

# Financial stability versus inflation

The ECB did not hesitate at its monetary policy meeting on 16 March to hike interest rates by 0.5%. Even with the uncertainty about Credit Suisse, the ECB does not believe that the eurozone banking sector is facing problems and therefore continues to tighten monetary policy.

Inflation remains a problem in both Europe and the US, and central banks must be hoping that the current challenges in the financial sector will prove to be temporary if they are to continue turning the monetary screws.

Central banks are trying to reduce economic activity and make borrowing more expensive. Higher borrowing costs in the financial markets will, of course, affect alternative lending too, which will be facing higher funding costs going forward.

Update – Holders of AT 1 or Contingent Convertible Bonds (CoCos) in Credit Suisse will lose their entire investment in the rescue deal with UBS as it would trigger a “complete writedown” of those bonds. Putting equity investors before bonds is not good news for the credit market.

These days, it is not easy to be a central banker!

On the one hand, they are fighting inflation caused partly by their own extremely loose monetary policy and partly by very expansive fiscal policy; on the other hand, they have to stabilize the financial system because some parts of it seemingly do not understand how financial institutions should be run.

## On Silicon Valley Bank (SVB)

How could things go wrong so quickly for a bank ranked by Forbes as one of the best in the US (at no. 20)?

As most people now know, SVB's clients were venture capital and tech companies, i.e. companies with close ties.

Simply put, venture capital funds raised money for tech companies and then placed the capital raised at SVB to be retained there until the funds were needed. Thus, SVB had to handle a large amount of deposits, but since it did not have a very big loan book to match these deposits, SVB had to place the funds somewhere, which it did, mainly in securities such as US Treasuries or asset-backed bonds earning a modest interest pick-up.

## **FAS 115 -Available-for-Sale vs Held-to-Maturity**

FAS 115 is a US standard for "Accounting for Certain investments in Debt and Equity Securities" and is essential to understanding why SVB got into trouble and why the Federal Reserve had a serious problem on its hands.

Under FAS 115, securities can be classified as either "Available-for-Sale" (AFS) or "Held-to-Maturity" (HTM).

Securities that are classified as AFS have to be "marked to market" (valuing an asset at its current price) and their gains/losses are excluded from earnings and recognized in a separate capital component.

HTM securities are not marked to market but can be amortized over the lifespan of the security.

SVB applied this accounting methodology to avoid volatility in earnings and capital ratios by classifying most of its securities as HTMs. But, after interest rates were raised, SVB had large unrealized losses, either unrecognized on HTMs or on the balance sheet for the AFSs.

When depositors began to withdraw their money, SVB needed liquidity. However, as a large part of its securities were HTMs and not "really" available for sale there was a problem. SVB would be forced to sell its securities at losses of maybe 20-30% of nominal value, which would not only have created an immediate loss in earnings but also failed to raise sufficient funds to cover all withdrawn deposits.

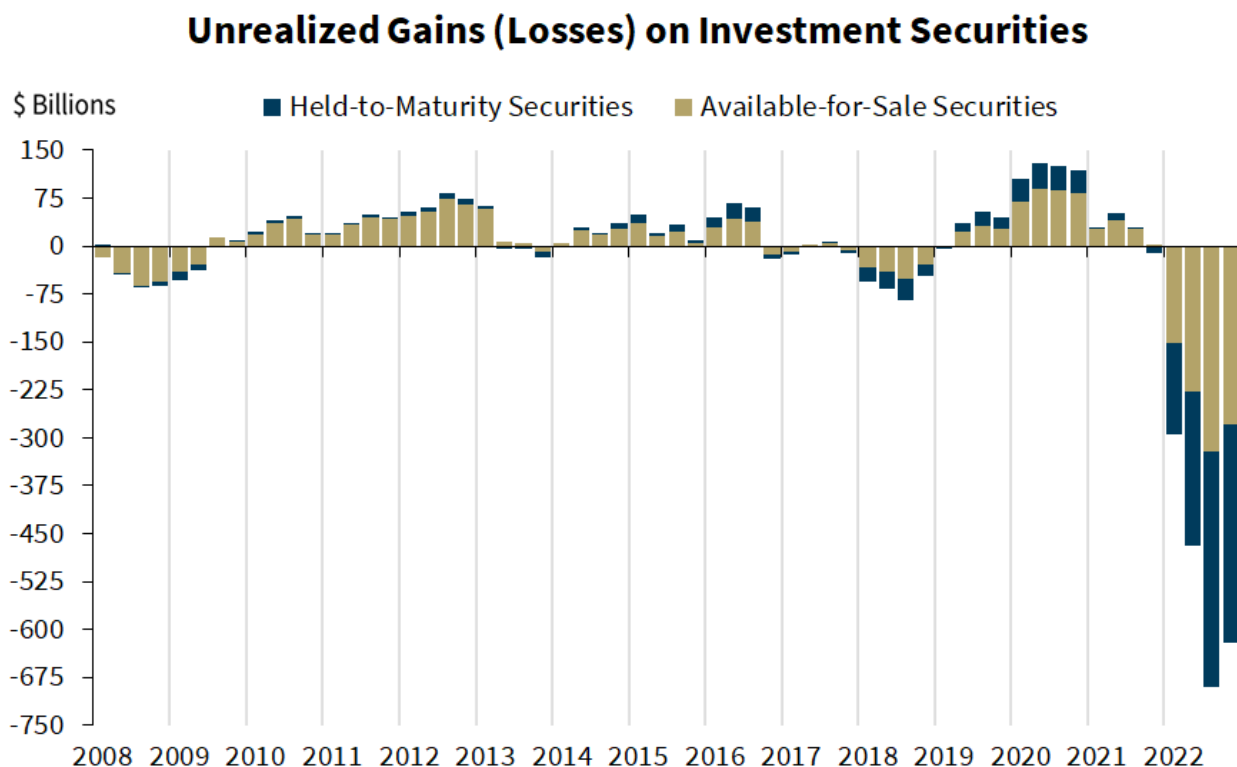
In addition, SVB had very poor risk management, in that it had neglected to hedge its interest rate risk.

This was the final straw that broke the camel back and send the bank over the edge, obliging the Federal Deposit Insurance Corporation (FDIC) to intervene.

## The \$600 billion elephant in the room

In its most recent publications, the FDIC has highlighted the underlying problem regarding unrealized gains/losses on investment securities.

**Figure 1 Unrealised gains and losses for All FDIC-Insured Institutions**



Source: FDIC.

Note: Insured Call Report filers only.

FDIC-insured institutions (mainly banks) had unrealised losses in portfolio securities of more than USD 600 billion as of the end of 2022. Well-managed and systemically relevant banks apply proper risk management, whereby gains on derivatives will partly offset losses on securities.

Because banks that have no interest rate hedges in place for HTMs potentially face problems if depositors withdraw funds. This is the reason behind the fact that Federal Reserve has given notice to all banks that they can receive all the liquidity they need at the nominal value of their securities and not at fair value as is the normal practice.

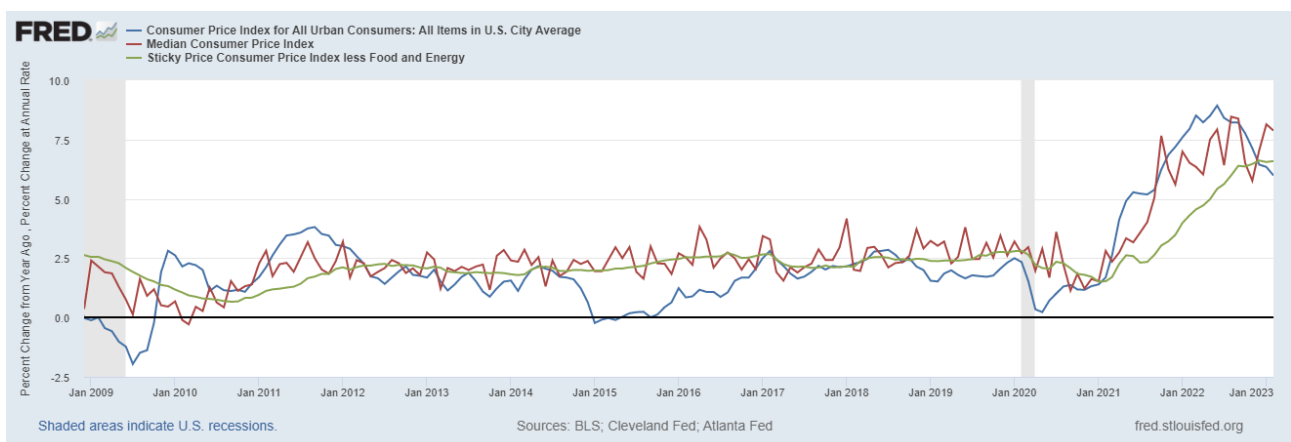
And here is the dilemma for the Federal Reserve's Open Market Committee (FOMC): should it raise interest rates to reduce activity and inflation in the

economy, or should it keep them unchanged to avert further problems in the banking sector?

## Inflation is not helping the Fed

Last week, US CPI figures for February were released but were not as helpful as the FOMC would have hoped (see Figure 2, below).

**Figure 2 US annual CPI inflation - different measures**



While overall inflation fell slightly to 6%, it is still a long way from the Fed's 2% target. Nor was there any good news in the numbers adjusted for "sticky prices" and "median" inflation, which continued to rise or remain at much higher levels.

Furthermore, the base effect in energy will diminish over the next three to four months. Thereafter, there will be no deflationary drag on overall CPI data from energy, thus implicitly increasing inflation.

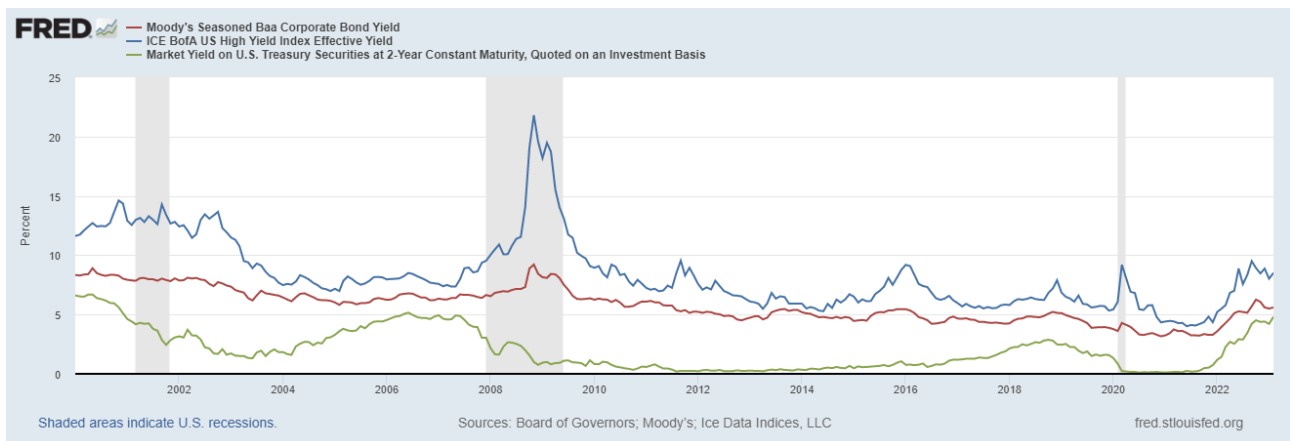
In short, with inflation still excessively high, the FOMC needs to hike interest rates to bring it down to target levels. However, banks are sitting on unrealized losses of more than USD 600 billion, which will only increase if the FOMC hikes rates further. A dilemma indeed!

## Credit spreads

With the aggressive increases in interest rates and, to some extent, withdrawn liquidity, central banks have tightened monetary policy over the last twelve months.

Yields on governments bonds, especially at the short end (2 years) have risen by 4-5%-points, as illustrated in Figure 3, below.

**Figure 3. 2-year Treasury yield, Baa Corporate yield and High Yield Index yield**



Until the SVB event, it was possible to buy 2-year US Treasuries at around 5% in yield, while buying Baa corporate bonds would have offered just over 5.5% and high-yield bonds just under 9%. Given all the uncertainty, why buy anything but short-dated Treasuries? Currently, risk premia are not very appealing, so there is only one reason to buy bonds other than Treasuries: too much liquidity.

The underlying problem for the central banks, and especially the Federal Reserve, is that the credit and equity markets all expect the US to enter recession soon; inflation will then decline to 2% and the Federal Reserve will begin to lower interest rates, or so the markets believe.

Unfortunately, inflation remains stubbornly high and there are no indications so far of rising unemployment. This makes it extremely difficult for central banks to lower interest rates. Ideally, for them at least, credit spreads need to increase significantly and thereby help restrain economic activity.

## Impact on alternative lending

The recent events involving SVB and the demise of Credit Suisse will likely lead to even tighter credit conditions for banks.

Credit lines provided by banks will be more and more restricted, as well as a lot more expensive for borrowers when they are renegotiated.

Likewise, it will become more and more difficult to issue bonds in the high-yield market, as investors will require a higher risk premium to commit funds.

For alternative lending, tighter credit lines and the shrinking possibility of raising funds in the corporate bond market will be challenging for those alternative lenders lacking a broad funding base.

As always in difficult times for the sector, financial institutions with prudent management, a diversified funding base, good risk management, and the ability to generate positive cash flow, will be most likely to prevail.