The banking crisis: the real causes and how to stop it.

Olivier Davanne

Paris-Dauphine University

Risk Premium Invest

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This banking crisis has two origins. The first is well understood and the second is not.

The most obvious is that some (many?) banks have not properly managed their interest rate risk. They believed that the surge in deposits following the COVID epidemic and the generalization of short rates at 0% - or even negative – could be used to invest in long-term fixed-rate assets. But these new large deposits (insured and uninsured) offered banks a low-cost resource only as long as short rates remained very low. Thus, with rising rates, banks made losses on these positions – realized or unrealized losses, it does not really matter. All financial crises begin with some sort of error by financial institutions. Each one has its particularities and this one will go down in history as the result of the naïve management of interest rate risks (with many tempted to also blame central banks for keeping interest rates at 0% - or below – for too long).

The second, less obvious, reason is the completely flawed framework for dealing with failing institutions put in place after the 2008-2009 crises. The overall goal, to end bailouts, was obviously right. But the extraordinary powers granted to regulators to bail-in shareholders and creditors are creating a lot of instability, and that was to be expected. At the slightest doubt about the risk of being bailed-in, uninsured deposits flee and central banks acting as lenders of last resort find it difficult to stem the panic. Clearly, regulators have overestimated the ability of lenders of last resort to stabilize deposits in this new situation where governments and public opinion have become extremely hostile to any form of taxpayer involvement.

But uninsured depositors are not the only one to panic due to the arbitrary exceptional powers granted to regulators. The general idea behind this new resolution framework was that when a bank is failing, we don't have to worry about the shareholders. They are the bad guys and they should be expropriated, even if the bank still has some fundamental value. This was explicitly written by the Financial Stability Board which stated that "the resolution regime should provide for timely and early entry into resolution **before a firm is balance-sheet insolvent and before all equity has been fully wiped out**" (Key Attributes 3.1 of Effective Resolution Regimes for Financial Institutions).

Regulators have failed to understand that property rights should not be played around with. If governments have the right to expropriate with little control the shareholders of the remaining value in the bank, who will be willing to bring new capital to a weakened institution? In many articles, we have warned of the huge volatility in share prices that the excessive public powers to subsidize (through a generous lender of last resort) or punish (through the weekend sale or closure of a weakened banks) would create when banks suffer large losses (see this 2018 paper, riskpremium.com/wp-content/uploads/2023/03/Banks-resolution.pdf). We also explained that there was a high risk of death spiral where share prices fall to zero even for a creditworthy institution. Obviously, this death spiral in share prices contributes to worry uninsured depositors and makes a run on the bank even more likely.

Here we are. Credit Suisse – the institution and its shareholders - was a clear victim of this death spiral. With shareholder equity estimated at SFr45bn ($49bn) at the end of last year, it was sold for only $3.25 bn to UBS (which obtained as a bonus some public guarantees and the cancellation of some Credit Suisse's debts…). Obviously, this was not a private business transaction: Over the weekend, Credit Suisse board had the choice between these $3.25 bn and nothing in the case of a publicly managed resolution of the bank.

Many other banks now look very undervalued due to the fear of regulators' excessive powers, and it may be extremely difficult for these weakened institutions to attract the new capital they might need. And obviously, this death spiral which has already taken SVB, Signature Bank and Credit Suisse may be amplified in the coming months by a negative feedback loop: banks may tighten credit, leading to a recession and further credit losses in addition to the losses already incurred on their long-term fixed-rate investments.

The worst is never certain. Perhaps this crisis will stop and secondary markets for banks securities will function more normally again. After all, this strange crisis began in a much more favorable context than the financial crisis of 2007-2009. Banks liquidity and capital were much stronger. And the initial shock was much less worrying: losses on long-term securities due to rising interest rates are easy to measure, whereas due to the complexity of illiquid securitized product, it was very difficult in 2008 to assess precisely how the various banks have been impacted by the bursting of the US real estate bubble.

Yet when you enter a negative feedback loop, it can be very difficult to stop the process. Thus, public authorities must act appropriately and quickly. Above all, they should think seriously about how they would handle a more serious situation in the future with widespread losses that are difficult to analyze following a recession. It may not be for tomorrow, but it will happen one day!

They need to understand that the flawed framework they have put in place to deal with failing institutions (the combination of a generous Lender of Last Resort and of a shareholders-adverse Liquidator of Last Resort…) is not working. It creates enormous volatility in the securities issued by financial institutions and makes it very difficult to recapitalize weakened institutions.

Thus, the public authorities should recognize the mistake they are making: shareholders are responsible for the losses of the banks, but have no reason to be expropriated for amounts massively greater than the losses actually suffered. It is not a question of justice: markets cannot function without clear property rights and clear rules on the public power to subsidize or expropriate.

In other words, in a context of crisis (this one or the next one…), public authorities must continue to act as efficient lenders of last resort and suspend for a limited period the threat of bank closures.

And ideally, to show that they have understood their mistakes and put an end to the current crisis in a few days or few weeks, they could announce that they are ready to participate to the recapitalization of weakened, but solvent banks. For example, they could take a small share (5%) of all new equity issues subscribed by the private sector. This investment would not be considered a bail-out as it would be small and would be done on market terms. But it would completely change the dynamics of the markets (we leave here open the question of genuinely insolvent banks which could not issue new shares despite the more supportive stance of the regulators).

Once the crisis is over, it will be time to rethink the best way to avoid the repetition of this type of crisis through a more effective supervisory system and a more rational way of dealing with failing institutions (see this post from 2018 on my website, riskpremium.com/?p=1005).