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Lessons learned from the bank-run playbook

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So far this year we've had very little respite from the relentless pace in markets. Russia continues to wage its atrocious and unprovoked war in Ukraine, a global recession looms, and the first quarter is ending with a bang as the dissolution of Credit Suisse into UBS has gripped investors' attention for the past two weeks. Still, just a couple of weeks ago*, you'd have been hard pushed to add another banking crisis to the list of market woes. Indeed, since the Global Financial Crisis, regulators have imposed a series of stringent checks and balances to ensure the health of the banking sector and avoid a repeat of 2008. Recent fears of 'national champion' bank solvency have certainly been overplayed, but whilst the systemic risks of 2008 remain improbable, liquidity risk has always been and will remain banks' proverbial 'monkey on the back'.

Banks constantly face liquidity risk given deposits held are subject to constant and sometimes unpredictable change. Terry Smith, manager of the Fundsmith strategy, recently recounted an anecdote whereby in the eighties, a local bank in China saw a group of people gather under an awning outside its building as they sought shelter from the rain. This led passers-by to believe that was the start of a bank run, which turned into a self-fulfilling prophecy. It doesn't take much to spook the markets, even if the fundamentals don't warrant it – an oft-reoccurring theme in the bank run playbook.

With the failure of Silicon Valley Bank on March 10, the global banking sector was shaken to its core, and nervous investors, long frustrated by Credit Suisse's poor performance and lack of profitability, started selling equity and debt, culminating with the Swiss National Bank (SNB) intervention which saw US$17 billion of Credit Suisse Additional Tier 1 (AT1) bonds getting wiped out. AT1 bonds (otherwise known as Contingent Convertibles or CoCos) are a tier of regulatory capital which itself is an amount designed as a buffer to absorb losses that might otherwise adversely affect the issuing firm and its creditors. Make no mistake though, the initial selling was not the result of savvy investors' fundamental analyses of Credit Suisse's business, but rather based on poorly informed and panic-driven inferences.

Yes, Credit Suisse had long been tarnished by a series of controversies (losing two Chief Executive Officers in the course of two years, suffering billions of dollars in losses – think Archegos and Greensill – and even getting marred in a drug cartel scandal!) which saw wealthy customers jump ship. And yes, Credit Suisse was the least profitable bank in the Euro Stoxx Index (the only one to have negative return on equity for the last five years), but its board of directors had begun a vital overhaul process involving changing the culture of the bank and raising sufficient capital to restructure the business (namely by spinning off its investment banking division). Despite all this, in the runup to the Swiss regulator's intervention on Sunday 19 March, the bank was very solvent, and even very liquid. In fact, its liquidity coverage ratio jumped to 190% following the 50 billion Swiss Franc injection by the SNB. Banks' liquidity positions are stress-tested every year by regulators and there were no concerns on this front. Unfortunately, this was not enough to reassure markets, hence the Swiss government forced through UBS' acquisition of Credit Suisse.

These events should serve as a stark reminder that it's easy to fall into a state of complacency from overly relying on quantitative indicators, but we cannot shun the importance of qualifying these with rigorous qualitative risk assessments. Indeed, fear and panic can rapidly take hold of investors, causing them to act irrationally, ultimately dismissing fundamental analysis and common sense. Importantly though, the market dislocations that result, often make for attractive valuation arguments and if coupled with solid fundamentals can produce compelling investment opportunities.

*at the time of writing (24/03/2023)

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