

Exchanges at Goldman Sachs

The impact of bank failures on markets and the economy

**Lotfi Karoui, Chief Credit Strategist, Head of Credit
Research, Goldman Sachs Research**

**Richard Ramsden, Business Unit Leader, Financials
Group, Goldman Sachs Research**

Allison Nathan, Host, Goldman Sachs Research

Recorded: March 14, 2023

Allison Nathan: There's a crisis of confidence in the banking industry. The collapse of Silicon Valley Bank and Signature Bank has sparked broader concerns about the health of the US banking sectors.

I'm Allison Nathan and this is Exchanges at Goldman Sachs.

[MUSIC INTRO]

Allison Nathan: To explain the significance of these moves and the implications for the banking sector and the economy more broadly, I'm sitting down with my colleagues in Goldman Sachs Research, Richard Ramsden, who leads

our coverage of the US banking sector. And Lotfi Karoui, chief credit strategist. Richard, Lotfi, welcome to the program.

Richard Ramsden: It's great to be here.

Lotfi Karoui: Good to be here.

Allison Nathan: So, on Friday, Silicon Valley Bank, a lender to some of the biggest name in the tech industry, became the largest bank to fail since the 2008 financial crisis. And another large bank, Signature Bank, became the third largest to fail shortly after.

So, Richard, let's just start with you. How did we get here and how did this happen?

Richard Ramsden: So, let's start with Silicon Valley Bank. And to explain how we're here, I think it's important to understand, really, the history. So. Silicon Valley Bank was a commercial orientated bank which really specialized in servicing the venture capital community. Over the last few years, we've obviously seen extraordinary activity in venture capital fundraising. So, in late 2020 and 2021,

there was obviously considerable levels of fundraising amongst venture capital firms. And Silicon Valley was a direct beneficiary of that.

Their balance sheet over six quarters went from roughly \$70 billion to over \$200 billion. And lending to venture capital firms was only a small part of what they did. So, this was a bank that ended up with significant levels of excess liquidity, over and above what they lent out.

They took that excess liquidity and they invested it in securities, predominantly treasuries and government guaranteed mortgages. And the intention was to hold those securities to maturity.

So, really what this bank did is it increased their risk profile towards interest rates. But they didn't really have a lot of credit risk on their book.

Now, over the course of 2022, they started to experience deposit outflows. And that was mainly driven by the fact that venture capital portfolio companies saw very high levels of cash burn. At the same time, the Fed hiked interest rates significantly, which led to unrealized losses

on their securities book.

And to put it in context, the unrealized losses on their securities portfolio increased from a negligible amount in 2021 to over \$18 billion, which was more than the tangible common equity of the bank itself.

Now, as the deposit outflows accelerated over the course of February, the bank took the decision to sell those securities at a loss with the intention of raising capital to offset those losses. However, the liquidity position of the bank deteriorated very rapidly. There was significant deposit outflows, \$42 billion of deposit outflows on Friday alone. They couldn't honor all of those deposit outflows. And the bank ended up getting taken over by the FDIC.

Allison Nathan: And was this a liquidity issue or a solvency issue? We often hear those two terms. Which was it?

Richard Ramsden: So, ultimately, it was a liquidity issue at the bank which resulted in it getting taken over by the FDIC. The reason though that I think the liquidity issue materialized was really twofold. Which is that this was a

very idiosyncratic situation where you had a bank that had taken a lot of interest rate or duration risk on their portfolio, coupled with the fact that they had a very concentrated deposit bank, very exposed, obviously, to the venture capital community and venture capital portfolio companies that were experiencing these very significant outflows.

So, it was liquidity in the end that resulted in the bank being foreclosed upon. But really what prompted that was concerns around the fact that they had these unrealized losses on securities, which they had to crystalize as deposits started to leave.

Allison Nathan: And we'll talk about contagion risk, because I think that's the biggest question out there. But what I'm hearing you say at this moment is there was a unique and somewhat idiosyncratic set of circumstances around SVPs position that led to this outcome.

Richard Ramsden: Yeah. So, to put this into context, there are no other banks that we cover within GIR at Goldman Sachs that have negative tangible common equity if you adjust for unrealized losses on their securities

portfolios.

Allison Nathan: And just, why didn't we see this coming?

Richard Ramsden: I think what we didn't see coming is just how rapidly liquidity seems to be draining from the system as the Fed raises rates and embarks on quantitative tightening.

So, deposits in the US banking system from the peak are down 8 percent. So far this year, if you look at core deposits, they're down close to 4 percent. So, I think what we're seeing is that the liquidity drain as a result of what the Federal Reserve is doing to contain inflation, is resulting in this significant liquidity drain within the financial system. And I think it is happening at just a faster rate, perhaps, than we would have anticipated.

Allison Nathan: And Lotfi, let me turn to you. Feeding off of the common set Richard made in terms of this was somewhat of an idiosyncratic event and risk, tell us why this isn't another September 2008, an episode that we all have PTSD from. What makes this moment different, if it is?

Lotfi Karoui: Yeah, without minimizing the magnitude of the shock or the need to, obviously, continue to monitor the situation. I do not think that this is another September 2008 moment. At a high level, you could argue that perhaps we're discovering that we're draining liquidity at a faster pace than we had initially anticipated. You could also argue that most financial institutions have to deal at a certain level with a deep inversion of the yield curve.

Similarly, by the way, outside of the financial system, households, non-financial corporations, also have to cope with the fastest and most abrupt increase in the cost of capital that they've witnessed since the onset of the great moderation. So, all of that is true.

However, I do think that there's a number of key differentiating factors today, relative to the fall of 2008. Number one and the most important one in my view is that the quality of the assets or the quality of the collateral is orders of magnitude better today than it was in 2008. There's also greater transparency over its valuations today relative to the run up to the global financial crisis. I think back then it was the bursting of the housing bubble that

ended up fueling large leverage losses in the financial systems that only spared a handful of financial institutions.

Today, the driver is different. I think as Richard was alluding to, we had a very aggressive and front-loaded hiking cycle. And we're discovering that a combination of liquidity draining and mismatches between assets and liabilities is causing some pain in the sector. But I think that is not representative of a broader reality for the sector as a whole.

A second thing. This is always a risk where a small shock can become a systemic story. I think it's important to keep in mind that the share of regional banks in the corporate bond market is really small. Depending on what index you look at, it doesn't exceed 1.5 percent. And so, the risk that losses on bonds, hypothetically, among large regional banks ends up constraining risk appetite within the broader market, that's also small.

And just to put things in context, the share of the large money center banks in the IG market in the US is 23.5 percent versus 1.5 percent for the regionals. And then

probably leads me to a third difference which is the current regulatory backdrop is also very different from 2008. But if you, again, look at the large money center banks, they've been facing a level of regulatory scrutiny that is orders of magnitude higher than the run up to the global financial crisis. Capital positions are stronger. Liquidity positions are stronger. And so, I do think that it's a very high bar to see a situation in which a mismatch between assets and liabilities or some kind of a concentrated position leads to a capital or liquidity event among the large money center banks.

Allison Nathan: And US regulators, obviously, have stepped in. They took some emergency measures that were designed to shore up confidence. Richard, can you explain to us exactly what they did and the significance of those moves?

Richard Ramsden: Yes. They did two things. The first thing that they did is that the FDIC reversed the decision that they made on Friday around reimbursing non-insured depositors at Silicon Valley Bank. And they confirmed that they will be reimbursing all depositors at Signature Bank, whether they are insured or not.

So, in the United States, if you have an account up to \$250,000, you are covered by the FDIC fund in the event of insolvency of the bank. Above 250,000, you are not covered and you become part of the bankruptcy process. So, you could end up with less than the deposited amount that you had at the bank. And you could also lose access to the funds that you had in the bank until the bankruptcy is resolved.

So, they effectively came out, and in my mind, sent the message that they're going to use this very specific rule, which is the Systemic Risk Exemption, to guarantee deposits in the case of insolvencies of banks if they think that the insolvency is going to create systemic risk or runs elsewhere within the banking system.

And I think really the message they were trying to send is that we need to deal with this on a case by case basis. But if your deposit is at a bank that is larger than Signature Bank, which is \$120 billion of assets, the message is that institution is going to be deemed to be systemically important.

So, I think that was a very important measure in terms of trying to reassure depositors that they will be made whole in the event of a bankruptcy, at least institutions above a certain size.

The second thing that they did is they put in place a lending facility to the banking system. It's called the Bank Term Funding Program. And what this does is it provides liquidity to banks so that if they are seeing deposit outflows, rather than have to sell securities at a loss, they can borrow from this facility by pledging securities as collateral. And therefore meet those outflows without having to sell, as I said, securities and crystallize losses.

So, I think they put in place two very important measures, which, I think, will go some way in terms of reassuring depositors in the system. But clearly, the question is did they go far enough?

Allison Nathan: I think that is the question. And they stopped short at saying that all deposits would be guaranteed, insured and uninsured, which they had put in place post the financial crisis. So, why didn't they go that extra step and guarantee that all uninsured deposits

would, in fact, be untouched?

Richard Ramsden: I think the simple answer is that the FDIC does not have the legal authority to do that. So, there were a number of changes to the regulatory framework after the global financial crisis in 2008. And one of those changes was that the FDIC cannot unilaterally guarantee all deposits in the financial system without seeking approval from Congress first.

So, if there is to be a blanket guarantee on all deposits in the system, the only way of achieving that is through a joint resolution from Congress. And at this stage, there is, obviously, a discussion and a debate around whether or not that could be achieved.

Allison Nathan: And so, we've talked about the fact that there was this unusual set of circumstances around SVB. But you did, Richard, talk about the liquidity drain that happened very quickly and much more quickly than many people anticipated. What's to stop depositors in smaller banks that are uninsured above the \$250,000 insured maximum from moving to larger banks where they feel more comfortable holding those deposits?

Richard Ramsden: Look, I think it's an important point. And I think it's important to understand why that is happening to a degree. So, after the global financial crisis, really there were two categories of banks in the US that were created. The first was what we refer to as the G-SIBs, which is the globally important systemic banks. And then there was everybody else.

The G-SIBs are often referred to as too big to fail banks, i.e., the view that was taken is that these institutions are so large and are so important that if there was an insolvency in one of those institutions, it would be destabilizing to the whole economy.

The way that too big to fail was really dealt with is that they forced these institutions to run with considerably more capital, considerably more liquidity, and considerably more oversight than all the other institutions that were not in that category. So, really, again, I think it's important to understand is that after Silicon Valley went into receivership, corporate treasurers, I think, for the first time since 2008 had to think about counterparty risk.

So, I think what Silicon Valley highlighted is that a deposit in one institution is not necessarily the same as a deposit in another institution, obviously, above the 250,000 cap from a counterparty perspective. And because the G-SIBs run with much more capital and much more liquidity, from a counterparty perspective, they're just deemed to be less risky.

So, I do think there is going to be migration of deposits from the smallest institutions to the largest institutions. But I also think there's going to be some migration of deposits outside of the banking system as well. And I think those two things are happening concurrently.

And the reason that deposits are leaving the banking system is that if you have a deposit in a bank and the bank goes through insolvency, you're part of the receivership process. But if you take that deposit out and buy a treasury and put it in a custody account, that is treated differently in bankruptcy. So, you can access that fund even in the event of a bankruptcy.

So, I think the market at this stage is just trying to figure out what is the migration going to be, how big will it be,

and is this going to put other, smaller institutions in jeopardy?

Allison Nathan: And of course there is some risk of that in the sense if smaller institutions lose a lot of deposits, then it could be troublesome.

Richard Ramsden: But I do think the measures they put in place should help to ease some of that pressure. So, the message, as I said, that I think the FDIC is trying to send to the system is that we will insure depositors, even if they are uninsured in certain instances. And to be very clear, that is not a bail out of those depositors because the FDIC fund, which makes those depositors whole is paid for by the banking system. So, this is not tax payer funds that are being put at risk. It is funds that have been contributed by the banks for this very purpose.

So, I think there is a very important signaling mechanism around how non-insured depositors are going to be treated, which I think will take some time, I think, for people to recognize. But there are, also, other facilities that I mentioned that are being put in place to make sure that banks have liquidity on hand to meet deposit outflows to

the extent that they happen.

Allison Nathan: And Lotfi, talk to us a little bit about the broader market reaction. Obviously, we saw bond yields come off quite sharply in the wake of these events. They are bouncing around a bit. Quite a lot of volatility. But talk to us about that reaction. And maybe the follow up to you and maybe Richard as well, is if bond yields are lower, does that actually, as well, ease some of the concern given that it's the very high rates that have put a lot of this in mention?

Lotfi Karoui: I think you have two key reactions. One, the absolute level of yields came down quite dramatically. And in fact, if you look at Fed funds pricing, for example, the market is essentially telling you that we're done with this hiking cycle, right? And so, that was quite a dramatic reaction that happened really quickly because we have to remember that March 9th, after Chair Powell's testimony, the market price then at peak level of Fed funds rates at almost 5.5 percent. And so, it was a dramatic reversal.

At the same time, we also had another shift which is rates volatility revisited the highs of 2022. And I think that's a

really important thing to keep in mind because going into the year, a lot of the optimism, vis-à-vis the value proposition of fixed income markets, was predicated on this idea that declining rates volatility should, actually, bring capital back into fixed income. And so, now we have a tension between the two where rates are down. Market is pricing in a lot of easing on a forward basis. But then the level of volatility has gone up, which tells you that the market also thinks that the range of outcomes is still pretty wide.

Whether the current pricing of Fed funds rates are justified, I think, will be tested over time, of course. But our review in the near term is that in order to offset the potential tightening and lending standards from this recent episode, there is a strong case that we can make for a pause, at least, in March. After that, it will really depend on how persistent this tightening and lending standards amongst some of those small, regional banks is going to persist. And the ramifications that will have for the broader economy. And so, that will determine the path of monetary policy from here.

But I would say one step at a time. It does seem to me that

the case for a pause in March is quite strong. After that, a lot of it will depend on how the economy, basically, digests all of this.

Allison Nathan: And what are the implications of all of this for credit creation in the economy?

Lotfi Karoui: Yes. So, one critique that I hear sometimes is that this will also draw the regulators' attention to new sources of capital formation that have grown over the last ten years. And private credit funds is one of them.

And the general argument that you hear all the time is that we just went through a pretty interesting episode of a duration mismatch. Do we have other cases like that outside of the banking system? I disagree. I do think that there are challenges in the private debt universe, just like there are challenges in other sectors of the economy. The broadly syndicated loan market is a good example. The commercial real estate market is a good example. And there's probably a common denominator behind those challenges. And that's, again, the abruptness and the speed of this hiking cycle.

But I don't think those challenges are actually systemic in nature. If anything, I would say that the fact that we have a new source of capital formation in the economy today probably provides an offset to the meaningful tightening and lending standards that we'll see on a forward basis among some of these regional banks.

But to me, there's two ingredients that are missing, so to speak, to make some of these challenges systemic in nature. The first one is that there is no mismatch between assets and liabilities in private debt markets. Capital is raised for five, seven years, or whatever the duration is. And it's lent for the same period. And so, it's really hard to see an analog to what happened the last couple of days.

And then the second channel through which a shock can become systemic is typically leverage. And most private debt funds carry very reasonable levels of leverage. Certainly, nothing that comes remotely close to what we experienced, again, in '07/'08 in the run up to the global financial crisis.

Allison Nathan: But Richard, just in terms of

conventional credit creation, and Lotfi just mentioned this, but how tight are lending restrictions going to become off the back of this?

Richard Ramsden: So, lending standards have been tightening going into this. So, we have seen a tightening of lending standards in the banking system. And my suspicion is that they will tighten further from here and potentially could tighten quite sharply, at least in the near-term.

And I think there are two reasons for that. The first is I think banks are going to want to reassess what their liquidity position is. So, banks, I think, in the very near term will be protective of the liquidity they have because they don't want to go through an experience that Silicon Valley and Signature Bank have been through. But secondly, I think banks will reevaluate what this means for the economic outlook broadly.

And I think, on balance, my guess is that banks will take a view that this could result in either a near-term recession or a deeper recession than you would have had without this event. And I think that, in turn, will also result in

banks being, again, just more conservative around their underwriting standards.

Allison Nathan: Lotfi, do you want to field that too? Is this just another catalyst that could raise the risk of recession?

Lotfi Karoui: Sure. It could definitely amplify it, at least. But as Richard said, I think lending standards have been tightening for quite some time now. So, there's nothing new there. And of course, this episode is going to exacerbate a lot of that tightening.

Maybe the one positive thing that I would mention there is that relative to 20 or 30 years ago, I would keep in mind that the US economy is more disintermediated [?] than it was 20 - 30 years ago. And so, there's, I think, the ability to digest a meaningful dose of tightening. And banking and lending standards is better today than it was 20 years ago.

But of course, if for whatever reason we have an exogenous shock that takes the economy into a recession, tight lending standards is not helpful and could definitely exacerbate the magnitude of that shock.

Allison Nathan: Richard, Lotfi, thanks so much for joining us.

Lotfi Karoui: Thank you.

Richard Ramsden: Thank you for having us.

Thanks for joining us for another episode of Exchanges at Goldman Sachs, recorded on Tuesday, March 14th, 2023.

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