SCOPE

Takeaways for European banks from SVB's collapse

Sam Theodore | March 2023

We are not witnessing the beginning of another banking crisis spreading from the US to Europe and beyond. SVB is not symptomatic of the state of the US or European banking landscapes. Market sentiment on most large European banks will bounce back in due course and sooner rather than later because there is no reason for sentiment not to rebound; at least if it's not related to SVB's demise.

Most of Europe's large banks, barring a minimal number of outliers, maintain reassuring prudential metrics for both capital and liquidity. Profitability is improving; risk appetite is conservative and the larger banks are effectively and proactively supervised. Having covered the European banking system since its deregulation some 35 years ago, I find the European banking sector in better prudential and credit shape that at any time since then.

All of that said, who can blame investors for being shocked by the collapse of the 16th largest US bank, supposedly properly supervised in the post-GFC framework, and boasting credit ratings solidly in investment-grade territory? The creditworthiness of banks in developed markets has been anchored for more than a decade in very calm seas. Equity and credit investors have mainly stressed about how high and how fast banks can boost their ROE.

Nevertheless, the collapse of SVB, its causes and implications, offer several various takeaways for European banks and supervisors.

Deposit volatility and concentration

The stability and dynamics of a bank's deposit base and depositor concentrations should be top elements for consideration in any assessment of banks. The concentration and up-and-down dynamics of deposits are vital metrics. Analysts differentiate between core deposits that are supposedly stable and reliable, and brokered/wholesale deposits, which are generally clustered with market funds and considered more volatile.

From this perspective, SVB was an odd outlier. Deposits tripled between the end of 2019 and March 2022 (far more and more quickly than the US bank average, which itself witnessed sharp growth during the pandemic years), declined to the end of 2022 and again to February 2023. These were supposedly stable deposits placed by core customers in the Silicon Valley tech ecosystem. SVB's depositor concentration was unhealthy in the extreme and its deposit structure was far from typical for any mainstream banking organisation in the US or in Europe.

Supervisory stress tests should focus more on this aspect. And if they already consider it internally, they should provide more visibility around it to benefit transparency for banks and market participants alike.

The pitfalls of softening existing regulations

Following the Trump-era softening of the Dodd-Frank regulatory framework, which was implemented in part due to active bank lobbying (including by SVB), the total-asset floor for US banks' full compliance with post-GFC regulations was raised to USD 250 bn from USD 50 bn. This means that SVB was not subject to two key Basel-agreed ratios for funding and liquidity: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

That said SVB's liquid portfolio (mainly agency MBS) whose value shrank due to the Fed's aggressive rate hikes would in fact have classified as High-Quality Liquid Assets (HQLA) for purposes of calculating the LCR. And it is not obvious that the bulk of the failed bank's deposits – insured or not – would not have qualified as stable funds for the NSFR.

Nevertheless, I believe that if SVB was forced to fully comply with the Basel regulations, which in Europe are applied on a universal basis including for a multitude of smaller institutions, the examiners of the California Fed would have had a better view of these critical aspects, anchored in specific and clearly defined prudential metrics.

Which brings me back to European bank regulations. In recent months, emboldened by reassuring fundamentals and much improved profitability, large European banks have been dusting off the old lobbying narrative that post-GFC regulations and supervision have placed them in a less competitive position than their US counterparts. Specifically by forcing them to operate with supposedly lower profitability and needlessly stringent capital and liquidity requirements. To quote the European Banking Federation: "When setting the regulatory agenda, authorities should closely consider the costs for financial institutions and the impact they will have on clients and more broadly on Europe's economic growth".

I cautioned on this aspect in an earlier "The Wide Angle". I believe that the current bank regulatory framework across Europe for both capital, funding and liquidity is a factor of strength for the sector, not an impediment. And the SVB experience in the US shows that both regulatory relaxation and bank lobbying to achieve it can easily lead to unpleasant outcomes.

The need to preserve strong capital

On capital, at year-end 2022 SVB reported nearly USD 17 bn in CET 1 equivalent, with its CET1 ratio at a comfortable 15.26%. And yet when the bank attempted to raise fresh equity to offset the USD 1.8 bn after-tax loss generated by selling its USD 21bn available-for-sale portfolio to match deposits being withdrawn at a rapid clip, it failed to find committed takers.

This undesirable outcome confirms that a bank in difficulty will not find it easy to raise new equity. Which strengthens the argument that the best avenue for a bank to stay well capitalised is to preserve and grow what it has already rather than rely on future market issuance. As the experience of recent years has shown, financially strong banks have little need to raise new equity, while financially stressed banks that do will find it punitively pricey or they won't obtain it at all. In this context, while paying dividends remains a sine qua non to keep investors on board, banks should think long and hard when it comes to share buybacks, especially at scale.

New era of digital runs: smaller banks more vulnerable

SVB was the first major bank run of the digital age. Customers demanded USD 42bn in deposit withdrawals in a single day, over 25% of its overall deposit base. Most of this massive deposit run, added to those in previous days, occurred online, out of the limelight of impactful images of worried customers queuing at the bank's branches.

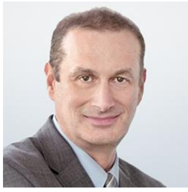
In the pre-digital age, it's difficult to imagine such a gigantic deposit withdrawal exercise occurring without a more immediate supervisory reaction that would have tried to alter the dynamics.

A digital deposit run can have fateful implications for any bank, but this is very unlikely to happen to large groups with diversified franchises – even if they are mostly domestic – like national champions across Europe. The situation is different for smaller and insufficiently diversified second and third-tier banks that remain inherently more vulnerable. Particularly as Europe pushes ahead with the Capital Markets Union, whose end game will see more credit and savings disintermediated away from banks.

When doubts emerge about a bank's creditworthiness – financial or non-financial alike (like a material money laundering event) – the blow is different for a smaller institution, which would see depositors' flight to quality toward a larger group. Particularly since, unlike the high USD 250k ceiling in the US, the limit is only EUR 100k in the euro area and GBP 85k in the UK.

Supervisors need to sharpen their scenarios and tools to anticipate and prevent bank runs custom-made for the digital age. Scenarios are discussed and analysed in supervisory and resolution colleges but they should share specific outcomes with the market beyond the non-public engagements they have with individual banks. They should even be considered as potential input factors for future stress tests.

Analyst



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