Bank of England points to deep-going financial problems

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After more than two weeks of turmoil following the collapse of the Silicon Valley Bank (SVB) in the US and the forced takeover of Credit Suisse by UBS, some calm has returned to financial markets in the past few days.

How long it might last is another question as the deep sources of structural instability within the financial system come into focus.

Some of them, any one of which could set off another crisis, were outlined in the quarterly report issued by the Bank of England's (BoE) Financial Policy Committee (FPC) on Wednesday.

Looking back to the last major crisis, the market freeze of March 2020 when not even US Treasury bonds could be sold for a number of days, the FPC report said "many of the vulnerabilities which had crystallised during previous stress episodes, such as the 'dash for cash' in March 2020, remain largely unaddressed and could amplify further sharp adjustments in asset prices."

Like his counterparts internationally, BoE governor Andrew Bailey insists the UK financial system is "resilient with robust capital and liquidity positions, and well placed to support the economy" as he put in a speech delivered at the London School of Economics on Monday.

But the FPC report paints a somewhat different picture.

Since the UK pensions funds crisis of last September, which was only quelled with a major BoE intervention into bond markets, attention of the FPC has been very much focused on this area.

In light of the bank run on SVB, which led to its closure, the significance of the UK crisis, which threatened major systemic problems, can be seen more clearly. The SVB demise was sparked by the rise in interest rates initiated by the US Fed.

This meant that the market value of the Treasury bonds it had purchased when flush with cash in 2020 and 2021, as a result of the Fed's ultra easy money policies, fell well below their book value and SVB had to realise the losses when they were sold off to meet the cash demands of customers.

The UK pension crisis was different in form but was sparked by the same cause—higher interest rates initiated by major central banks, in the name of fighting inflation but in reality directed at trying to push back the upsurge of the working class in support of wage demands.

To meet their obligations, pension funds, on the recommendation of financial authorities, had adopted a strategy known as liability-driven investment (LDI) in which they invested heavily in government bonds.

When the short-lived Truss government sought to fund massive tax cuts for corporations and the ultra-wealthy by increasing debt, interest rates on bonds rose sharply and their price fell (the two have an inverse relationship) and the pension funds were faced with major losses on their holdings.

They were forced into a fire sale resulting in a downward price spiral for bonds and a severe increase in interest rates.

To try to prevent a recurrence the FPC recommended that the Pensions Regulator act "as soon as possible" to ensure that LDI funds had sufficient liquidity to meet an increase of 250 basis points (2.5 percentage points) in interest rates without having to sell off bonds. Previously they have been required only to cover a move of 100 basis points. The increase in September was 160 points and occurred at a pace rarely seen before.

But pension funds were by no means the only area of concern.

It pointed to the fast-growing global private credit market where interest rates tend to be higher, meaning that loans are "more vulnerable to a deteriorating macro environment" and stress in this area "could cause a rapid reassessment of risk by investors potentially resulting in sharp revaluations."

It also called for "urgent work" to be undertaken globally to ensure the resilience of non-bank financial markets, warning that "vulnerabilities" could "crystallise should there be further volatility or sharp movements in asset prices."

The FPC said the UK banking system was resilient to a wide range of severe economic outcomes, including higher interest rates. But, as with every national financial system, it acknowledged that there was a risk of "spillover" effects from global developments.

"There remain channels through which UK economic conditions could be affected by recent and possible future strains from banks outside the UK," it said.

One of those channels is the effect of interest rate increases and a credit crunch on the US real estate market, both commercial and residential, where smaller and middle-size banks provide the largest portion of finance.

"Commercial real estate remains a potentially vulnerable sector globally, as higher interest rates reduce property values along with borrowers' ability to service debt," the FPC report said.

Asked about possible problems in the US real estate market following the meeting of the Fed's policy meeting earlier this month, chair Jerome Powell waved aside concerns saying he was "aware" of the concentration of medium-sized banks in this area but did not think it was comparable to other strains on banks.

That may be the case, at least for the present, but financial conditions are changing and the effects of the Fed interest rate increases have yet to fully flow through. And there no doubt that as a result of the turmoil surrounding SVB there will be a credit crunch as banks constrict lending and seek to build up cash buffers.

Powell may not be overly worried, but others are.

An article in the *Financial Times* (FT) last week reported that even before the SVB failure "strains in the $5.6 trillion market for commercial real estate (CRE) loans have deepened in recent months" because of the Fed's interest rate increases and "analysts fear any further reduction in lending … could make a perilous situation worse."

According to analysis by JP Morgan small and medium-sized banks account for 70 percent of all CRE loans and these loans comprise 43 percent of the banks' total lending as opposed to 13 percent for the big banks.

The FT report cited a note by JP Morgan securitisation analyst Chong Sin. "The collapse of SVB is putting a magnifying glass on regional banks and their commercial real estate loan books remains an area of major concern," he wrote.