MARCH 17, 2023

CRACKS IN THE SYSTEM

Pity the Federal Reserve policy makers. In less than a week's time, they must decide whether – and if so, by how much – their monetary policy decisions should be affected by bank failures and emergency rescue operations.

In the past 10 days, confidence in the health of the banking system has been rocked on both sides of the Atlantic. Rapidly rising interest rates revealed weaknesses, which had been ignored by management and regulators of at least two – and probably more – mid-sized US banks, as well as of the Swiss giant Credit Suisse. In today's world of electronic banking and social media instant information, deposit runs can happen quickly – and they did.

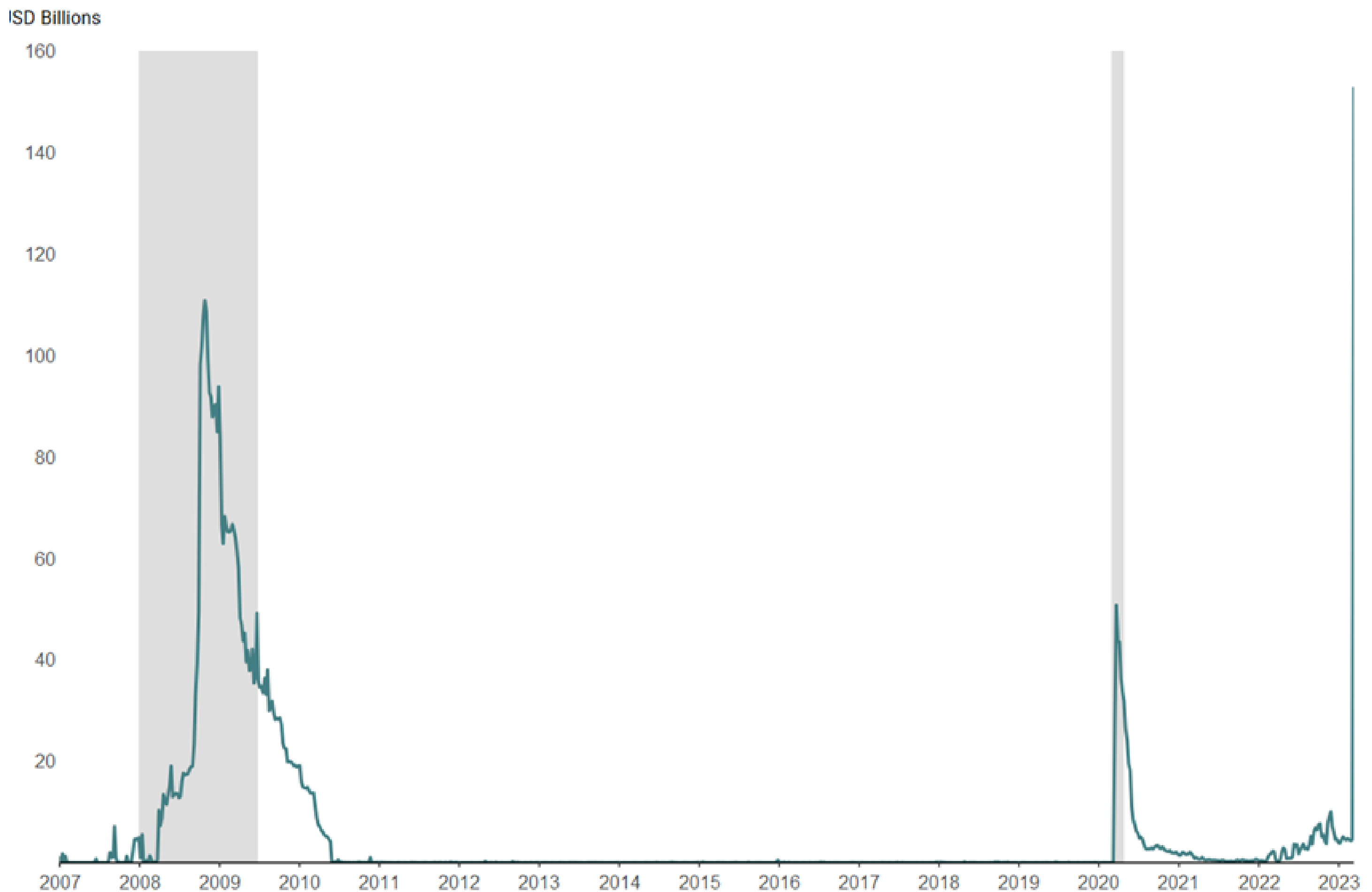
The US authorities took emergency action last weekend to bolster depositor confidence and stave off further runs. The Treasury, Fed, and the Federal Deposit Insurance Corporation (FDIC), guaranteed even the uninsured deposits of two failed banks – Silicon Valley Bank (SVB) and Signature Bank. The Fed also announced a new lending facility that allowed banks to post government bonds as collateral at full face value rather than at a mark-to-market loss. Later this week, a group of private banks deposited $30 billion into First Republic to counter an accelerating run of its uninsured depositors. And Swiss authorities extended emergency lending to Credit Suisse in the middle of Wednesday night.

Best practice in central banking would argue for keeping interest rate decisions – i.e., monetary policy – quite separate from financial stability measures. But at a time when confidence appears shaken in a swath of US mid-sized banks, contagion has crossed the Atlantic, and market swings are bigger than anything since the Global Financial Crisis, many expect the Fed to temper its actions next week.

On Thursday, Fed data showed how funding strains escalated in the wake of the shocks. Banks borrowed $165 billion this week from the Fed's backstop facilities (mostly from the traditional discount window and some from the new Bank Term Funding Program), more than during the 2008 crisis. The Fed's reserve balances jumped $440 billion, reversing about half of the balance sheet unwinding – or Quantitative Tightening (QT) – that the Fed has been conducting since June 2022.

Federal Reserve traditional backstop provides $153 billion in liquidity

Fed discount window borrowing exceeds 2008 crisis levels



Source: RockCreek, Federal Reserve H.4.1 Factors Affecting Reserves. As of March 16, 2023.

In Europe, the European Central Bank (ECB) this week pressed ahead with the 50 basis point interest rate rise it had prefigured. The Fed has more room to maneuver on monetary policy. It has raised rates further and faster than the ECB in the past year. Inflation in Europe is higher than in the US. Federal Reserve Chair Jerome Powell warned recently that the Fed was ready to accelerate its tightening if the data showed continued economic strength and high inflation. But the sudden collapse last week of Silicon Valley Bank, the sixteenth largest bank in the US, as well as the smaller Signature Bank, and the risk evident this week of broader contagion have changed the Fed's calculus. After extreme swings in Treasury markets, the S&P ended the week up 1.4%, and a 25 bp rate hike is now priced in.

If banking turmoil continues in coming days, even inflation hawks might give the Fed a pass, despite the latest disappointing consumer price report that showed the US is still far from price stability. A credit crunch could tip the economy into recession, as vulnerable banks try to shore up their balance sheets while also holding on to newly flighty deposits. A smaller rate hike – or even a pause – could then be justified on the grounds of monetary policy.

Some retrenchment in bank lending is almost certain to result from the debacle of the past two weeks. Bank managers, risk officers, regulators and depositors have all had their attention drawn to underlying

vulnerabilities in banks outside the core. In a demonstration of the scale of potential stress, Sebastian Mallaby notes that recent estimates of unrealized losses sitting on bank balance sheets are so large that if all US banks suddenly had to liquidate their bond and loan portfolios, to meet mass depositor flight, the resulting losses could erase between 77 percent and 91 percent of their combined capital cushion. Of course, depositors would not all flee the banking system. This is not 2008. But it may still be true that large numbers of banks need to rebuild capital, one way or another.

Silicon Valley Bank and the domino effect

As is the case with accidents, there was no single cause of the collapse of SVB a week ago. The fact that it followed the failure of another bank, the smaller, crypto-focused Silvergate, and in turn triggered federal intervention of New York-based Signature Bank and a run on deposits of smaller California bank First Republic suggests some general features have made regional banks vulnerable. Rapidly rising interest rates as the Fed tightened monetary policy revealed the vulnerabilities.

But at the core of SVB's problem was poor management, coupled with inadequate supervisory oversight. University of Chicago Professor Douglas Diamond – who won the Nobel Prize last year for research on bank and financial crises – explained this week that SVB violated two tenets of sound banking: they failed to match their investment maturities to their depositors' likely demands, and they focused on a narrow mix of customers.

As Diamond has detailed, both sides of the balance sheet can make mid-sized US banks vulnerable in today's circumstances. A deposit base of largely uninsured accounts from local businesses is susceptible to runs once fears spread that cash needs may not be met, or competition for deposits rises with rising interest rates. Tighter monetary policy in the past year has also led to unrealized losses on the assets side of these banks, whether in long-dated government securities, commercial real estate or other loans that may become impaired under the pressure of a slowing economy and higher interest rates. Finally, the capital requirements for mid-sized banks are lower than those for systemically significant institutions that have been labeled and recognized as "too big to fail."

Regulatory reforms after the Global Financial Crisis, forced major financial institutions to submit to regular stress tests, to build up loss-absorbing capital, and to create "living wills" that lay out how to allocate losses in the event of failure. A rollback of these reforms, through legislation and regulatory changes in 2018-2019, meant that banks with assets of less than $250 billion have been exempted from these tighter rules. Former Fed Vice Chair Lael Brainard, now President Biden's chief economic adviser, opposed the regulatory loosening at the time, as did the Supervisory Risk Council of former global regulators and central bankers.

In SVB's case, deposits began to drain out as a result of the post-pandemic squeeze on funding for the small and often unprofitable start-ups that made up much of its customer base. Widespread depositor fears were triggered when the bank's holding company tried, and failed, to raise capital. Within two days, the run overwhelmed the bank. The low-interest rate government bonds held by SVB had plunged in value, making sales of the portion held as "available for sale" an expensive proposition. There was not enough cash and not enough capital to meet withdrawals, and the FDIC closed and then took over the bank. As crisis veteran and noted economist Rudiger Dornbusch famously said, "Things take longer to happen than you think they will, and then they happen faster than you thought they could."

Management was fired when the FDIC took over the bank last week and shareholders may be wiped out – depending on the final resolution of the bank, which is still operating under new management put in place by the FDIC. On Friday, the bank holding company filed for Chapter 11 bankruptcy. The problems discovered after the deposit runs that triggered the bank's collapse were sufficient to cause the Justice Department and the SEC to open investigations this week. The Federal Reserve has also admitted regulatory failures and opened its own investigation, with a report due in 6 weeks.

The investigations and after-action reviews will certainly lead to Congressional hearings in the coming weeks. But even before the post-mortems really get underway, investors are looking for opportunities in a rapidly-evolving landscape. SVB's implosion and subsequent banking struggles have investors exploring the effects on private credit. When banks and other traditional forms of financing are forced to retrench, private credit managers are often the providers of liquidity. If bank lending standards continue to tighten – which is likely – and bank regulators and supervisors take a banks' cost of capital will increase and bank regulatory requirements will likely increase, reducing companies' access to capital. That could allow private lenders to take market share.

Credit Suisse – different, but the same?

The eventual decision last weekend of the US authorities to designate SVB and Signature bank as systemic, which allowed the government to promise to make all depositors whole, was criticized roundly, albeit mostly anonymously, by European policymakers and former regulators as unnecessary and inducing moral hazard. Finance expert and Peterson Institute scholar Nicolas Veron commented that the regulators "really killed a fly with a sledgehammer." The motivation was likely to avoid contagion to other US banks that could be vulnerable to a deposit run, although without SVB's underlying solvency problems. It was a surprise this week that spillover came first to the large, systemically significant Swiss bank, Credit Suisse. The Swiss regulatory authorities, after first refusing to help, made an emergency line of credit available.

On the surface, Credit Suisse looks very different from SVB and its fellow US mid-sized banks. It is a huge, complex institution with global operations. Its troubles have been well-publicized, with successive issues of bad management, involvement in one scandal after another – Archegos, Greensill, 'tuna bonds' – and unsuccessful attempts to reset. But in one important sense Credit Suisse was similar to SVB. It has a large, concentrated, and well-informed depositor base that has gradually been deserting the bank. And no other private actor wants to put in more capital at a price that values the franchise.

The dilemma for central banks

Recent macroeconomic data, including this week's disappointing consumer price report, makes the Fed's interest rate decision and its messaging difficult. Price increases on a range of measures have stayed stubbornly high since the end of last year, running at a rate in February that was twice or three times above the Fed's 2% target.

Other indicators suggest that the US economy has continued to grow this year, and that labor markets remain tight. Claims for unemployment insurance fell again last week, below market expectations. But, as we have noted before, systemic risk is the one factor that could give monetary policy makers pause, even as they fight inflation.

CPI Measures show persistently stubborn inflation

Core and Headline CPI, 3-month annualized

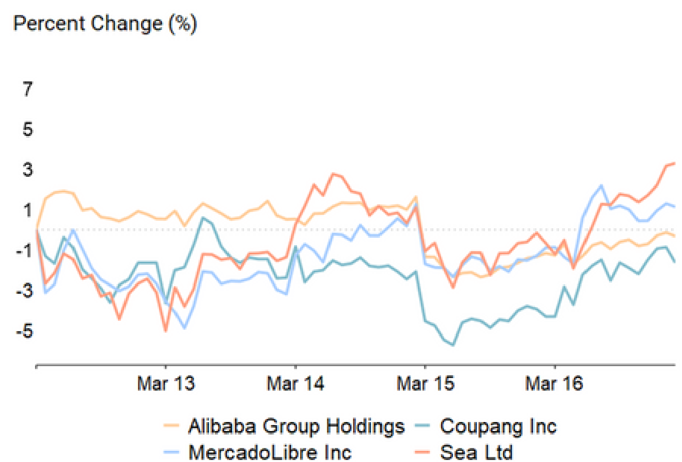
Source: RockCreek, BLS

Emerging Markets

Emerging markets dropped this week and are in the red on a year-to-date basis. Non-China markets led the selloff: investors in India, Latin America, and EMEA all took chips off the table as inflation and external demand data proved disappointing.

After a terrible February, Chinese equities found renewed vigor this week, led by the communications services, energy, and financial sectors. Indeed, all sectors in China were up this week with the exception of IT, perhaps not surprising given the roller coaster drama at Silicon Valley Bank and its close ties to the tech sector. But emerging markets tech behemoths, many with venture arms of their own, avoided major corrections on the SVB news. Our research shows that the venture ecosystems in their markets remain well capitalized. Indeed, by virtue of relatively underdeveloped ecosystems, local start-ups have traditionally been forced to seek multiple sources of funding and banking relationships.

EM Tech Muted Reaction to SVB News



Source: RockCreek, U.S. Securities Information Processor (SIP) via Alpha Vantage API

Latin American equity markets had a particularly tough week, with Argentine, Chilean, and Brazilian markets leading the region's selloff. The drop off in commodity prices, coupled with stubborn inflation and a local economy stuck in neutral, have all

contributed to the region's reversal of fortune after last year's banner year. President Lula's first days in office have so far been characterized by base pleasing speeches and proposals; the markets hope to see the pragmatic Lula of yester-year sooner rather than later. They may have to wait a while longer as Brazil today is not close to the financial mess it was in 2003.

Upcoming Events

Caroline Atkinson will moderate a discussion on the global economy with Harvard Professor and former World Bank Chief Economist Carmen Reinhart and University of Michigan Professor and former member of President Obama's Council of Economic Advisors Betsey Stevenson on March 20th. Register here.

Maria Woodman will speak at the Berkeley-Haas conference, organized by RockCreek advisor Dr. Laura Tyson, *Mobilizing Capital to Achieve Net-Zero by 2050* on March 22nd. Register here to view online.

RockCreek Update

Afsaneh Beschloss joined David Westin on Bloomberg's *Wall Street Week* to break down the opportunities and economics of investing in the energy transition. Watch the show here.

Afsaneh also joined David Westin and Romaine Bostick to discuss how the collapse of Silicon Valley Bank and the subsequent banking crisis are impacting climate-focused startups, local and regional banks, and potential ramifications for the Inflation Reduction Act. Watch here.

With more to come,

Team RockCreek

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