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Bank stresses bubble to the surface

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Interest rates have soared over the past year as the world's central banks combat problematic inflation. The purpose of the monetary tightening is primarily economic in nature: to cool housing markets, slow economies and tame inflation.

But there can also be unintended pressure on the financial system, especially when the monetary tightening is as substantial as that of the past year, and when interest rates were unusually low for an extended period of time beforehand.

There was a glimpse of this last fall when some British pension funds buckled due to an especially sudden jump in British bond yields. That was ultimately resolved via government intervention.

Now, some regional U.S. banks are under stress. These smaller banks are less strictly regulated than their larger brethren and generally hold less capital as a buffer against adverse events.

As interest rates have risen, the bond holdings of financial institutions have accordingly declined in value. Under normal circumstances, this doesn't matter much because the bonds are usually held until they mature, at which point the price of the bond is restored to its full par value.

But if a bank's deposits are being withdrawn at an unusually rapid clip, the bank may need to sell some of its bonds early so as to have sufficient liquid funds to return money to depositors. This crystallizes bond losses, eating into the bank's capital.

Under normal circumstances, this is unpleasant but not fatal. However, in the case of a small handful of U.S. banks – most prominently, Silicon Valley Bank – the problem has proved unrecoverable. Depositors left the bank at such a pace that the bank had to sell so many bonds at a loss that its capital was eroded, rendering it insolvent. The bank has since been taken over by the Federal Deposit Insurance Corporation.

It is important to understand that Silicon Valley Bank was unusually poorly positioned to survive recent headwinds. Small technology companies constituted a disproportionate share of its depositors. As the tech sector has suffered over the past year, funding dried up and such firms were steadily drawing down their bank deposits to remain afloat. Simultaneously, Silicon Valley Bank had a relatively small loan book, leaving a disproportionately high share of its assets in fixed income securities that lost value as rates rose. As these struggles came to the attention of the public, its efforts to raise money in financial markets failed and depositors withdrew their money at an accelerating clip, sealing the fate of the bank.

While only a tiny number of small U.S. banks have suffered a similar fate, there are many others with sufficient bond-market exposure that may be considerably more fragile than usual.

To prevent a wave of further failures, the U.S. government stepped in over the weekend with new policies designed to stem any further contagion:

- Whereas customers with deposits above $250,000 at a failed bank are normally exposed to losses, the FDIC has promised that all Silicon Valley Bank customers will get their money back, potentially financed by a special surcharge on the broader banking sector. This special action was likely motivated at least in part to avoid copycat bank runs, and also because more than half of the most promising small tech-oriented companies in the U.S. were customers of the bank, and had sums well above the insurance limit.
- The Federal Reserve also established a new liquidity window called the Bank Term Funding Program that allows U.S. banks to swap their bonds at face value for cash for up to a year. Thus, even if the bonds are currently worth less than 100 cents on the dollar, the Fed will lend banks the full dollar, keeping them both liquid and technically solvent for a year. A catch is that the cost of funding is fairly expensive and there is always a reputational risk to using such windows, so banks will not want to gorge excessively.

The result is that, while further bank runs remain possible, the U.S. government has arguably done enough to render such outcomes illogical: the great majority of banks should have sufficient liquidity to meet their customers' needs.

From an economic standpoint, the recent bank failures are clearly not helpful. We believe the economy was already on a recessionary trajectory. Now, financial conditions have tightened somewhat further and risk-taking in the economy will likely diminish somewhat. As such, we remain content in our longstanding view that the coming recession will be incrementally worse than that assumed by the consensus.

But it is not so much the base-case forecast that has substantially changed as the risks that surround the base case. It is certainly easier to envision a larger downside risk involving banking sector stress in the future, be it the failure of additional American regional banks or of certain vulnerable international financial institutions. More generally, rising interest rates punish leveraged players of nearly every description, including sovereign borrowers, leveraged private markets, and so on. Stresses could emerge from any of these.

There is much debate over how monetary policy will respond to this latest shock. The anticipated trajectory as recently as a week ago was for moderately further monetary tightening. U.S. Federal Reserve Chair Powell had signaled at least two further rate hikes, and was hinting that even more action might be needed to tame recent robust economic data and stubborn inflation. Now, the market is questioning whether the Fed will deliver even one 25 basis point rate hike over the next two meetings, and then anticipates rate cuts starting in July 2023.

The abrupt change in expectations for central bank policy seems overblown. Certainly the shock will dampen animal spirits to a degree and lending conditions, already tightening, will no doubt become an even greater drag on growth going forward. But inflation is still too high and growth is still too fast, and these things demand tighter monetary policy. The government response to the banking crisis so far looks credible. Central banks should thus proceed more gingerly than before with their tightening plans, but rate cuts are not probable at this juncture. Were the crisis to broaden and the economic downturn to gather intensity a result, the typical central bank response of cutting rates would put at risk recent gains on inflation, creating conditions for even more painful tightening in outlying months and, ultimately, a deeper recession in the future. So rate cuts should not be celebrated, even if they were to come.

The central message is that higher interest rates slow inflation and weaken the economy, but also expose financial system vulnerabilities. That last element is manifesting now. Our base case for the economy has been a bit softer than the soft landing embedded in the consensus, and now stress in the financial system indicates downside risks likely exceed the possibility of upside surprise. While a relatively cautious investment stance remains appropriate in the near term, we would also point out that major financial events often lead to eventual accommodation in monetary policy, a bottoming in economic activity and, ultimately a recovery in corporate earnings and investor confidence.

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