Never trust analysts specialized in banks!

Insight into why bank deaths are largely unpredictable and misjudged

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Let's start with a paradox. Banks are by far the biggest sector within corporate bond markets[1]. Yet analysts and fund managers specialized in them are rather scarce and looked upon as geeks. These specialists – and I include myself as one – often like to hide behind their gobbledygook, with terms such as "Common Equity Tier 1", "risk-weighted assets", "cost of risk", "IFRS9 loan impairments", "MREL bond issuance", "Additional Tier 1 capital layer" and so on. As wide as the market for bank bonds may be, it still looks like a niche, where analysts are mere meteorologists, who can never really predict how, when or even why a bank may die.

Banks do not really go bust as non-financial companies do

Banks never really "die" or go into bankruptcy. They are too economically relevant and prone to contagion risk to really go bust, as a regular non-financial company would do. Banks can be placed "into resolution", "under supervision by the central bank", be "nationalized" or sold at a symbolic price to another bank. **There are many laws and regulations overseeing how banks could die in an orderly fashion, but they have quite often been circumvented** (e.g., several German banks these past few years) or laws have been changed overnight to accommodate regulators (e.g., Credit Suisse).

Bank resolutions (that is the official designation of when a bank goes bust) never resemble one another for a reason that has always been underestimated by analysts and investors: **they are first and foremost political decisions, aimed at preserving financial stability**. This is our own "whatever it takes"[2]. However, it has a consequence for bond investors: depending on which kind of bond layer you are invested in (classified by subordination, i.e., how likely you are to suffer losses), the outcome of a resolution may not always be logical, nor easy to estimate.

To illustrate that, let's take two examples:

- **Banco Popular**: although the fundamental and corporate governance woes of the bank were quite well known for some time, things escalated very quickly when rumors emerged that some local Spanish politicians were advising others to withdraw their deposits from Popular. While its solvency metrics were still optically fine, the bank endured a liquidity crisis in only a few weeks, when the ECB decided to step in and sell it to Santander for €1. All shareholders and subordinated debt holders were completely wiped out with absolutely no recovery. Senior debt was preserved and transferred to Santander.

- **Credit Suisse**: the bank had been largely affected by corporate governance issues and controversies that arose as soon as 2020 and which peaked in 2022 when the bank lost close to a third of its deposit base between Q2 and Q3 2022. A capital increase and abysmal Q4 2022 results failed to restore confidence, and Credit Suisse was then fatally wounded by the contagion arising from the deposit flights of three US banks. Its solvency and liquidity metrics were still sound a few weeks

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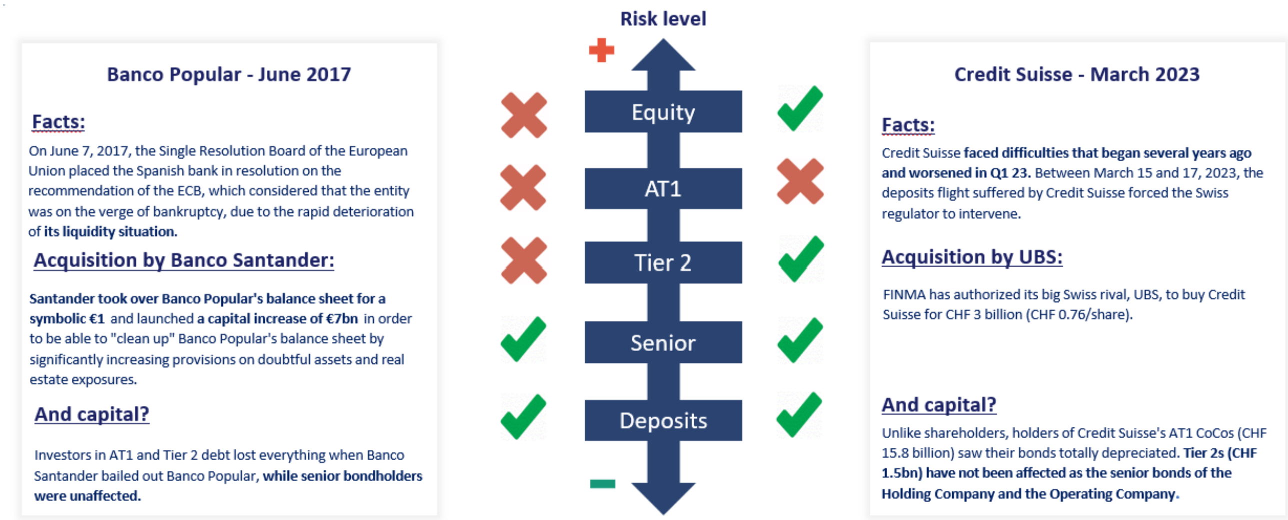
[1] Bank bonds represent 31% of European Investment Grade markets (Source: Bloomberg Euro-Aggregate Corporates Index in August 2023)
[2] Reference to Mario Draghi's famous words pronounced in July 2012, which helped bringing back stability to the eurozone.

before its ultimate collapse though. UBS bought the bank and, while equity holders of Credit Suisse got heavily diluted, they fared somewhat better than Additional Tier 1 bond holders, who lost everything, due to a change in the law passed one day before the regulatory decision.



Sources: La Française AM.

These two examples serve to show that bank failures can arise relatively quickly and surprise a lot of investors, as they cannot pursue a classic "corporate restructuring" process. We have several other examples where all stakeholders were spared and some others where most stakeholders were hit, and to very different degrees.

Why do banks die and how can we predict that, or at least protect ourselves from that?

You can feel a pattern emerging when discussing the examples of Banco Popular and Credit Suisse. **Banks always die because of bank runs (i.e., deposit flights) and not because of solvency nor profitability issues.**

After what happened in the US these past few months, where three banks collapsed in a matter of weeks due to fast deposit flights, it could be argued that all European banks could be at risk. Yet, **there is no fire without smoke**. Deposits should not disappear overnight just because customers are better remunerated elsewhere. The usual deposit base of European banks is stickier, as other opportunities come at a cost. The three US banks had deeper balance sheet issues and poor risk management, which then led to bank runs.

There is one problem though: how can you know whether a bank will collapse due to a liquidity crisis or not? How reliable are all those nerdy figures given by bank analysts on solvency and liquidity metrics, when banks can still collapse in a few weeks? We can split that issue into several categories:

- <u>Profitability issues and risks on assets</u>: turning a net profit is the most usual way to build stronger capital ratios, which, in turn, enable banks to sustain harsher macroeconomic or idiosyncratic shocks. Of course, **it matters way more for shareholders than bondholders, who just want the bank to stay afloat in the future. Some banks can have negative net profits for several years and still stay alive** (Natwest, formerly known as Royal Bank of Scotland, had been loss-making for 8 straight years without any liquidity crisis!).
- <u>Controversies & legal issues</u>: several banks have been involved in miscellaneous scandals over the past 15 years. Deutsche Bank was infamously known at some point for being involved in most of them, which even led them to the verge of collapsing in 2016. BNP Paribas also got a hefty $9bn fine

by US authorities in 2013 and still managed to cope with it. **These issues have more in them than just being hindrances to profitability: they show a lack of good corporate governance and a potential inability to restore confidence, unless strong responses are taken**.

- Solvency issues: European banks have been heavily forced by regulators and governments to build stronger capital ratios over the past ten years. Those who could not do that have been forced to merge with other institutions, which led to a much higher degree of sector concentration (Spain is a very good example of such a trend). Should a bank fail to respect its solvency requirements, the regulator will push it to raise capital, sell activities or force it to merge with someone else. **A bank with low solvency metrics poses a threat to its investors, who may become more reluctant to lend money to it on bond markets**. But the central bank is always there to provide liquidity, if need be, unless…
- Liquidity issues & deposit flights: now, that's where things can turn sour very quickly. **A bank can have as much capital and profit as possible, but it cannot sustain the distrust from its clients and counterparties. Deposit flights are a self-fulfilling prophecy and a vicious circle, whereby clients want to jump out of the train as quickly as possible. A central bank can act as a "lender of last resort"**, but it will be reluctant to burn hundreds of millions of cash everyday just to keep a bank afloat. Moreover, **regulators and central banks want contagion risks to be contained as fast as possible, in order to avoid a systemic crisis**. This is why most banks die during weekends, just to let governments, regulators and central banks find the right solution.

Factors leading to the demise of a bank (ranked by order of significance from left to right)

Source: La Française AM.

Conclusion: are we really that powerless?

Looking at credit metrics (profitability, asset quality, solvency and liquidity ratios) is insufficient to assess whether a bank can bear the risk of a liquidity run. Do not get me wrong, these metrics *do* matter, as **the root of a collapse can always be traced back to poor corporate governance, leading to balance sheet issues and/or controversies**. **However, the health of a banking system is too tied to politics and monetary policy to let investors be solely reliant on quarterly figures given by financial institutions.**

Investors and analysts are not powerless though. **Going beyond financial metrics is more than ever mandatory, as deposit flights arise from distrust, which comes from corporate governance**. It takes time and effort to analyze such matters, so you have two choices: sticking to "good quality names" or pushing your luck to pursue higher yields, but at the risk of losing something, or everything, if you are not careful enough.

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