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WHOM DOES ONE BANK ON?

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When it rains, it pours. With a handful of banks falling/failing in quick succession, it is time to ask " Who is next, and when is this likely to stop".

A recent post, which has gone viral, has the following text - "My bank messaged me, 'Stay healthy, stay safe'. I replied, you too."

Existential questions are beginning to be raised on the future of quite a few banks in the western world. There have been 3 big ticket failures already in the recent past, with another battling for survival in the ICU. Should things have turned out thus?

The Silicon Valley Bank (SVB) is a prime example of what need not have gone wrong. The problem with SVB was not the normal problem that banks in stressed situations face. They did not have an issue with asset quality. It was the composition of their portfolio that was to blame for the bank's predicament. A very large holding of Government securities, on the facile and misleading assumption that nothing much can go wrong with this asset class, seems to have brought the bank to its knees. Any banker worth his or her salt should have known that as the Fed increased the interest rates, the bond yields would rise, adversely impacting on the price and marketability of the bonds held by the bank. This was a disaster waiting to happen. The Fed has gone in for several rounds of increase in interest rates, with at least one more on the horizon, while clearly signalling the market that inflation ought to be brought under control. Therefore, it would be idle for inter alia anyone to pretend that they suddenly woke up and discovered that the yields had travelled significantly northwards, making a huge dent in their portfolio. Alongside this, was the lackadaisical manner in which the basics of a banking organisation was ignored. The post of Chief Risk Officer remained vacant for several months, and clearly the Risk Management Committee, if one such committee existed, was a nominal presence in the bank's organisational structure. This is a valley on which the sun was bound to set, sooner rather than later.

Yet another bank, celebrated by its constituents, the Signature Bank (hopefully not a sign of the times), went belly up *inter alia* because of its exposure to cryptocurrency. One does not have to look too far back to discover that

cryptocurrency came into existence because in the opinion of some persons, impacted by the 2008 financial crisis, the banking system, including banking regulators, had failed its stakeholders. Cryptocurrency, briefly stated, was intended to keep banks aside, and transact business. Therefore, for a bank to have a large exposure to cryptocurrency is a situation that defies common sense. This is not a situation in which banks should be saying if you cannot beat them, join them. The requisite nimbleness simply does not exist in large structures.

The First Republic Bank has benefitted from around a dozen large banks supporting it with fund infusion, either voluntarily to prevent systemic shock, or at the instance of the regulatory agencies, to prop up a clearly failed bank. The lessons in this are not far to seek, should one wish to do so. Latest indications are that the bank would need significantly more funds, with possible sources of such funds not in sight.

Credit Suisse merits a separate article. After being in existence for 163 years, as a large entity in the banking space, and after having occasionally faced difficulties, and surmounted them, the bank should have known better than to get into a situation in which a larger bank, ironically a competitor, has moved in to pick up the ailing bank at a throw away price, and has, in the process, obtained backup facilities from the Government, and the infusion of additional capital support. The western pandits, who often cock a snook at the attempts made in developing countries to support ailing institutions, seem to have forgotten that moral hazard, an expression they use with reasonable frequency, will come to haunt them, courtesy the kind of bailouts that are taking place.

Have we seen the end of these blowouts in the banking space? The answer regrettably is “no”. The effects of these failures, no matter what support is being provided to prop them up, will play out in other geographies and other markets, and entities that are barely surviving, could go down with a rapidity that might make 2008 look like a picnic. There is clearly a need for the leadership in the banking community, and for regulators across jurisdictions, to sit together, and to stem the rot that has occurred in the system.

Interestingly, and this comment cannot be resisted, India’s Central Bank Regulator, the RBI Governor, has recently been declared “Governor of the Year” by Central Banking, a reputed publication, for steering the organisation and the economy through difficult situations, and working with the Government, while doing what Central Bankers need to do, to put the system on even keel. It would seem that conservatism is not an outdated virtue in these fast-paced times.

The focus of this newsletter is not to get into individual banking failures (or God forbid, future failures) in great detail. It is to look at the events that have unfolded from a Corporate Governance perspective, and to see what has gone wrong, and what ought to be done sooner, rather than later.

Notwithstanding the variety of reasons, each different from the others, for individual cases of failures, what clearly emerges is that there has been Corporate Governance failure on the leadership front. Corporate Governance is doing the right things, at the right time, in the right manner, and for the right reasons. It is respectful of, and acts in the interest of, all stakeholders of that entity, and of that ecosystem. Leadership in such organisations and situations necessarily call for a flow of credible and actionable information, in a timely fashion, so that what is required to be done, is done, without any loss of time. An analysis will show that in all these organisations, as in the case of the big failures (Lehman Brothers and Bear Stearns) in 2008, the leadership lost focus, obstructed the flow of relevant information, and followed their own pursuits, while their organisations came to grief. While a crisis does not give anyone the ability to wave a magic wand, and to put the problem out of sight, it affords every opportunity to plan for the crisis, mitigate the crisis, cut one’s losses, refashion the portfolio, shrink the books, if necessary, and in the process, emerge leaner and stronger. This is not a course of action that easily commenced itself to celebrated leaders. They forget the eternal truth that growth at all costs is not a desirable option, and that “top line is vanity, and bottom line is sanity”.

The problem with the western financial sector is that 15 years after 2008, not a single person associated with the financial crisis, has been taken to Court, tried and punished. Some of them got away with a rap on their knuckles, and some others have departed with enviable terminal benefits. In a sense, Regulators and lawmakers have nodded even post the significance of the event registering on them, and in the name of saving institutions, have ended up saving individuals, who should have paid the price for crimes and misdemeanours. To begin with, the bonuses that senior leaders of SVB got, and the proceeds of the sale of shares before the bank went under, should be clawed back.

Corporate Governance is premised on checks and balances. The concentration of decision-making powers at some select senior levels in the organisation, is a sure shot at failure. The four eyes principle, which has been talked about time and again, should not have been abandoned even momentarily.

Regulators also need to share a large portion of the blame. With facilities in place for near concurrent supervision, it would seem unthinkable that no one noticed that things were going wrong. It is reminiscent of what Nick Leeson eloquently described in his book, "Rogue Trader", when he said that the Bank of England representative was seated alongside him, looking at his computer screen, while he was continuing to take and execute questionable decisions.

The performance of the auditing profession also does not stand up to scrutiny. It is inconceivable that auditors did not red flag any of the irregularities which were taking these institutions hurtling to their doom. If they had pointed out some, if not all, of these dangers, and threatened to go public in the event of resistance by the management, the problem could have been contained. In a recent case in India, much attention seems to have been given to the fact that the auditor of the group companies was not one of the big 4 multinational entities. The same persons who thought that size was critical, now need to take a closer look at who were the auditors of these entities that came to grief. The truth that quality, rather than size, is critical in the auditing profession, will surface with blinding clarity.

Rating agencies could feel left out if a portion of the blame was not laid at their doorsteps. It is useful to ask whether the decline in the health of these entities was noticed in time, with resultant timely downgrades in the ratings. Absent this, the usefulness of the rating exercise itself gets called into question.

The financial sector also needs to take a close look at the contribution of the "mark to market" phenomenon to the downfall of entities. Mark to market played a major role in adversely impacting large entities, following the collapse in July 2007 of the 2 funds that Bear Stearns had promoted. Suddenly large entities discovered that the value of their holdings, when marked to market, shrank significantly, and over time there was no market for these instruments because of the steep decline in their value. The view exists in some quarters that this being a notional loss, unless the entity actually sold the holdings at a loss, should have alerted the protagonists of the mark to market model that, while it was well intended, the outcome was not necessarily positive. This is yet another instance in which the way to hell has been paved with good intentions.

There was a time when the bank was considered the safest organisation to deal with because it reflected solidity, stability and soundness. Today, some of these attributes seem to have moved into the realm of rebuttable presumptions. It is time, in the interest of the global economies, that all right-thinking persons, with the right intentions and expertise, abandon the hobby horses of their ideological positions, and collectively address the problem that is upon us. The world has enough problems to deal with, and a banking crisis that could be the mother of all problems, should be addressed, without any further loss of time. Baby steps taken by individual regulators are inadequate, and if academic discussions of the growth versus inflation debate detains us, the problem will assume a much bigger size, and a much faster speed that we will ever be able to deal with. Enlightened common sense, courage, commitment, conviction, and confidence must manifest themselves in abundant measures.

Tailpiece: SVB and Signature Bank were among the largest banks in the US, and Credit Suisse was a global giant. Rightly did Shakespeare observe:
"When beggars die, there are no comets seen.
The heavens themselves blaze forth the death of princes."

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