Is there a solution to recurrent bank crises?

Shocks, uncertainty and contagion being inevitable, the only 'solution' to recurrent crises could lie with central banks

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The recent Silicon Valley Bank (SVB) and Credit Suisse crises has once again triggered fears over the fragility of the financial system, both in the US and across the world.

Highlights

- *Throughout the nineteenth century there were cataclysmic bank failures and bank runs in England, Europe and the US*
- *Two questions arise. Why is the banking system prone to recurring crisis in spite of regulation and other prudential banking norms? Is there really any permanent solution to this chronic phenomenon?*
- *The growing concentration in the banking sector, more frequent and larger bailouts becoming imperative, and the further intensification of moral hazard, opens up a bigger question on the future of commercial banking*

The Bank of England's website has an interesting page on its history. The first event is its founding in 1694, the second being the appointment of Sir John Houblon as its first Governor in the same year, and (not) surprisingly, the third event is a financial crisis: the South Sea Bubble of 1720.

Throughout the nineteenth century there were cataclysmic bank failures and bank runs in England, Europe and the US; those of 1825, 1847, 1866, 1873 and 1893 being the favourites of economic historians, often recalled as 'panics' and 'commercial distress'. India too, as Britain's largest erstwhile colony was severely impacted by some of these episodes. The rise of the US as an economic superpower made it the new epicentre of global banking crises from the twentieth century onwards: the Great Depression of the 1930s, the S&L crisis of the 1980s and the Great Recession of 2009 are some of the events that easily come to mind. The recent Silicon Valley Bank (SVB) and Credit Suisse crises has once again triggered fears over the fragility of the financial system, both in the US and across the world.

With such a dismal historical record of crises, two critical questions arise at this juncture: first, why is the banking system prone to recurring crisis in spite of regulation and other prudential banking norms and second, whether there really is any permanent solution to this chronic phenomenon?

Banking crises almost always arise from asset-liability mismatches. A maturity mismatch between short-term liabilities and long-term assets can lead to liquidity risks while a loss in asset values over and above the capital of the bank leads to bankruptcy or solvency risk. Moreover, as the SVB crisis starkly revealed, the loss in market value of assets can arise not just from loans going bad but even from the marked-to-market value of safe government securities. Fear over bankruptcy induced a sell-off of SVB shares on the stock markets, triggering a bank run that resulted in a liquidity crisis, forcing the bank to then sell securities at a loss and consequently, the imminent bankruptcy of the bank.

Despite satisfying Basel III norms on capital adequacy as well as minimum leverage ratio and liquidity requirements, the too-big-to-fail, Swiss giant, Credit Suisse had to be bought out by UBS when it was on the verge of collapse a few days ago. A multitude of factors had contributed to Credit Suisse's predicament: incurring losses on operations, bad investments, money laundering scams and criminal/espionage scandals, larger than reported off-balance sheet liabilities, and lack of confidence of depositors and shareholders. All these factors were reflected in the rising price of its credit default swaps (CDSs), which can essentially be thought of as the price for insurance against default by a borrower.

The recent **SVB and Credit Suisse episodes** have shown that the fragility of banks is not always captured by regulatory norms. Even the possibility of deterioration in the quality and/or price of assets that leads to a breach of confidence in a bank is sufficient to cause its failure. The strong destabilizing contagion to the global financial system emanating from bank failures is obvious, which therefore calls for immediate action to stem the crisis. And here only one option exists: state coordination and support through its central bank. The market system has no automatic corrective response to a bank failure and even more unnervingly, stem the contagion from such failures.

Although his precise recommendations are subject to misinterpretation, the nineteenth century economist, Walter Bagehot articulated the 'lender of last resort' function of the Bank of England in his book *Lombard Street: A Description of the Money Market* (1873): '[lend] most freely... to merchants, to minor bankers, to 'this and that man', whenever the security is good.' After the 2008 crisis, Ben Bernanke had commented on how banks were rescued: 'It's not tax money… We simply use the computer to mark up the size of the account [of banks].' Central Bank interventions during the COVID pandemic – short- and long-term repo operations, standing facility operations to name few – is what saved the day, at least for the financial system. In the SVB crisis, the Fed opened its discount window to swap securities at their par value in lieu of a credit in reserve money in their accounts and even in the case of Credit Suisse it was the Swiss Central Bank that orchestrated its takeover by UBS with an assurance of CHF 100 billion in liquidity assistance.

These examples show that the state is increasingly playing a more critical role in the sustainability of the banking system. At the same time, bank mergers, driven by technology, risk diversification and/or failures, are leading to the gradual emergence of oligopolistic banks dominating the financial landscape. Both these characteristics are contradictory to some of the fundamental tenets of modern banking. The banking sector has essentially developed as an extension of central banks, with the role of credit money creation devolved to commercial banks. These banks at the same time attract deposits of businesses and individuals in order to accumulate a cheap source of reserve balances in their accounts at the Central Bank. With the state's acceptance of tax payments through demand deposits, bank money has become widely acceptable in settlement of liabilities that arise in trade and exchange. Moreover, competition amongst banks and maximization of shareholder value should ensure that banks lent diligently while competing for deposits through enhanced services to their customers.

The growing concentration in the banking sector, more frequent and larger bailouts becoming imperative, and the further intensification of moral hazard, opens up a bigger question on the future of commercial banking. Shocks, uncertainty and contagion being inevitable, the only 'solution' to recurrent crises could lie with central banks – who in any case have ultimately backstopped every recent banking crisis. The emergence of Central Bank Digital Currencies (CBDCs) may not only enable the private sector to hold deposit accounts at the Central Bank but the utilisation of fintech could challenge the role of commercial banks in prudential credit disbursement. If this happens, then any loss arising from bad loans could simply be absorbed directly by the Central Bank, which, unlike commercial banks, is not subject to liquidity and/or solvency (negative net worth) risks.

While there are groups like Positive Money in the UK calling for quicker transition to CBDCs and snipping the role of commercial banks, there are others like **Randal Quarles**, U.S. Fed board member who argue that 'an arrangement where the Federal Reserve replaces commercial banks as the dominant provider of money to the general public could constrict the availability of credit, fundamentally alter the economy and expose the public to a host of unanticipated, and undesirable, consequences.' But doesn't a warning subtly allude to a threat?

Perhaps it's time to pay heed to another warning (or threat perhaps) in the same context from Mark Carney, former Governor of the Bank of England: 'There will be a change, measured over decades. It is very hard to predict. That which is unsustainable tends to go on for longer than you think and then happen more quickly than you expect … but these structural flaws [in banking], in the end … will ultimately result in a change.'

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