Rathbones
Look forward

Review of the week

2 May 2023

Banking eagle, hawked

A regional bank caught up in the March banking crisis has been forcibly sold by an American regulator. Hopefully this marks the end of the chapter.

Another American bank has been bundled in a sack by a federal regulator and hawked over a weekend. Unlike with Silicon Valley Bank, which made a big splash when it failed in mid-March, this time the Federal Deposit Insurance Corporation (FDIC) has found a buyer quickly.

First Republic was a quality bank built by a well-respected banking executive with a pristine track record. It offered the well-to-do premium service in lending, day-to-day banking and wealth management. It boasted top-tier customer satisfaction surveys and delivered reliable cash profits year after year. It had also been selling about twice as many loans relative to its size than its peers over the past five years, during a time of ultra-low interest rates.

However, after more than a year of aggressive interest rate hikes from US central bankers, First Republic became embattled as its depositors fled, first in pursuit of better deposit rates and then, after the failure of several other regional lenders, out of fear. Its share price plummeted dramatically over the past couple of months to the point where it all but implied the bank would fail. First Republic has spent the past month or more casting around in vain for a merger or an investor willing to inject more money. The problem appeared to be that no one wanted to take it on because its debts were in all likelihood worth much more than its assets. Contrast that with Credit Suisse, which was tucked into rival banking giant UBS in March month. In that deal, shareholders were paid out – a pittance, sure, but something – because UBS had enough confidence that the value of the assets it was taking on would most probably outstrip the liabilities that came with it. No one wanted to buy First Republic because they were concerned that even if they paid a token $1, they would have to report large losses immediately and then struggle to reap any benefit in the future.

Over the weekend, the federal deposits regulator took control of First Republic because it believed that it could no longer continue as an independent bank. It was the second-largest banking failure in American history. The FDIC shopped around large US banks for offers to take on First Republic's deposits (its liabilities), the loans it has made (assets) and the investment management accounts it administers for wealthy customers (a lucrative business line). Giant JPMorgan Chase (JPM) won the hastily prepared auction, paying the FDIC $10.6 billion. Why did the regulator have more luck in inking a deal than First Republic's own managers? Because it could wipe out the shareholders and bondholders, immediately reducing the business's debts and the amounts due to its owners, creating a buffer that makes the company more attractive. It could also offer some sweeteners, which it did. It agreed to assume 80% of any losses from First Republic loans that go bad in the coming eight years (the remaining 20% will be absorbed by JPM). It has also given JPM a five-year $50bn fixed-rate loan (probably at a bargain interest rate), which helps reinforce JPM's capital funding relative to its risks so that it can comfortably take on First Republic. And, finally, the deal carves out about $93bn of emergency funding that First Republic took from the US Federal Reserve. Those debts remain with the shell of First Republic and the FDIC will have to return the cash using the proceeds of both the sale and the loan to JPM. Because of this, First Republic's failure is expected to cost the federal deposit regulator roughly $13bn.

No doubt quite a few people will read 'federal' and 'losses' and assume this is, once again, private companies getting bailed out with taxpayers' money. This is very far from the truth. The FDIC receives no congressional funding. Each quarter it takes money from the banks based on a very small percentage of their total liabilities. If the cash it holds and levies on lenders were ever insufficient – because of widespread or very large bank failures depleting its war chest – then it can borrow money from the federal government or issue debt itself. So the losses that it expects to make from the First Republic failure will simply be recouped from the banking industry. This way, however, there will be much less damage caused by panicked contagion as depositors of all banks start to worry about the safety of their nest eggs and withdraw their money all at once.

Unfortunately, the recent bank failures will no doubt be misused in the debate about the US debt ceiling that is fast approaching a deadline. Treasury Secretary Janet Yellen has warned that the US will run out of money and default on its debts in a month if Congress doesn't agree to pass legislation to allow the government to issue more debt. This is because, since 1917, America has written into law a maximum amount that the Treasury can borrow. It has been increased almost 80 times over the years.

It is currently set at $31.4trn, which is about 135% of US GDP, and the US has already used all of it. For the last few months it has used strange workarounds to keep the government funded, but that will only last another month or so. Republicans in Congress proposed raising the ceiling by just $1.5trn in return for very large cuts to welfare and government budgets, which Democrats are strongly against.

When listening to the debt ceiling debate, it's important to remember that increasing the ceiling doesn't approve extra spending – the spending has already been approved by Congress. Instead, this ceiling just approves the issuance of debt required to fulfil those promises, which include government budgets, interest on outstanding debts, social security and other programmes. If the US doesn't raise the debt ceiling, it won't be able to pay its bills and will default, which would be cataclysmic for the economy. In the past, this game of chicken tends to go right to the last minute before a compromise. Hopefully this happens once again.

The large get larger

Many people will ask why First Republic, SVB and other failed banks didn't 'hedge' or protect themselves against the risk of rising interest rates. While that is a reasonable question, asking it in such a binary manner is not altogether fair.

Banks are in the business of taking interest rate risk: effectively, they buy money (deposits and borrowing from investors) at interest rates that typically have a shorter term than the money they sell to their customers (loans and mortgages). Like all retail businesses, banks make profits if they can sell their wares for more than it costs them to buy wholesale. But if a bank were to fully protect itself against interest rate moves, then it would have to immediately sell any loans it made, either by entering into derivative contracts with peers to counteract future interest rate moves or by actually selling them on. Doing that would greatly reduce the profit they make on loans because the buyers would need to be compensated to take on that risk.

Banks are constantly assessing the risks they are taking, from potential interest rate moves, to whether the people and businesses they've lent to can repay their debts. Rather than hedging *everything*, the game is hedging the right amount – protecting yourself enough to avoid getting into trouble, but not so much that all profits are paid away to other parties that have more appetite for the business than you do. Without wanting to sound like an apologist for bankers, matters of degree become exceptionally difficult when you're dealing with very large numbers and massive amounts of leverage (i.e. 80%-90% of a business funded by debt). This is banking in a nutshell: intrinsically holding huge amounts of assets funded with huge amounts of debt. We call debt 'leverage' as a nod to its powers of magnification. It amplifies moves in prices like you wouldn't believe.

Say you have £100 of assets, with £5 of your own money (equity) and £95 that you've borrowed. Then say the value of your assets falls 2% to £98. The new value of your equity is £3 (£98 of assets minus the £95 of debts) so the value of your equity stake has slumped 40%. Small mistakes have big consequences when leverage is involved.

But leverage works the other way too! So given what we discussed above, it makes sense that the effects of various decisions made by different banks would create a large range of possible outcomes. In plain English, it doesn't surprise us that while some banks are toppling into bankruptcy there are also banks reporting bumper profits. UK-based multinational bank HSBC bought the British arm of SVB when it failed; this week it revealed its first-quarter profits were three times higher than a year earlier. While the SVB transaction is unlikely to have moved the needle too much, it no doubt helped (it paid £1 for an arguably decent business struggling with a timing mismatch of its assets and obligations). In the US, large financiers JPM, Citigroup and Wells Fargo have all reported higher profits for Q1.

Banks tend to be black boxes at the best of times. They are so big, varied and complex that it's hard to determine exactly how healthy they are and what will drive their profits from one quarter to the next. Perhaps, as a rule of thumb, it's fair to say that during a time of turbulent change, the biggest and most opaque black boxes fare better. The more people can peer within, the easier they can see mismatches between the value of assets and the value of liabilities, the more likely they are to cut their losses, shift their money elsewhere and cause banks to fail. Big banks have definitely done much better in the past year than their smaller peers. This means that we have come full circle on the 'too big to fail' debate that started with the Great Financial Crisis. After taking on First Republic, JPM will hold the deposits for more than 12% of Americans. Expect this to cause consternation and arguments.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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