Allianz Research

US bank failures—What's next?

What to watch: Spillover effects to Europe? Implications for monetary policy? How have markets reacted so far?

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What to watch

- **Implications for the European banking sector –** little spillover risk so far and shock absorbers are in place
- **Monetary policy response –** rates close to peak as retrenching credit and slowing growth will do the heavy lifting to bring down inflation
- **Implications for markets –** headed for hard landing in the blink of an eye!

In focus – SVB failure: cause and impact

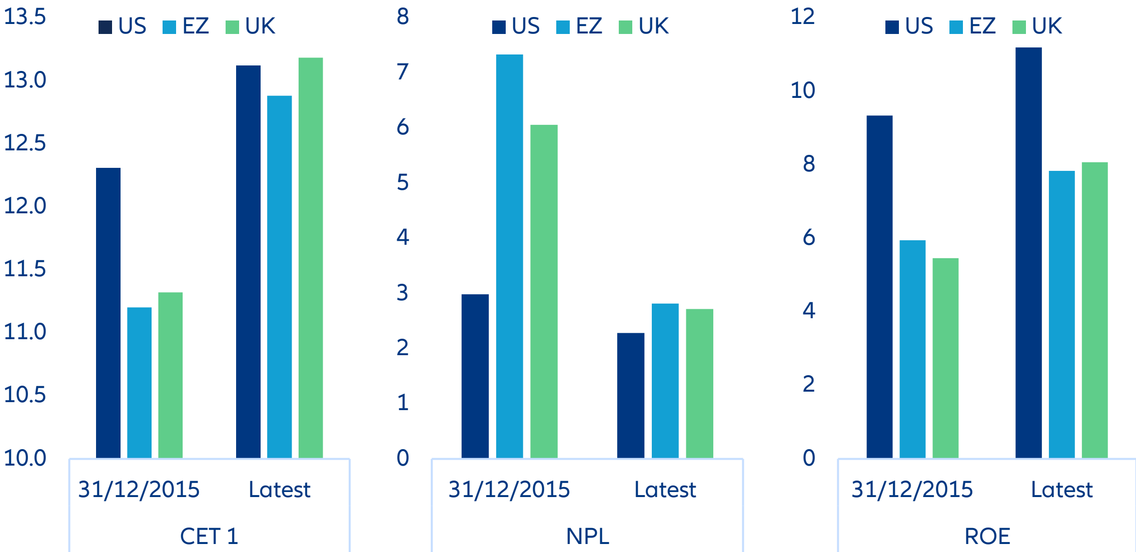
The SVB failure was caused by poor risk management choices but also highlights banks' general macro-financial challenges from restrictive monetary policy, which essentially removes diversification. Negative returns from bonds and equity put pressure on assets while quantitative tightening has led to a contraction of money supply, resulting in greater competition for deposits (as banks lend less) .

- Essentially, SVB was the epitome of wrong-way risk – it accepted very lumpy deposits from start-ups (which parked their venture capital funding), used related-party equity in these start-ups to collateralize loans and invested excess funds in mostly long-dated mortgage-backed securities at a time when the yield curve was inverting even more, squeezing their net interest margin. As much as central banks' fast rate hikes to tackle inflation hit the bank's asset side (resulting in unrealized losses that exceeded their capital base) they also caused an economic pinch for their start-up depositors, who started withdrawing their funds long before the deposit run that brought SVB to its knees.
- In the wake of SVB's failure, banks will become even more conservative in their lending. The planned resolution of the SVB imposes direct cost of other US banks, which will foot the bill for making all depositors whole (though higher FDIC fees) but, more critically; there is also an indirect effect of rising moral hazard in the banking sector as the Federal Reserve seems to be willing to still backstop failing banks. Over the near term, financing conditions are bound to tighten further in the US economy (and other countries) as banks raise lending standards and carefully safeguard their liquidity positions, further retrenching credit.

Implications for the European banking sector – What shock absorbers are in place?

The health of the European banking sector has significantly improved over the last decade, mitigating potential spillover effects of SVB's failure. With a focus on the largest[1] Eurozone banks (with total assets amounting to 80% of the region's GDP, we find that the sector is a much better shape today than it was in 2015 thanks to better and more consistent regulation and supervision (Figure 1). Non-performing loans (NPLs) declined to less than 3% of the loan book (down from more than 7%) while the average common equity Tier 1 (CET1) ratio has increased by more than 2pp (and now comes close to the capitalization of US peers). Liquidity also improved, with the liquidity coverage ratio (LCR) rising from 125% in 2015 to 150% in 2022, way above the regulatory minimum of 100%. However, major US banks are on average still more profitable, with a return on equity (RoE) that is 3pps higher ; this also shows in market pricing: the price-to-book (PtB) ratio has constantly been higher in the US (Figure 2). Extending our sample coverage include also smaller ones, European banks are generally stronger (Figure 3).

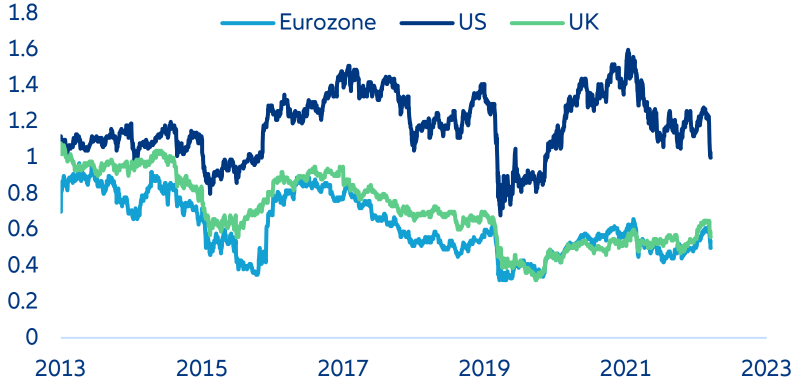
Figure 1. Selected banking sector financial soundness indicators: capital adequacy, non-performing loans and profitability



Sources: Refinitiv Datastream, Allianz Research. Note: G-SIB= global, systemically important banks.

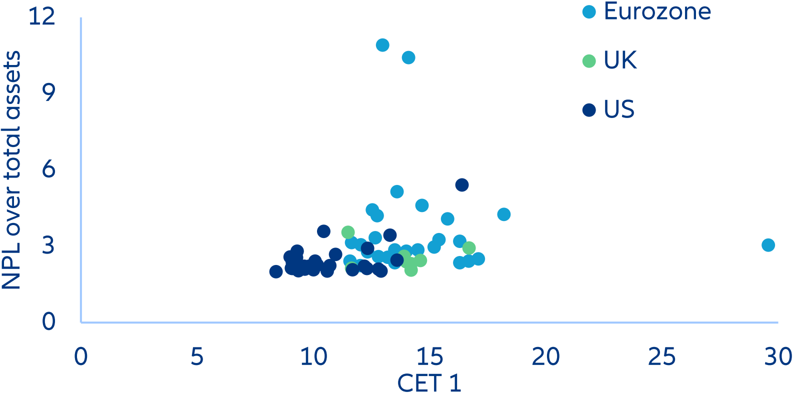
[1] *https://www.fsb.org/2022/11/2022-list-of-global-systemically-important-banks-g-sibs/*

Figure 2. Banking sector: price-to-book ratio (15 March 2023)



Sources: Refinitiv, Allianz Research

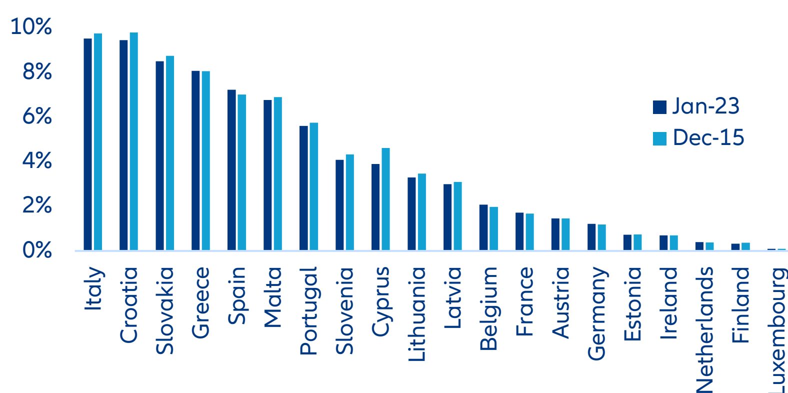
Figure 3. Banking sector: non-performing loan (NPL) ratio (% of total loans) vs. common equity Tier 1 (CET) (% of total risk-weighted assets)



Sources: Refinitiv, Allianz Research. Banks from Germany, France, Italy, Spain, Greece and Ireland are included in the Eurozone sample.

European banks learnt their lessons from the Euro sovereign debt crisis. However, some countries remain very exposed to their sovereign (Figure 4), with banks sitting on large holdings of domestic debt securities – also due to the banks' need for liquid assets. The risks of feedback loops can materialize in two directions: when the banking sector's troubles translate into fiscal costs and when the price of sovereign debt impairs banks' government debt holdings on their balance sheets. This is particularly pronounced when holdings are recorded at market value. The bank-sovereign nexus poses serious risks to financial stability and has been only partially addressed in recent years (no material reduction in domestic debt holdings).

Figure 4. Eurozone banking sector: holdings of domestic government debt securities (% of total assets)



Sources: ECB, Allianz Research

The Eurozone has significantly strengthened its banking supervision and resolution framework. The global financial crisis in 2008 and the subsequent sovereign debt crisis in Europe highlighted the need for a Banking Union (BU), with a consistent application of banking rules essential for financial stability and building resilience. Common decision-making procedures and tools create a more transparent, unified and safer market for banks, and help to prevent financial distress. The BU is currently based on two pillars: the Single Supervision Mechanism (SSM) and the Single Resolution Mechanism (SRM). The SSM consists of the ECB and national supervisory authorities. It is essentially a system of consistent banking supervision in Europe that aims for the safety and soundness of the EU banking system and increases financial integration and stability. The SRM comprises the Single Resolution Board (SRB), the central resolution authority within the BU, and the national resolution authorities. It promotes financial stability, provides the tools to resolve failing banks in an orderly manner (with as little impact as possible on the real economy and public finances) and protects taxpayers in the participating EU countries from the cost of bailouts. However, the third pillar of the BU, the European Deposit Insurance Scheme (EDIS), which would provide a stronger and more uniform degree of deposit insurance coverage than the existing national deposit-guarantee schemes, has yet to be completed. Indeed, one pre-condition is a material reduction of banks' domestic sovereign exposure with a view to severing sovereign-bank linkages.

The Single Resolution Fund (SRF) is Europe's first and foremost firefighting mechanism. The SRF is embedded in the SRM and is an emergency fund to be used after all other options have been exhausted (i.e. bail-in). Through the SRF, the financial industry itself ensures the stabilization of the financial system, not taxpayers. Banks are legally required to pay an annual contribution to the fund; by the end of 2022, the SRF held EUR66bn. The fund needs to reach at least 1% of the amount of covered deposits of credit institutions in the BU by the end of 2023. The reform of the European Stability Mechanism (ESM) created the Common Backstop, another instrument enhancing the firepower of the BU to manage bank failures. This additional emergency fund mirrors the size of the SRF using public money and will bring further confidence to the system. The backstop works as follows: in case the SRF is depleted, the ESM can lend necessary funds to the SRF to finance resolution. To this end, the ESM is a last resort and will provide a revolving credit line; the nominal cap for ESM loans is set at EUR68bn. The SRF must pay back the ESM loan with money from the contribution of banks within three years (possible extension of up to five years). Hence, over the medium term, the ESM loans are fiscally neutral. Together, the SRF and the Common Backstop provide Europe with firepower to address even a severe systemic crisis.

Monetary policy response: rates close to peak as retrenching credit and slowing growth will do the heavy lifting to bring down inflation

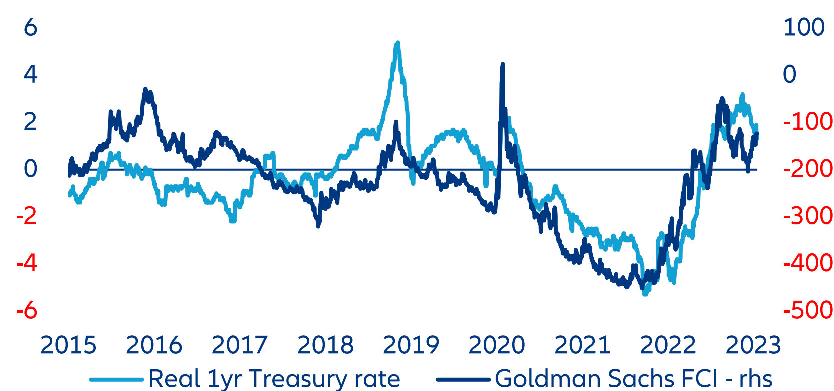
For both the US Federal Reserve and, to a lesser extent, the ECB, financial stability concerns might complicate the already difficult trade-off between inflation vs. growth in setting policy rates over the next few months. Should they keep hiking rates even though core inflation is becoming increasingly sticky or prioritize financial stability over price stability? In any event, the fight against inflation is likely to become more prolonged unless slowing demand is sufficiently disinflationary to allow central banks to tread more carefully.

Implications for the US

The Fed is in a seemingly difficult position, caught between its two core objectives of financial stability and price stability. Price pressures remain stubbornly high, with the recent February CPI report showing that the pace of monthly increases in core prices is not slowing (+0.5% m/m, in line with the average since mid-2021). On the other hand, lower bond yields and the potential injection of liquidity by the Fed (through its new bank term funding program and the existing reverse repo facility) could ease financial conditions. Easier financial conditions can complicate the Fed's objective to bring inflation back to target, undermine its credibility and potentially lead to more volatile and higher inflation expectations.

Financing conditions have not moved much overall while the Fed's stance has eased because of lower short-term bond yield expectations (Figure 5). Since the SVB debacle, US financial conditions, as measured by various financial condition indices (FCIs), have not moved much: lower equity prices and tighter credit spreads have been broadly offset by declining bond yields. The Fed' stance[2] has, however, eased quite noticeably as markets have pared back Fed funds rate-hike expectations.

Figure 5: US: Federal Reserve monetary policy stance (1-year real US Treasury yield) and financial conditions index



Sources: Goldman Sachs, Refinitiv Datastream, Allianz Research

However, the SVB failure will most likely curtail the supply of credit further, squeeze demand and help the Fed to bring down inflation. The latest Senior Loan Officer Opinion Survey (Q4 2022) showed a marked tightening of credit standards across all types of products (Figure 6, left panel). On the housing market, the pullback in the flows of new mortgage lending suggests that real property prices growth is bound to decline further (Figure 6, right panel), with probable adverse wealth effects on household consumption. It is likely that US banks will tighten lending standards further to preserve capital and build liquidity buffers.

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[2] The stance of monetary policy – which we define as the inflation-adjusted 1yr Treasury rate[2] – has a good correlation with financial conditions.