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SECTOR COMMENT
14 March 2023

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Banking – Europe

European bank balance sheet structure limits contagion from distressed US banks

The failures of Silicon Valley Bank (SVB) and Signature Bank and receivership of Silvergate Bank (Silvergate) disrupted financial markets in the US and beyond. US authorities' announcement that all depositors of Silicon Valley Bank and Signature Bank will be made whole will buffer the impact of the banks' failures on depositor and investor confidence in the US, and we expect the direct impact on banks beyond the US to be small, though root causes and second order effects bear close watching.

Monetary tightening likely still has some way to run, and developing stresses in the US banking system will also weaken investor confidence and heighten funding tensions for European institutions that, as with any bank, by construction combine maturity mismatches with leverage. These effects are magnified when rates increase faster than expected, which causes some fixed-rate assets to fall in value and liabilities to start repricing upward more quickly than assets roll off and are replaced.

However, a critical difference between the European and US systems, which will limit the impact across the Atlantic, is that European banks' bond holdings are lower and their deposits more stable, having grown less rapidly. While European banks' debt securities grew by 10% in the 12 months to June 2020, it was their cash placed at central banks that ballooned, in response to the ECB's TLTRO programme and the resulting arbitrage opportunity available. This has resulted in some structural differences between Euro area and US banks.

» **Cash at central banks is a bigger part of European banks' balance sheets, and debt securities a smaller part**. Debt securities are about 12% of euro area bank balance sheets, versus over 30% for US commercial banks, and about 40% of Euro area banks' holdings are government securities, versus about 80% government and agency securities for US banks. EU banks are also subject to capital requirements on interest rate risk in the banking book. This means that European banks have less exposure to market risk on bonds, despite a similar rise in yields on the five-year benchmark from 2020 lows.

» **Deposits are likely to be more stable in Europe**, having grown far less rapidly in the first place, and all EU banks are subject to liquidity coverage ratio requirements.

» **Strong cash balances at central banks** totalling 16% of assets means European banks are less likely to require recourse to selling securities and realising any losses.

» **Both the BoE and ECB have well-developed contingent liquidity facilities** which are actively utilised by the banks.

These critical differences do not make European issuers invulnerable. When confidence is punctured, contagion can be rapid. Banks' balance sheets are by definition leveraged, run maturity mismatches and are often complex and opaque, with interlinkages and exposures that are often only known after the event. In addition, the ECB likely has further to run in its tightening cycle than the Federal Reserve, and although close to half of the TLTRO has now been repaid, this leaves €1.2 trillion outstanding that has to be withdrawn. So the full effects of monetary tightening may yet lie ahead.

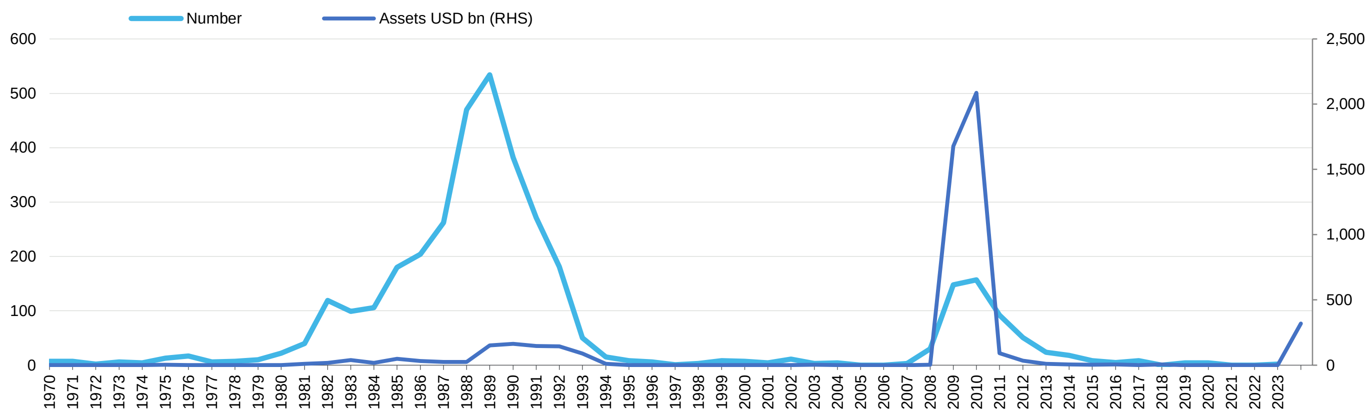
Bank failures typically point to broader implications for the financial sector; however, there have been key differences in monetary policy and deposit dynamics between Europe and the US

Bank failures are generally rare but tend to occur in clusters in response to shocks. In recent times, there have been two main such clusters in the US (Exhibit 1), one in the late 1980s and early 1990s (the savings and loans crisis) and a second in the late 2000s (financial crisis).

Exhibit 1

US bank failures were concentrated around major shock events

Number and asset size of US bank failures



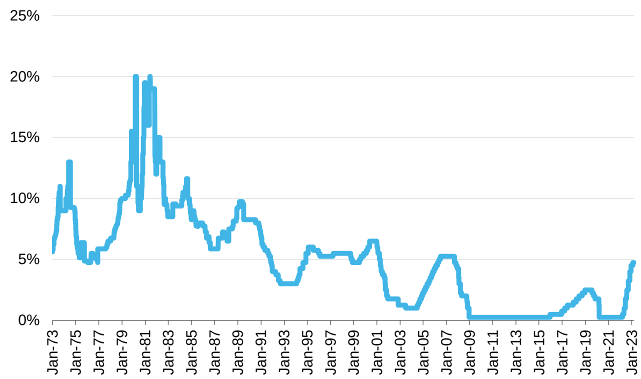
Source: Federal Deposit Insurance Corporation

Each wave of bank failures was preceded and to some degree triggered by rising interest rates followed by falls in economic output and real estate prices (Exhibits 2 and 3).

Exhibit 2

US policy rates increased ahead of the episodes of concentrated bank failures and are on the rise

Federal funds target rate (until December 2008) and upper limit (since December 2008)

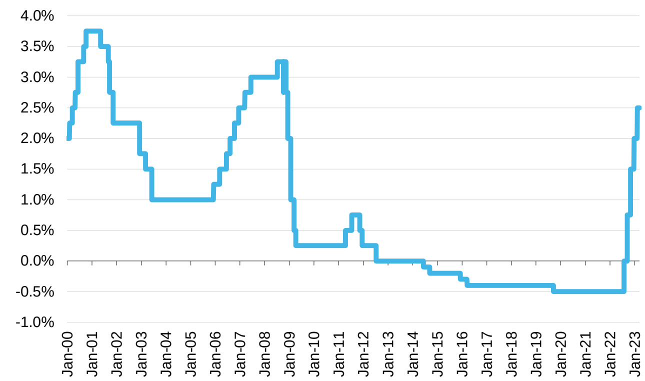


Source: St. Louis Federal Reserve, Factset

Exhibit 3

Euro area policy rates are approaching the levels reached in the ECB's early years

ECB deposit rate



Source: European Central Bank

Any new failure prompts the question of whether an individual failure reflects idiosyncratic considerations or whether similar characteristics and interlinkages will lead to a contagion effect and further bank failures.

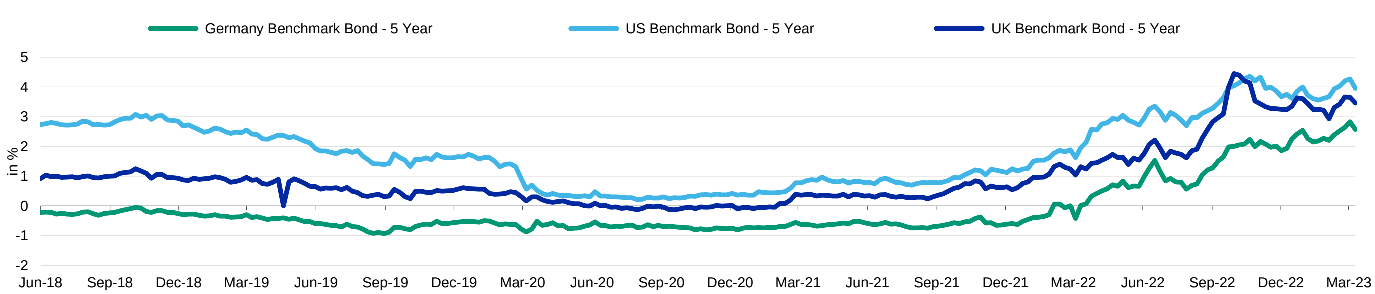
What is fairly clear is that an inflation shock and rapid reversal in monetary policy in both the US and Europe will likely have further consequences for the financial sector. The US, Euro area and the United Kingdom (UK) have all had sharp rises in policy rates and bond yields since late 2021 (Exhibit 4), and central banks have begun withdrawing liquidity by shifting to quantitative tightening (i.e., selling securities back into the market rather than buying them, or simply not reinvesting the proceeds of maturing debt, and hence shrinking their own balance sheets).

While the liquidity supply has been scaled back, banks in the euro area, and more prominently the UK, have continued to benefit from central banks' well-developed contingent liquidity facilities. Under these arrangements, banks pre-position a broad range of eligible assets, enabling them to source secured central bank funds quickly. Such a broad arrangement was previously not available in the US and was put in place as the Bank Term Funding Program (BTFP)[1] on Sunday by the US regulators.

Exhibit 4

Treasury yields have risen sharply in Europe and the US since late 2021

Five-year treasury yields for the US, UK and Germany



Source: FactSet

The consequent rise in rates has initially driven net interest margins higher, for the most part, as many assets such as variable rate loans and deposits at central banks have repriced more quickly than many liabilities (most notably, current account deposits). This is positive for banks, especially in Europe, where negative interest rates have ground down deposit margins over many years. Earnings have risen as a result, providing a greater buffer to absorb credit losses, which for the most part have yet to rise materially despite the economic slowdown in Europe because of the energy shock.

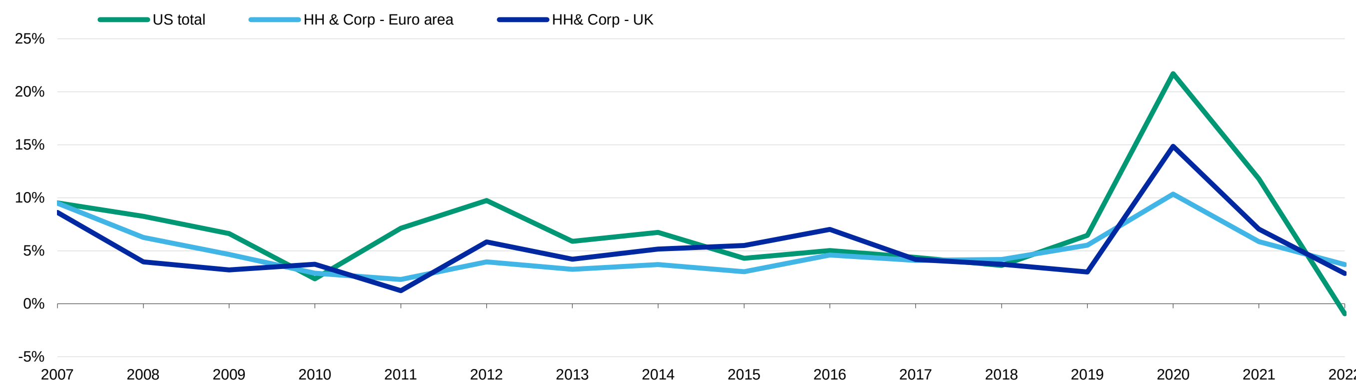
However, the shift in monetary policy has been particularly rapid in this tightening cycle, with broad implications for banking systems. The excess savings generated in the pandemic, boosted by direct stimulus in some cases, has along with quantitative easing resulted in considerable deposit creation that ended up on banks' balance sheets. Banks were nonetheless fairly restrained in lending and, hence, loan-to-deposit ratios fell. The excess funds were therefore placed in part in central bank cash, and in part in high-quality liquid securities.

In the US, this trend was particularly acute, with deposits growing by 49% in Q2 2020. On the asset side, this was accompanied by growth in Treasury and agency securities of more than 20% in both 2020 and 2021, while cash assets also jumped. In the last few quarters, deposits have started to shrink, falling 5% in Q4 2022 (Exhibit 5). In addition, there has been a shift from sight deposits to time deposits, given the extra yield available. Treasury holdings and cash assets have therefore also begun to shrink.

Exhibit 5

Massive deposit inflows during the pandemic have abated and turned negative in the US

Year-on-year change in the stock of deposits



HH = Households, Corp = Corporates

Sources: European Central Bank, Bank of England, Federal Reserve

In the euro area, economic and monetary stimulus in response to the pandemic functioned differently. Deposits grew in response to higher savings rates, but less dramatically: the annual growth rate in corporate nonfinancial deposits peaked at almost 20% in October 2020, while that of households peaked at 8.4% a few months later. Sight deposits have so far remained dominant, and the shift into term deposits has started only slowly in recent months.

Similarly, the UK had material deposit growth in 2020, which peaked at an annual growth rate of 16% in February 2021, as households and companies reined in their spending and investment. Since credit demand was muted, these inflows generated very strong liquidity for UK banks, which was supplemented by cheap funding under the Bank of England's term funding scheme, with additional incentives for small and medium-sized enterprises (TFSME). Deposit growth moderated in 2022, but remained positive, with a moderate shift of current account deposits into term deposits.

Endnotes

1 Please refer to the Federal Reserve's policy tool description.

REPORT NUMBER 1361120

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