SVB - European banks in focus but contagion risk seems low (EN)

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The second largest bank failure in the US is having rippling effects throughout markets. Government bonds rallied in a flight to safe haven assets and also markets pricing out large parts of future rate hikes by the central banks for now. We would argue for the SVB failure to be a rather local event and point to the ample liquidity situation of the European banking sector - also thanks to TLTRO and differences in the deposit base in general.

- Silicon Valley Bank failure due to large deposit outflows mainly
- Large unrealized losses on govie bond portfolios had to be partly realized due to deposit outflows
- FDIC to guarantee all deposits of the former bank and Fed to setup "Bank Term Funding Program" to address possible liquidity shortages
- European banking sector also in focus when it comes to unrealized HTM portfolio losses
- **Liquidity risk at European banks** are **balanced, but pressures on lending margins** may be expected

Overview

What was supposed to be an ECB and inflation centered week on markets, has turned into a flight to safe haven assets (temporarily) due to the collapse of US bank Silicon Valley Bank (SVB). Today’s market reaction on the European side of things, left the financial sector with significant losses on the equity and bond side and saw a buying frenzy when it comes to “safe haven” assets e.g. government bonds. This came already after the Fed, the US Treasury and the FDIC said that “all depositors’ money is safe” (from the institutions concerned) and set up a new lending program. So the fear in the market is real, but is it overshooting?

SVB collapse in short

The bank which was mainly operating in the start-up world of things, saw strong deposit outflows of corporate customers (start-ups) that forced it to cover the latter by selling parts of its available-for-sale and held-to-maturity portfolios. These were to a large extend build on US government securities and agency-issued MBS. In sum the AFS and HTM portfolio was reported at YE 2022 with a net carry value of USD 117 bn and an average duration of 3.6 and 6.2 years for AFS and HTM respectively. Unrealized losses on those portfolios due to the changed interest rate environment in the past quarters therefore amounted to roughly USD 18 bn for the FY 22. This, in combination with the mentioned bank-run on deposits and the need to liquify parts of the AFS and HTM securities led to the demise of the bank and saw the FDIC close shop.

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Status quo

The FDIC, US Treasury and the Fed have come out with a statement (**Statement**) and as a reaction extended the deposit guarantee to all deposits and not only the USD 250.000 (of the banks concerned) as required in an effort to calm markets before opening today. Also the Fed has initiated the "Bank Term Funding Program" (**BTFP**) to address any liquidity pressure from the sector.

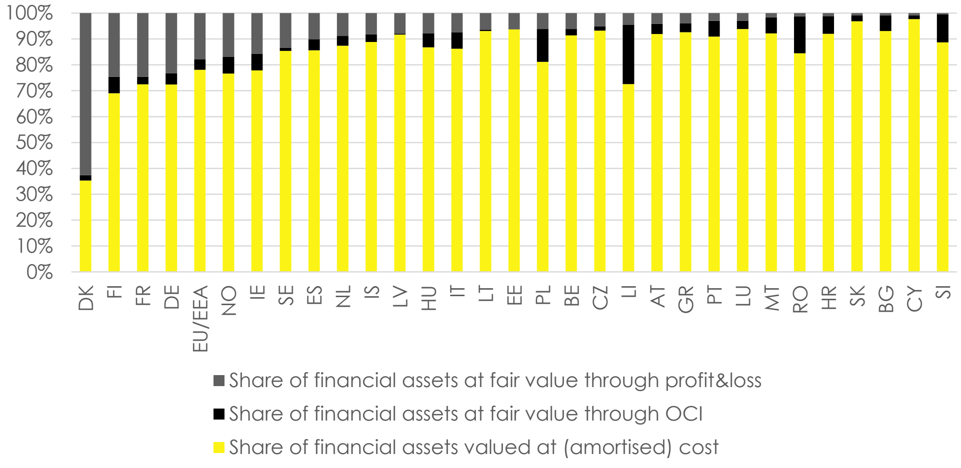
Through the program banks, savings associations, credit unions and other eligible depository institutions can pledge US Treasuries, agency debt and MBS and other qualifying assets as collateral and draw on loans with maturity of up to one year. The latter securities will be valued at par. In other parts of the World, HSBC acquired SVB UK for GBP 1 and the German branch was put under moratoria by the BaFin.

"Clean your own house" – European banking sector view

This saying now more than ever is coming to mind when investors and the European banking sector undoubtedly are now scanning the European banks for their AFS (available-for-sale) and HTM (hold-to-maturity) portfolios and assessing potential danger for the sector. First we would still like to mention, that one is still talking about "unrealized losses/gains" in these books and the European banking sector has still some "safeguards" in place that the US sector was lacking.

When looking at the composition of total banking assets in the EBA-realm as of September 2022, 78% of assets are reported on an amortized cost basis and 18% at FVPL (Fair Value through Profit and Loss). The rest is reported through way of other comprehensive income. The European sector held roughly EUR 3.129 bn in government securities on the books as of September 2022. When it comes to reporting, around 60% of these exposures are in the HTM category with another 15% in the trading book and 20% which run through other comprehensive income. As with the composition total assets, also in the reporting of government securities there are some outliers to the mentioned overall European figure, but for simplicity we concentrate on the latter for this publication.

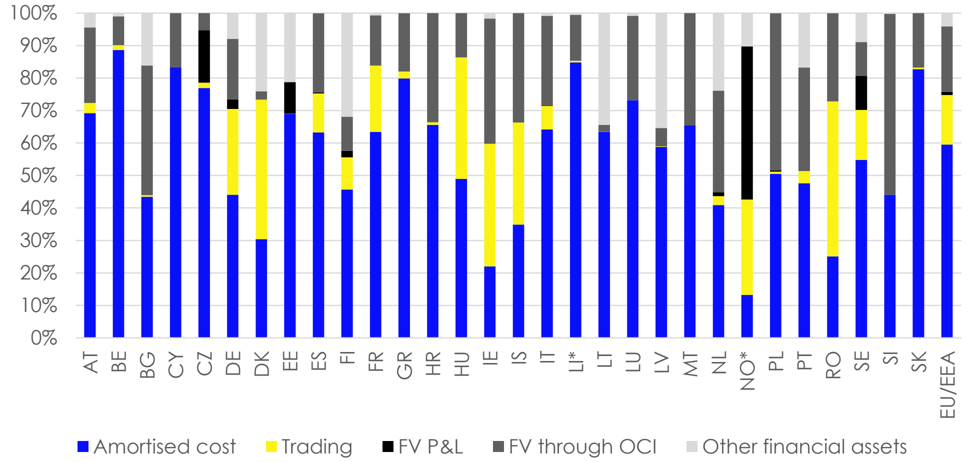
Split financial assets EBA banks



Data as of September 2022
Source: EBA, RBI/Raiffeisen Research

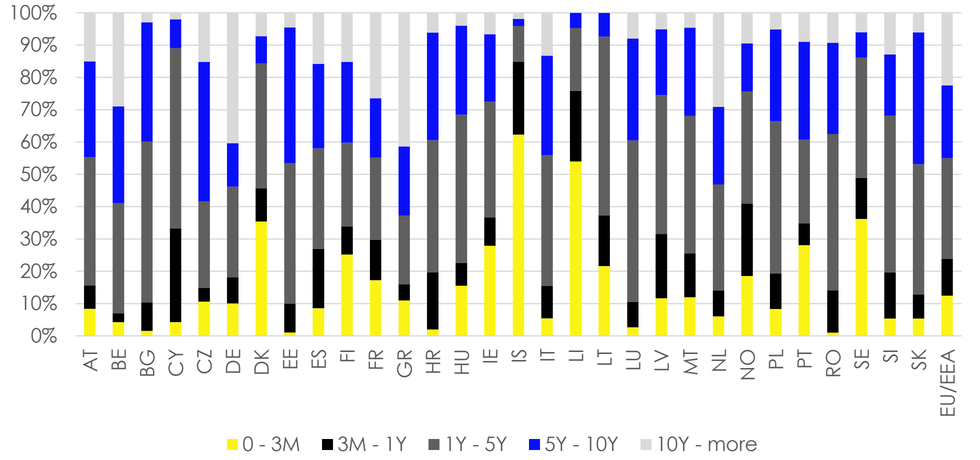
Duration and the changed interest rate environment in the past quarters has had an obviously negative impact on the government bond portfolios (also on fixed income as a whole), with the year 2022 one of the worst years for fixed income markets on record. Duration being one of the hot topics in the past quarters brings us to the maturities of the government bond holdings of European banks. Roughly 54% of the latter fall in the 1y-10y category with another 23% having maturities over 10y.

Split of sovereign exposures EBA banks



Data as of September 2022
Source: EBA, RBI/Raiffeisen Research

Maturities within the government bond holdings



EBA banks; Data as of September 2022
Source: EBA, RBI/Raiffeisen Research

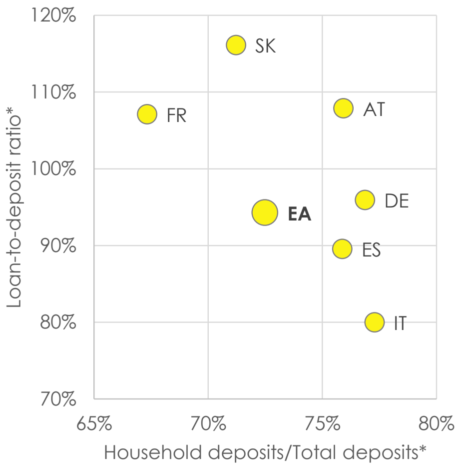
That obviously means that also the European banking sector sits on hefty unrealized losses from those portfolios. Just how much are we talking? Again referring to the latest EBA data (dated September 2022), one can observe a total amount of government securities of EUR 3.129 bn. For argument's sake we set the average maturity of government bond holdings at 5.5y and looked at the development of the Bund5y for the FY 2022. The latter showed a widening of 298bp on yield basis. This then would result in unrealized losses of roughly EUR 513 bn. However, only 60% of the portfolio was in the HTM category, which would leave unrealized losses of roughly EUR 308 bn (or a loss of 16%) for the European banking sector out of its government bond exposures only.

To put it in more perspective we held this against the reported Tier 1 capital of the sector. The latter reported EUR 1.555 bn in Tier 1 capital as of September 2022 (EBA). Therefore, the above-mentioned unrealized losses if realized would represent roughly 20% of Tier 1 capital. The European banking sector also reported RWAs of EUR 9.545 bn as of the same date and a Tier 1 capital ratio of 16.3%. Unrealized losses on the 60% portion of the HTM book, would therefore reduce its absolute capital base and result in a Tier 1 ratio of 13.1% for the sector (minus 320bp). This figure could still be considered adequate from our point of view and should not necessarily be cause for questioning the strength of the European banking sector as a whole due to the failure of SVB.

Liquidity risks in focus, pressures on margin may be coming

Importantly, any mark-to-market losses in the securities portfolio may remain a "dormant" risk unless they are realised to cover emergency liquidity needs triggering real pain in cash terms. The banks' funding profile and liquidity risks hence represent the other part of the equation which falls under investors' scrutiny. Prima facie, in aggregate terms European banks' funding profile remains relatively balanced with the loan-to-deposit (LTD) ratio staying a touch north of 100%. The dispersion, however, may be significant with some single banks or countries in aggregate featuring greater reliance on non-deposit wholesale funding (e.g. LTD 150-300% in Denmark, Sweden) and others funded more conservatively (LTD at ~80% in CEE). The comfortable LTD balance is also echoed by the strong liquidity coverage ratios (LCR) which hovered around 160% as of Q3 2022 (EBA data). We do not think the repercussions from the SVB failure can challenge the stickiness of household accounts, however granularity of company placings merits attention. Thinking in this dimension, in relative terms corporate deposits are on average a sizable source of funds for banks in France and Denmark, while household savings are more dominant in Germany and Italy. Amid the aggressive tightening of monetary conditions, the composition of the deposit base informs well the resilience of banks' net interest margin, as the cost of retail accounts typically show higher inertia as compared to company deposits. Here, we note that on the back of the normalisation (reduction) of saving rates in the post-COVID reality the banks' LTD ratios were prone to an upward drift in the course of 2022, however the customer funds base has been still ample enough to maintain the favourable wedge between the interest rates on (new) loans and deposits — up until recently. For instance, French banks now find themselves on a relative fast lane for the upward repricing of deposits, which we link to the greater share of corporate funds in the structure. Respectively, their indicative lending margin, as gauged by new business loans and deposits, has ticked notably down in the last few months and should be vulnerable to any adverse fluctuations on the liability side. Many other eurozone peers can for the moment still enjoy staying on a widening margin streak (e.g. in Italy, Spain, Portugal), but for them too we think the recent development may temper the trend. Even without material fund outflows, stiffer competition for wallets of corporate clients should dictate an increase in respective deposit rates and also make banks eventually more active on the repricing of their retail deposit offers, which in concert may bring about a meaningful step-up in the cost of funding.

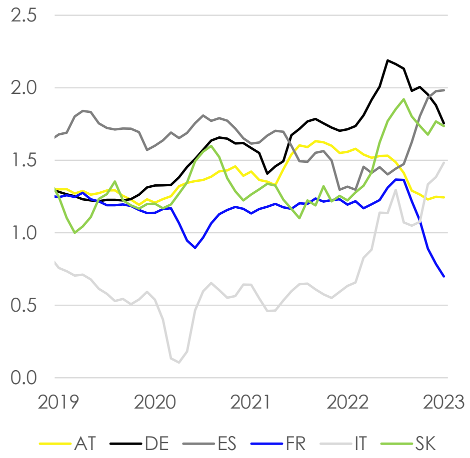
Liquidity vs funding structure as of Jan 2023



** Based on loans and deposits to households and non-financial corporates that are euro area residents*

Source: ECB, RBI/Raiffeisen Research

Banks' lending margin (new business)* 3-month moving average



** Differential between weighted average rates on new loans and new deposits (households and non-financial corporates)*

Source: ECB, RBI/Raiffeisen Research

Conculsion

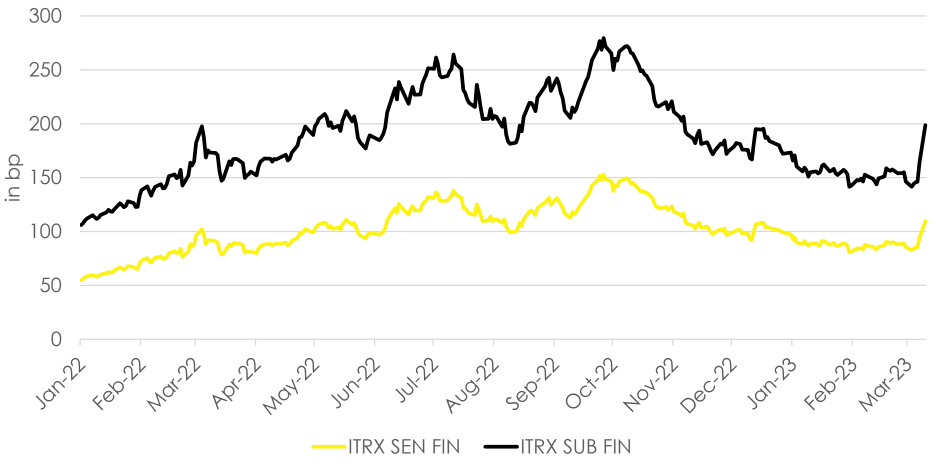
Whereas the SVB failure could be considered a bit of a special case, investor eyes are for sure now working through the risks for the European banking sector, especially related to unrealized losses from its government bond portfolios. As mentioned above we would argue the risk being largely contained as of now and other losses should “only” related to direct exposures to SVB (e.g. Alecta (the largest Swedish pension fund EUR 1 bn), Norway’s sovereign wealth fund (USD 160 mn)). Nevertheless, even though we welcome the swift decision by the Fed, FDIC and US Treasury to insure all deposits, one could argue that this is creating a blueprint for future bank failures also in Europe. As for bondholders and equity investors the story seems to be clear-cut, as there is not bail-out in sight.

As for deposits and they being guaranteed by governments and/or central banks one could also focus on the differences between the US banking market and the European one. Whereas "only" roughly 51% of US deposits would have fallen under the FDIC guarantee, roughly 63% of EU deposits are covered by guarantee schemes and 72% of deposits are due to retail customers. This might reduce the risk of a deposit flight or a run on the latter.

Markets are also quickly pricing out future rate hikes by the Fed and ECB as the rates market is rallying. This might be a little to premature for our liking. Although inflation as a topic took the back seat since Friday – and will do so for the coming days – it is still lingering at high levels. As we view the SVB event as a more localized event with the effects to be largely contained so far, we would argue that this does not necessarily deter the ECB from its path this week and the 50bp hike that is penciled in.

The financial segment of the fixed income market is also going to suffer which could lead to increased credit risk in the short term. Spreads (OAS) of financial seniors and subordinated bonds already jumped 8bp and 13bp respectively on index basis on Friday, and we would see this to continue in the short term. Also, we would keep in mind that from our point of view, credit spreads in the financial segment have been lagging any reaction to the changed interest rate environment for a long time. Cost of insuring bank debt has jumped 17bp and 37bp for financial senior and subordinated debt respectively as of 13/3/2023 15:50 CET.

Financial CDS with clear reaction



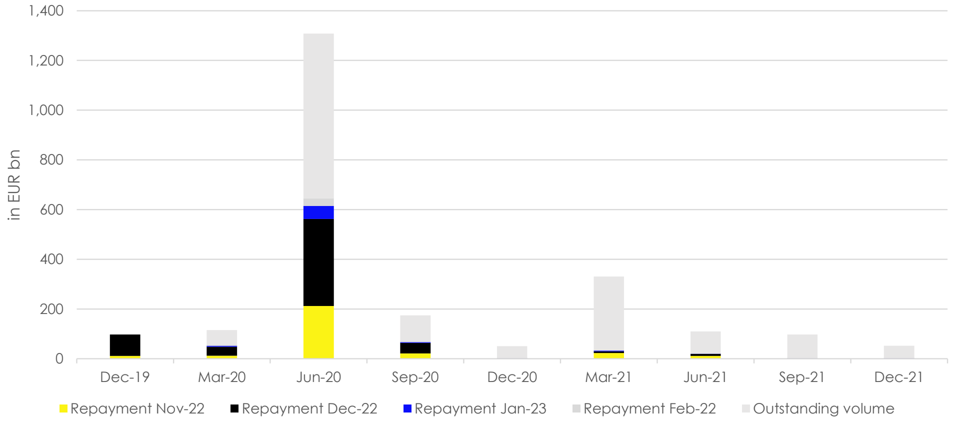
Data as of 13/3/2023 16:02 CET

Source: Bloomberg Finance L.P., RBI/Raiffeisen Research

In addition, this brings the liquidity metrics of European banks and the ending TLTRO III again to the forefront. Banks have had the opportunity to repay their TLTRO III funds early since autumn 2022. Nevertheless, after the initial two early repayments in the volume of EUR 293 bn and 534 bn, the following opportunities for early repayment have largely remained unused. That means that European banks can still "draw" on roughly EUR 1.200 bn in TLTRO III funds of which however, EUR 550 bn will reach maturity in June 2023. Over EUR 500 bn will reach maturity in 2024 alone. We think that despite the increased costs in holding the TLTRO III funds to maturity, if banks were not already thinking of holding these funds to maturity, they will most definitely do so now. Depending on the market and depositor reactions we will see in the coming weeks, there might even be an argument for a new TLTRO IV, albeit at increased cost, with maturity of one year.

Lastly, margin pressure on the European banking sector from increased deposit rates will accelerate in the coming months as a fight for quality deposits will heat up and therefore will put pressure on the banks "glorious" profitability figures for the year 2022 coming in 2023.

Repayments and outstanding volume TLTRO III



Source: ECB, RBI/Raiffeisen Research

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