

# Schroders Talking Point



## One year into the credit crunch – a view on banks

### An interview with Roger Doig, Credit Analyst

#### **A year on from the start of the credit crunch, are conditions for banks returning to normal?**

Swap spreads are a good measure of the cost of credit for banks. Prior to the credit crunch, US 5 year swap spreads were typically around 40bps. At their peak at the time of the Bear Stearns bailout in March they reached 115bps. Currently they are just under 100bps, so they remain at elevated levels. The numbers for swap spreads in the Eurozone and UK are similar. Credit conditions for banks therefore remain tight, and are a long way from pre-credit crunch levels.

#### **Does this mean the actions taken by central banks to alleviate the crunch have failed?**

The market interventions of the Fed, the Bank of England and the European Central Bank have been aimed at ensuring that markets have adequate liquidity. They are not aimed at 'bailing out' or underpinning the market per se. In this respect they have been quite successful. While the Northern Rock situation showed up weaknesses in the Bank of England's Lender of Last Resort operations, the mechanisms it has put in place since, notably the Special Liquidity Scheme introduced in April, have successfully averted further bank failures, even as the asset quality of the loans on their books has deteriorated sharply over the course of the year. The Fed enhanced its liquidity facilities in March and this has greatly reduced systemic risk.

Indeed, our view is that the central bank actions have strengthened the financial system to such an extent that they effectively eliminated the risk of failure of major European and US banks. These banks, the AA rated 'National Champions', really are – in practice as well as in principle – 'too big to fail'. We will continue to see banks increasing provisions for bad loans and taking writedowns, but we expect the majority of banks to have sufficient underlying earnings to absorb these losses. If we do see bank failures, it will be due to specific circumstances affecting smaller, regional banks.

#### **Why are credit spreads still so high then?**

When the credit crunch started there was a lot of debate about whether spreads in the interbank market were wide because banks were reluctant to lend to each other as they were worried other banks might fail, or because they were hoarding cash because they were worried about being able to access funding themselves. Banks only fail if they run out of cash; by guaranteeing backstop liquidity, the central bank actions ensure banks will always have access to cash, so the first explanation is no longer valid. The second explanation for high spreads is the correct one. The problem is that central bank backstop liquidity comes at a price and with strict terms and conditions, so it is not appropriate for funding an entire balance sheet. The reason credit spreads remain high is that banks are having problems securing adequate funding.



### **What are these funding problems?**

The core funding problem banks have is that securitisation has disappeared as a funding source. In 2007, over 40% of UK mortgages were funded in this way, as well as large volumes of credit card, trade and auto loan receivables. Over the last 10 years securitisation had become so central to banking, it was enshrined in the Basel II bank solvency regulations introduced in 2008. Under the model, banks would originate assets, securitise them, and sell them on to the capital markets, which in turn funded these assets with short-term debt.

When the credit crunch hit, the buyers of these securities were unable to obtain the short-term funding they required to fund their positions, which in turn were rendered illiquid by sudden oversupply and lack of transparency about the quality of the underlying assets.

We believe that this is the central problem facing banks today, and is the reason conditions have not returned to normal. In Europe, it is a far greater issue for bank credit than asset quality or bank solvency. Banks need to find a source of funding to replace securitisation.

### **What are the alternative sources of funding?**

Broadly speaking, banks have three funding options: 1) deposits, 2) secured term funding (securitisation or covered bonds) and 3) unsecured term funding (senior debt). The second option has closed indefinitely, meaning banks need to replace it for both new funding and to refinance maturing issues. Generally the preference is for deposits, but in the most affected countries like the UK and Spain there is a shortage of these, and competition is thus intense. Unsecured funding is the main alternative, therefore, but investors are aware of the scale of potential issuance. There is therefore a kind of standoff in the market – banks are hoping spreads will fall to make issuing bonds economic, but on the other hand investors know banks need to issue a lot of bonds, so they keep spreads high.

Gradually banks are realising they have no choice, and from March this year have been repricing their lending sufficiently to be able to afford the cost of borrowing. Unfortunately this is driving a negative feedback loop that impacts the credit performance of some of their customers and in the case of residential mortgages drives a decline in value of their collateral. This is the situation the banks currently find themselves in.

We would note that this is primarily a problem for equity investors who will absorb the losses and writedowns banks will take. In the majority of cases, however, banks will be able to absorb any losses without impairing their credit quality.

### **Does this mean investing in bank bonds represents good value?**

Absolute spreads for banks are at their highest ever levels, and we believe the senior bonds of AA rated banks with significant deposit franchises represent attractive return opportunities. However, with the value of housing collateral in many countries falling, and corporate credit quality likely to deteriorate as the economy slows, the potential for spreads coming down looks limited in the near term, and the potential for substantial new issuance could keep spreads at high levels for some time.

Furthermore, the possibility of spikes in systemic risk remains high, despite the efforts of central banks. The failure of an investment bank, or a large US banking institution with deteriorating mortgage exposures, or even problems triggered by banks' overreliance on capital market funding affecting an entire market like New Zealand, could lead to another generalised sell off of bank credit. We would expect these to be short lived risk spikes, however. Central bank measures, good risk diversification and adequate solvency mean we have limited concern about the credit risk of the National Champion banks, so we believe they are attractive opportunities for bond investment in the sector.

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