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# Recession Watch: the banking system's known knowns

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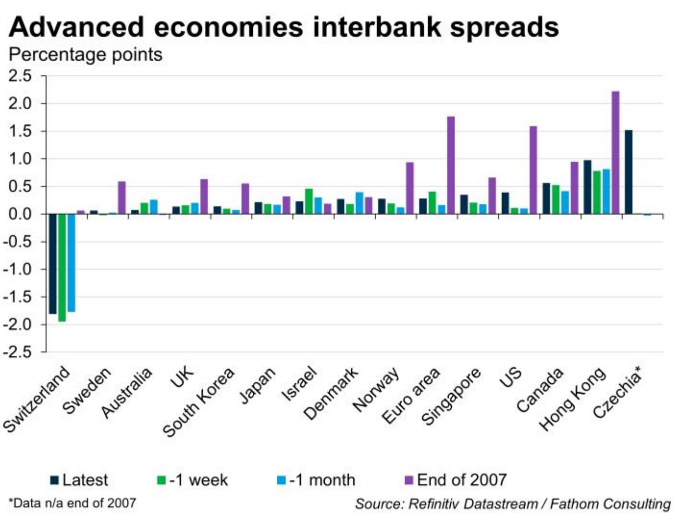
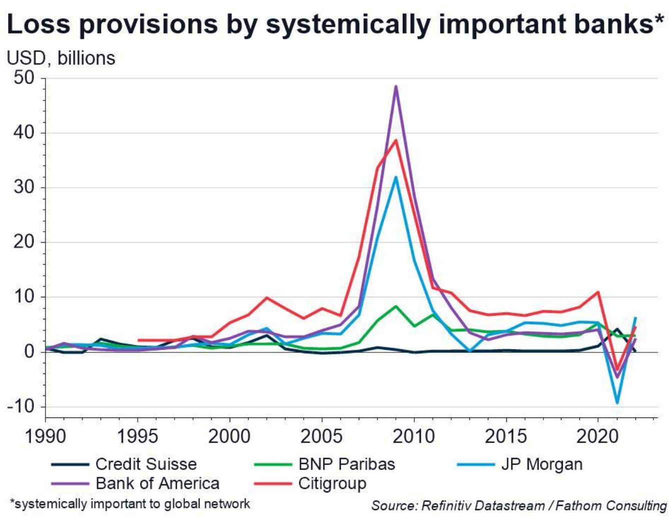
## Headlines

- We do not think that the banks, or economy, are set to implode as they did in 2008
- New risks have however emerged, related to poor, unhedged, lending decisions by regional US banks
- The policy response has been swift and should be enough to calm the situation
- The FOMC's policy decision, and accompanying communications, will provide a first glimpse into the committee's assessment of the recent turmoil

The recent failure of two US banks, coupled with problems at Credit Suisse which led to the bank's takeover by Swiss rival UBS, raised fears over a global banking crisis. A swift and strong policy response by US and Swiss authorities has stabilised the situation, although it would be premature to conclude that further concerns – unknown unknowns – about the banking system may not resurface. In this note we draw comparisons to 2008 and look more clearly at known knowns and how the nature of banking risks have changed.

In a previous note, we highlighted four reasons for confidence that the world is not on the verge of a global financial crisis or a banking sector meltdown like that of 2008. These were: the speed of the US and Swiss response, suggesting policymakers had learnt lessons from 2008; the fact that banks, on the whole, have healthier capital positions than they did in 2007; household balance sheets and the housing market are also in better shape than they were before the 2008 banking crisis, at least in the US; and the ECB's decision to press ahead with lifting its policy rate – in the face of the market turmoil last week – was a vote of confidence in the bloc's banking system. We can add two further measures to this list.



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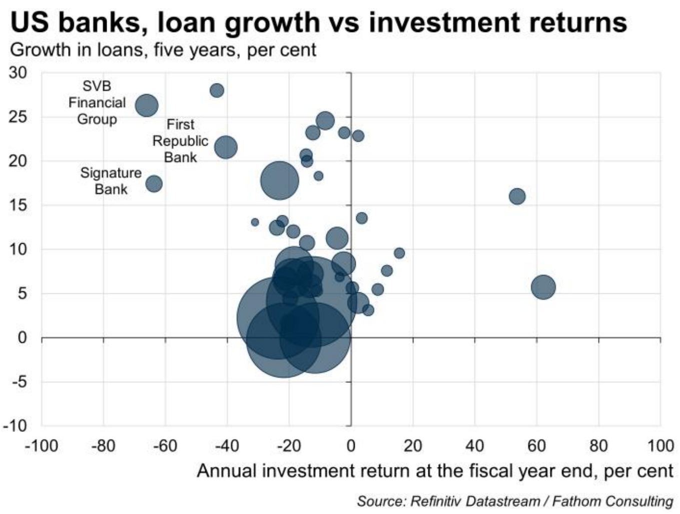
First, interbank spreads in advanced economies remain low, and — with the exception of Czechia — are much lower than before or during the 2008 global financial crisis. While this measure does not reflect issues at specific banks, it does suggest that contagion fears remain muted for now. Interbank spreads may not reflect stress in the banking system as much as they once did, given lower volumes as a result of abundant liquidity.[1] But the very existence of additional liquidity means that credit channels are less likely to get clogged than in the past. Second, the loss provisions of those large banks that are important to the global financial system are much lower now than they were in the build up to the 2008 crisis. Banks could be caught out by unexpected and unprovisioned losses, but it also shows that there has not been a fundamental and systematic deterioration in underlying economic conditions now, as there was in the build up to 2008 — at least, not yet.

**The problems today**

While these factors provide some reassurance about the current situation, the issues facing the economy, and banks, are different from 2008. Then, the issues emanated from the US housing market, and the mispricing of financial instruments tied to that; today, the issues relate to the sharp rise in interest rates over the last year or so, and to poor investment and risk management decisions by some financial institutions. These problems seem to be restricted to the US, although we cannot rule out similar problems coming to light elsewhere. The problems at Credit Suisse were long-running and do not seem to be primarily related to this.

The US financial institutions that have run into trouble are those that have both grown their loan portfolios by most in recent years and also reported the biggest losses on their investment portfolios last year. These became a serious problem when the banks were forced to sell the underlying assets, thus realising the losses.




Capital ratios are much higher now than they were; but as the chart below shows, capital reserves of some banks would appear a lot lower if adjusted to reflect the current state of their losses as if those investments weren't 'held-to-maturity'.[2] Banks below the 45-degree line would be booking unrealised losses on their books, while those above the line would be booking unrealised gains.

1. An alternative gauge of baking sector stress, known as the FTA/OIS spread, has risen over the last two weeks, but only to a 3-month high: https://www.reuters.com/business/finance/us-funding-stress-metric-hits-three-month-high-crisis-rattles-regional-banks-2023-03-20/
2. To create this chart, we adjusted the capital ratio by the disclosed total investment return of the bank's held investment assets. This approximates what the capital adequacy ratio would have been, had the bank had to book the gains or losses of its investments against its Tier 1 capital.



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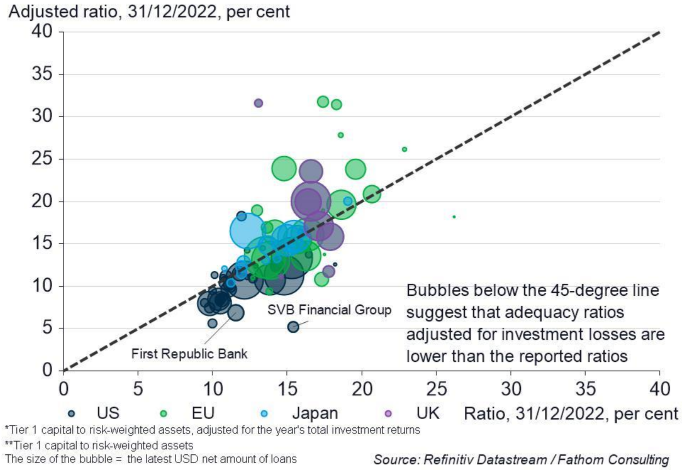
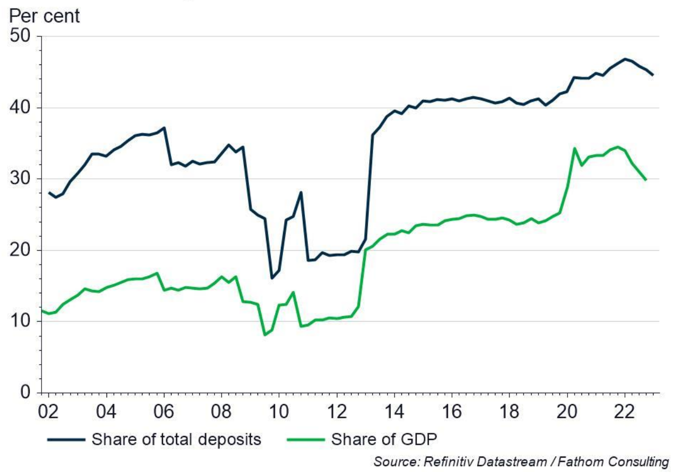
**Banks adjusted* vs reported capital adequacy****




The charts show that the problems exist mainly at smaller US banks. SVB is an outlier, although most US banks are below the line (possibly because the US policy rate has risen by more than elsewhere). First Republic Bank, which came in for heavy selling even after a coalition of larger banks provided it with a deposit boost last week, is also near the bottom. The charts below show how a slightly higher share than previously of US banking deposits reside at smaller banks, which are not subject to the same regulations as the largest US financial institutions. Another issue is that a higher share of deposits compared to the past are not covered by deposit insurance. This could make bank runs more likely, and more painful if they happen.

**Uninsured deposits**




US policymakers have taken steps to address both these issues. First, they agreed to insure depositors at SVB bank in their entirety, not just the usual $250,000 limit per bank (much to the annoyance of European regulators).[3] US Treasury Secretary Janet Yellen has also said that they would be willing to extend this promise to other institutions if needed, specifically saying “similar actions could be warranted if smaller institutions suffer deposit runs that pose the risk of contagion”.[4] Second, they have

3. https://www.ft.com/content/5e4a8dde-c053-4510-8cd9-8aecb9082a6e
4. https://www.ft.com/content/fcfaea32-7288-49f8-acb0-84c846b157d9



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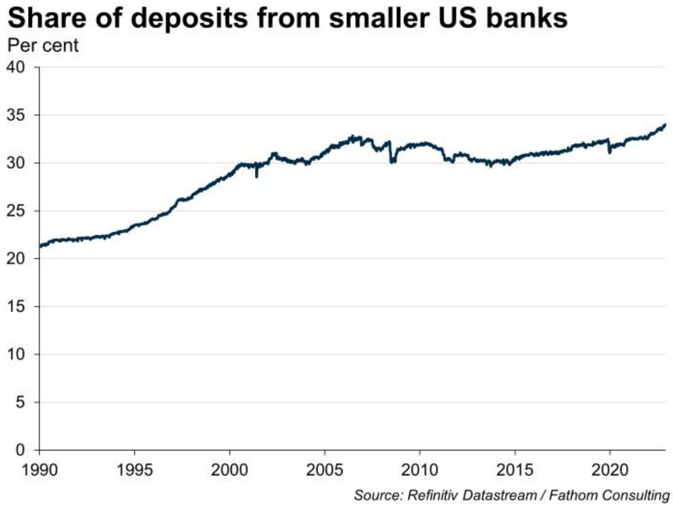
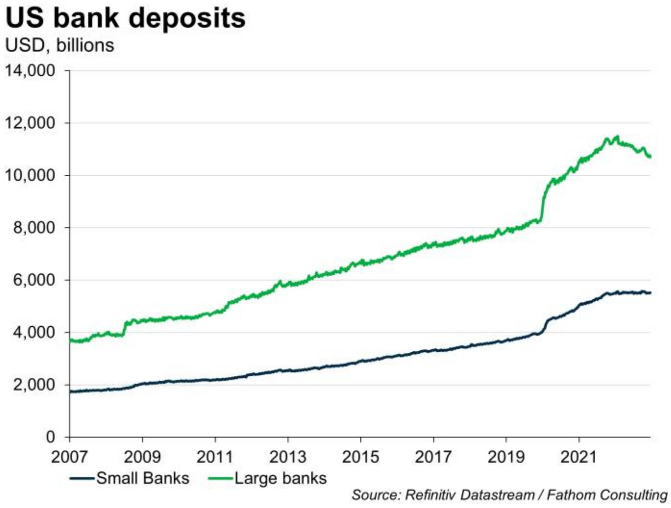
tackled the problem of banks realising losses when selling Treasury securities, by allowing banks to swap such securities for a cash amount equivalent to par value for a year, thus reducing the fallout from any forced, short-term, fire sale of assets.[5] While these steps may well create moral hazard and potentially lead to problems down the line, they do reduce the problems today.




### Stress tests

In the wake of the 2008 financial crisis, banks are now required by regulators to undergo periodic stress tests. This should increase confidence in the robustness of the banking system, although there are criticisms of this process — particularly in the US, where only the largest financial institutions are required to do all the stress tests. In addition, the scenarios that US banks were asked to simulate do not reflect the economic scenario we are in today. The severely adverse scenario in the US stress tests is one where the policy rate is close to zero, having been prompted by a negative demand shock. In other words, the results of those tests tell us little about the ability of banks to withstand the situation we face today, and this perhaps explains why US policymakers have taken such swift and decisive action. The situation in the UK and Europe is different: more banks are required to undertake the stress tests, while a broader range of scenarios, including higher interest rate scenarios, are considered.[6]

5. https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm
6. The BoE's 2022 stress scenarios included Bank Rate peaking at 6%. Results haven't been published but the Bank should have had the submissions for a couple of months. Meanwhile the 2019 exercise showed banks were resilient to Bank Rate rising suddenly to 4%, its current level. In the euro area, the stress scenario in this year's test includes one-year swap rates going to 5.2%, with the results published in the summer. Last year the ECB Banking Supervision conducted a "targeted review of interest rate risk-management practices", and separately concluded in a December blog post that "the euro area banking sector would remain broadly resilient to a variety of interest rate shocks": https://www.ecb.europa.eu/press/blog/date/2022/html/ecb.blog221220~c6210e3f0b.en.html



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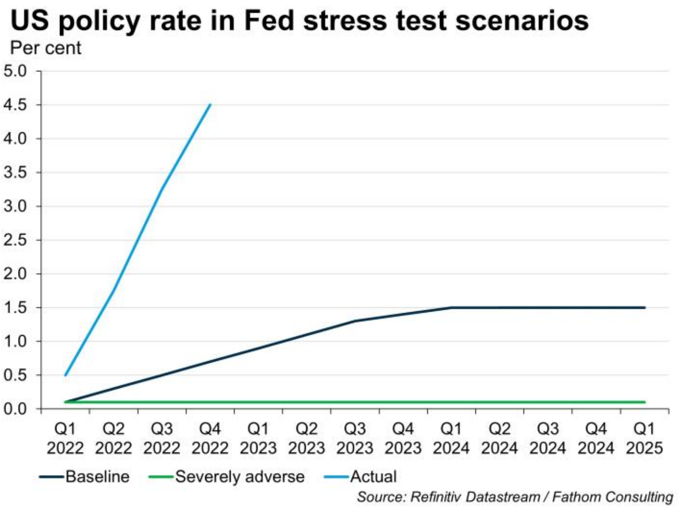
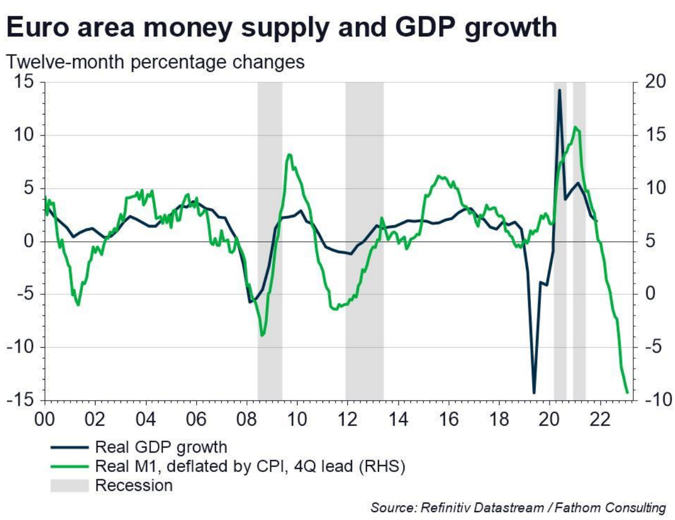
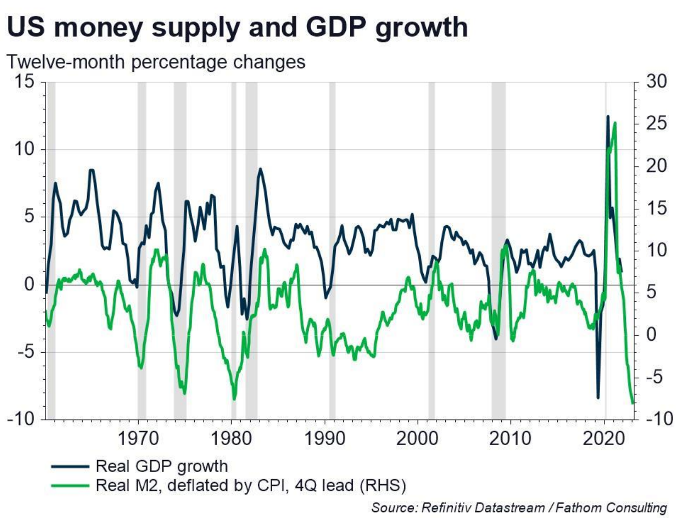



**Monetary policy is working**

It is worth remembering that the reason that the Fed and other central banks have been tightening monetary policy is to cool the economy. Admittedly, you might expect to see the impact of higher rates emerge in the real economy before the banks, but the fact that tightening is causing some economic pain should be expected. The recent turmoil may have the effect of additional policy tightening.

Fathom still expects developed economies to enter a recession later this year. The two charts below, which show the relationship between GDP growth and the real change in money supply, point to a particularly sharp contraction. While growth has repeatedly surprised to the upside in the current economic cycle, and we do not expect such a sharp contraction (assuming a fully-blown banking crisis and credit crunch are avoided), these two charts reinforce our central call. An economic downturn, including corporate defaults in the real economy, would add further stresses to banks, although we have no reason to believe that these would cause a banking crisis – and if the downturn is followed by lower policy rates this could help unwind some of the current problems facing US banks.



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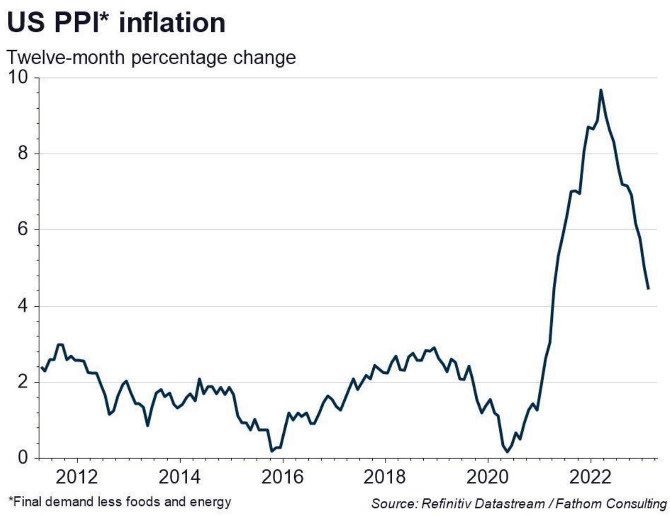
### How will the Fed respond?

Given the communications blackout ahead of the FOMC's meeting, which will conclude today, we do not know how the FOMC views the current banking situation and how this will affect its thinking on monetary policy. The ECB raised rates by 50 basis points last week in the midst of the market turmoil. The Fed may be less inclined to hike by a similar amount for a few reasons. First, the ECB had signalled its intention to do at its previous meeting, while the FOMC has not made such a firm commitment. Second, the banking problems seem to be greater in the US than in the euro area. Third, US data released over the last couple of weeks point to some easing of inflationary pressures: wage growth eased despite another strong headline payrolls number, while producer price inflation continued to fall sharply.

Were it not for the recent banking issues, the Fed would certainly be hiking today, probably by 50 basis points. But given the banking concerns, although they seem to have stabilised, a 25-basis point rate increase seems more likely. More important, perhaps, is what the decision and subsequent communication from Fed chairman Jerome Powell and other FOMC members tells us about severity of the current situation.


### Further reading

[Gauging the risk of a banking crisis]

[Recession Watch: SVB triggers risk-off mood]

[Contagion risks from SVB failure]

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