Pressure grows on another US bank amid controversy over Credit Suisse takeover

Nick Beams
21 March 2023

The desperate actions by governments, regulatory authorities, and banks in both the US and Europe have not only failed to stem the growing financial crisis but in some ways are making it worse.

In the US, following the failure of the Silvergate bank, Silicon Valley Bank and Signature over the past two weeks, the latter two recording the second- and third-largest banking failures in US history respectively, attention has turned to the travails of the First Republic Bank with growing concerns that it could be the next to go.

Last week, a consortium of 11 major banks, under the leadership of JPMorgan Chase CEO Jamie Dimon, with the collaboration of Treasury Secretary Janet Yellen, deposited $30 billion with the struggling bank. It was hoped this show of confidence would stop the outflow of depositors' money, ease the pressure on its share price and stabilise it.

In just a few days, the operation has been revealed as a complete failure. While the outflows are reported to have slowed somewhat, First Republic has lost $70 billion out of the total of $176 billion it held at the start of the year.

And despite the injection of cash, the company's shares have continued to plummet. Its share price has fallen by 90 percent since the beginning of the month, closing 47 percent down yesterday. Long-term bonds that mature in 2046 were trading at 55 cents on the dollar, down from 75 cents in early March.

First Republic took another hit before trading opened yesterday, when the ratings agency S&P Global downgraded its credit rating for the second time in a week. It said the $30 billion in deposits from the major banks "should ease near-term liquidity pressures, but it may not solve the substantial business, liquidity, funding and profitability challenges that we believe the bank is now likely facing."

With the deposit operation having failed, a new plan is under discussion today in which the banks may convert a part or all their deposits into an infusion of capital.

The failure of SVB and the deepening problems of First Republic have focussed attention on the role of small to middle-sized banks in the US financial system and their potential for setting off a systemic crisis.

The limited regulatory measures introduced after the crisis of 2008 focussed on the large banks, characterised as "too big to fail." In 2018, Congress removed many middle-sized banks from oversight with a decision that some regulations should only apply to banks with assets of $250 billion and above as opposed to the earlier stipulation of $50 billion.

This posed no great danger so long as the Fed was continuing its policy of ultra-cheap money. But the situation has shifted sharply with interest rate hikes initiated by the Fed over the past year, lifting its base rate from near zero to 4.5 percent.

This has meant that the assets held by these banks, which play a significant role in regional areas and in key sectors of the economy—there are some 4000 banks in the US—have suffered a decline in their market value, such that they are well below the book value as recorded in the banks' balance sheets.

This applies not only to Treasury bonds and other financial assets, the value of which falls with interest rate rises, but also to other interest rate-sensitive assets such as commercial real estate.

A divergence between market value and book value does not present a problem so long as money continues to flow in. But if it starts going in the other direction, as it did for SVB, then those losses must be recognized when the assets are sold to cover the cash outflow.

The situation recalls that which developed with regard to subprime loans, the spark that set off the 2008 crisis. When problems first came to the surface in 2007, Fed chair Ben Bernanke said they would not spread because the subprime market was so small relative to the total financial system.

The circumstances of the present crisis are very different from those of subprime. But there are similarities in that a crisis that erupted in what might have been regarded as an inconsequential area of the system has been shown to have broad implications. And in some ways the present crisis is more serious than that which erupted with subprime.

Subprime mortgages, which were sliced and diced to form bond packages and then sold off to investors, were in essence speculative assets.

Today the crisis arises from the fact that many middle-sized banks have invested heavily in what are supposed to be the safest assets of all, Treasury bonds and mortgage-backed securities, which have fallen in value because of the Fed's interest rate hikes.

This is what led financial regulators to invoke the danger of "systemic risk" as they moved in to guarantee the money of wealthy individuals at SVB whose holdings went well beyond the limit of $250,000 automatically covered by insurance.

The issue now is: How far will these measures be extended? Are all deposits throughout the banking system now guaranteed? And what is going to happen to the value of the holdings of Treasury bonds and other financial assets held on the books of so many small and middle-sized banks if the Fed continues its rate rises? And if there is a pause in the rate hike cycle what does this mean for the Fed's so-called "fight" against inflation?

These are some of the issues which will confront the Fed's policy-making body when it meets today and tomorrow.

It will also have to consider the implications of the takeover of Credit Suisse, a globally significant bank, for the stability of the US and international financial system.

One issue of immediate concern is the effect of the Credit Suisse takeover by UBS, organised at the insistence of the Swiss government and the country's financial regulator FINMA, on the bond market.

In any liquidation or takeover, as financial interests salvage what they can from the carcass, bond holders are further up the line from shareholders.

But in the takeover of Credit Suisse, the Swiss National Bank declared that holders of $17 billion worth of so-called additional tier ones (AT1s) would get zero. The AT1s are a variant of contingent convertible bonds, known as cocos, which were introduced after the 2008 crisis in which debt could be converted into equity.

The pecking order in the event of liquidation was that shareholders would be wiped out first, followed by cocos and then senior creditors. In return for increased risks, the holders of the coco bonds were paid a higher rate of interest.

However, in the takeover of Credit Suisse these rules were overturned. While equity holders may get something, AT1 holders will get nothing.

Financial Times columnist Gillian Tett pointed to some of the motivations for the decision.

"It is hard to escape the suspicion," she wrote, "that the Swiss authorities decided to make (modest) payments to equity holders – but not to bond investors – because the former included a powerful Saudi shareholder [the Saudi National Bank] (that Bern did not want to offend.)"

Protectionism, geopolitical self-interest and state intervention "seem to have over-ruled free-market principles."

But she went on to note that there was "uncertainty about the legal structures surrounding US finance too."

When SVB and Signature failed, protection was given to all depositors despite the mandate of the Federal Deposit Insurance Corporation that it only applied to the first $250,000 of deposits.

The net result, she concluded, is that investors are in limbo land, not knowing whether capital market laws apply as a "pillar of faith" for the future or whether governments in the US and Europe have the desire or the means to stand behind all banks. It was "no wonder fear abounds."

The Bank of England (BoE) and the European Central Bank (ECB) both issued statements criticising the Swiss decision, with ECB president Christine Lagarde pointedly telling the European parliament, "Switzerland does not set standards in Europe."

The ECB statement said, "Common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier 1 be required to be written down."

The BoE set out its opposition, saying there was a "clear statutory order" in which shareholders and creditors should bear losses.

There are important political conclusions to be drawn from this incident. One of the central tenets of bourgeois ideology is that the capitalist system, and above all its financial mechanisms, are a rules-based order to which the working class must submit and obey as if it derives from Nature itself.

In fact, the financial system is not some natural and therefore eternal mechanism but a product of class society in which supposedly immutable rules are overturned overnight in a time of crisis as the conflicting interests of the ruling elites come to the surface.

A product of society, it can therefore be changed by society, but only if the working class intervenes politically into the mounting crisis and fights for a socialist program to completely remake the socioeconomic order.