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Bank Bail-outs Are The Next Step in The Unfolding Economic Crisis

Banks and Investment banks are being hit at the same time by a unique combination of systemic events:

- Rapidly rising loan defaults, hurting their commercial bank divisions;
- Rising consumer defaults, generating significant losses for retail banks;
- Evaporated transactions pipeline hurting their corporate finance divisions; and
- Zero interest rates environment, reducing the interest margin on bank loans.

None of the stress tests run by regulators in 2019 contemplated this perfect storm of circumstances. All stress tests assumed a classic recessionary style economic crisis, with impairments and asset prices falling over an extended period of time. Do banks have sufficient capital to survive the COVID crisis?

Financial stock indices have fallen by approximately 40% in the UK since the end of February, according to the FTSE 350 Financial Stocks Index. At the same time, credit default swap spreads, a measure of banks' borrowing costs, have doubled, over the same period.

It is very likely that, within the next three months, swathes of the banking sector, across all major world economies, will need a bailout. That is presumably why, under the pressure of the Bank of England, UK banks have agreed to pause dividend payments. We expect regulators around the world to follow suit.

To understand why bail-out will become necessary, Fideres has reviewed the latest set of stress tests conducted by central banks and the latest set of banks' available annual reports. Here is what we found:

- Regulatory stress tests assumed mild recessionary assumptions by today's standards: GDP drop of 4.7% in the UK and 2.6% globally, UK unemployment rising to 9.2%, UK residential and commercial real estate prices dropping by 33% and 41%, respectively.
- UK banks, for example, currently hold: GBP 167bn of SME loans, GBP 100bn of leveraged loans, GBP 88bn of commercial real estate loans and GBP 224bn of unsecured consumer loans, just to mention some of the most distressed asset classes. In aggregate, these exposures alone add up to more than 2 times the total amount of core tier 1 capital available to the entire UK banking system, according to the latest figures published by the Bank of England in December 2019. And this does not take into account exposures to other illiquid and dislocated asset classes such as structured finance bonds, loan warehousing facilities or high yield corporate debt.
- Under mounting defaults, banks will need to raise additional capital. This will prove impossible under current market conditions and will lead to government bail-outs.

There is another important implication to this analysis: governments can't rely on the banking sector to provide credit to SMEs and consumers. Policies like the CBILS scheme in the UK are misguided as they seek to rely on banks to, when banks will not be in a position to expand their balance sheet.

Effective and wide-ranging macroeconomic policies by all major governments to prevent layoffs by businesses could have prevented bank bail-outs, that will be hard to digest for taxpayers who have not seen bank executives held to account after the last financial crisis.

It is not too late but time is running out.

Alberto Thomas, founding partner of Fideres, said:

"While everyone is rightly focus on the immediate fallout of the unfolding economic crisis, it is important that governments and regulators alike stay ahead of the curve and start to plan shoring up the capital for weaker banks.

Fideres's analysis suggests that banks are ill suited to provide liquidity support to businesses in the current climate: with bank capital ratios projected to fall, banks are not willing to lend and expand their balance sheets."