On the Minds of Investors

Answers to the key questions raised by the recent stress in the banking sector

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How similar are the current stresses facing US and European banks?

The collapse of Silicon Valley Bank (SVB) in the US highlighted two key concerns for the banking sector: the potential for rapid deposit outflows, and difficulties in meeting these obligations given the extent of unrealised losses on government bond holdings. In short, liquidity concerns quickly became solvency concerns.

While some aspects of these risks may be present in both the US and Europe, there were two specific characteristics that made SVB particularly vulnerable. First, its depositors were highly concentrated, with over 90% of deposits from corporates and over 50% of deposits coming from early-stage technologies.[1] Second, SVB had a particularly large bond portfolio relative to its deposits, which left the bank sitting on large unrealised losses due to the dramatic rise in yields since 2021. When outflows spiked, these bonds then had to be sold to generate cash, realising losses in the process.

We do not see other banks in the US or Europe having the same deposit base concerns. In addition, tighter regulation forces European banks – regardless of size (unlike in the US) – to maintain a liquidity coverage ratio of at least 100%, which aims to ensure that banks have enough easily accessible assets to meet potential withdrawals. At an aggregate level, European banks appear to have stronger overall liquidity positions than their US counterparts. European banks also have smaller bond portfolios on average, totalling around 20% of deposits versus 31% in the US.[2]

What happened to Credit Suisse?

The issues facing Credit Suisse pre-date the recent stress, with the bank's stock price already down by almost 80% from its 2021 peak prior to the latest issues in the financial sector.[3] More recently, Credit Suisse reported problems with its financial reporting process, and a major shareholder suggested it would not be willing to increase its stake any further. In an already stressed environment for banking shares, these issues acted as triggers for a renewed wave of selling pressure on the stock.

UBS has now agreed to take over Credit Suisse. Markets broadly welcomed the swift and decisive action taken by policymakers and regulators, although a difference in regulation between Switzerland and the rest of Europe led to further worries related to AT1 (Additional Tier 1) bonds.

[1] Source: J.P. Morgan North American Equity Research, Large Cap Banks, 10 March 2023.
[2] Source: Bloomberg, Federal Deposit Insurance Corporation, J.P. Morgan Europe Equity Research, European Banks, 13 March 2023.
[3] Source: Bloomberg, Credit Suisse.

AT1 bonds are a form of convertible debt that count towards part of a bank's regulatory capital requirements. They can be converted into equity or written down to zero if certain conditions are met (usually when a bank is facing liquidity or solvency issues). As debt, AT1 bonds would traditionally have priority over equity for some repayment of capital if a bank was being restructured.

However, in the UBS deal, Swiss law allowed Credit Suisse's AT1 bonds to be completely written down even though shareholders will still receive a partial payment for their shares. The result was volatility in bank debt markets with investors left confused about whether AT1 bonds sat above equities in the "capital stack". European regulators have since sought to clarify that AT1 debt would have priority over equity in the rest of Europe (and in the UK) in the event of future restructurings.

What is the risk that a financial crisis in Europe could evolve into another sovereign crisis?

Thanks to significant improvements in the institutional architecture of the eurozone over the past 10 years, we believe the risk of another sovereign debt crisis to be low. The monetary union is now complemented by a partial fiscal union, as evidenced by programmes such as the Recovery and Resilience Facility (RRF) which use common debt issuance at the European Union (EU) level.

More broadly, there is a different mindset at play in Europe, particularly after Russia's invasion of Ukraine. Problems seem more likely to be tackled together at a European level – see, for example, the REPowerEU scheme, which aims to completely eliminate European reliance on Russian energy by 2030.

Alongside this, the EU's crisis toolkit has improved. The European Stability Mechanism (ESM) and Transmission Protection Instrument (TPI) are two examples, both specifically designed to avoid a repeat of the sovereign debt crisis. The ESM provides financial assistance to eurozone countries experiencing or threatened by financing difficulties, while the TPI allows the European Central Bank to buy a country's bonds if spreads are widening beyond that warranted by fundamentals.

What are the implications of recent stresses for central bank policy?

From an economic perspective, the most likely impact of the recent financial sector stress is a slowdown in bank lending. We expect tighter credit conditions to drag on economic activity over time, therefore reducing inflationary pressures. The challenge for both investors and the central banks is that they don't yet know by how much bank lending will slow.

At its March meeting, the European Central Bank (ECB) went ahead with a 50 basis point rate hike. The strength of recent economic data was cited as a justification for the interest rate hike, but all forward guidance was dropped and the ECB President, Christine Lagarde, made it clear that the ECB would step in to provide further support for banks as appropriate. Ultimately, we now expect a lower terminal rate for central banks across developed markets, but how quickly they pause will be dependent on the data.

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