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Mara Monti March 30th, 2023

Is Europe heading for another banking crisis?

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Pressure on Deutsche Bank following the collapse of Silicon Valley Bank and Credit Suisse has raised fears of a new banking crisis in Europe. **Mara Monti** *writes that while these fears are understandable, the European banking sector is in a far stronger position than it was during the global financial crisis in 2008, and the banking turmoil has encouraged EU leaders to push for financial integration.*

When a new wave of financial instability began with the rapid collapse of Silicon Valley Bank (SVB), it immediately raised the prospect that this could spill-over into a systemic banking crisis. This brought back memories of how trouble in a small corner of the US mortgage market

in 2006-07 grew and engulfed the financial system, becoming a full-blown global financial crisis in 2008.

The case of SVB was resolved quickly as authorities moved to protect all deposits to avoid the risk of contagion, as in the case of Lehman Brothers which defaulted in 2008, even though SVB wasn't a global financial institution. SVB was a poorly managed bank which had operated without a chief risk officer. It had seen a massive growth in deposits and lending concentrated in high-risk IT start-ups and the real estate sector, all risky areas that didn't attract the attention of supervisors.

Despite the actions of the financial authorities in the US and UK, which helped avoid a general bank run, SVB's implosion sparked a global market panic that claimed Signature Bank and Credit Suisse, and put at risk a third US non-systemic lender, First Republic. But if the failure of a bank with 1% of the system's assets constitutes a systemic event because of the contagion, there is a problem in the structure of the financial system: the 2008 financial crisis started in the credit market, but in this case the monetary market has provided the chain of contagion along with a lack of confidence.

Policymakers have stressed that the turmoil is different from the global financial crisis 15 years ago, saying banks are better capitalised and funds are more easily available. But the worries spread quickly, with Swiss bank UBS rushing in to take over its rival Credit Suisse after it lost the confidence of investors. According to the Swiss National Bank, a takeover by UBS was "the only option" because nationalisation would have risked a systemic crisis. Many analysts have raised concern about the decision taken by the Swiss authorities because Credit Suisse's troubles have been known about for many years, and the warnings were plain to see.

Deutsche Bank

Despite the efforts to avoid contagion, the financial tensions eventually landed in Europe via Deutsche Bank. The prelude was a steep rise in the cost to insure bondholders against the bank defaulting on its debts, known as credit default swaps, and the value of junior debts Additional Tier 1 (AT1) bond, a type of hybrid debt instrument created after the financial crisis of 2008 to give banks greater capital flexibility in the event of a crisis.

Rising costs on insuring debt were also at play in the instability leading to Credit Suisse's government rescue by rival UBS, while the wipeout of 17 billion dollars of AT1 by the deal put selling pressure on banks. This was of the most critical aspect of the takeover because Swiss authorities violated the rule of resolution by switching the seniority between equity and AT1 bonds, evoking emergency legislation, something which had never happened before. The European Central Bank and the Bank of England rushed to assure everyone that they would never take such a decision. That said, the effect will be that costs will increase for banks to meet their capital requirements, and that will be passed on to customers, too.

As in 2008, the troubles started in the subprime mortgage market, whereas now Additional Tier 1 has become the latest focus of the banking turmoil in Europe. Unlike Silicon Valley Bank, Deutsche Bank and Credit Suisse, are among the 30 banks considered globally significant financial institutions, so international rules require them to hold higher levels of capital reserves because failure could cause widespread losses. So why is the market worried about Deutsche Bank?

Deutsche Bank has turned in ten straight quarters of profit, including 5.7 billion euros last year. But before that, there was a long period of low profitability and trouble with regulators going back to the 2008 global financial crisis, including a 7.2-billion-dollar penalty from US authorities for misleading buyers of complex mortgage-backed securities that later

went sour. Its previous troubles, large, complex holdings, derivative exposure, and market scepticism about its future profits, make Deutsche Bank a natural candidate for a market sell-off. And as with Credit Suisse, the troubles have been known about for years, so does it matter?

A European banking crisis?

German Chancellor Olaf Scholz has sought to reassure, stating: “There is no reason to worry. Deutsche Bank has modernised and reorganised its business and is a very profitable bank”. Indeed, European regulators have pushed German lenders to reduce leverage and improve their capital position, resulting in a far healthier balance sheet than during the global financial crisis in 2008.

Since then, the European banking system has been monitored and surveillance work on banks has focused on the need to build up sufficiently large capital buffers and strict liquidity rules to withstand the next crisis without significant hurdles, in an era in which there are many structural challenges to their business model.

The tighter regulation and stronger capitalisation of European banks has stabilised credit profiles affected by high stocks of non-performing loans, bad debt, likely defaults, non-performing past due loans/exposures, and deteriorating bank balance sheets, all of which affect the ability of banks to generate new lending in the real economy. But it has also triggered a vicious circle while the contraction in credit supply driven by the level of non-performing loans could lead to lower growth, a slower recovery, and hence further deterioration in the balance sheets of banks.

The EU has put significant efforts into dealing with the high stock of non-performing loans, including bank recapitalisations and a Council action plan providing banking supervision, reforms to insolvency and

debt recovery frameworks, as well as the development of secondary markets of non-performing loans.

This action plan has been implemented during the Covid-19 pandemic: the European Commission put forward a plan to prevent a future build-up of non-performing loans across the European Union as the virus spread. The aim was to ensure that EU households and businesses continued to have access to the funding they needed throughout the crisis. This is because banks have a crucial role to play in mitigating the economic effects of the pandemic by maintaining the financing of the economy.

Given the impact Covid-19 has had on the EU's economy, the volume of non-performing loans was expected to rise across the bloc. Depending on how quickly the EU's economy recovers from the pandemic, banks' asset quality, and in turn, their lending capacity, could also deteriorate. The plans regarding the reform of the EU's corporate insolvency and debt recovery legislation, as well as support for the establishment and cooperation of national asset management companies at the EU level, and public support measures, were all needed to ensure the continued funding of the real economy under the EU's Bank Recovery and Resolution Directive and state aid frameworks.

All these measures have helped to avoid a deterioration in non-performing loans: from the peak of 2015 when the non-performing loan ratio at the European level was 6.3%, it had decreased to 2.29% by the third quarter of 2022, according to ECB banking supervision data. On risk assets, the movement since 2008 toward strict rules for capital requirements has helped to maintain the solidity of ECB supervised banks, thanks to strong capital and liquidity positions, as the most recent stress tests showed. This is despite the tensions caused by the Ukraine war and the increase in interest rates and inflation.

European banks have strong liquidity with an average liquidity coverage ratio of about 140%. European banks maintain about three trillion euros in central bank deposits, with about 23% of their customer deposits base. Additionally, European banks are well capitalised: CET1 ratios average about 14% and they have not had this strength for decades. This is due to robust supervision, the banks' own de-risking following the global financial crisis, and adjustments to more conservative business models.

Banking union

The President of the ECB, Christine Lagarde, recently said that the eurozone banking sector "is strong because we have applied the regulatory reforms agreed internationally after the Global Financial Crisis to all of them," adding that the ECB's "toolkit" was fully equipped to provide liquidity to the system if needed. She stressed that EU leaders should proceed to strengthen the Banking Union within the bloc as she played down any risk of turmoil.

Last June, euro-area members failed to agree on a calendar to conclude the Banking Union due to Germany's opposition to the European Deposit Insurance Scheme and disagreements among some governments about limiting exposure to banks' sovereign bond holdings. While most EU countries have some form of national insurance that guarantees deposits up to 100,000 euros, there is no EU-wide scheme, nor a way for authorities to cooperate across borders if a banking crisis proves too expensive for one single country.

In the meantime, banking turmoil has encouraged EU leaders to push for financial integration. The Eurogroup agreed to make progress in the areas where more consensus existed, including strengthening the common framework for bank crisis management and national deposit guarantee schemes. The Banking Union is already two-thirds complete. The EU has set up a single supervision structure for the eurozone's top

banks in the hands of the ECB and a Single Resolution Authority with a special fund to address failing lenders.

The decision to set up a European Deposit Insurance Scheme is tied to the issue of mutualisation, which emerged during the sovereign crisis and the division of Europe between debtor countries and creditor countries. The costs and benefits of policies at the eurozone level should be evaluated in terms of how they maximise the utility of the whole area and not simply focus on individual countries' needs. The Covid-19 pandemic shows how Europe can achieve a political consensus aimed at building greater solidarity. This will be the biggest challenge for Europe as it seeks to safeguard its very nature and deliver on economic and financial stability in the future.

Note: This article gives the views of the author, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: Igor Flek on Unsplash

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About the author

Mara Monti

Mara Monti was a Visiting Fellow at the LSE's European Institute for six years and a journalist at Il Sole 24 Ore, Italy's leading financial/economic newspaper, based in Milan. She completed an MSc (Econ) in Politics of the World Economy at LSE career in journalism, specialising in the financial sector. Over the past 16 years, she has been part of the financial team at Il Sole 24 Ore, writing extensively on financial issues, sovereign crisis and monetary policy issues. Prior to joining Il Sole 24 Ore, Mara worked

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