Special Report

A crisis for a few banks is not a banking crisis

Wealth Management

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It's understandable that investors remain scarred by memories of 2008–09 and that any word of bank failures brings fears. But several factors distinguish the current turmoil from the banking system crisis of 2008–09. We discuss the drivers of U.S. policymakers' current approach to today's stress, and the risks for investors in U.S. banks.

Financial turmoil inevitably awakens memories of 2008–09 and the global financial crisis. We believe strongly that the recent events in the U.S. financial system are not the early stages of a 2008 repeat; 15 years ago, we had a banking crisis and today we have a crisis at a few banks. This distinction is critical for investors, in our view.

We see the relative paucity of new measures by U.S. policymakers to date as a reflection of the ultimate manageability of today's issues. But we also believe it could mark a potentially unwise attempt to assign losses between depositors and investors, a move that we see as fraught with potential unintended consequences.

Banking basics

Banking at its core is a relatively simple business. Depositors give an institution savings, and banks invest those savings. Sometimes banks buy existing investments such as U.S. Treasury bonds, and sometimes banks create their own investments by making loans. As long as the bank's investments return more in interest and principal than it owes depositors, the bank is in good shape. Since some borrowers don't pay and some bonds go bad, banks also have money from their owners, referred to as either capital or equity, to cover those losses.

One complication for banks is that depositors can, by and large, withdraw their money at any time, but banks don't always have the same luxury. Borrowers can't be forced to repay a mortgage on demand and bond prices may have temporarily declined. To allow for this, banks always try to keep plenty of cash on hand to meet depositor withdrawals, but they cannot keep it all in cash or they would not have a way of generating the cash flow to pay interest or dividends to investors.

Past problems

In 2008, banks had a genuine problem. Assets they had carried on their books were worth less (and in some cases worthless) because of extremely lax loan standards that resulted in widespread loan defaults. That created a hole in the banks' capital and some banks were likely technically insolvent; if we added up all the money they would ever receive from their investments, the amount would have been insufficient to pay all the money that the bank owed.

Fixing this type of permanent drop in future income requires capital. Capital is risky, and as a result it's expensive, even in good times. In 2008–09, banks needed someone to replenish money that had already been lost, and that is a particularly difficult request. Ultimately, the government had to step in and provide assistance.

The easy part

Today's issue is not that the expected money from banks' assets will never be received. Many of the assets with the steepest price declines are U.S. Treasuries that we, and all market participants that we are aware of, fully expect to be repaid on time and in full.

The issue today is that more depositors than normal are demanding their cash, driven by fear of bank failure. It's a classic bank run that the existence of the deposit insurance is supposed to avoid.

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There are two ways to deal with a bank run. One is to calm depositors' fears and discourage them from removing money. To a certain extent, that has worked. Much of the money being withdrawn isn't leaving the banking system overall but moving from a few small banks to larger ones. This is not ideal for the long-term health of a competitive banking system, but it is a far cry from 2008's global financial instability. It is also why we think this is a crisis for some banks but not for the banking system.

The other way to deal with a bank run is to find new money for the bank to use. To a large part, that's already happened. The Federal Reserve's new lending facility allows banks to use central bank financing to replace depositor money for certain U.S. Treasury and mortgage bonds. Critically, the Fed allows the banks to fund the bonds at the face value of the investment, meaning that in most cases this is a near seamless transition for depositor funding amounts; it's more expensive, but it's there.

The existing Fed mechanism doesn't work for all types of bank investments. Commercial and individual loans are not homogenous risks like government bonds. But the central bank has plenty of experience in crafting joint solutions for these types of assets with the U.S. Treasury Department, where the Fed provides financing to non-government assets and Treasury absorbs any realized credit losses. Historically, these arrangements have worked to the Fed's and the government's advantage.

Turmoil in European banks could add to the pressure on certain U.S. financial institutions and potentially raise the stakes for the Fed and Treasury. But with asset quality sound and with our view that major European banks are likely to continue to perform on their obligations, we think this remains a problem well within the capacity of the U.S. government.

Moral hazard

Since the current problem should be relatively easy to solve, the obvious question is why have policymakers failed to act more decisively.

We see three reasons. First, existing legal authority to act is murky, at best. The Federal Deposit Insurance Corporation (FDIC) has wide powers to resolve banks in receivership, but absent congressional action it is relatively hamstrung in preventive moves. Second, because the overall system is not in crisis—as noted, large banks have seen deposit inflows—there is less immediate pressure on regulators to push the limits of their authority. Finally, and we believe somewhat hazardously, policymakers, in our view, are willing to see bank failures in part to combat potential moral hazards created by the 2008 bailouts. We think they are using this episode to reinforce that investors in banks—buyers of bonds, preferred shares, and stocks—are at risk if a bank fails.

While this is not necessarily a bad message to send, it is a different message than investors had perhaps believed after 2008. In 2008, we think that investors largely—and reasonably—concluded that investments made in sound financial institutions would be respected in a resolution if the bank later fell as part of an external risk event. A full government guarantee may not have been thought likely, but given the highly regulated nature of the institutions and the key role banks play in the economy, some consideration for investors may have been expected.

We are worried that policymakers may get what they seem to wish for: a sudden repricing of the risks in investing in bank bonds and stocks. If that were to occur, it could make it difficult for some banks—particularly smaller institutions—to borrow sufficient money in the public markets at economically viable rates to support their current levels of lending, let alone the type of loan growth companies have come to rely on. The impacts would likely be felt across the economy but would be especially detrimental for small businesses that rely on local lenders.

For investors, we think it is key to remember that the primary support for any investment is the fundamental underlying business and, broadly speaking, we believe the U.S. banking system's fundamentals remain solid. Even if the goalposts have moved from 2008 on the impact to investors in the case of default, that change does not directly impact investors in institutions that remain in operation. To state it plainly, we think that will be the case for the overwhelming majority of U.S. banks.

Not the end

The 2008–09 global financial crisis was a critical, if not *the* critical, financial event of the century to date. It's understandable that investors remain scarred by the event and that any word of bank failures brings fears. But we believe the underlying causes of the current market upheaval are both less substantial for the banking system and more easily controlled by existing central bank and regulatory mechanisms.

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