1890s v 2023 Bank Runs

It seems unlikely that we have reached the Credit Suisse end game. Why?

Because while the Swiss National Bank credit lines will provide short-term liquidity, history says the proper focus is the underlying cause(s) of the bank run.

Victoria 1890s

Some are trying to draw lessons from the Global Financial Crisis (GFC). The fact that merchant bankers living in a bubble did not understand the reality of their complicated mortgages nor the contagion effect of those mortgages defaulting has some elements of the current bank crisis, particularly as it relates to Credit Suisse.

The 1890s in Victoria, Australia saw a series of devastating bank runs.

Marvellous Melbourne experienced a massive property boom in the 1880s, which was followed by a crushing depression. Rural industries basked in a series of good seasons and bountiful harvests. Urban growth was stimulated by higher wages and an enhanced demand for housing for the large numbers of young people who had been born in the late 1850's and 1860s to gold-era migrant parents and who were now reaching marriageable age. The prosperity was aided by a steady inflow of British investment which the resulting growth further encouraged.

Politicians tried to bribe the electorate by proposing a huge railway building program. There was a massive public spending program which greatly broadened the area of government control and activity. The economy took off in 1887, spiralling upwards in a heady boom. The confidence in the future of Victoria , especially Melbourne, brought British investment flooding in. Melbourne went mad as money became readily available for any purpose, public or private, soundly based or speculative.

The so-called land banks or land finance companies were a central element. These had developed after the 1887 Royal Commission into banking recommended that one of the safeguards be removed and that banks be able to issue advances on the security of land. The resulting legislation opened the way for the establishment of institutions, calling themselves banks, to solicit deposits which were then used to speculate in land. Their only security was the maintenance of the inflated land values. Some 150 banks and land finance companies were established in 1888. The only serious attempt to control the situation was made by the Associated Banks, which was an alliance of established note-issuing banks.

Between 1886-90 some 50 million pounds of British capital was invested in Victoria, most of which was invested in unproductive public works (including railways with little hope of paying their away), land speculation, home and office building and extending the northern Australian pastoral industry beyond its viable limits. In December 1889 one of the largest boom finance companies suspended payment. Unemployment was rising and government finances were decidedly unhealthy. To re-fill its coffers the Government floated a 4 million pound loan in London in early 1890. When British investors showed such confidence that they subscribed 13 million pounds, the Government interpreted it as a sign that all was well and revived its railway program.

Later that year the fragile card house began to shake and fall apart. The crisis was precipitated by the collapse in November 1890 of the great London banking house of Baring, mainly as a result of bad investments in South America. Confidence in all colonial investments was shaken. Some British depositors started withdrawing their Victorian investments. As confidence was eroded the demand for land dropped away and values fell. More and more depositors sought to withdraw their investments. Melbourne was shaken in the early months of 1892 by the collapse of several large institutions including the Mercantile Bank.

The repercussions spread rapidly. The surviving building societies drastically curtailed advances. The building industry ground to a halt and the demand for goods and services declined. Thousands lost their savings and were thrown out of work and the government contributed to the situation by reducing public expenditure. A dreadful pall of misery, gloom and hardship fell over the colony as the economy spiralled downwards.

The Government's main concern was to balance the budget by a combination of retrenchment and higher taxation, both of which made life more difficult for the people. The lowest point was reached in the great bank crash of 1893. The demise of the Federal Bank, one of the Associated Banks, caused a run. On 5 April the Commercial Bank suspended payment. On 29 April the National Bank decided to close their doors to undertake reconstruction. Alarmed by the news, the Premier declared a bank holiday from 1-5 May for the banks to regain their breath. News of the closure brought panic and thousands of people crowded into Collins Street. Fortunately the Bank of Australasia, the Bank of New South Wales, the Union Bank, the Royal Bank and the City Bank of Sydney decided to ignore the proclamation and remained open. There was a rush on their deposits, but as they proved to be able to withstand the onslaught some confidence returned.

The Sydney Bulletin christened Melbourne "Smellboom", for indeed the name of Melbourne stank in Britain and in other colonies. Victoria lost over 100,000 people between 1891 and 1898.

The depression of the 1890s was a pivotal point in Victorian history. Before the economic calamity Victoria was notable as being progressive, optimistic, probably the most advanced of the colonies and politically liberal. Afterwards Melbourne was greatly changed. Progress was slower, the breezy optimism was gone; they were chastened, quieter and in the future to become more staid and conservative.

The above is largely selected from "VICTORIA: A History" by Don Garden. Your diarist spent a year in Melbourne and enjoyed many aspects, including their colourful history.

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Lessons From Victoria:

Like the USA today and unlike Australia, the US banking system has many banks of different shapes & sizes serving different constituencies and with various business models. Some of these models will fail, some will fail by bad management- the probability of US bank shareholders and other creditors losing their investment is much higher than in the highly regulated Australian banking system.

Bank failures are significant negative economic and shareholder events. Even where bailouts occur, it is likely the impacts will take some time to play out.

While regulators and governments will focus on depositors, the question of whether a bank survives and even prospers in times of bank runs will depend on the underlying bank model, management, strength of brand name and confidence of counterparties to continue to deal with a bank. The Victorian land banks failed because the business model was fatally flawed. In contrast most of the note-issuing banks including Bank of New South Wales withstood the test and prospered.

Governments and regulators had no idea what to do. The Victorian banking crisis was pre Keynesian economics, but given the reckless government spending, their ability to provide assistance would have been constrained even if they were equipped with the Keynesian model i.e.: GDP= Consumption + Investment + Government +Exports- Imports.

Might our central banks now have the wrong paradigm or have failed to apply the learnings we have e.g. from Milton Friedman on monetary policy?

2023 Bank Bailouts/Failures

The bailouts/failures to date all had fraud, flawed models and/or poor management.

- FTX platform material executive fraud. FTX isn't strictly a bank but a crypto platform.

- Silvergate Community Bank facilitated crypto transactions on FTX and secondly, had losses on long dated bonds, so the FTX bankruptcy caused the domino effect, together with major crypto clients e.g. Coinbase ceasing to regard Silvergate as an acceptable counterparty to transact their business.

- Silicone Valley Bank fails, biggest since Washington Mutual 2008. One fifth smaller than ANZ. Concentration risks re technology, low retail deposit balances but high commercial deposits on short terms, large losses on government bonds. Technology companies had raised large sums from shareholders during low interest rate environment of last few years. Those funds dried up, so technology companies started drawing down on their deposits with SVB. Government/regulators put facility to loan face value US government treasuries. A key difference to 1890s bank runs is depositors don't have to line up for their money. Electronic transfers allowed a staggering $US42B ($A63B) to be withdrawn in a single day. US President national broadcast to tell depositors their funds are safe. Notwithstanding enters chapter 11 a week later.

- Signature Bank in New York fails. Regulators unhappy some lending aspects including crypto. Suggestion more unrealised losses on long dated bands.

- First Republic 11 private US banks deposit $US30B to allow deposits to be paid, similar to Associated Banks in 1890s.

- Credit Suisse (CS) run on bank with funds withdrawn follows litany of management errors. Fundamentally CS don't appear to understand risk. Their corporate people are doing whatever they can get away with and earn large bonuses on, notwithstanding the deals are terrible. Latest in January is Adani companies giving paper used as collateral for margin loans for private bank clients - illegal under Australian corporations law. Archegos margin loan losses, Greensill/IAG funding trusts… they deserve to fail. Swiss National Bank, the central bank in Switzerland has provided a $US 50B facility(~$80B A). 70% of CS business outside Switzerland. The end game may be that the Swiss National Bank ends up owning CS. The wealth business is sold or spun off and Swiss National ends up with the legacy assets including the long dated treasuries with large unrealized losses.
  Stop press: Swiss National Bank has facilitated a 'merger' or shotgun wedding between UBS and cs. A token consideration, $100 Billion Swiss National Bank Lines and SNB bearing some losses.

Could it get worse? Yes…

At first analysis, the above can be rationalised as a group of banks that deserved to fail. They are a small set of assets viewed globally. Most , if not all, depositors will get their money back. They will move it to other better-managed banks. Bank of America reported receiving $US11B last week. Shareholders and other creditors will lose all their investment in most cases. So some say tough luck.

But there is an elephant in the room. The central banks. The institutions charged with managing monetary policy have let us down badly. They misunderstood Covid 19 interpreting it as a systemic event rather than a health event. Governments had already over stimulated with fiscal policy - in Australia Jobseeker, Jobkeeper, Homemaker. The central banks flooded the economies with money in global unison, they introduced quantitative easing i.e. buying long dated bonds and bidding up the prices to keep 10-year rates low. Central banks threw out Milton Friedman's monetary learnings that if you let the money supply run rampant, the result is inflation. They adopted a new theory -MMT modern monetary theory. MMT says you can flood the economies with $ and no inflation results. Guess what - the MMT guys are wrong & Friedman was right. Then they told all and sundry inflation was transitory, rates would stay low for years. Whoops, got that wrong too.

The problem now is the regulators won't admit they're wrong & are on a crusade to raise rates even higher to cause more pain, because that's the only way they believe inflation can be reduced. Like those who sought to balance the budget in the 1890s, your diarist suspects economists will look back at a terrible set of decisions that caused more harm than good at every step.

At the core is a failure to understand time lags. Central banks failed to understand the effects of ultra loose monetary policy. Now they seem to want to look at each week's data, when we know interest rate increases take 12 months to flow through.

Central banks also appear to have misunderstood that it is not so much the absolute interest rates, but the rate of change of interest rates (the double derivative) that is causing the damage. Businesses and individuals enter into transactions based on the difference between borrowing rates and rates of return on the investments. If the borrowing rates move quickly, a large number of those investments entered in good faith may be uneconomic. The unrealized losses on long dated treasuries held by US banks are $US620B. These have not been booked under the applicable accounting standards.

How to invest

Avoid the over valued sectors: nouveau technology, private equity and venture capital, high P/E companies and those with no earnings.

Stay the course with value and growth-at-reasonable-price (GARP) stocks. A number of GARP stocks should come back to Burrell FVEs (FairValue Estimates) over coming months. Keep engaged.

Be astute on fixed interest - stay short and investment grade companies.

Happy investing

Chris Burrell