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The Banking Crisis and Superhero Central Banks

Part 1: Setting the Scene

The past two weeks have been very interesting for global banks. We've been inundated with articles, opinion pieces and professional viewpoints. However, the reality is that no one has a crystal-ball and knows exactly what will happen next. The best we can do is understand the facts as simply as possible and 'be prepared' for the various scenarios that could play out.

You have likely received numerous queries from clients enquiring about what is happening with global banks, and more importantly, how it affects them and their portfolios. I try to simplify the noise, weigh in on what these bank runs mean for markets, and explain the impact it may have on your client's portfolio.

In a period of a few days, we saw banks like SVB, Signature bank and Credit Suisse go belly-up thanks to a liquidity crisis, that in hindsight, has been building since the rapid interest rate hikes started more than a year ago. Simplistically, banks make money by paying depositors (customers) interest for keeping their money with the bank (in various savings accounts) and lending those deposits out at a higher rate than they are paying their customers.

When the banks were taking in deposits, interest rates were very low. Management decided to invest some of the deposits in 'very safe' fixed income instruments, in the form of government bonds.

Now fast forward a year, where we have seen massive interest rate hikes all over the world, with the US hiking rates by just under 5% in 12 months. Interest rates and price have an inverse relationship so as interest rates rise, the price of bonds goes down. So, the long-dated bonds that SVB bought, are still set to pay the same amount at maturity, but their current value (price) has decreased. This created a mismatch in bank assets (investments) and liabilities (customer deposits).

Simultaneously, numerous SVB customers (start-ups etc.) began withdrawing their deposits, as their funding dried up due to the high interest rates. As more customers looked to access their money, SVB needed to raise liquid capital to meet the withdrawal demands and so had to sell the bonds, at a lower price than what they originally paid (a loss of $1.8 billion). SVB also looked to issue equity to raise more than $1 billion additional capital. The signs of illiquidity spooked investors and depositors causing a run on the bank. Although they tried to plug the hole, the damage had already been done: Enter the Federal Reserve.

The Fed basically promised that all capital deposited with the bank, would be protected, whether it was insured or not. The UK arm of SVB has since been acquired by HSBC, a transaction which includes a helpful £2 Billion liquidity injection, to help ensure business as usual for SVB UK customers.

Now the question is, what caused these depositors to pull their money out of SVB, and how did this result in other large banks feeling the liquidity crunch?

The answer, in part, is market signalling. The market often acts on signals that companies send out, and SVB sent out a flashing red light on the 8th of March when they tried issuing equity, after the loss on the sale of their bonds. This panicked the market, causing SVB's share price to fall by more than 60%. Shareholders in SVB started dumping their shares, and customers rushed to withdraw the money they had in SVB. This was quickly followed by the collapse of Signature Bank and eventually Credit Suisse, indicating that the panic had spread.

This panic and spread of market disturbances is known as *the contagion effect* and the unfortunate result is that potentially well-run banks that are not considered one of the 'big banks' could also feel a liquidity crunch. They are at risk of their clients flocking to pull their money and rather place it in what they believe are banks that are 'too big to fail', due to the likely bailout by central banks around the world.

It is during times like these where central banks flex their muscle and put plans in place to ensure that these big market players do not completely fail, with the aim of reducing the impact on the market and economy.

In next week's article, we will look at the issue of risk management within the banking sector, what impact potential future failures can have and why it might not be the end of the world for your client's portfolio- even if they (or you) might be over-stimulated by the noise that currently rules the news headlines.

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