

# Banking Crisis 2023: Deep Origins and Future Directions

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*It's been a week since the collapse of the Silicon Valley Bank, the 16th largest bank in the US at the time of its collapse and reportedly a source of funding for half of all the tech start ups in the US.*

*It's now become clear the more general banking crisis that has emerged is not due simply to a rogue, mismanaged bank that over-extended itself during the recent tech boom and then somehow mysteriously imploded in just 72 hours, March 7-9, until seized by the FDIC on the morning of March 10, 2023.*

*Deeper, more systemic forces are at play—in the case of both the SVB collapse and the now spreading contagion to US regional banks as well as to European banks. The SVB is just the tip of the current financial instability iceberg. In Europe the focus is the now collapsed big Credit Suisse bank announced today, March 19, by Switzerland's central bank. The problem is thus now not just US regional bank centric, but is rapidly becoming global systemic.*

*What then are the systemic forces responsible for the SVB collapse and now spreading instability to US regional banks and European banks?*

## Causation: Precipitating, Enabling, and Fundamental

When discussing causation of a financial institution collapse it is necessary to distinguish between precipitating causes, enabling causes, and fundamental causes.

Clearly the Fed's historically rapid rise in interest rates since March 2022 has played a key role in precipitating the crisis. And SVB's management in recent years clearly engaged in

classic mismanagement of its assets, so that mismanagement has enabled its eventual collapse.

But at a more fundamental, deeper level the SVB collapse—and the now spreading contagion—is a reflection of the speculative investing boom that occurred in the tech industry over the last decade, especially after 2019. That tech boom was fueled in large part by the Federal Reserve’s massive liquidity injections into the US banking system since 2009—which accelerated further from September 2019 to February 2022. Massive, excess liquidity injections by the Fed since the fall of 2019 drove corporate borrowing rates to zero (and below zero in real terms), thus fueling much of the tech over-investment bubble.

Overlaid on that longer term fundamental cause of excess liquidity driving borrowing rates to zero, the Fed then precipitated the crisis by abruptly reversing its decade-long free money policy by raising interest rates in 2022 at the fastest pace in its history and shutting off that free money spigot.

Before examining the Fed’s contributions and role in the current crisis in more detail, a review of what actually happened at SVB (and now is happening at other regional banks and in European banks) is perhaps instructive, revealing the dynamics of bank instability today at the bank level itself.

We might therefore ask: what then were the processes behind SVB’s collapse? What actually happened at SVB? And is that same Fed-induced processes now at work in other banks behind the scenes—eventually to be revealed in coming weeks with further subsequent depositors’ bank withdrawals, collapsing bank stock prices, rising credit default swap costs insuring against possible bank failure, and more US announcements to try to stem the contagion? To what extent is the collapse this weekend of the giant European bank, Credit Suisse, also influenced by events of the week prior in the US banking system?

Most important, what are the possible scenarios for continuing US and European banking instability in the coming weeks.

## The SVB Collapse ‘Template’

In general terms, here’s how banks typically fail:

The basic mechanics of financial institution instability typically occurs as follows:

a bank becomes more ‘fragile’ (i.e. is prone to a financial instability) when it either takes on excessive debt, or structures that debt poorly, and then experiences either a sharp decline in its cash flow required to service that debt (i.e. to pay principal and interest due) or experiences a loss of prior cash (or near cash) on hand with which to service that debt. SVB fell into that chasm, into which many other regional US banks have now been sliding into as well. The Fed created the chasm. SVB management simply decided to dance along the edge of that financial cliff, until it slipped and fell into the hole.

In the specific case of SVB, it took on too much asset liability, poorly structured its long term debt, then suffered a severe decline in cash on hand as depositors and investors withdrew their money from the bank.

Here’s a statistic worth noting:

SVB's total asset base by 2019 was approximately \$50 billion. That accelerated to more than \$200 billion by year end 2022.

How did that happen? For one thing, the tech boom produced massive financial gains for investors and managers (and even employees) in the tech sector. SVB in California was the 'place to be' to deposit those gains.

It was a favorite locale for the highly concentrated Venture Capitalist industry located in California in which to deposit funds earmarked for the tech start ups the VCs were funding. Capital gains by rich tech managers and 'founding employees' who just cashed in their IPO stock awards also found their way to SVB. And then there was Covid!

The Federal Reserve in March 2020 pumped \$4 trillion into the banking system in the US. It was theoretically to prevent another bank crisis, as in 2008-09. Except there was no bank crisis. It was a pre-bank bailout that never happened. It was a preventive bank bailout that was never needed. But the \$4T went out into the banking system anyway.

That Fed \$4T followed a prior Fed liquidity injection of \$1 to \$1.5T that occurred in September 2019 to bail out the 'repo' bond market. So more than \$5T flowed into the economy in 2019-2020.

The tech sector was booming already, fueled in part by the Trump administration's 2017 \$4.5T tax cut for investors and businesses. That tax cut had fueled the Fortune 500 corporations distributing \$3.5T in stock buybacks and dividend payouts to their shareholders during the three years, 2017-19 alone. One can only imagine how much more was distributed to shareholders by the 5000 largest US corporations as well.

Massive amounts of money capital thus flowed into financial asset markets, especially into the then booming tech and tech start up sector.

Tech companies went even further. As result of the Fed's \$4T liquidity injection during the Covid crisis, the zero interest rates created by that liquidity made it possible for tech companies to issue their own corporate bonds at a record pace. For example, Apple Corp., had a cash hoard on hand of \$252 billion. But it issued its own corporate bonds anyway to take advantage of the near zero interest rates made possible by the Fed's \$4T injection during Covid, from March 2020 through February 2022.

Countless millionaires were made and the ranks of billionaire tech investors billowed as well. The tech bubble—fueled both directly and indirectly by the Fed's zero rate policy—expanded. Many of those investors riding the wave—whether VCs, tech start ups, tech CEOs, and even founding tech employees—funneled their money capital into SVB the celebrity tech bank of choice in silicon valley.

The bank's deposit base surged from the \$50 billion to more than \$200 billion by end of 2022. And not all of that was depositors' or investors' inflow. SVB also borrowed heavily from the Fed taking up the latter's long term Treasury bonds that were virtually cost free given the zero rates of interest. About \$150B of SVB's asset base was depositors money. And more than 90% of that \$150B was individual deposits in excess of the \$250,000 limit guaranteed by the FDIC in the event of a bank failure.

So lots of deposits on hand at SVB but most of the \$200 billion asset base locked into long

term treasuries and other bonds. In other words, a poorly structured financial portfolio. Should a crisis emerge, and depositors and investors started leaving, the bank could not give them their deposits since they were locked up in long term bonds. A classic long term asset vs short term cash structure. That was a serious financial mismanagement problem 'enabled' by SVB management.

Then the Fed started raising rates in March 2022. Because rate hikes result in corresponding bond price deflation, SVB's balance sheet quickly fell into the red. The corporate rating agency, Moody's warned of a rating cut for SVB. The bank's stock price began to fall. Investors and the bank's savvy depositor base made note.

SVB management tried to rectify its bond deflation and now higher borrowing costs by selling off some of its own bonds in order to raise money capital to offset its deflating assets. But with bond prices continuing to fall (as Fed continued to accelerate its rate hikes), it was like 'catching a knife', as the saying goes. SVB lost nearly \$2B on its attempted bond sale. Moody's and investors took further note.

Now desperate, in the days immediately leading up to its collapse SVB management arranged with Goldman Sachs bank to sell more of its stock. But that act really grabbed the attention of its VCs, investors and depositors. During the week before its collapse, the VCs reportedly started telling their start ups with money deposited at SVB to get their money out and move it elsewhere. As VCs and tech companies started withdrawals, the word quickly got out in the silicon valley tech community and general depositors began withdrawing their cash as well. Given how fast the events were occurring, SVB didn't have time to obtain a bridge loan. Or to sell some of its better assets to raise cash. Or find a partner to buy in or even acquire it. The rapidity of events is a characteristic of today's bank runs that wasn't a factor as much even back in 2008.

All this happened at near financial 'lightspeed', made possible by (ironically) technology. In bank runs in the past, depositors typically ran down to the bank before its doors opened the next day once rumors spread. But today they don't. They simply get on their smart phone and enact a wire transfer to another bank—at least until the bank shuts down its servers.

To sum up: the SVB 'template' is a classic bank run event. The bank had over-invested and poorly structured its assets into mostly long term securities. As the broader tech bubble in general began to implode in late 2022, investors and depositors got nervous about the bank's exposure to long term securities and the likely slow down of cash flow into the bank by VCs and wealthy tech sector individuals. Like the tech sector in general, the bank's stock price also began to fall which further exacerbated the loss of potential cash on hand. Bad and failed moves by SVB management to raise capital, more warnings by Moody's, and the VCs communicating to their start ups with deposits in SVB to exit quickly consequently resulted in an accelerating outflow of deposits needed for the bank to continue servicing its debts. The FDIC stepped in to save what was left of depositors funds.

But, as previously noted, the FDIC guaranteed only \$250k per investor and depositor. And of the roughly \$174B in deposits at the bank, more than \$151B involved more than \$250K.

## Regional US Banks Contagion

The processes that led to SVB's crash a week ago continue to exist throughout US tech and the US banking system—especially in the smaller regional banks and in particular in those

regionals serving the tech industry.

Caught between the Fed's fundamental, long term and shorter term contributions to the current crisis, SVB's CEO and senior team mismanaged their bank's assets—i.e. enabled its collapse. But the Fed's policies made that mismanagement possible, and indeed likely. And not just at SVB but throughout the regional banking sector.

Another institution, Signature Bank in NY, failed just days before the SVB's collapse. Other banks approached failure last week and remain on the brink in this week two of the emerging crisis.

Most notable perhaps is the First Republic Bank of San Francisco, also exposed to the tech sector. Its stock price plummeted 80% during the last two weeks as it was the next target for withdrawals. To try to stem the collapse of First Republic, a consortium of the six big US commercial banks (JPMorgan, Wells, Citi, BofA, Goldman Sachs and Morgan Stanley), arranged by the Fed and US Treasury, pledged by phone to put \$30 billion into First Republic. The following day after the announcement of the \$30 billion, however, another \$89B in withdrawals from First Republic occurred. Clearly, \$30B was not near enough. It is unlike the big six will up their ante. The Fed will have to throw more into the pot to save First Republic from SVB's fate.

Following SVB's collapse, the Fed and the US Treasury also announced a new Bank Bailout Facility, the first such since 2008, funded by \$25B by the government. Reportedly the facility planned to make available to banks a new kind of loan from the government, issued 'at par' as they say (which means the value of the money would not deflate).

The Fed also simultaneously announced it would open its 'discount window', where banks can borrow cheaply short term in an emergency. During the first week no less than \$165 billion was borrowed by the regional banks from the discount window and the \$25B new facility.

The question remains, however, whether the Fed next week will continue to raise interest rates which can only exacerbate depositors and investors' fears about their regional banks' stability and likely accelerate withdrawals.

But the Fed is between 'a rock and hard place' of its own making. If it doesn't continue to raise rates it undermines its legitimacy and claims it will raise them until inflation is under control, which means moving decisively lower toward the Fed's official 2% inflation target. But if it does raise rates, the move could exacerbate withdrawals and regional banks' stability. Which then will it choose: inflation or banking stability. This writer is willing to bet bank stability comes first, inflation second (and employment and recession a distant third if at all).

The most likely event is the Fed will raise rates just a 0.25% one more time in March next week, and give 'forward guidance' it won't raise rates further should the bank situation not stabilize. Also highly likely is the Fed will announce a hold on its 'Quantitative Tightening' so-called policy by which it recalls some of the \$8T plus liquidity it formerly injected into the economy. QT has the effect of raising long term rates, which the Fed cannot afford until stability returns to the banking sector. Even longer term, this writer predicts the Fed will try to reconcile its contradiction of 'reducing inflation by rate hikes with halting rate hikes to stabilize the banks' by raising its current 2% inflation target to 3% or more later this year.

It was already clear that even the rapid hike in rates of nearly 5% by the Fed in 2022-23 hasn't had much impact on slowing prices. From a peak of 8.5% or so in the consumer price index, prices have abated only to around 6%. Most of the current inflation is supply side driven and not demand driven and even the Fed has admitted it can't do anything about supply forces driving up prices.

This writer has also been predicting for more than a year—and since 2017 in the book, 'Central Bankers at the End of Their Ropes'—that in this the third decade of the 21st century the Fed can't raise interest rates much above 5% (and certainly not 6%) without precipitating significant financial market instability.

The Fed and US Treasury will almost certainly have to up their bailout measures in the coming week should more regional US banks weaken. That weakening may be revealed in further bank stock price declines, in rising withdrawals from the banks, or in a sharp further increase in the cost of insuring investors in the event of a bank failure by means of credit default swaps securities.

And in its latest announcement this past Sunday, March 19, 2023, the Fed has said it will immediately provide currency swaps with other central banks in Europe and Japan to enable dollar liquidity injections into offshore banks. Central banks are now fearful the bank runs and instability may well spread from regional US banks to weak banks abroad.

### Credit Suisse Bank Implodes: Which EU Banks Are Next?

As regional banks shudder and weaken in the US, in Europe the giant Credit Suisse bank (CS) crashed this weekend. Over the weekend banks, central banks and their government regulators have been gathering to try to figure out how to stem the crisis in confidence in their banking systems. In Europe the focus has been Credit Suisse, which was forced to merger with the second large Swiss bank, UBS. The arrangement of that merger may just precipitate further financial market instability in Europe. Already two other unmentioned EU banks are reportedly in trouble.

The 'deal' arranged by the Swiss national bank forcing CS to merge with UBS involved an unprecedented action: instead of shareholders losing all their equity and bondholders getting to recover some of their losses by the bank's sale of remaining assets, as typically occur when a bank or a corporation collapses, the opposite has happened in the CS-UBS deal. The holders of CS junk (AT1) bonds worth \$17B will now be wiped out and receive nothing—while shareholders of CS will receive a partial bailout of \$3.3B.

The fallout of restoring some shareholders while bond holders are wiped out may result in subsequent serious financial consequences. That 'inverted' capital bailout—i.e. shareholders first and nada for bondholders—has never happened before. Bondholders in Europe will now worry and take action, perhaps provoking financial instability in bond markets. Contagion at the big banks may be contained by the CS-UBS deal (emphasize 'may'), while contagion in the Europe bond markets may now escalated and exacerbate.

The Swiss National Bank is also providing UBS with a \$100B loan and Swiss government another \$9B guarantee to UBS. In exchange for the \$109B UBS pays only \$3.3B for CS. Why then is another \$100B loan being given to UBS if it's paying only \$3.3B? Does the Swiss Central bank know something about UBS's liquidity and potential instability it's not saying?



Another curious element of the CS-UBS 'deal' is the \$3.3B UBS is paying for CS is almost exactly the same amount that CS stockholders are getting reimbursed in the deal. Could it be that the \$3.3B for shareholders will go to the main stockholders and senior managers of CS, a kind of legal 'bribe' to get them to go along with the forced merger? Or is \$3.3B for \$3.3B just a coincidence?

Bottom line, in Europe the stability of the \$275B bank junk bond market is now a question. So too are the stability of the rumored two other major EU banks. To backstop both these potential instabilities is why the Fed and other EU central banks now agreeing to a dollar currency swap.

Watch for Europe bank stock prices to fall noticeably in coming weeks. They've already fallen 15% in the past week. (US regional banks stock prices have fallen 22%). More bank stock price decline will now occur. Withdrawals will move from weaker to stronger banks. CDS insurance contracts will rise in cost. As unstable as this picture may be, certain segments of the Europe bond market may fare even worse in the week ahead.

## A Few Conclusions and Predictions

The collapse of SVB and other regional banks in the US represents a classic run on commercial banks not seen since the 1930s. Some argue it's not a bank run but of course it is. When depositors withdraw half or more of a bank's available cash assets and the bank cannot raise immediate additional cash to cover withdrawal demands—that's a bank run!

The process is also classic in its dynamics: the bank over-extends making risky lending and loads up on long-term assets that can't be quickly converted to cash. General economic conditions result in a reduction of cash inflow. It can't raise cash to cover debt servicing. Its financial securities on hand deflate, exacerbating further its ability to service debt and satisfy withdrawals. It can't obtain roll over loans or financing from other banks or lenders. Its lenders won't restructure its current debt. And it can't get another partner to invest in it or buy it. The only option at that point is bankruptcy or government takeover and the distribution of its remaining assets to bondholders and stockholders get wiped out. (Except as noted in the case of CS-UBS where the bailout is reversed).

It's almost inevitable now that further contagion will result from both the US regional banks' crisis and the Credit Suisse affair in Europe. Bank regulators, central banks, and governments will scurry around to provide liquidity and bail out funding to try to convince investors and shareholders and depositors that the banks are 'safe'. This means raising the funding of the special 'bank facilities' created by the Fed and other banks. Making the 'discount window' borrowing terms even below market costs. Providing currency swaps among banks. And for depositors, quickly raising the FDIC \$250,000 guarantee to at least \$400K or even \$500K.

The central banks and regulators have moved at a record pace to construct their bailouts. But depositors and investors still can move more quickly given current communication technology. And fear moves even faster across capitalist financial markets in the 21st century.

But ultimately the problem of the instability lies with the Fed and other central banks that have fueled the tech and other industry bubbles in recent decades—and especially since March 2020—with their massive liquidity injections.

Not much has changed since 2008-10.

The Fed never 'recalled' the \$4T in excess liquidity it injected into the banking system to bail out the banks (and shadow banks, insurance companies, auto companies, etc.) in 2008-10.

Nor did the ECB from 2010-14. That money injection flowed mostly into financial asset markets, or abroad, fueling financial price bubbles and making big tech and financial speculators incredibly rich in the process—a process that resulted in a weak, below historic averages, real GDP recovery after 2010. Following that weak real economic recovery, the dynamics of financial crisis resumed.

The Fed attempted briefly to retrieve some of the liquidity in 2016-17 but was slapped down by Trump and returned to a free money regime. Fiscal policy then joined the process after 2017 with the Trump \$4.5T in tax cuts for investors and businesses. Both the tax cuts and Fed largesse resulted in more than \$3.5T in stock buybacks and dividend payouts to investors in the F500 US corporations alone! More liquidity. More tax cuts. More flowing into financing the tech bubble and financial asset inflation in stocks, bonds, derivatives, forex and other asset markets.

Then the Fed and other central banks tried pulled out the free money rug and raised rates to try to check accelerating inflation. Its results in that regard were poor. Inflation continued but the rate hikes began to fracture the banking system just as the tech boom itself began contracting. Tech centric regional banks began to implode.

The Fed, FDIC and US Treasury may yet 'contain' the contagion and stabilize the creaking US and global banking system in the short run by throwing more record amounts of liquidity and free money into the black hole of financial asset deflation and collapsing banks.

But that 'short term' solution is the ultimate source of the longer term problem and crisis: excess liquidity in 21st century capitalist now for decades has largely flowed into financial asset markets making financial speculation even more profitable—all the while the real economy struggles and stumbles along.

The Fed and central banks' solution to periodic banking instability in the short run is the problem creating that same instability in the longer run.

But some capitalists get incredibly rich and richer in the process. So the excess liquidity shell game is allowed to continue. The political elites make sure the central banks' goose keeps laying the free money golden eggs.

The latest scene in that play has is now being acted out. Subsequent commentary and analysis by yours truly will thus continue.

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