Quarterly News

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Next to him on stage, Credit Suisse's Lehman was asked, "who is responsible for this disaster?" He chose to blame Twitter. Excerpt from a Financial Times article on the demise of Credit Suisse, quoting Axel Lehman, Credit Suisse Chairman.

Dear Sir, Dear Madam,

It was only three months ago that everyone was worried about inflation, recession, and the continuing war in Ukraine. As we discussed with many of you, we expected 2023 to bring new and unexpected things to worry about that would, if not replace, at least displace last year's main worries.

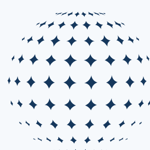
And, boy, did the first three months of 2023 not disappoint on that front! Silicon Valley Bank! Credit Suisse! A new financial crisis! 2008 redux! Bank runs! As with any good TV series (think Succession or The Wire), the new season so far is just as good if not better than previous ones. And, as any good plot twist should do, these events re-shuffles the chairs on the deck somewhat, with regards to inflation and recession, among other things.

But let's not get ahead of ourselves with regards to possible consequences and let's go back to the beginning: we had banks that went under and that had to be taken over either by the regulator (Silicon Valley Bank by the FDIC) or by a competitor (Credit Suisse by UBS in a government-backed shotgun marriage).

The papers have sufficiently talked about this, but there are two important questions we would like to assess: is this anything like 2008 and why does this keep on happening? The first question is important because, if the answer is positive, well we are about to be in a world of hurt. The second question, although more theoretical, is in our opinion the more important of the two.

First, is this 2008 redux? Having lived through it, our answer can only be a resounding "NO", it's nothing like 2008. Banks today are better capitalized and safer than they have been since probably the 1960's. The rules and regulations put in place after 2008 have greatly reduced the leverage ratio inherent in a bank balance sheet. Before 2008, it was not unusual for some banks to be leveraged 30 to 35 times, which meant that they only needed to experience a 4% loss on their balance sheet to go bankrupt.

These days, banks have a healthy leverage ratio of around 10x, which is par for the course and not too dangerous if the bank is well managed (big emphasis on IF). This is because, for a bank to lose 10% of its balance sheet in bad investments is not impossible (as we saw with Silicon Valley Bank) but much harder to do. So, to sum up, this is not 2008 because, unlike then, the risks are not systemic (spread around the whole financial system, as subprime products were back then) but rather idiosyncratic (specific to each failing bank).



In the case of Silicon Valley Bank, they made a duration bet on risk-free assets (US Treasury bonds with far away maturities) in a period of very low interest rates and, when that period ended and rates rose, losses mounted. This could have been survivable had suspicions not arisen among some of its biggest depositors (who became vocal about it and accelerated the bank run).

In the case of Credit Suisse, rot had started to set in quite a long time ago and big private clients had already left the bank in droves. To quote Hemingway about bankruptcy it happens "gradually then suddenly", and this could not be truer of Credit Suisse. Had the Silicon Valley Bank accident not occurred, Credit Suisse could have limped on for a while more, but the outcome was never really in doubt.

Had it not been an emergency takeover, it would have been a slow dismantling of the different parts of the bank (the investment bank part was a particular basket case), but it would not have ended well for shareholders regardless. It was not just Twitter, as the Chairman implied (thus trying to absolve himself and carve out one last, sweet, bonus payoff), that sunk Credit Suisse, it was years of managerial incompetence and wrong strategic decisions.

Because, and this is vital to understand, banks deal in one commodity and one commodity only. No, not money, that's just a conduit. No, the only thing that matters for a bank is TRUST. Its customers have to trust that the bank will be able to give them their money back at any point in time. Once trust goes, the bank is done. Once the bank's chairman or its CEO have to utter the dreaded words "everything is fine", it is over. Just having to say it means it's just not true anymore. Once trust is gone, the orchestra can keep on playing, but just like on the Titanic, it won't stop the ship from sinking.

One still has to recognize that they have rarely been as profitable as they are today. Even so, regulators are ever vigilant and, in most developed countries, regulators have to give their go ahead before banks can increase dividends or buy back shares. This confirms our choice to never invest in financial companies like banks or insurance companies. We avoid them because one never really knows what they have in their balance sheet and whether management is good enough to manage all the risks. But, as we have seen during this crisis, it goes even further than that. For instance, Silicon Valley Bank's balance sheet composition was known by all and had no fishy products, just long-dated US Treasury bonds and, hence an asset-liability duration mismatch. It was also known that the bank had had no active Chief Risk Officer for the whole of 2022. Unlike 2008, there was no big secret, no products so complex that no one really understood them it until they blew up in their faces. Even so, the bank went under.

In the case of Credit Suisse, the balance sheet was fine as well. The issue there was mostly management, which had turned over quite a few times over the past years. Each management team left the bank more or less willingly, but always with fat checks in their pockets (why they should have been paid so handsomely is not clear). But trust had begun eroding some time ago, thanks to bad investments by the bank itself (think Archegos, which we explained a few quarters ago) or bad products sold to its customers (think the factoring fund created in partnership with Australian fraudster Lex Greensill).

Now then, to the second question: why do such events keep on happening? Why do banks fail? Well, banks are not particularly special, lots of businesses in lots of different sectors fail. It is more publicized when it's a bank because customers' money is at risk and there are usually many customers.

The answer is just one word, and that is true both in the banking sector or any other industry: incentives. Once a near-bankruptcy event occurs, one of the first questions that is usually uttered is "how could management be so dumb?". And the answer, most of the time, is that management wasn't dumb at all, it was just incentivized by the company's board to do the things they did. And the incentive, most of the time, is more money: more regular pay, more bonuses, more stocks, more stock options, it doesn't really matter. The only thing that matters is that, if management does a certain thing, it will get paid more money.

As we said, this is true in every sector, and incentives and how they are structured is something we spend quite some time looking at in the companies we are investing in. There are no perfect incentive systems, but this is magnified in the financial sectors because the payoffs are generally just so much bigger than in any other sector (although tech has seen some outrageous stuff in the past five years).
And, more than in any other sector, management at a bank has usually no skin in the game. Its pay structure is mostly cash in all forms, or stock options so outrageously favorable that its quasi-cash. Management does not have to invest in the financial products the bank sells to its clients, and it is usually measured over the short-term. In no other sector are incentives so misaligned with shareholders interests. And so, in no other sectors are the risks so high for an investor. Not all banks are badly managed of course, and not all incentive packages are badly structured. JPMorgan Chase, BNP, Santander or Unicredit are expertly managed right now by excellent management teams. But, at some point that will change. Back in 2008, Credit Suisse had managed to escape the subprime debacle with no government help because its management had been smart (or lucky) enough to see the writing on the wall, whereas UBS was teetering on the edge of bankruptcy. How the tables have turned…

But enough about banks, let's discuss this first quarter of the new year. Clearly, not having any exposure to the financial sector (except via stock exchanges, credit rating agencies and credit card providers) proved to be a clear benefit.

We are seeing more normal returns in 2023. In fact, the first quarter is truly excellent, and some backing and filling should be expected in the coming months. It is interesting to note that, apart from mood, nothing has really changed since last year. The only thing that has changed is the type of worries. We have gone from worrying about inflation and recession to bank failures but that is par for the course.

Actually, the mood about a possible recession had already changed since late last year, going from a near certainty to something much less probable (as we had always argued). And, while inflation has shown some signs of life in January and central banks have continued increasing interest rates even in the face of banking trouble, we still believe inflation is on the wane.

What seems pretty clear is that, while this is no 2008, banking failures still have an impact on the global banking environment. Other banks want to show shareholders that they are in good health and that means reining in lending. In the US, where regional banks (still 25% of the market and very important for small and medium companies) have seen record outflows on the back of fears of contagion from Silicon Valley Bank, shoring up balance sheets is the most important thing.

This should in turn mean that slower bank lending will lead to an economic slowdown at some point during 2023. Whether this turns into a recession is impossible to forecast, but there will be a slowdown for sure. This also means that inflation should continue its downward trajectory. In this context, we believe the rate hike cycle that central banks have embarked on since early 2022 is over and that we have reached the peak.

As you have read, 2023 started off with a bang and lots of stress. One can only hope for a few months of quieter news and markets digesting their gains.

All the best,

Your CaridaB team