Course 9
1/ Developments in the US

2/ "Accidents" – SVB (First Republic), the UK "mini-budget", Crédit Suisse

3/ Conclusion

Slide 3

After the global financial crisis (GFC, 2007-2008), the US re-regulated finance along the lines developed within the G20/Basel III framework. This meant adopting the various sets of regulatory changes discussed in previous courses (notably consumer protection, higher capital reserves, stress-testing, resolution procedures, derivative trading on exchanges, etc.).

In the US, these various principles of regulation were applied in the Dodd-Frank Act (2010), which runs to 850 pages, indicating the complexity of modern finance.

The Act and re-regulation in the US also included strengthening oversight, through the creation of new agencies…

Slide 4
…like the Financial Stability Oversight Council, the Consumer Financial Protection Bureau and the Office of Credit Ratings at the SEC (failure by ratings agencies was considered as one – among many – of the weaknesses of the system that had led to the GFC).

Slide 5
The expansion of agencies came on top of the dispersed structure of the Federal Reserve System itself…

… and raises questions about oversight of regulation when seen as a whole.

Slide 6
For information – a key historical institution supporting the banking system in the US is also the Federal Deposit Insurance Corporation, created after the Great Crash in 1929, with the aim of insuring depositors. Presently, it guarantees deposits of up to $250,000 within one category (although the ceiling was waived during the failure of the Silicon Valley Bank in March 2023 – see below).

Slide 7
An important, and somewhat contested part of re-regulation was the introduction of the so-called Volcker Rule. Instead of opting to go back to the separation of commercial and investment banking activities, the Rule prohibited "propriety trading" by commercial banks. In other words, they were prevented from trading in (speculative) financial markets with their own capital.

Slide 8
President Trump saw himself as a great deregulator, not just of finance, but of economic activity in general (including over the environment etc.). While his actions may have been less than what he claimed he was doing (as shown in the photo), he did roll back regulation in finance. In particular, he reduced regulation on small banks, with balance sheets of between $50 and $250 billion. Henceforth, these were no longer to be considered as systemically important banks or financial institutions.

Consequently, they were freed from various new regulatory practices, notably in terms of liquidity constraints (and as we shall see below, this likely was a factor in the collapse of the Silicon Valley Bank).

Slide 9
According to a GPT-4 information request (16/11/2023) other deregulation by the Trump administration (which included financial market actors like Steven Mnuchin and Gary Cohn) reduced the powers of the CFPB, gave greater flexibility to financial advisors responsible for giving information to retail clients (i.e. households), and simplified information disclosures to the SEC (the Securities and Exchange Commission).

The Trump administration also passed a major corporate tax cut, which released corporate money for financial investments.

Slide 10
The graph here shows the inexorable concentration of the US banking sector, that is likely to have aggravated the "to-big-to-fail" problem.

And, in 2023, the ultimate "master of the universe", the impeccable and brilliant billionaire Jamie Dimon, CEO of JP Morgan, agreed to takeover First Republic, a mid-sized bank that failed after the Silicon Valley Bank. He got a "sweetheart" deal from the FDIC.

Slide 11
One area of financial activity that remains largely unregulated, even since the GFC, is shadow banking. This involves largely legal activities – despite the name implying that they may be "shady". Very simply, shadow banking involves banking-like activities by financial institutions which are not typical banks, because they do not take deposits. Such institutions include hedge funds, private equity funds, etc.

These institutions may make fairly standard (large) loans to a range of corporate clients, as a bank might do. There is generally nothing illicit about this. However, because these institutions do not manage household accounts and deposits, they are not regulated like normal banks. Oversight by the authorities is there much less, although presumably these financial institutions have to present accounts to their shareholders, file tax forms etc.

According to the Financial Stability Board (FSB), this sector accounted for 49.2% of total financial assets in 2021. It could therefore be a potential source of financial instability, should something go wrong in the markets – should "accidents" take place.

Slide 12 Accidents

Slide 13
Indeed there have been several accidents in the last couple of years (2022, 2023), as inflation and interest rates have been rising – bringing to an end the era of ultra-low interest rates that began in late 2008, after the collapse of Lehman Brothers.

Thus 2022 saw the spectacular collapse of a number of crypto currencies, including a big slide in the price of Bitcoin from about $60,000 to under $20,000 at one point.

The largest meltdown in the crypto world came with the bankruptcy of FTX in the autumn of 2022. This involved very poor management and fraudulent practices by FTX and the investment companies linked to it.

In retrospect, FTX turns out to have been operating a bit like a Ponzi scheme – i.e. returns on investment ("interest") was being paid by new capital entering FTX.

The failure of FTX demonstrates the way the crypto world is subject of sharp practices and little regulation: indeed the whole point about so-called "decentralised ledgers" and blockchain encrypted transactions was to make them opaque and outside the control of central banks.

Crypto may still have a future is central banks start issuing their own currencies, something which is being widely discussed, but which has many implications for banking and privacy, as in principle a central bank digital currency would mean that all agents (households and companies) would have accounts at the central bank.

Slide 14
Higher interest rates also had their part to play in the collapse of the Silicon Valley Bank (SVB). The SVB had accumulated a lot of US government bonds in its assets. When interest rates started to rise (to fight inflation), this made it more difficult for Silicon Valley start ups to borrow money to expand their business. As a result, they began drawing down savings with the SVB.

This caused liquidity problems for the SVB, which found itself obliged to start selling government bonds at lower prices, because higher interest rates in early 2023 had pushed down bond prices mechanically.

SVB then started showing signs of financial stress, and in the small world of Silicon Valley, investors began withdrawing their deposits from the bank, leading to a bank run. This in turn led the Fed to step in and guarantee deposits above the standard ceiling of $250,000. This was partly justified to keep finance flowing in Silicon Valley and maintain this very important economic cluster functioning. But the decision was controversial.

Slides 15 to 17
These slides show how inflation picked up rapidly, and unexpectedly in late spring 2021, and how this led to a strong – if somewhat belated – rise in interest rates, bringing to an end the ear of “low bound” rates.

Slides 19 to 21
Another big “accident” took place in September 2022 when the new British government under Theresa May and her Chancellor of the Exchequer (Kwasi Kwarteng) announced a mini-budget to boost growth. This involved government borrowing to fund tax cuts – mainly to higher income earners – the “rich”.

The financial markets reacted very badly to what was seen as very irresponsible fiscal policy. They began selling government bonds and the pound. As a result, interest rates rose: see the jump in the “yield curve” (Slide 19), and the collapse of the pound to near parity with the dollar (Slide 20).

With the fall in the price of British government bonds (called “gilts”, because they used to be printed with paper that had golden edges), several pension schemes suffered extreme financial stress. These pension schemes had been involved in “liability-driven investment derivatives” to increase returns (i.e. earnings). When gilt prices started to slide, the pension schemes faced potential very high losses (the scheme for university teachers, for example, was very badly hit).

To stabilise the situation and worried about a financial crisis, the Bank of England stepped in to say that it would buy up gilts, to support prices and to prevent a financial crisis. This was a temporary policy, as on the whole the Bank wanted to unwind its asset holdings in gilts, which had risen significantly due to quantitative easing after the GFC, the Brexit vote in 2016, and the Covid pandemic.

The Bank of England did succeed rapidly in stabilising the situation, and the British government changed policy to being more conventional and careful about government spending and budgets. In the process, “Kami-Kwasi” Kwarteng was sacked by Liz Truss, and she herself resigned after being Prime Minister for only 45 days – the shortest period in office ever. As Dominique de Villepin noted on French radio, “elle a enterré la Reine, la livre et le parti conservateur”.

Overall, the episode points to possible, unexpected fragilities that may arise elsewhere in the international financial system, given the “change in regime” from low inflation and ultra-low interest rates, to moderate inflation and more “normal” levels of interest rates.

Slide 22
Outside the English-speaking countries, the collapse of Crédit Suisse in 2023 was also a spectacular event. This was one of Switzerland’s oldest, most prestigious banks, operating in many ways as a private bank to the world’s rich – including operating in somewhat shady areas.

The collapse of the bank, which was absorbed by its rival USB in a deal organized with the Swiss government, was due to multiple factors – including bitter rivalries at the top of the bank: see the FT video which is very telling.

The changing international interest rate environment would also have played its part.

Conclusion

Slide 24
The quote here shows that however much things change, financial speculation and crises are a permanent feature of capitalism and financial markets.

Despite the above “accidents”, the international financial system seems quite resilient – so far – to the rise in rates. But difficulties may still emerge in the future, as the higher-rate environment may last for longer than we now (November 2023) expect.

As Warren Buffet famously said, “when the tide goes out, you see who was swimming naked.”

The availability of credit is important to growth, whether to finance company development, the buying of homes or household consumption. The modern consumer society would be in unimaginable without credit: that may be good or bad, depending on your views, and it certainly is contributing to global warming – history’s largest market failure (as we do not pay for the real cost of the energy we use).

But as long as credit may be offered by independent, private actors – albeit it regulated – there will likely also be speculation, and market players will seek to get rich quick. But even speculation has a role to play in allowing actors in the “real economy” to insure against risks (crop failures, currency fluctuations, etc. etc.). Yet where there is speculation, there will also be risks of crises.