Paladin Advisors: UK ALMA Master Class

MAY 2023

Introduction

- After almost a decade of quiet, 2023 has seen a quick succession of bank failures – four in the US, and one megabank global SIFI failure in Switzerland
- Despite being grouped in short order, the cause of the failures are distinct and unrelated
- Today's master class looks at the five failures – Silvergate, Silicon Valley, Signature, and First Republic in the US, and Credit Suisse in Switzerland – as individual case studies
- Are there more failures on the horizon? Perhaps, but this is not a repeat of the 2008-2009 GFC – and these failures are fundamentally idiosyncratic

Masterclass format

- We'll review the failures roughly in sequence:
  - SVB and Signature will come first
  - Credit Suisse
  - First Republic
  - And last but not least – Silvergate Bank, the "non failure failure"

- Quick discussion of failure characteristics, with time for Q&A
- Final Q&A at the end
- One hour overall

The easy ones: SVB and Signature Bank

- Basic failure of ALM management
  - Regulators thought they had ”cured” this in North America in the late 1980s – apparently many of them, and many managers, forgot the obvious lessons
  - A combination of *ALM IRRBB mismatch* and *bad liability modeling* – the combination was the problem, not one or the other
  - Other banks in the US show similar IRRBB bad bets – but their deposit bases are fundamentally different...
  - ... And other banks in the US have similar wholesale deposit bases, but prudently avoided the IRRBB mismatches

- Likely outcome: more forceful regulatory intervention in stressed banks – and more focus on fundamental ALM management

The obvious one: Credit Suisse

- Basic failure of enterprise risk management
  - Extended management chaos
  - Seemingly intractable compliance failures – compounded by the nature of the failures in emerging markets and with internal executive indifference
  - Compliance failures led to capital losses – shareholders can understand credit mishaps, but losing money due to fraud and self-dealing issues is harder to withstand
  - Reliance on dwindling numbers of backstop investors
  - And finally: overconcentration in a national regulator, which is a lesson for German, Canadian, UK, and Spanish global SIFIs

- Endgame was obvious, timing was accelerated by US failures but largely coincidental: frontier justice is sometimes inevitable and correct

The interesting one: First Republic

- First Republic had similar issues to SVB and Signature, but without the rush to the exit up front
- This is an example of regulators using flexibility to **buy time, not buy success:** it was clear from day one that FRC would not survive, but FDIC and FRB bought time to find buyers and construct a "final bailout" that would put a period on mid-tier bank panic
- JPM takeout was likely not preferred solution, but must be viewed in context
  - Other large banks also had large HTM MTM losses
  - FRC client base was unique – concentrated in HNW and with large non-liquid asset exposures – that would have overloaded other obvious buyers (PNC, Citizens, etc)
- Lesson for US regulators: **more living will work is required for midtier regionals (>$50bln < $250bln) – not so much more regulation as more prudential oversight and pre-emptive resolution planning**

The successful one: Silvergate

- Lost in the shuffle is the most successful “failure” of this latest round: Silvergate Bank
- A California state bank that aggressively pursued ”stablecoin” deposits, it experienced a run in early 2023 which eventually turned uninsured depositors focus to the bigger failures of SVB, Signature, and FRC
- However, **prudent and cautious deposit modeling and ALM management** meant that Silvergate was able to unwind itself, without losses to depositors, and with expected recoveries available to shareholders
- While regulators effectively shut down Silvergate’s crypto-focused deposit gathering model, they also allowed for independent unwind
- Treasurers should learn: **Silent unwinds of unsuccessful business models are the ideal to pursue – and it can be done without falling into resolution**

Key takeaways

- Basic bank management never goes out of style – and incompetent bank management is a sure pathway toward perdition
  - This cycle saw ALM incompetence lead to failure...
  - ... and compliance and business model incompetence lead to failure
  - We haven't seen credit exuberance failures yet, but it's early sailing
- While US regulators took some extraordinary measures, by and large, existing resolution tools honed in the GFC succeeded in avoiding chaotic takedowns...
- ... however, G-SIFIs which are outsized relative to local central bank liquidity resourcing remain key areas of threat to the global banking system, even if regional banks can be readily dealt with
- Next up: what this means for the UK, with its mix of super G-SIFIs and its emerging tier of smaller but meaningful challenger and building society depositories