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Decomposing current bank worries

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- **The banking sector has been in the spotlight again in financial markets**
- **This reflects the failure of two US banks as well as concerns regarding Credit Suisse**
- **Credit Suisse issues are mainly related to credibility, as the bank looks solid from a fundamental point of view**
- **Very early signs are that the steps taken by Swiss authorities and this morning's capital injection seem to have turned the tide**
- **We see Credit Suisse as a special case, which was also reflected by the fact that spreads of other banks' bonds widened by less than Credit Suisse**
- **We also assess the extent to which European bank are exposed to the risks seen in the US**
- **We find that a relatively large part of deposits in Europe are covered by the Deposit Guarantee Scheme**
- **European banks also have lower investments as share of total assets, reducing risks of changes to asset valuations**
- **Overall, recent developments can be seen as a wake-up call for the sector, as it will not be immune for the sharp rise in policy rates**
- **We expect pressure on funding costs and larger differentiation between larger and smaller banks**

Introduction

The banking sector has been in the spotlights in financial markets, with last week's failure of two US banks as well as concerns about the viability of Swiss bank Credit Suisse leaving their mark on equity as well as bank bonds. Below we address these concerns, showing that the sell-off is largely driven by a lack of trust rather that fundamentals. We also compare the situation in the US with that in Europe.

What are the worries surrounding Credit Suisse?

Yesterday, Credit Suisse's (CS) share price ended the day at an all-time low, while its CDS spreads skyrocketed, implying that investors were judging that the bank needed to be rescued. Yesterday's developments came as a bit of a surprise, although CS had been one of the most beleaguered banks for a while, given that it has been surrounded by negative headline news as well as doubts about the execution of its strategic review.

Credit Suisse equite price

In CHF

Source: Bloomberg, ABN AMRO

Credit Suisse CDS spread

5y EUR CDS spread, bp

Source: Bloomberg, ABN AMRO

We think that the market movements were driven by the delayed publication of its annual report on Tuesday (see here), which included the statement of its auditor about weaknesses in the bank's internal controls over financial reporting. This likely further eroded investor's credibility in the bank. On top of that, there was the news that its largest shareholder (the Saudi National Bank) noted that it would be unable to raise its equity stake in the bank. However, this was mainly due to regulatory and statutory reasons (e.g., a higher than 10% equity stake would make it fall under 'all kind of new rules' in different regulatory regimes, which it is not allowed to). Finally, the recent failure of two US banks has made investors much more cautious on the sector, bringing 'problem' banks under even more scrutiny.

Overall, markets started to doubt the viability of Credit Suisse, which resulted in the stark market movements, while eyes were also on the Swiss Financial Market Supervisory Authority (FINMA) to see whether it would take action to stem market jitters. During the day, the regulator refrained from doing so, but in the evening the FINMA, together with the Swiss National Bank, released a statement (here) saying:

'*The problems of certain banks in the USA do not pose a direct risk of contagion for the Swiss financial markets. The strict capital and liquidity requirements applicable to Swiss financial institutions ensure their stability. Credit Suisse meets the capital and liquidity requirements imposed on systemically important banks. If necessary, the SNB will provide CS with liquidity*'.

This morning, CS announced (here) that it will used the central bank's credit line, borrowing CHF 50bn, of which it will use CHF 3bn to buy back some senior debt securities. It will tender ten USD denominated bonds for an amount up to USD 2.5bn, while the tender offer also includes four euro-denominated senior bonds up to EUR 500mn. Furthermore, CS noted that the use of the credit facility would strengthen its liquidity position by CHF 39bn.

Are the authorities right about the strength of Credit Suisse's balance sheet?
We tend to agree with the FINMA/SNB statement, as the bank looks solid from a fundamental point of view. For starters, the bank has a CET1 ratio of 14.1%, which is roughly the average of the CET1 ratios of the largest banks in the iBoxx euro senior bail-in index (see graph below). In CHF, the bank has CHF 50bn of Tier 1 capital, which added with CHF 49bn of bail-in debt instruments, gives CHF 99bn of total loss absorbing capital. This compares to a total balance sheet of CHF 531bn (and CHF 651bn of leverage exposure) and total risk-weighted assets of CHF 250bn (at the end of 2022). What is more, the almost 40% total loss-absorbing capacity exceeds the 25.1% required by the Swiss regulator. As such, the bank seems relatively well positioned to absorb strong headwinds, which was also mentioned in the FINMA/SNB statement.

CET1 ratio of banks with most EUR senior bail-in paper outstanding, %

Source: Bloomberg

Meanwhile, the bank had around CHF 264bn of net loans on its balance sheet of which CHF 151bn consumer loans (CHF 108bn mortgages) and CHF 115bn corporate & institutional loans. Of total net loans, only 1.3% were impaired loans, which seems also limited and not out of line with other banks.

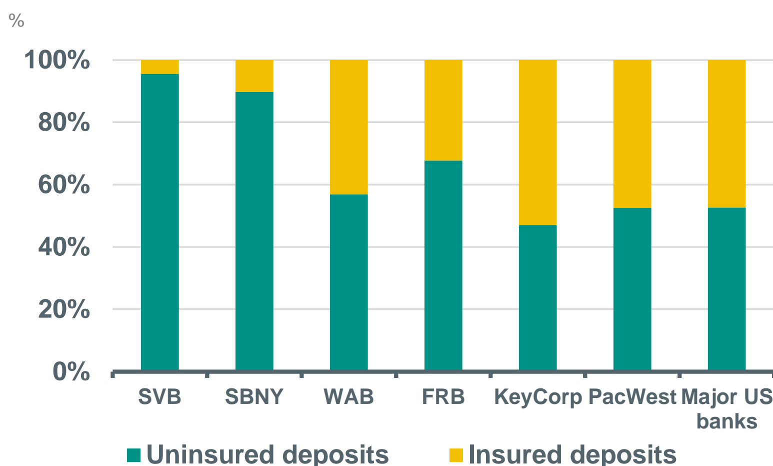
Is Credit Suisse a sign of broader weakness in the banking sector?

We do not think so and we see the CS situation as a special case. The bank had already to cope with fragile investor confidence, having been plagued by a string of negative news events, while it is also the reason why it announced its strategy overhaul in October last year. So far, the bank has not been able to regain investor confidence, with yesterday's events marking a new low. Moreover, the bank does not expect to be profitable again until 2024. That CS is a special case was also reflected by the fact that spreads of senior bail-in paper of other banks have widened much less on a z-spread basis this week. While CS bonds have widened by almost 700bp, this is 20bp for the index as a whole. Interesting to note is that the bank bonds of its Swiss peer UBS have widened by 16bp this week. Today, the mood has turned for the better following the liquidity injection, with equity and bond prices regained some ground.

But to what extent are European banks exposed to risks seen in the US?

Overall, we think that European banks are less exposed to the risks that triggered the failure of Silicon Valley Bank (SVB) and Signature Bank (SB) in the US. This is by the way also true for the larger US banks. Firstly, SVB's and SB's ran on deposits was aggravated because these banks had a very large share of uninsured deposits (96%). This compares, for instance, to an average share of around 50% for the larger US banks.

Share of (un)insured deposits at US banks



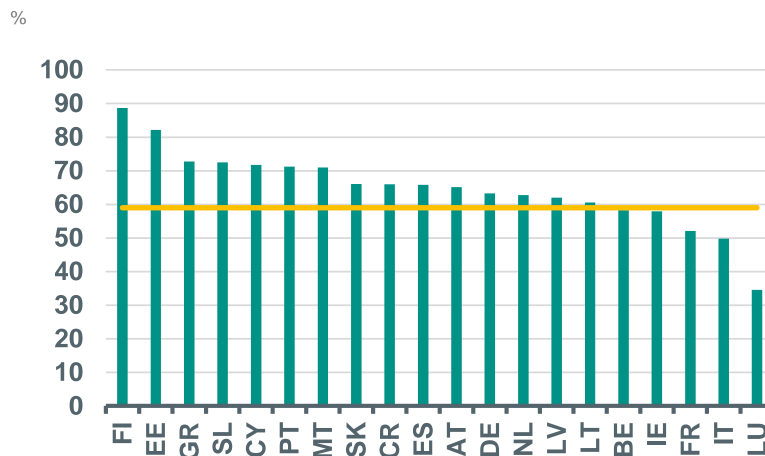
Source: Bloomberg, bank reports, ABN AMRO

In Europe, the deposit guarantee scheme (DGS) protects household and corporate deposits up to EUR 100K. Data from the European Banking Authority from end 2021 shows that roughly 60% of bank deposits stem from households (in SVB's case the majority was from venture capitalists), while we estimate that almost 60% of household and corporate deposits were guaranteed by the DGS at that time. Taking total bank deposits (so including these from insurers, pension funds and other financial corporates), the coverage ratio remains roughly 50%.

The graph below shows that coverage is highest in Finland and lowest in Luxemburg and Italy. The latter is likely reflecting the relatively high net worth of Italian households, which also implies that

they will have placed larger savings at banks. All in all, this suggest that the risks of a bank run of the type that SVB experienced is likely to be lower in Europe.

% of household and corporate deposits guaranteed by DGS



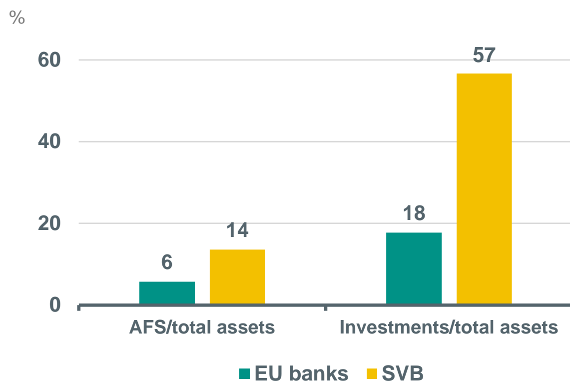
Source: EBA, ECB, ABN AMRO

But don't European banks also have large investments?

Another factor why SVB went bust last week was that it had invested large amounts in (longer-dated) government bonds and agency debt, which it had to sell with a loss due to the sharp rise in interest rates. As a result, focus has turned to the potential losses for banks on their investments. In this case, it is worth highlighting that banks can invest in securities that they can label as 'hold-to-maturity' (HTM), implying that they do not have to keep these investments at market value on their balance sheet, or as 'Available-for-Sale' (AFS), when changes in their market value are reflected on the balance sheet (and P&L). So, it is the unrealised losses/gains related to banks' AFS portfolios that matters most, although banks faced with deposit outflows might need to sell part of the HTM portfolio as well.

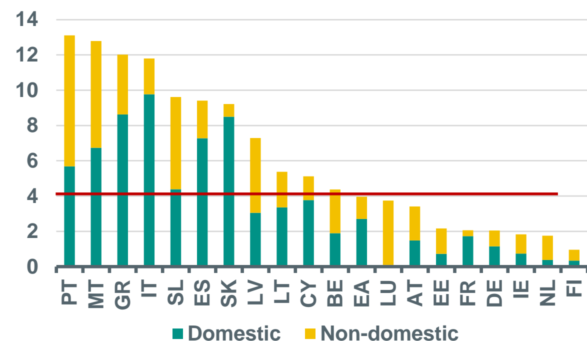
SVB had 14% of its assets invested in its AFS portfolio, while its total investments as share of total assets was 57%. In the EU, banks have 6% of total assets invested in AFS portfolios (although data not available for all banks), while their total investments are only 18% of their total balance sheet. This should make them less prone to sharp valuation changes. Furthermore, there are some discrepancies between banks in different countries. Peripheral banks are, for instance, most exposed to investments in euro area/domestic government bonds, with mostly 10% or more of their assets invested in these securities. French, German, Irish, Dutch, and Finnish banks have less than 2% of total assets invested in euro area government bonds. Overall, also in this case, it seems that banks in Europe are less exposed to large losses on their investments than SVB.

AFS and total investments as % of total assets



Source: Bloomberg, bank reports, ABN AMRO

Share of total assets invested in government bonds



Source: ECB, ABN AMRO

Finally, it is worth noting is that the ECB already conducted an exercise at the end of last year assessing the vulnerability of the euro area banking sector to a strong flattening/steepening of the yield curve (see here). This exercise was conducted to estimate the impact of the sharp increase in interest rates due to central banks forcefully raising policy rates. The stress test revealed that most banks were well positioned to cope with the sharp rise in interest rates. It also underlines that the ECB has already been aware of the risks that the sudden rise in interest rates could pose to the banking sector for some time. As a result, the central bank should also be well positioned to identify the banks at risk, telling them to take action to stem these risks.

Thus all is fine in the banking sector?

No it is not, as recent developments, and mainly those in the US, show that the banking sector will not be immune to the sharp rise in policy rates, and consequently base rates. Financial markets have been rather complacent since Q4 of last year, anticipating a goldilocks scenario in which economies would manage a soft landing with inflation eventually also coming down. However, the sharp increase in interest rates now start to show some cracks in the system. Looking forward, we expect economies in the US and the eurozone not to escape a recession, which is likely to result in higher loan-losses for banks. At the same time, banks still benefit from the fact that interest rates are back into positive territory, which should support net interest income.

Having said that, some side-effects of the recent turmoil in the banking sector is that bank funding costs are likely to rise further, especially for smaller banks. This, in turn, could start a battle for deposits, which remain the most attractive source of funding. However, this will lower growth in net interest income, which, together with higher loan-losses, is likely to weigh in bank earnings. As this is particularly true for smaller banks, investor appetite is likely to favour larger banks.

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