



## Turmoil in the financial system and Cypriot banks

### **Description**

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Certainly, the collapse of the Silicon Valley and Signature banks in the United States, and even the takeover of Credit Suisse by UBS, have idiosyncratic elements that led to a loss of confidence in these institutions and ultimately to their demise. Silicon and Signature made some very elementary mistakes, and Credit Suisse made some serious blunders that cost a lot of money. In all cases, there were liquidity runs on the banks and some weaknesses in regulatory oversight were exposed. After a long period of excessively low interest rates, many business models, both inside and outside the banking system, have become dependent on cheap money. Not surprisingly, the normalisation of interest rates is bound to cause some financial distress, and we may not have seen the end of it yet. In this article, we discuss the complexities of these failures, the implications for inflation and inflation targeting, and the trade-offs with financial stability. We also briefly discuss the Cypriot banking sector. We conclude that while the systemic banking sector remains robust, the pace of monetary tightening will slow from here; credit expansion may reverse gear as banks seek to unwind their riskier exposures and further strengthen their balance sheets.

#### **But first, Silicon Valley Bank**

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Silicon was not a very big bank, and certainly not systemic in itself. But it was a very special bank at the heart of the important start-up sector. Its customers were a special breed of millionaires who, curiously, made up both sides of its balance sheet, assets and liabilities. We explain.

Startups, and technology startups in particular, do not make money in the early stages. Some never do. The cash they put into Silicon came from venture capitalists in exchange for equity. It was, in effect, hot money that the startups would draw on to run their businesses. Then the Silicon Valley managers decided to invest this hot money in Treasuries - notes and bonds - of the US government. But if you were going to match hot money deposits with Treasuries, you would do so in short-term maturities. Instead, Silicon Valley managers invested in long-term assets when interest rates were very low.

### **When a safe bond is not safe**

But long-term government bonds are vulnerable to changing interest rates. A bond is a promise by the government to pay a certain fixed rate of interest each year for the life of the bond, and to repay the principal at maturity, all intact. Holding the bond until maturity is pretty safe, regardless of what happens to interest rates in the meantime. However, this is not the case if you need to sell the bond before maturity at a time when market interest rates have risen. The value of the original bond will fall relative to the new interest rate level, so the buyer will get the same return for the remaining life of the bond as he would by buying a new bond paying the higher interest rate.

This is what happened to Silicon Valley Bank. They had a surge of hot money deposits in 2021, when interest rates were low. They invested these deposits in long-term government bonds. This exposed the bank, without hedging, to a large liquidity risk that would materialize, if interest rates rose, which they did. Faced with deposit withdrawals, Silicon Valley had to liquidate its long-term securities at a large loss as interest rates rose. Fearing solvency problems, customers began to withdraw their deposits in large numbers, leading to a bank run and forcing regulatory intervention.

### **The controversial bailout**

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Silicon Valley Bank was not a big bank, and certainly not too big to fail. So the normal course of action would have been to wind it down and bail in, the uninsured depositors. Instead, the FDIC announced a massive bailout with an unlimited guarantee of all deposits, insured and uninsured.

As a measure, this is not unprecedented. It happened again in 2008, immediately after the collapse of Lehman Brothers. But today's crisis is not the same as 2008. Back then, the financial system was more fragile, and the crisis was systemic. Today, the financial system is more resilient and there was no real threat to financial stability.

What the unlimited deposit guarantee backstops is a potential crisis of confidence of deposits that would expose many medium-sized banks to the risk of bank runs.

### **Inflation blues**

Raising interest rates to fight inflation leads to economic austerity and recession. Companies downsize, some fail, and unemployment rises. Institutions such as banks come under stress.

With the labour market not cooling fast enough, the thought was that the Federal Reserve would become more aggressive, making a series of big 50 basis point rate hikes and perhaps taking the Fed Funds rate much higher. But at its meeting on Wednesday 22nd March, the Federal Reserve only managed 25 basis points, signaling more caution. The ECB had raised its key rate by 50 basis points a few days earlier.

The interest rate needed to achieve 2% inflation may be more than the banking system can bear and, if so, a revision of the inflation target may be necessary.

### **Credit Suisse**

Credit Suisse has struggled for several years, plagued by missteps and scandals, as well as large financial losses from some very bad investments. In the year before it collapsed, there were massive withdrawals of very large deposits due to a loss of confidence in the bank. But when you face such a liquidity run, you have to sell assets for cash and take losses.

Then the Swiss National Bank did what the Federal Reserve and the Treasury Department did in the United States. It threw the bank a lifeline of about €50 billion to support liquidity by offering to buy its fixed-income securities off its books at par, not marked-to-market.

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But investors remained wary, and Credit Suisse was eventually rescued by a takeover by UBS. The Swiss government offered contingent credit guarantees and the Swiss National Bank provided substantial liquidity support.

## **Cyprus banks**

None of these idiosyncratic causes of the turmoil are present in the Cypriot banking system. It is not just a matter of better regulation and the credibility of the European Central Bank. Nor is it that Cypriot banks are very well capitalised. Rather, it is the nature of their balance sheets and the changes that have taken place in the private economy since the crisis of 2012-14 that are now fundamentally different. Cypriot banks have a very modest exposure to long-dated fixed income securities, and at the same time they have a lot of liquidity. Second, total private debt in the economy has been reduced significantly over the past decade and is now below 80% of GDP, compared to 270% at the end of 2012. Bank lending is therefore relatively low by comparison, while capital buffers are comfortably high. Lower private debt means that companies are less dependent on bank credit and their interest expenses represent a much smaller share of their turnover.

A third reason has to do with the difference between real and nominal interest rates. What really matters is the real interest rate, which is the nominal interest rate minus inflation. Despite the significant rise in nominal interest rates, real interest rates are still low.

Understandably, a higher interest rate environment creates stress in the broader financial system, but the fundamentals of the Cypriot banking system are not comparable to the problems that have plagued banks in the United States or even Credit Suisse.

## **Lessons and conclusions**

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There are a number of lessons and conclusions to be drawn from this episode of financial turmoil. First, the normalisation of interest rates after a very long period of ultra-low interest rates following the 2008 global financial crisis is a slippery slope, as it is certain to expose financial vulnerabilities. Second, unlike 2008, this is not a credit crisis, and the risk of contagion is easier to contain. The global economic recovery after the global financial crisis was driven by fiscal and monetary stimulus, while bank credit remained weak. Banks therefore invested their excess liquidity in long-term securities instead. While higher and rising interest rates will reduce the underlying value of these securities, losses need not be realised unless there is a loss of confidence that triggers a liquidity run.

Third, the vulnerable part of the financial system is the less regulated, mid-sized regional banks, particularly in the US. Current circumstances will force them to be more tightly regulated and possibly to consolidate, which is not necessarily a bad thing. Larger and more systemically important banks are not at significant risk. A system-wide fallout should be manageable, even in the likely event that the balance sheets of more mid-sized banks come under increased pressure.

Another important lesson is that early and decisive intervention at the onset of a potential banking or financial crisis is crucial, as the authorities in the US and Switzerland have largely done. A widespread run-on deposits could potentially trigger a domino effect of further bank failures, which would also affect banks' willingness to lend.

Finally, the banking problems revealed by the current turmoil suggest limits to monetary tightening and may prompt both the Federal Reserve and the ECB to end monetary tightening sooner rather than later. If the fundamentals of the global economy point to higher inflation, pursuing a lower inflation target will require higher interest rates, which will be a drag on economic growth. In the end, a revision of monetary targeting may become inevitable. This will not necessarily be a bad thing.

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