IJCRT.ORG ISSN : 2320-2882

INTERNATIONAL JOURNAL OF CREATIVE RESEARCH THOUGHTS (IJCRT)

An International Open Access, Peer-reviewed, Refereed Journal

THE REVIEW ON THE DOWNFALL OF THE AMERICAN BANKS

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ABSTRACT

The bank can crash for various reasons. A severe financial crisis or recession can increase the number of defaults on loans and mortgages , making it difficult for banks to recover the funds or it may be due to overextension of credit or they can crash if the bank do not have enough cash reserves to meet the demands of the depositors or it may crash due to bad investments or the fraudulent activity or unethical practices by bank officials can harm the bank's reputation, leading to a loss of trust from customers and investors. This study is on the downfall of American Banks in 2023 and the reason for the downfall.

Keywords: Banks, Defaults, Fradulent activity, crash, downfall

INTRODUCTION

The bank can crash for various reasons , A severe financial crisis or recession can increase the number of defaults on loans and mortgages , making it difficult for banks to recover the funds or it may be due to overextension of credit or they can crash if the bank do not have enough cash reserves to meet the demands of the depositors or it may crash due to bad investments or the fraudulent activity or unethical practices by bank officials can harm the bank's reputation, leading to a loss of trust from customers and investors. This study is on the downfall of American Banks in 2023 and the reason for the downfall.

THE HISTORY OF THE FINANCIAL CRISIS

The two banks of America collapsed in the month of March 2023, The Silicon Valley Bank and New York's Signature Bank. This is said to be the second biggest banking failure in American history. The 2008 collapse of the Washington Mutual Bank was the biggest and it was followed by 2008 financial crisis, bringing a global recession. People are worried that this banking collapse might create another recession like in 2008. Because if American Financial system crashes, the impact can be seen all over the world. We need to understand how banks works. From the perspective of an individual, bank is the place where we keep our hard earned money. We deposit our money with the bank for safe keeping. From the perspective of a bank, it is running a business. They are not working for us for free. Banks have distinct business model. The money deposited by us with the banks is used by them to make money for themselves. There are different ways of making money. For example, giving loans to other companies and individuals. The interest charged on the loan would be the profit for the bank. The second source of income is investing in various places. Banks invest the money deposited with them in the stock market, government bonds or for buying gold.

The Silicon Valley Bank was established in 1983. Its headquarters are located in Santa Carla, California. And initially, the bank invested a large amount of money in to real estate. In early 1990's, half of the bank portfolio was made up of the real estate property business. All your investments are collectively known as portfolio. Every person has portfolio. Any investment into stocks, gold or even in cash makes your portfolio. You would have seen the financial experts' advice that every portfolio needs to be diversified. One should not invest all the funds into a single asset. The Silicon Valley bank had 50% of their portfolio in real estate investments. And in 1992, California's real estate market crashed terribly. Due to this, the bank had to incur a loss of 2.2 million dollars. After this, the bank realized that they need to diversify their portfolio. So after 1995, the contribution of the real estate business has remained around 10%. In 2023, the bank was in the similar situation as it was in the year 1992 but this time it was on a much larger scale. From 1995 to 2000, the bank was known for a new thing. The bank was heavily investing in startups especially technology based startups. The technology based companies that were in the venture stage were given loans by the Silicon Valley bank. By 2015, the bank had expanded so much. It was reported that 65% of all startups in America were served by the Silicon Valley bank. The companies in the tech industry were the biggest customers of SVB. Several Indian technology based startups were also among these companies. In this aspect, the SVB was quite unique. It was almost exclusively for technology based startups. But the other banks look for diversified customers to give loans to. Such as SBI in India, all types of entities borrow loans from it. Companies across the industry line use the bank. But this wasn't the case for SVB. By the end of 2022, SVB was the 16th biggest lender in America with the value of its total assets at 209 billion dollars. So why did this bank crash? The problems began with the covid 19 pandemic. With global lockdowns, venture capitalist from all over the world began investing in software companies. People saw that even during the lockdown when everything else had to be shutdown, the software based companies are the most successful ones. In 2021, those companies raised more money. In America, 330 million dollars were raised in total. It was almost double the record of the previous year. These technology based companies would want to deposit the funds with the bank and SVB was the first preference. In March 2021, the value of the total deposits with the bank was around 124 million dollars. It was 62 billion dollars the year before. This was a huge jump with so much money being deposited into the bank suddenly. If we Compare this with the other banks such as IP Morgan Chase bank , it saw an increase of 24% only. Since the bank had so much money in the form of customer deposits, they decided to use it to make even more money. The SVB used the billions of dollars to invest in government bonds. Investing in government bonds is considered relatively very safe. SVB bought a large number of bonds at a time where the prevailing interest rates in the market was quite low. According to America's Federal Reserve, the interest rates were around 0% to 0.25%. It was expected that the interest rate will remain low, but the interest rates went high in the year 2023. The bond price and the interest rates have an inverse relationship. If interest rates go down, bond prices go up. The longer period you hold the bond, the riskier it becomes. The interest rates can fluctuate while you are holding onto it. The price may fluctuate. It might benefit you or may cause you losses. But if the price of the bond you have bought falls, you will have to bear the losses. This turned into a worst case scenario for SVB. The American government increased the interest rates. By raising the interest rates, the value of the bonds held by the SVB crashed. They suffered a huge loss. They also faced second negative impact which was even greater than expected. By increasing the interest rates, the interest rate on borrowing loans increased as well. For startups and companies, taking loans became more expensive. So they avoided taking loans. To meet the funding requirements, the companies use the money they have deposited into the banks. By 2022, after the interest rates had increased, the tech startups wanted to withdraw their deposits to meet their financial needs. Venture capitalists weren't funding them anymore. Since they had their deposits with SVB, they wanted to make withdrawals at the same time. It became problematic for the bank. Due to the demands of the customers, SVB started selling the bonds. Selling them at a loss. They sold about 21 billion dollars' worth of bonds at a loss of 1.8 billion dollars. As soon as this news reaches public, the value of the shares of the SVB began decreasing. As on 9th March 2023, the shares of this bank were down by 60%. The day before, the rating of SVB was downgraded by Moody's. As soon as the news broke that the bank did not have enough funds and it was selling its investments at billions of dollars in losses, everyone who had deposited their money with the bank rushed to withdraw it. They were worried about their money. This is known as bank run. The actual reason for this downfall is bad decision making of the bank. People in charge of the management of the bank made wrong decisions. Over the last several months, inflation was rapidly increasing in America and Europe due to several reasons, one of which is Russian Ukraine war. To control this inflation, the Federal Reserve increased the interest rates. Interest rates will fluctuate, the banks needs to have a robust portfolio of investments. The California Department of Financial Protection and Innovation pounced on the SVB's office. The receivership of the bank was handed over to the Federal Deposit Insurance Corporation. Customer deposits to the tune of 175 billion dollars were used by FDIC to create a new bank, the National Bank of Santa Clara. The assets of SVB were taken over so that the usual business activities could be continued. And then began the search of a bank willing to merge with SVB. Due to this crash, the value of US banks has taken a nosedive in the stock market. US banks have lost over 100 billion dollars from the stock market. Several companies that had deposited their money in SVB have lost share value due to this such as streaming device maker Roku Inc. which reported that their deposits with the bank were largely uninsured. They lost their 10% of their share value.

CONCLUSION

The 2008 crisis was due to the crash of American housing market. Banks had lent a sleuth of irresponsible housing loan to people and companies who could not afford to repay it. So the housing market crashed and a global recession followed. After this several strong regulations have been imposed, new laws and regulations were imposed. The SVB served customers largely of a specific sector. There might be an impact on those startups but a global financial crisis would be unlikely.