US ECONOMICS UPDATE

Could the pandemic trigger another banking crisis?

- **The coronavirus-related recession will lead to a marked increase in defaults on bank loans but, while that will hit earnings and justifies the sharp sell-off in banking stocks, the greatly improved financial health of banks means that we don't believe this represents a systemic risk to the banking system.** In particular, we think the risk of a GFC-style adverse feedback loop developing – in which mounting losses in the banking system trigger a further contraction in credit, additional asset price declines and, consequently, even greater loan losses – is quite low.
- The increase in the spread between unsecured three-month LIBOR and the corresponding T-bill rate has raised fears of a renewed crisis in bank funding. But **it is important to remember that LIBOR is being phased out and isn't a particularly useful gauge of anything these days given how low trading volumes have fallen. Its replacement, the Secured Overnight Funding Rate (SOFR), which is basically a repo rate, indicates that borrowing costs have fallen to zero** and, in particular, there has been no repeat of the temporary liquidity shortage that caused a spike in rates last September. (See Chart 1.) Even three-month LIBOR is lower than it was a month ago, it just hasn't fallen as much as the corresponding T-bill rate.
- **Commercial bank's balance sheets are much stronger than they were in 2008**. In part thanks to the Fed's bigger balance sheet, overall deposits are far bigger than overall loans, banks are holding a lot of cash, which is mostly reserve balances held at the Fed, and short-term borrowing is roughly the same size as it was in 2008, even though the overall size of banks' balance sheets is now double what it was back then. (See Chart 2.) **The loan-to-deposit ratio remains below its historical average and is a long way off the record high going into the 2008 crisis**. (See Chart 3.)
- In recent weeks, commercial banks' cash holdings and deposit balances have increased markedly, mainly as a result of the Fed's asset purchases. When the Fed buys a Treasury bond or note, the seller deposits the cash into a commercial bank, where it is added to cash holdings. Commercial banks have also seen a surge in overall loans**, which is mostly businesses drawing on pre-arranged lines of credit**. (See Chart 4.)

(Continued overleaf)

Chart 1: Short-Term Money Market Rates (%)

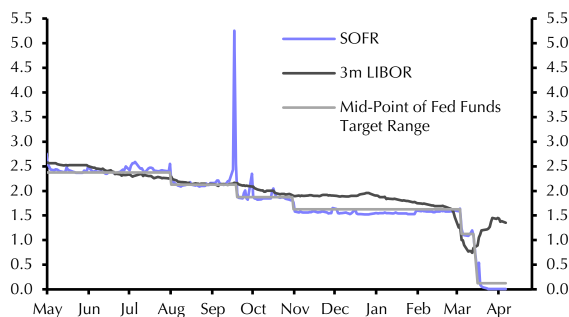


Chart 2: Commercial Banks - Assets & Liabilities ($bn)

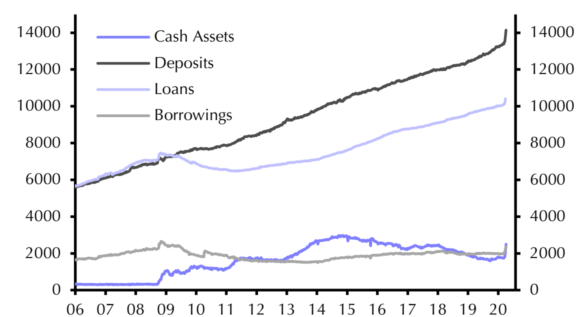


Chart 3: Commercial Banks - Loan-to-Deposit Ratio (%)

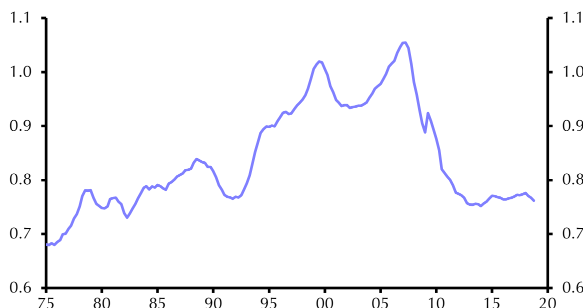
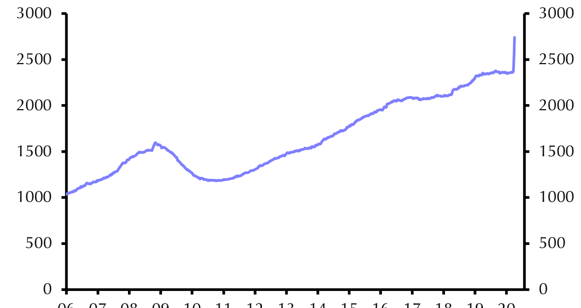


Chart 4: Commercial Banks - C&I Loans ($bn)



Source: Refinitiv

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- There was a similar, albeit smaller, surge in the use of lines of credit during the GFC. **But given the elevated level of non-financial corporate debt, it could be more of a threat because of the potential for a bigger increase in business bankruptcies**. Banks were slightly more exposed to the collapse of the housing bubble and the associated surge in mortgage default rates from 2007 onwards, with residential mortgages accounting for almost 30% of total loans at that time. (See Chart 5.) But commercial and industrial (C&I) loans account for 25% of loans now and we arguably should be including commercial mortgages too, which account for another 22%. Nevertheless, it is important to remember that total loans are also a much smaller exposure for commercial banks than they were during the GFC – 55% of total assets, down from 64% at end-2007. **As a share of overall bank assets, rather than just total loans, C&I loans account for a more modest 14%**, barely changed from 13% at end-2007.
- More generally, **while the surge in non-financial corporate debt over the past decade could become a big problem, it doesn't represent a systemic risk for banks because most of that expansion was funded via corporate bonds and other types of loans (i.e. leveraged loans)**. (See Chart 6.) This could generate massive losses for the holders of corporate bonds – foreigners (who own 28.0% of the outstanding supply) US life & property insurers (26.3%), mutual funds & ETFs (20.4%), and pension funds (10.2%). But US banks hold only 3.5% of outstanding corporate bonds, worth $500bn. **The upshot is that corporate debt defaults are going to hit Asian life insurers harder than US banks.**
- Admittedly, **the losses on loan defaults could still prove painful for commercial banks** but, as long as the lockdowns are lifted within a few months, we anticipate that banks will be able to absorb those losses within operating profits, even allowing for the impact of the flat yield curve on the latter. The overall charge-off rate for bank loans has a close relationship with the unemployment rate. (See Chart 7.) Our forecast that the unemployment rate will peak at around 12.5% does suggest the charge-off rate will rebound to 3%, matching the peak during the GFC. But there are two mitigating factors. First, the spike in unemployment is likely to be much shorter since many people are on temporary layoffs and will return to work when the lockdowns are lifted. Second, the Treasury and the Fed have already set up schemes to provide emergency financing for affected households and businesses.
- Finally, **even if bank loan defaults reach unprecedented levels above the 2009 peak, banks have far more capital on hand than during the GFC to absorb those losses**. (See Chart 8.) **The upshot is we think the risk of an adverse feedback loop developing between the banking system and the economy is low.**

Chart 5: Commercials Banks - Share of Total Loans (%)

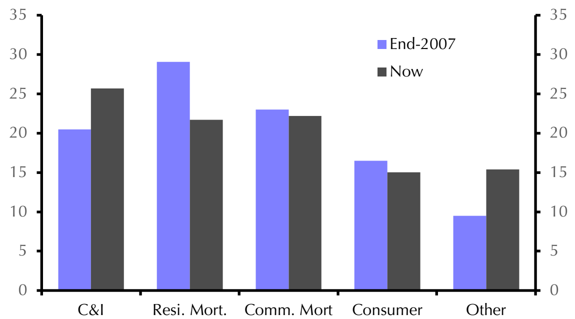


Chart 6: Non-Financial Corporate Debt (As % of GDP)

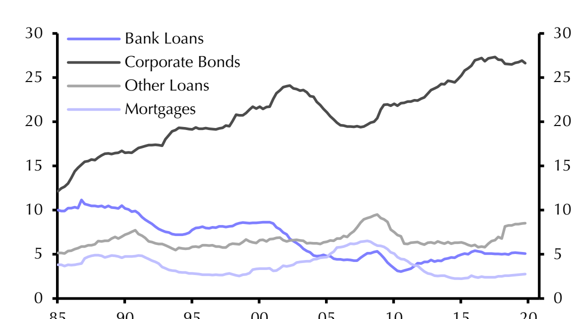


Chart 7: Banks - Charge-Off & Unemployment Rates (%)

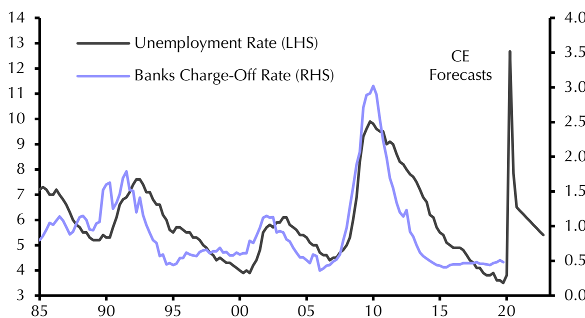
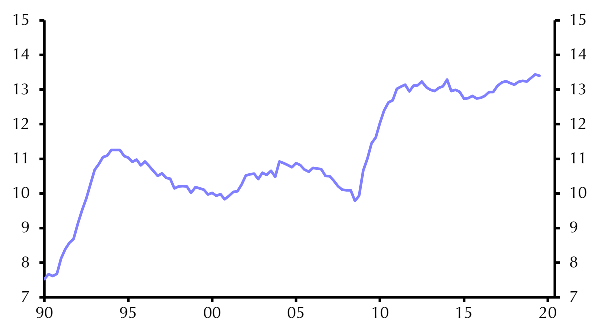


Chart 8: Banks - Tier 1 Capital Ratio (%)



Sources: Refinitiv, FDIC

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