

Fears of a banking crisis overdone

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Summary

- Fears of a banking crisis have arisen as mid-sized US banks failed and Credit Suisse ran into trouble
- Swift action by the authorities has contained these fears but volatility is up
- A banking crisis as in 2007-2008 is not in the cards though more bank failures may occur
- Impact on the economy is limited so far

US banks and Credit Suisse woes swiftly addressed

Against the background of aggressive monetary tightening to fight inflation, pressure has built up in the banking system. March 2023 turned out to be a month in which some of the pressure came to the surface. This has been quickly addressed by various authorities, but the question arises whether a banking crisis is possible. Let us look at the facts first.

In the US, on the 8th Silicon Valley Bank (SVB), a 40-year-old bank serving the tech sector reported that it would lose more than USD 2bn in equity, in part to cover bond losses. It appeared half its assets were long-dated bonds, many valued below par. That triggered a withdrawal of deposits worth USD 42bn, a quarter of its total. On March 10th its faith was sealed. On March 13th it became clear Signature Bank, a New York lender, had failed as well. A syndicate of US banks rescued First Republic Bank on March 17th. Addressing potential contagion across the US banking sector, the Federal Reserve and the Treasury Department reacted by announcing three measures. First, going beyond the guarantee of USD 250,000, all depositors in both banks would be made whole, and straightaway. Second, the Treasury promised to extend this support to smaller banks, if needed. Third, the Fed

created a new emergency-lending program allowing the banks to obtain cash in exchange for Treasuries or government-backed mortgages at face value (rather than market value).

In Europe, a wide range of existing specific troubles of Credit Suisse (CS) came to the surface on March 15th when Saudi National Bank, its biggest shareholder ruled out any further investment in the firm. The share price plunged by a quarter to its ever-lowest level with other European banks taking a hit as well. Early on March 16th CS announced that it would borrow USD 54bn from the Swiss National Bank and buy back debt, which provided some support to the share price. That was not a first step. On March 17th UBS came to the rescue buying CS at a 60% discount, backed up by CHF 100bn liquidity support from the Swiss National Bank and a CHF 9bn protection from losses. Meanwhile the Bank of England and the ECB had announced statements in support of the banking sector, if needed.

New banking crisis still far off

We see some contagion in the banking system. US events clearly sparked the CS failure and worries have arisen over Deutsche Bank, another large institution with problems. Share prices in European banks have fallen by 18% since early March, similar to the decline in the US.

Moreover, some issues with USD liquidity have prompted the Fed to increase the availability of swap lines, though only to a limited extent. It remains limited, but still. It raises the question if a new banking crisis, in the US, Europe or even globally, is imminent. We think not.

Before we explore this two notes should be made. First, the problem with SVB was that Fed interest rate hikes increasingly started to weigh on the value of (fixed rate) bonds. Then if the chunk of these assets on the balance sheet is sufficiently large, as was the case, at a certain moment depositors will start to worry, and withdraw. That necessitates the bank to sell bonds at a loss. That will cause a loss of confidence and a classical bank run. Second, the CS failure was triggered by the US wobbles, but the underlying problem was not similar. Rather, it was multi-billion dollar losses from clients such as Archegos Capital and Greenshill Capital. There were also accounting issues, triggering an annual report publication delay. CS posted five consecutive quarters of losses. Assets under CS management shrank 8% in the last quarter only.

So why do we think a new crisis is not imminent? With crisis we mean a crisis such as in 2007-2008, the Great Financial Crisis (GFC). First, thanks to regulatory reforms after the GFC, the capital position of banks are stronger than before the GFC, just like the quality of capital. Second, liquidity has improved: banks hold bigger amounts of liquid assets for cash flows and collateral needs for periods of stress. Third, we see no equivalent to the risky subprime mortgage and mortgage backed securities that undermined bank insolvency in the GFC. As argued above, the problem - for US some banks, not the US system, let alone the global system - is liquidity, not solvency. In Europe, the problem is bank specific, as we saw for CS. Fourth, the current problems focus on the US. European banks are in much better position than in 2007, with high liquidity ratios and low non-performing loans. Even margins have improved owing to the sharp rate hikes of the ECB. Fourth, as we have seen above, authorities have learned from the GFC and come up with swift and decisive action if needed. That firewall contrasts with the Lehman failure in 2008.

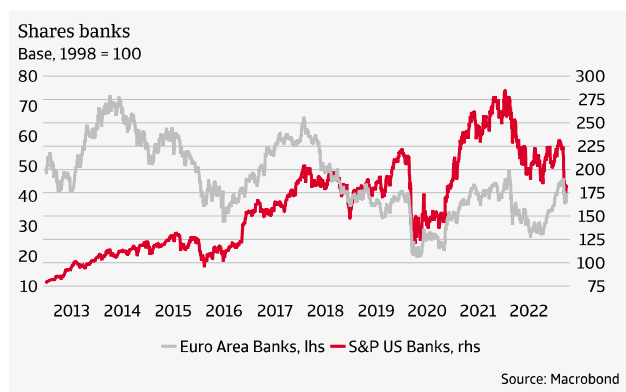
All this does not mean that we can lean back. With this kind of unrest, risks are certainly up. Systematically important banks may be fine in general, but smaller lenders, especially in the US for where regulation has been weakened, need attention. Furthermore, especially for US banks, weak spots on the asset side of the balance may contain: (i) the extent of interest rate hedging; (ii) property sector exposures; and (iii) leveraged loans exposures. These could, in an environment of further rising interest rates, compound the - essentially - liquidity problem that was faced by SVB. For these reasons, we are likely to see more bank failures, especially in the US. But a new banking crisis, that is far off.

Macro-economic ramifications limited

The implications for the real economy under the above scenario will depend on the intensity of the current developments. We assess these to be limited. The main point here is that after the bank failures central banks have become constrained with respect to inflation fighting. They have to take into account financial stability concerns as well. This will slow down the hiking process. Is that a problem? No. Current events are in essence deflationary. As banks are facing share price declines and losses on the assets side of the balance sheet, there lending will be constrained. That implies less investment and economic growth in the business environment as well as less consumption of durable goods. This lower demand will depress prices and thus reduce inflationary pressures. This is precisely what the Fed and ECB are trying to achieve with the rates hikes, or monetary tightening in general. The conclusion is then that as this deflationary effect was to occur anyway (via tightening which us now slowing), the impact on economic growth is limited. Indeed, if and only if a new banking crisis remains far off.

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Figure 1 Share prices in European and US banks have fallen



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