CIO Viewpoint

Containing or contagion? High rates take a bite out of banks

Investment Solutions

20 March 2023

A series of US bank failures and deteriorating market sentiment over the past week culminated in an emergency deal to sell Credit Suisse to competitor Swiss bank UBS on 19 March. While it is too soon to know whether this will restore market confidence, the current environment looks very different to that which preceded 2008's financial crisis.

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Tremors in the banking system started with the failure of California-based Silicon Valley Bank (SVB) on 10 March. On 8 March, Silvergate, a specialist lender to cryptofirms, had said it would wind down banking operations. On 12 March, New York-based Signature Bank failed after a run on its deposits. Shares in San-Francisco based First Republic continued to fall on 17 March, despite support by the Federal Reserve (Fed) and 11 larger banks. Meanwhile in Europe, Credit Suisse's share price sank over the course of the week, despite a CHF 50 bn liquidity injection by the Swiss National Bank (SNB), culminating in the SNB- and Swiss government-engineered rescue on 19 March.

Not 2008

These developments are taking place against a general backdrop of rising interest rates and quantitative tightening, resulting in more difficult financial conditions that have made investors wary (see chart 1). That said, the current situation looks very different from that in early 2008, when the Global Financial Crisis (GFC) was brewing. Banks have bigger capital buffers, particularly the largest banks, where capital requirements were increased significantly post-GFC. They have less exposure to subprime mortgages and commercial real estate. Regulation has been reinforced, and regulators have learnt lessons about the importance of swift and decisive action.

The complex global UBS-Credit Suisse deal was pushed through in a weekend. The US Treasury, Fed and Federal Deposit Insurance Corporation quickly guaranteed all deposits in the failed US banks, and offered all banks a one-year lending facility against collateral (the assets used to back the loan) valued at par. This means any lender in need of liquidity would not have to undermine its capital by selling securities at a loss. Fifteen years ago, and again during the European sovereign debt crisis, regulators imposed haircuts on the assets held by institutions seeking access to rescue packages. The other significant difference from 2008 is that 'crisis' indicators such as interbank lending conditions remain relatively healthy and credit default swap (CDS) spreads for most banks – the annual amount holders must pay to insure against default of a bank's debt – have widened, but not to levels that would indicate that markets anticipate deeper problems.

Key takeaways

- Banking turmoil is taking place against a backdrop of rising interest rates and tightening financial conditions
- Authorities have reacted swiftly and decisively to contain financial stress, including coordinated central bank action to support global liquidity
- In general, banks look better capitalised than before the global financial crisis. Slowing loan growth will impact economic activity, with a potential disinflationary impact
- We maintain balanced risk levels in portfolios and have recently increased cash positions, as we monitor ongoing developments closely.

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Weekly publication of Lombard Odier – Contacts: Investment Solutions, investment-solutions@lombardodier.com
Data as of 20 March 2023 unless otherwise stated.

Lower profits, tougher lending

Even taking all of these factors into account, it is too early to tell whether problems have been stemmed. The business model of all banks requires confidence, and the speed of SVB's collapse demonstrates how quickly a bank run can materialise, partly because of social media and the ability to transfer deposits between banks online within seconds.

It may also be too early to tell what the full implications will be for both banks and the wider US economy. Many clients are switching deposits from smaller institutions to the perceived safety of larger US banks. Small and medium-sized banks may have to offer higher interest rates to retain depositors or tempt them through the door, or else seek other, much more expensive sources of funding. Neither will help profitability.

Recent events also make it likely that existing capital requirements for large banks will also be extended to every US lender, further reducing profitability. Markets are already demanding a higher cost of equity to account for this hit to profitability. In light of the hit to earnings, banks are in turn likely to tighten lending and credit standards further, increasing the slowdown in consumer and corporate borrowing. This would be both disinflationary, and slow economic growth.

In general terms, however, most banks in the European Union and the UK are operating in very different conditions from their peers in the US. Most are still enjoying the profitability boost from rising rates, while for many US banks this benefit has now receded. European banks broadly enjoy both solid funding and liquidity buffers, while interest rates have not risen as high as in the US. The region's banks have a weighted average liquidity coverage ratio (LCR) of between 140% and more than 160%, compared with a minimum requirement of 100%. The LCR is designed to ensure banks hold a sufficient reserve of high quality liquid assets to endure a period of significant stress and potential deposit outflows lasting 30 days. In addition, their deposits are less concentrated and securities portfolios are generally smaller and often hedged against adverse interest rate fluctuations. However, even with all this, retaining the confidence of depositors remains key.

As investors consider global banking sector risks, Chinese banks operate in a very different environment. They are also reported to be attracting deposits thanks to their perceived stability. Many Chinese banks are state-owned, and monetary policy remains accommodative, with regulations facilitating bank loans, bond issuance and equity financing. Their primary issue remains non-performing loans in parts of the corporate sector, but the economy is rebounding strongly.

Too soon to tell

Issues in the banking sector illustrate how the real economy is responding to the Fed's monetary tightening cycle. The risk is that more restrictive financial conditions and the resulting lower liquidity could amplify yet-unidentified vulnerabilities in other markets. To ease these concerns, the Fed and other major central banks, including the European Central Bank, the SNB, the Bank of England, the Bank of Canada and the Bank of Japan have announced coordinated action to bolster global liquidity.

We are focusing on several indicators to estimate the ongoing impact on markets: firstly, gauges of contagion, including markets for contingent convertible debt issued by banks – which have been impacted sharply by recent developments – as well as measures of stress in money markets, and movements in banks' share prices. Secondly, the use of central bank liquidity facilities; the Fed's new funding programme has already been widely used (see chart 2). And finally, the impact on future monetary policy, and notably whether central banks

1. US financial conditions tighten[1]

Bloomberg Financial Conditions Index

Sources: Bloomberg, Lombard Odier

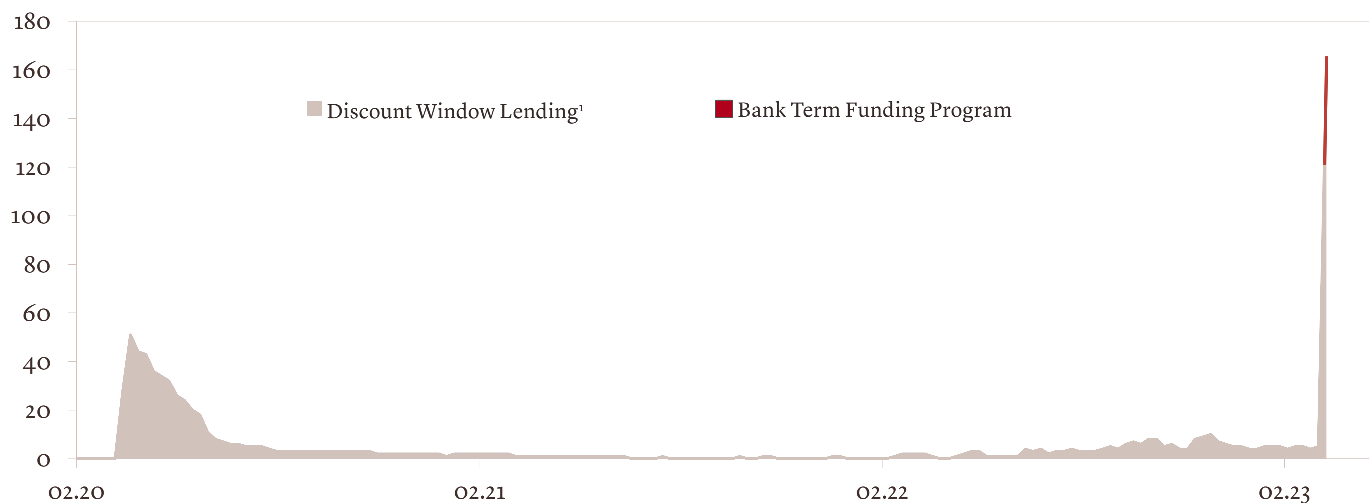
[1] The Bloomberg US Financial Conditions Index tracks the overall level of financial stress in the US money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms. Source: Bloomberg

will continue to raise rates. The Fed's next rate-setting meeting on 22 March will set the tone.

In terms of equity markets, we maintain our expectation that the S&P500 will end 2023 around current levels of 3,900. However, in the face of recession risks we see an increased probability that the index could fall to 3,200. In this context, we maintain balanced risk levels, and recently increased cash in portfolios. We continue to closely monitor developments, and adjust our portfolio allocations as necessary.

2. US banks made ample use of liquidity facilities from the Fed in the wake of financial system turmoil

Federal Reserve loan balances for Discount Window Lending and Bank Term Funding Program (in USD bn)



Sources: Federal Reserve, Bloomberg, Lombard Odier
[1] Discount Window Lending is an existing Fed programme to extend liquidity to banks

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