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Aram Balagyozyan
Associate Professor

Satyajit Ghosh
Professor

Department of Economics, Finance, and International Business

Foreword

Only a few days after the publication of the first issue of 2023 of Brennan Barometer, we all felt a jolt when two U.S. banks failed and a third was on the verge of failing. A well-known international bank was also in trouble. Could it be the repeat of the financial crisis of 2008? We now have some answers. In our continuing effort to inform the members of our community, we have decided to publish this supplement on the recent banking crisis without waiting for our next regular issue. We also plan to update with the data on local banks as they become available from FDIC. This document reflects the views and opinions of the author. Any comments and suggestions are most welcome.

Aram Balagyozyan (aram.balagyozyan[at]scranton.edu)
Satyajit Ghosh (satyajit.ghosh[at]scranton.edu)

March Madness: the Banking Crisis

Satyajit Ghosh[1]

When the news of a bank run on a little-known California bank, the Silicon Valley Bank, broke on March 9, those who saw the news most likely were not thinking about Frank Capra's iconic film It's a Wonderful Life, where George Bailey (played by Jimmy Stewart) stepped in and save Bedford Falls. They were uncomfortable and worried; the memories of the financial crisis of 2008 and the largest bank failure in the U.S. banking history propelled by the collapse of the Washington Mutual Bank in September 2008 were all too fresh. The next few days added to the collective anxiety of the nation.

On March 10, the Federal Deposit Insurance Corporation (FDIC) took control of SVB. SVB's collapse was now the biggest banking failure in the U.S. since Washington Mutual's failure some fifteen years back. On March 12, the FDIC shut down Signature Bank of New York after its customers began to withdraw their deposits from the bank and started a bank run. To calm the nerves of a jittery nation, early Monday morning, March 13, President Biden addressed the nation to announce that the depositors of the California-based SVB and Signature Bank of New York would be able to access their money by Monday morning, even above the federally insured limit of $250,000. He emphasized that people "should feel confident that their deposits will be there, if and when they need them." While this unprecedented step by the Federal government helped, it still did not put an end to the troubles of the banking sector. On March 15, it became clear that the Credit Suisse, Switzerland's second largest bank, could be on the verge of a collapse—its stock price fell by 30 percent. On March 16, a group of American lenders provided the First Republic Bank 30 billion dollars so that it did not collapse after its customers started to withdraw their deposits.

How did we get here and what does the future hold for the banking sector?

The Anatomy of a Bank Failure: This Time It Was Different

During the financial crisis of 2008 that led to the Great Recession of 2007-2009, over 600 banks failed. But banks failed at the time mostly because they were exposed to enormous credit risk due to bad loans and poor credit underwriting. This was not the case with SVB– the 16th largest U.S. bank when it failed. SVB failed due to bad risk management that was caused by a risky concentrated customer segment and a rapidly changing interest rate environment. This was also true for the Signature Bank which was the 19th largest bank at the time of its failure.

Over the last two years, the deposits at SVB grew rapidly. But the depositors were not very diversified; most of SVB's customers were related to venture capital firms and companies

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in the tech sector. SVB took great pride in its close association with the tech sector. At the end of 2022, the bank claimed "half of all US venture-backed startups and 44% of the US venture backed technology and health care companies that went public in 2022" were SVB's clients. But along with the new deposits came significant risks. By some estimates, out of its $175 billion dollar deposits about 90 percent were uninsured, because hundreds of SVB's customers had deposits far in excess of FDIC's insurance limits of $250,000. Given the huge growth in its deposits, SVB held 55 percent of its assets in longer term Treasury securities and Agency mortgage-backed securities to earn higher yields. The industry average is about 24 percent. While these treasury securities and mortgage-backed securities issued by government-sponsored enterprises such as Fannie Mae, Freddie Mac, and Ginnie Mae are considered to be virtually free of default risk, because of the changing interest rate environment and the changing fortune of the tech sector concentrated customer base, SVB became exposed to unusual interest rate risk.

However, exposure to interest rate risk is not unusual. As interest rates increase, the market value of the debt securities falls. But as long as the bank (or any other investor) can hold on to securities and do not need to sell them before their maturity, the loss due to the fall in the value of the securities stays as unrealized loss in bank's balance sheet. In order to reduce inflation, the Federal Reserve aggressively raised interest rates between March and December of 2022—a trend that continued in 2023. As a result, the value of SVB's debt securities fell. In the third quarter of 2022 SVB had about $15.9 billion in unrealized losses of its investment portfolio.

But SVB's unrealized losses didn't stay hidden as unrealized for long. Earlier this year, dealing with their own financial troubles, many of its customers in the tech sector started to withdraw their deposits. But SVB had only 7% of its assets in cash. Thus, SVB was facing enormous liquidity risk since it became evident that it could not meet the demands of its depositors without incurring heavy loss. It was forced to sell $21 billion of its investments in U.S. treasuries and mortgage-backed securities and on March 8, it announced that it sustained a loss of approximately $1.8 billion from such a sale and that it was trying to raise new capital in order to meet its obligations to its customers. The news of the realized loss and SVB's attempt to raise new equity capital sent shockwaves through its customer base and particularly spooked those large number of businesses that held uninsured deposits in excess of FDIC's insured limit of $250,000.

Not surprisingly, on March 9, SVB's customers tried to withdraw their deposits from the bank. As the California Department of Financial Protection and Innovation (DEPI) put it, "Despite the bank being in sound financial condition prior to March 9, 2023, investors and depositors reacted by initiating withdrawals of $42 billion in deposits from the Bank on March 9, 2023, causing a run on the Bank." As it often happens with a bank run, the fear of insolvency of SVB was turned into the real thing. As of the close of business on March 9, the bank had a negative cash balance of approximately $958 million. On March 10, California DEPI announced that SVB was insolvent and the regulators took possession of the property and business of the bank.

The outline of the story of the failure of the New York based Signature Bank is eerily similar to that of SVB. Both banks relied on a risky, concentrated customer segment; both had very large amount of uninsured deposits and both faced high level of liquidity risk. In addition, the failure of Signature Bank was influenced by the collapse of SVB.

Signature Bank was the 19th largest bank in the United States with $110.36 billion in assets and $88.59 billion in deposits in December 2022. It was the third-largest commercial real estate bank in New York City. But Signature bank was also closely tied to the cryptocurrency industry and by September 2022, just before the failure of the cryptocurrency exchange FTX in November, nearly a quarter of its deposits came from its crypto clients. By December 2022, nearly 90 percent of its deposits were uninsured. It announced a plan to reduce its deposits from its crypto clients by $8 billion and took some steps to do just that in the first two months of 2023. But nervous depositors from other sectors, worried after the failure of SVB, started to withdraw their deposits from Signature on Friday, March 10. Signature faced substantial liquidity risk since it had only about 5% of its assets in cash. As the bank run continued over the weekend, on Sunday, March 12, the New York State Department of Financial Services (DFS) took possession of the bank "in order to protect depositors." The regulators wanted to stop the possibility of further spread of bank runs to other banks causing a crisis in the U.S. banking sector and a panic in the entire economy.

As opposed to the financial crisis of 2008 when banks failed due to bad loans, the current crisis was brought about by poor risk management. But could this be avoided? The Dodd-Frank act which was passed after the financial crisis was supposed to usher in an era of better risk management and better oversight. But Dodd-Frank was severely weakened during the Trump administration. One may argue that this may have played a role in this crisis. In the revision of the Dodd-Frank act, only banks with assets of $250 billion or more are designated as Systemically Important Financial Institutions which receive highest scrutiny. SVB and Signature bank—the sixteenth and nineteenth largest banks—with assets less than the $250 billion would not have made the cut for very close oversight.

What Next?

Signature Bank was finally taken over by New York Community Bancorp on March 20. On March 26, the FDIC announced that the First Citizens Bank of North Carolina purchased the remaining assets, deposits, and loans of the Silicon Valley Bank. The stock prices of both banks that purchased the two failed banks rose sharply. It seems that at least for now, after the second and third largest bank failures in the U.S. banking history, the banking crisis is over. Locally, in NEPA no banks seem to be at risk for failure. Fear of a global banking crisis was also put to rest after UBS bought Credit Suisse bank on March 19.

But while the U.S. banking system is now stabilized after these tumultuous few days in March, when no depositors lost any money regardless of the amount of their deposits, there may still be some fallout from this short-lived crisis. For nearly one year, banks are losing deposits since depositors are moving away from low or no interest paying bank deposits to financial vehicles that pay higher returns as the Federal Reserve continues to increase interest rates. If the fear of losing bank deposits is also added to that, the smaller regional banks and credit unions that provide the all-important credit to run local economies will be at a greater risk of losing deposits compared to the bigger institutions. This will reduce their ability to extend loans and the credit crunch can increase significantly. By some estimates that may lower the economy's growth rate by half a percentage or more.