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CHARLES STANLEY

Patrick Farrell, Chief Investment Officer and Head of Research, Charles Stanley

Markets rocked by failing banks

The banking sector has seen several casualties in the past two weeks. Most recently, UBS was coerced into buying its long-term rival Swiss bank Credit Suisse, whilst in the US, some smaller banks are struggling as depositors seek more secure options. While this impact on confidence, if left unchecked is a cause for concern, we do not believe this is a repeat of 2008.

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Stock markets have fallen in recent weeks as concerns about the financial health of some banks on both sides of the Atlantic have spread. The most significant of these centred on Swiss bank Credit Suisse, but regional US banks, such as Silicon Valley Bank, Signature Bank and First Republic, have also needed government assistance to protect depositors.

With memories of the banking crisis in 2007/08 still relatively fresh, this has caused some concern amongst investors that we could once again experience a major problem in the global banking system that could lead to a sharp recession. However, although the issues faced by some banks are real, they are issues for individual banks in idiosyncratic situations. Overall, banks are well capitalised and stringently regulated, particularly following the tighter regulations post 2008. Therefore, the likelihood of a broader systemic problem in the sector is low.

However, sharply rising interest rates in the US have hit the value of government bonds and for some banks have caused mismatch issues between their lending book and asset book. Some of this problem has abated with recent bond market moves, easing some of the stress for other banks.

Two of the banks were also highly exposed to customers that have been experiencing financial stress and needed to withdraw money fast. Silicon Valley Bank was heavily exposed to the technology sector, particularly start up organisations, which rely extensively on debt to fund day-to-day operations, so they have had to withdraw more cash. Signature Bank has a lot of clients in the cryptocurrency sector, a sector that has been experiencing a lack of confidence following recent high profile fraud accusations.

Confidence is also essential in the banking sector. If a business or individual is not confident that their money is safe at a bank, then they will withdraw it. A major fall in confidence can create a run on a bank when it doesn't have sufficient cash on hand to meet the withdrawal demands from their depositors.

However, after learning important lessons in the financial crisis and resulting "credit crunch" earlier this century, authorities swifty acted to try and nip these problems in the bud. Central banks, government agencies and regulators all stepped in, with the central focus being the protection of bank deposits. In Europe, Credit Suisse is being taken over by Swiss rival UBS in a deal worth US$3.25bn. Central banks across the world have taken co-ordinated action to ensure that the flow of money around the world continues unhindered – making sure liquidity is available to those that need it.

A crisis in confidence can quickly turn into a crisis in the financial system, however, and swift co-ordinated actions are required in the form of further reassuring announcements from regulators, central banks and governments to stem these concerns and provide a degree of stability.

The aim of these actions is to provide a circuit breaker to a potential cascade of concerns and improve stability and henceforth, confidence. It seems likely that some smaller US regional banks could be hit by the same issues in the next few weeks, as well as some weaker European banks so it will be important for regulators to act quickly.

What does this mean for central bank policy?

This represents a modest relaxation of Fed monetary policy. The main cause of the collapse seems to have been worries about Silicon Valley Bank seeking to raise additional capital because of losses on its bond and mortgage securities portfolio. This alarmed some depositors, and led to the attempted withdrawal of funds, triggering more sales of bonds and mortgage securities at a loss. Silicon Valley Bank is a casualty of quantitative tightening and rising interest rates.

Against this background a 50-basis-point rise in US interest rates at the next meeting seems unlikely. The latest economic

data provided more mixed news from the labour market. There was a rise in unemployment and slowing wages set against the fast pace of jobs growth in some sectors, and wage growth remained higher than the Fed would like. This balance gives the Fed reasons to avoid unduly hawkish actions, assuming it has to continue to reassure markets about the stability of the banks.

It is all a timely reminder that a tough money squeeze designed to stem inflation can have unwanted consequences. The technology sector is already reducing its workforce and experiencing more constrained profits and cashflows. Technology companies that used Silicon Valley Bank as an industry-friendly service provider could not afford to lose their deposits, which often represented money held there to pay wages and their suppliers. These events provide a further limit on how high the Fed needs to take rates in order to slow the economy.

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