ECMI EUROPEAN CAPITAL MARKETS INSTITUTE

ECMI Commentary no 83 | June 2023

SVB and Credit Suisse:

When rules yield, it is time to change the system

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There are two countries (the US and Switzerland), two regulators (the Fed and the Swiss Financial Market Supervisory Authority (FINMA)) and two banks (SVB and Credit Suisse). There are also regulatory structures and processes in place for failing banks. The question, however, is whether these processes were followed in the case of SVB and Credit Suisse. It seems that they were not. The regulatory system that was put in place after the global financial crisis was a bail-in system – alongside other tools that were added to the toolkit, like systemic stress testing, living wills, etc. The bail-in process for dealing with failing banks means that a bank's creditors take a haircut in order to cover the losses that the bank has made. But the bail-in process was not applied to either of these two banks.

The SVB and Credit Suisse cases illustrate the failure of (part of) the global regime put in place after the great financial crisis – a failure of supervisory practice. Neither SVB nor Credit Suisse should have failed in the first place. When politics meets rules, rules yield. What happened in both the US and Switzerland, was a political resolution at the highest possible political level. In taking it, the rules became secondary. If we keep changing the rules without changing the system, we won't get far. Instead of regulating by risk and buffers, it is now time to make the financial system more shock-absorbent and diverse, and to bring individual accountability to the forefront.

SVB

SVB was the 16th largest bank in the US (out of 4 800 banks) and described as a mid-sized regional bank, yet its failure was considered systemic. Rather than following the bail-in process, the Fed effectively undertook a bailout process. SVB was central to the venture capital sector

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not just in California, but globally[1]. The UK branch, for example, had half of all UK venture capital and associated founder companies. That's a huge systemic concentration.

Furthermore, the bank engineered customer loyalty by attracting deposits (i.e. seed A round, seed B round, IPO). It also attracted an enormous number of foreign founders. Unlike most banks in the US, SVB did not require a social security number. So foreign founders could get an account at SVB, while they couldn't get one anywhere else. In other words, SVB created an ecosystem around itself.

What's more, just 6 % of SVB's deposits were covered by the Federal Deposit Insurance Corporation under the limit of USD 250 000. In other words, 94 % of deposits were uninsured. By comparison, the average community bank had 71 % of deposits within the limit and insured. SVB was an outlier. In addition, 35 % of its assets were loans and only 10 % of these were commercial loans. The remaining 65 %, was invested in what were perceived as very safe government bonds and mortgage-backed securities (although skewed towards the longer term). And that's where their problem arose, because they had interest rate and duration risk that was not adequately hedged[2].

The Fed had already noted risk control problems at SVB as early as 2019. In 2020, SVB hired BlackRock's Financial Markets Advisory Group to conduct a risk analysis of the bank's systems. They found that SVB was behind its peer banks in 11 out of 11 categories in which the bank was evaluated, and in 10 out of 11 categories SVB was very far behind. Nevertheless, not much changed at SVB. While the management clearly ignored these messages, it seems that the supervisors did too, as the Fed's recent review on supervision and regulation of SVB shows.

Was SVB's mistake that they trusted the Fed when it said that rates won't rise and inflation is transitory? Although its portfolio devalued at speed in 2022, that was not a problem as long as there was no bank run (because a hold-to-maturity book doesn't have to be marked to market). One reason for perhaps not hedging as much is that any hedge needs to be marked to market as a profit and loss. So there was a mismatch in the accounting treatment of hedges and the hold-to-maturity book. But supervisors didn't take any action, given that this type of problem is rather common to thousands of banks, and the Fed continued hiking rates. As SVB's stability was questioned, founders and venture capital sector spread the word (including through social media) and USD 42 billion of deposits were withdrawn in two days. There is no bank that can withstand a run of that scale at that speed.

Credit Suisse

For Credit Suisse, the order in which bank creditors should have lost their money in the event of insolvency was turned upside down, whereby the bondholders were completely wiped out

[1] Perhaps SVB's collapse is a reminder of why startups are better financed via capital markets, as innovation is inherently risky.

[2] In fact, SVB reduced its hedging portfolio from about USD 10 billion at end-2021 to just USD 500 million at end-2022.

and the equity holders were not. Does this indicate that central banks are not going to abide by the bail-in process whenever there is a problem?

What bail-in is supposed to do is get subordinated creditors to rapidly bail-in a bank and take on equity-type positions. If in the case of Credit Suisse it was important to resolve a bank in distress, this was the right solution. Yet, we will have to wait over the coming years and see how the litigation plans out.

The idea that the shareholders of Credit Suisse got some of their securities back (not a 100 % write-down) is consistent with the academic view of optimal regulation. Assuming that there are two equilibrium outcomes, one good and one bad, a bank run is considered a bad outcome. Although illiquid positions may be good in the long run (or less of a problem), if there is a bank run and a need to liquidate them very quickly, the positions will result in huge losses. Still, if there is a bankruptcy regime that allows a bank to be restructured fairly efficiently, there could be some upside for equity. And the way this should be dealt with is through warrants – not with new shares.

Although government securities have always been described as not needing any risk weighting, and perceived as safe and riskless, this is not the case. There can be enormous interest rate risk, unless it is hedged. This means that the risk weighting of government bonds (depending on their duration) needs to be reconsidered. On the one hand, governments do not want to see their debt obligations subject to any kind of risk weighting, but on the other hand, regulators and supervisors need to be conscious of the riskiness of government bonds.

A long decade of quantitative easing with a flood of funding, particularly in the months following Covid-19, has left its stigma. Now that we are seeing an unwinding or reversal of that (e.g. an increase of short-term rates, the most inverted yield curve for 40 years), it may be the right time to reconsider the regulatory framework and update our models. During this decade, there was neglect, spurning and demotion of depositors in the financial system, as if they had become a bit of a sideshow. The focus was on regulatory compliance and metrics, and on the fintech/digital revolution, rather than on some of the softer issues of cultural leadership, credibility, trust building and communication. These issues can act as circuit breakers or risk amplifiers when in the spotlight. In the case of Credit Suisse, for example, the issues relate to the composition of the board, the executive leadership, competence and information cascades. Depositors are the key constituents of the financial system, and may prove crucial to averting systemic risk.

Unlike SVB, Credit Suisse was one of the 30 global systemically important banks. According to the December 2022 Annual Report and Pillar 3 disclosure report, the bank was fully compliant and was doing very well. It was apparently solvent enough for the central bank to offer CHF 50 billion of liquidity, which evaporated just two days later. This was as much a run on the regulator as it was a run on the bank. Clearly depositors were not convinced by the endorsement of liquidity.

Is the regulation we have fit for purpose?

There's a general feeling that the two supervisory authorities involved, the Fed and FINMA, did the right thing and headed off a real crisis. In fact, SVB and Credit Suisse have more in common with the collapse of Long-Term Capital Management – because of duration risk – than with the collapse of Lehman Brothers. Perhaps it would be wise to look back and relearn old lessons. With all the bells and whistles of the new regulatory regime, it looks like there is more reliance on the tools that were introduced after the global financial crisis, and some of the basic ABCs of banking are being forgotten.

There were also supervisory failures. In the case of SVB, there were cultural/management failures, while in the case of Credit Suisse, there were long-running problems with a business model that was not sustainable. In the EU, both of these risks are covered by the Capital Requirements Directive and Regulation, and are meant to be addressed through the Supervisory Review and Evaluation Process. Although we have the tools for dealing with such problems, they keep recurring. The rulebook is there, let's apply it.

The Fed should never have allowed the situation with SVB to develop. It clearly failed in its duties to supervise its own monetary system and banking institutions, as highlighted by its own review. It also looks like the Fed is directly exposed to political pressure. Maybe the mandate of the Fed and its independence have seriously been undermined in recent years. Giving the Fed, and any central bank, more protection to take difficult decisions based on principle rather than the details of the rules that have been set down, may be a sensible regulatory response going forward.

As for the bond markets, underlying the fragility of the banking system is the regulatory requirement on the holding of bonds by credit institutions. The basis of every bank regulation since the first Basel accord of 1988 is that banks hold bonds as assets[3]. This means that if the bond market becomes vulnerable to a shock, instability or price dislocation, the entire financial sector is under threat. In July 2019, the US Treasury market was vulnerable and likely to be disrupted. This happened a few months later in September 2019, as well as in March 2020 and November 2022.

At the same time as the Fed recognised SVB as systemically important and took Signature Bank into administration, it introduced a new programme. The bank term funding program (BTFP) is an emergency lending programme that offers short-term loans to eligible financial institutions (e.g. banks, savings associations, credit unions and other depository institutions, as well as any US branch or agency of a foreign bank) in exchange for certain long-term securities pledged as collateral. In other words, a bank can effectively use its bond portfolios, which on a mark-to-market basis are worth 30 %, 40 %, or 50 % less in 2023 than they were in 2021, and

[3] They do that in order to address their liquidity coverage ratio requirements in the high-quality liquid assets portfolios, composed of deposits at the central bank and sovereign debt. The need to comply with very high liquidity requirements, combined with a zero or negative return on central bank deposits, has massively increased the holdings of sovereign debt by banks, and consequently their sensitivity to interest rate risk, unless it is properly hedged.

exchange/finance it at 100 % par value (regardless of the current market value of the collateral)[4]. By doing that, a bank that does not hedge its bond risk can now borrow 100 % and have liquidity. This essentially means that the duration risk and interest rate risk have been eliminated.

The BTFP has created a two-tier market by subordinating all of the US government debt and mortgage-backed securities that are held by financial institutions (domestic and foreign). In essence, the Fed has subordinated the rest of the world that has bought US Treasuries by 30 % to 40 %. This creates a huge imbalance in the financial system and we will have to wait and see how it plays out. Moreover, when a central bank acts as lender of last resort it is supposed to take good collateral with a haircut. But with the BTFP, the Fed is taking bad collateral with no haircut. US Treasury securities are bad collateral, as their market value is not worth their par value. This is a revolution in the role of central banks as lenders of last resort.

When it comes to regulation, financial authorities face two key problems. First, the financial system is infinitely complex. This means that policing and de-risking a tiny part of it will result in the risk emerging somewhere else. But, trying to eliminate all risk in the system will simply hamper the economy. It is also not viable. Second, regulating by risk means being able to measure it. The problem here is that we can only infer risk by using past prices.

Time to change the system

Looking ahead, there are several options to consider. One is to increase existing regulation, making it tighter and more intrusive. However, in the short run this would cause market distress, while in the long run it would be highly recessionary, raise systemic risk and squeeze out funding – especially for SMEs.

Another is to leave it to the markets to sort it out themselves. While the 'law of least intervention' sounds attractive, politics is part of the game and in a crisis situation governments are forced to step in. So it's better to be prepared in advance.

A further solution may come from technology, whether it is called blockchain, artificial intelligence, Web5 or central bank digital currencies. Even so, there is a lot of uncertainty surrounding these technologies and they will only materialise in a few years' time. Moreover, their impact on financial stability is questionable.

Perhaps a more revolutionary way forward that is worth considering is to reform the current system. At the moment, regulators regulate through risk and buffers, aiming to protect against the unforeseen. Instead, it would be more sustainable to make the system shock-absorbent, to absorb shocks rather than spreading them. Trying to harmonise the way we see and react to risk, to make banks all behave in the same way, ends up being a shock amplifier whenever a shock occurs.

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[4] The exchangeable assets become part of the Fed's balance sheet, which depending on the BTFP's utilisation rate, it can expand significantly. Since March 7, 2023, Fed's balance sheet expanded by USD 391 billion to USD 8.7 trillion on March 22.

In addition, there is a need to allow for more diversity in the system and to increase the variety of institutions. This could mean, for example, encouraging new banks and new banking models, making it easier for fintech companies to innovate and facilitating the access of new entrants to the market. There is no need to apply the very expensive regulatory apparatus that is used for the largest systemically important banks to the small banks. But there is need for supervisors to be better equipped to supervise new and novel business models.

Minimising moral hazard is equally important. That can be done by exposing CEOs and senior management directly to downside risks. If the CEO and chair of SVB or Credit Suisse had their personal fortunes directly tied to the success or failure of their banks, they would have addressed and resolved problems much more carefully and earlier. Individual accountability – which, for example, is insufficiently covered in the EU enforcement regime – is key.

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