel-metric-could-have-shone-light-on-svb-risks

37 Forbes: The Silicon Valley Bank Collapse And The Polycrisis; https://www.forbes.com/sites/frankvangansbeke/2023/03/12/the-silicon-valley-bank-collapse-and-the-polycrisis/?sh=7f7c42832909

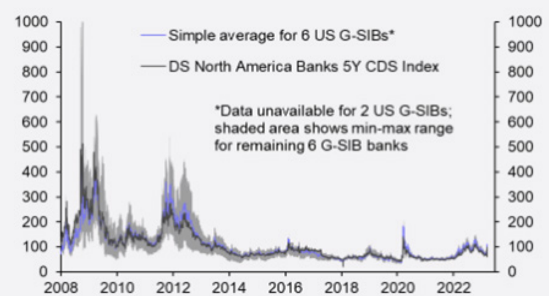
38 Bloomberg: Banks Rush to Backstop Liquidity, Borrow $164.8 Billion From Fed; https://news.bloomberglaw.com/securities-law/banks-rush-to-backstop-liquidity-borrow-164-8-billion-from-fed

- **16th March:** First Republic Bank, another regional US lender, received an injection of $30bn of uninsured deposits from a group of large banks including JPMorgan Chase, Bank of America and Citigroup. This has not stopped the fall in its share price, which was down 33% at market close on Friday 17th March[39]. First Republic shares two features with SVB: a big exposure to long-dated, low-yielding assets (home mortgage securities represent ~50% of its total assets) and a big proportion of uninsured deposits (67% of total)[40].
- We note that banks are much better capitalised than they were in the GFC.

CET1 Ratios vs GFC[39]



US Bank 5-Year CDS Premia[39]



- **More banks getting into trouble due to other idiosyncratic reasons**. Even if SVB, Signature Bank and Credit Suisse all have idiosyncratic factors affecting them, they all reflect vulnerabilities in the financial system, which could manifest in other ways at different European or US institutions.
- **Interest rate risk evolving into a credit crisis.** In response to the currently uncertain environment, the risk of deposit flights and / or the need to reorganise their balance sheets, banks could tighten their lending criteria and reduce the supply of credit. This would harm the real economy, push up loan losses and lead to a credit crisis.
- **Maturity mismatch issues elsewhere:** there are other areas of the financial system that may come under stress from this mismatch, e.g. open-ended funds with material illiquid holding – investors could look to flee these funds, causing asset fire sales to meet redemptions.

39 Capital Economics: How could the situation escalate?; https://www.capitaleconomics.com/publications/global-economics-update/how-could-situation-escalate
40 FT: First Reublic's red flags; https://www.ft.com/content/9869c0f7-24f6-43c3-b8d3-b0d884f402fc

Conclusion

Undoubtedly, the last week saw some of the highest levels of instability since the GFC. Indeed, the collapse of SVB was the largest US bank failure since that of Washington Mutual in 2008[41].

In Europe, just like in the US, governments had to intervene in order to demonstrate support for struggling institutions.

The two events were the result of idiosyncratically challenged institutions. SVB was mismanaged and mis-regulated, while CS has had reputational and profitability issues for decades. The question is therefore whether these are symptomatic of broader, systemic issues in the global financial system, and whether this will lead to contagion spreading to engulf other institutions.

In our view, the risk of systemic contagion is low at this point. There will certainly be ripples and reverberations around certain parts of the financial system. Regional US banks may see further casualties – it is hard to see why consumers would keep their money with banks that have been shown to be of lower quality than their larger peers. A long-term solution for Credit Suisse appears to have been found – it remains to be seen whether this calms the markets in the coming days and weeks.

It is hard to predict how stress can spread through a hugely interconnected financial system. This opacity is the main reason why fear can spread so quickly to seemingly unrelated areas of the markets. Every crisis is of course different, but we believe that the financial system is in a much better place to tackle stress than at the time of the GFC. Banks are stronger, and governments have a ready playbook of support that was developed after the GFC and tested over the Covid crisis.

At Arcmont, we continue to monitor the situation closely. We are in close contact with our borrowers, and we are working to make sure that they are well insulated from the current and any future stress. Our close relationships with management teams and sponsors allow us to do this quickly and effectively. **We have undertaken an analysis of our portfolio companies and have determined that they have negligible exposure to SVB**.

These events once again underline what we believe are the structural advantages of Private Debt as an asset class, compared to traditional bank lenders. We also believe that the current pressure on banks and the liquid markets will increase the attractiveness of Private Debt firms as an alternative and reliable source of finance to companies.

41 Market Watch: Silicon Valley Bank Shut Down, Biggest Bank to Fail Since Financial Crisis; https://www.marketwatch.com/articles/svb-financial-stock-portfolio-outlook-loss-93287f3d

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