What's happening in the banking sector and should I be worried?

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Troubles at Credit Suisse have fuelled concerns about weaknesses in the banking sector. Guy Foster, our Chief Strategist, discusses what is really happening at Switzerland's second-biggest lender, the reasons behind the failure of Silicon Valley Bank, and why we are unlikely to see a repeat of the 2008 global financial crisis.

This has been a dramatic and unnerving few days for stock market investors. The collapse of Silicon Valley Bank (SVB) and Signature Bank in the US last week sparked fears about weaknesses in the banking sector. These fears have now been compounded by troubles at major European bank Credit Suisse.

It would be natural for this situation to seem reminiscent of the 2008 global financial crisis. One of the lessons from that period was not to be complacent or underestimate the potential for seemingly isolated incidents to become systemic in nature. However, there are some very significant nuances between the financial crisis of 2008 and the current stresses in banks, as well as between the different banks under pressure today.

Ultimately, the lessons learned from 2008 will be enough to prevent anything so severe from being repeated. But that is not to say some corners of the banking industry couldn't have done more to guard against the current situation.

What is going on with banks at the moment?

Over the last week we have seen two significant banks failing. Several more appear to be under severe pressure, judging by their share price performance. Banks have been sharply underperforming in recent days. They were one of the preferred sectors among many investors who expected banks to benefit from rising interest rates. As it turns out, that kind of rule of thumb is a little too simplistic for a sector which is characterised by complexity and fragility.

Why is this happening? It is worth remembering why we have banks in the first place. Banks facilitate economic activity by intermediating between borrowers and lenders. This is risky business. Banks could make loans which don't get repaid (credit issues), or they could suffer more withdrawals of deposits which they are unable to meet (liquidity issues).

Banks, primarily their shareholders, bear this risk. The bank's capital is what prevents losses on loans from being suffered by depositors. It is referred to as a buffer. If a loan goes bad it will diminish the bank's capital until that capital has been fully depleted, at which point other creditors would suffer. With good reason, depositors are at the very back of the queue when it comes to suffering losses and, in practice, they have generally been protected by either formal or informal state guarantees.

What happened at Silicon Valley Bank?

SVB had an unusual depositor base drawn primarily from startup businesses. This is important because it means they had extremely large deposits. These kind of startup businesses often survive by living off large injections of capital, which come in funding rounds which will be months or even years apart. Each round will result in large deposits of cash which can then be drawn upon until the business becomes self-sustaining. Many of these funding rounds took place during 2021, during which time SVB's deposits almost doubled.

In the US, deposits of $250,000 or less are subject to insurance from the Federal Depository Insurance Company, but most of the deposits made at SVB were well above this limit.

The biggest deposits were made during 2021. At the time, interest rates were very low, so in order to be able to earn money from these large deposits SVB bought holdings of high-quality bonds. In order to earn a profit, it had to buy long-term bonds. As interest rates rose, the prices of those bonds fell and selling them early would mean suffering a loss. This became inevitable due to withdrawals.

Although SVB suffered a liquidity problem (triggered by withdrawals), resolving it by selling securities would turn it into a credit issue. In fact, ultimately this had the power to wipe out all of the bank's capital, rendering it insolvent and theoretically subjecting creditors, including depositors, to losses.

Most banks did not share the same unusual profile of large uninsured deposits by business that needed to withdraw them regularly. But when SVB and the smaller Signature Bank failed, all deposits were protected anyway, implying that insurance covers all deposits, and reducing the tendency of bank runs to take place.

Regulators also established a mechanism to allow banks to borrow against the redemption value of their bond assets, rather than the current market value; this avoids the need to sell bonds below the price paid for them in a way that would cause losses and deplete capital. Effectively, that prevents the problem that SVB had from happening at other US regional banks.

What's happening at Credit Suisse?

Unlike SVB, Credit Suisse doesn't have a credit or a liquidity problem at the moment. Also, unlike SVB which is a regional bank, Credit Suisse is a 'global systemically important bank' (G-SIB). This means it is subject to greater scrutiny than regional US banks (who collectively lobbied hard to stay outside of the requirements of the Basel III framework of banking reforms).

Since the financial crisis, banks have been under pressure from regulators, but above all from shareholders, to ensure that their capital and liquidity positions are robust. Banks are required to hold twice as much capital as they did prior to the financial crisis, but most have gone further. Credit Suisse is no exception, confirming that it plans to comfortably exceed mandatory capital requirements throughout a costly structuring process. All banks must be in a position to bolster their capital should anything occur that would deplete it; again, Credit Suisse goes beyond the minimum requirement in this regard. Capital, remember, is that part of the business which protects depositors from any losses the bank may suffer on its lending.

From a liquidity perspective, Credit Suisse also has a diverse depositor base and assumes that some of that will move quickly, as has indeed been the case. It would be required to show the effect of falling bond prices on its capital position in a way that smaller US regional banks would not.

Credit Suisse's current travails stem not from its financial stability, where it holds surplus capital and liquidity, but from the fact that it has found it hard to operate profitably without lending to the wrong entities or the wrong people and being embroiled in controversy. Its reputation as a competent and conservative Swiss bank has been impaired and it has seen high, but manageable, deposit withdrawals.

Credit Suisse's management have been open about its shortcomings and are planning a turnaround, but they have warned that this will be a long process. Losses suffered during 2022 will likely continue into 2023 as it reorientates itself. They are asking for patience from investors whom they hope will take heart from a strong balance sheet.

Its financial stability has been reiterated by the regulators and it has been given access to a loan facility, which allows it to buy back some of its own bonds while they trade at currently distressed prices. This bolsters its capital position further.

Despite this, Credit Suisse's future as an independent corporate entity cannot be assured at this stage. Having tried the patience of its investors for some years, that patience is now wearing thin. This led Saudi National Bank to announce that it would not be investing more in the bank, which further undermined confidence.

Is another financial crisis on the cards?

Silicon Valley Bank targeted a fast-growing part of the market. Its focus led it to be heavily reliant on depositors who moved as a pack. This business model is naturally fragile. Management then made the unusual decision to allow a dramatic mismatch between the effective liquidity of the bank's assets and its liabilities (deposits). It was able to do this because it is a less strictly regulated regional bank. Bank failures are more common than you might think in the US because of its fragmented regional banking system. A handful of failures take place most years. Most of the failures are small and deposits are insured, making their demise not particularly newsworthy. SVB was unusual because it was relatively large and its deposits were too large to be entitled to deposit insurance (but when push came to shove, they were covered anyway).

Banks as an industry rely upon trust. Being able to point to sound liquidity and capital position should enable banks to maintain that trust but, ultimately, if panic spreads, then their failure can become a self-fulfilling prophecy.

What can be done about the collapsing confidence in banks? Sometimes, state intervention is necessary. This can include a public show of support, the provision of liquidity, pushing a troubled institution into the arms of willing (or reluctant) suitor, more forceful restructuring and, as a last resort, nationalisation. While it can be controversial at the time, the costs of intervening to support the banking sector almost always outweigh the costs of not doing so.

The eventual safeguards therefore remain the state and central bank's ability and willingness to restore confidence and, if absolutely necessary, accept the systemically important liabilities of the banking system (including, but not limited to, its depositors). Doing that in the aftermath of the financial crisis exposed taxpayers to substantial financial risk. That is what drove the development of the Basel III accords. These accords mean that systemically important banks like Credit Suisse are regulated and that their liabilities can be assumed without taxpayers being subjected to losses.

Addressing the undercapitalised state of banks serves an important role in mitigating the chances of another financial crisis. However, other mitigating factors are also present. The financial crisis reflected the implosion of a credit bubble. During the bubble, consumers amassed excessive amounts of debt. Mortgages were sold to consumers who could not repay them. A housing bubble emerged in which buyers felt confident that they could flip a property for more than they paid for it. In response to high house prices, house building also accelerated. The confluence of all these factors on a banking system which was undercapitalised caused the financial crisis. In 2023, alongside the much better capitalised banking system, houses remain in short supply and consumer credit has generally declined as a share of gross domestic product (GDP).

The combination of stronger balance sheets at banks, and stronger consumer balance sheets, makes a second great financial crisis less likely. We will, of course, continue to monitor the situation very closely over the coming days, weeks and months.

Are there wider implications?

The current turmoil in banks does have wider implications. The banking system also serves as the mechanism by which monetary policy is transmitted into the real economy. Changes in interest rates are designed to change the levels of borrowing and saving within the economy, but these will also be influenced by other factors and material amongst them is the risk appetite of banks.

If banks feel that investors are sceptical about their financial stability then they are likely to lend more cautiously, which effectively tightens monetary policy. For that reason, uncertainty about the future direction of interest rates has soared since SVB failed. At a time when rising interest rates have caused problems for some banks, policymakers might be tempted to refrain from raising rates again until calm has been restored.

On Thursday, however, the European Central Bank (ECB) proceeded with an interest rate increase which had been very much expected prior to the increase in volatility. Raising interest rates by half a percent makes this a relatively large move for the bank. It suggests the ECB does not wish to confuse its dual priorities of maintaining price stability (controlling inflation) and maintaining financial stability (ensuring the smooth functioning of the financial system).

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Guy leads RBC Brewin Dolphin's Investment Solutions team working to align our investment capabilities with the needs of clients. He also provides recommendations on tactical investment strategy to our investment managers and strategic recommendations to the group's Asset Allocation Committee. Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. He frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of RBC Brewin Dolphin.

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