Insights
Fixed Income

October 2021

From Crisis Cause to Crisis Cushion

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In a previous piece, we presented our view that global banks would act as a cushion to the broader economy during the next recession rather than a cause of the downturn, as was the case during the Global Financial Crisis (GFC). This view was predicated on a concept we dubbed *foundational oversight*, or the post-GFC impact of new regulations and internal self-correction that served to reduce bank risk appetite and strengthened fundamentals. Though a global pandemic was not contemplated, the banking sector did indeed act a source of strength during the Covid-19 pandemic. Without broader government support for the economy, however, outcomes could have been far worse. We conclude that post-GFC changes allowed banks to act as a cushion to the broader economy but were not a panacea in the face of a total collapse in economic activity. Moving ahead, we remain confident about bank fundamentals but also cautious given the potential for loose monetary and fiscal policies to promote asset bubbles. As such, we maintain a preference for large, diversified banks with scale.

Background: The GFC and Post-Crisis Improvements

There was plenty of blame to go around for what transpired leading up to the GFC, and banks rightfully took their fair share. For some, problems that led to the GFC were built on shaky foundation of poor governance and misaligned incentives. This was reflected in exorbitant levels of risk-taking across assets that banks originated, held and, in some cases, fraudulently sold to investors. As asset risks emerged and balance sheets became overleveraged, confidence from counterparties and funding providers evaporated. Naturally, non-existent market liquidity was exacerbated by funding mismatches which caused asset fire sales and drove sharp price movement lower. Underpinning all of this was a financial system which was far too complex and interconnected.

Following the GFC, the predisposition of banks became increasingly cautious as regulators forced balance sheets to strengthen. Though attempts to reduce financial system complexity and interconnectedness helped mitigate systemic risk, this was far from perfect. In terms of key outcomes, however, banks were required to hold greater amounts of capital and liquidity, wholesale funding mismatches became discouraged and higher-risk assets became less attractive to hold under capital rules. Speaking to the degree of regulatory reach, even some of the least risky assets came under a microscope due to leverage-based capital rules. In the end, banks got safer from debtholders and this generally remained the case leading up to the COVID-19 pandemic.

COVID-19: A Real Life Stress Test

The 2020 recession was unlike any in recent memory as it not only featured one of the sharpest contractions in economic growth ever recorded, but also one of the fastest recoveries. A main reason for this V-shaped recovery[1] was an unprecedented level of monetary and stimulus which helped to fill a massive gap left by the evaporation of private sector demand. The easing of bank regulatory standards also helped banks to accommodate their customers. As this support was also undertaken with unprecedented speed, it helped to combat mounting cash flow issues across private sector balance sheets.

Australia was quite proactive during the depths of the pandemic. On the fiscal policy front, examples of support included the JobSeeker/JobKeeper programmes and aid to first time homebuyers. Monetary policy support came from a lower policy rate, quantitative easing and the Term Funding Facility (TFF) for banks. Finally, financial regulatory support came with the easing of capital and asset quality reporting standards related to customer loan deferral programmes, which were implemented proactively by banks.

Support Mechanism	What Was Accomplished
Fiscal Policy Authorities	Sustained economic activity and improved borrower finances
Monetary Policy Authorities	Maintained market liquidity and functioning of debt/credit markets
Financial Regulatory Authorities	Provided banks flexibility to grow balance sheet and assist borrowers

Support Was Needed (for Banks to Support the Economy)

Even as standalone bank fundamentals improved markedly post-GFC, it is clear that private sector participants would not have easily navigated this pandemic without government support for the broader economy. Indeed, had the government not responded as it did to the halting of private sector consumption, it would have caused an even greater and more perilous insolvency phase for the public sector. The cascading implications across individuals, businesses and the capital markets could have been far larger.

For scale, we examine JPMorgan Chase, the largest US bank by asset size. In April 2021, the bank indicated that a worst-case outcome with a 100% probability-weighting would require US$45B in reserves for credit losses.[2] While this would have been manageable in the context of US$232B of total capital at YE19, provisions for FY20 came in much lower at US$17.5B. Still, it is notable that JPMorgan's action took place only *after* the Fed and other global authorities took actions to support their respective economies. Had this degree of support not been provided, JPMorgan's loss estimate would have been worse by an order of magnitude, in our view. In summary, government support for the broader economy was needed for the banking sector itself to support the economy.

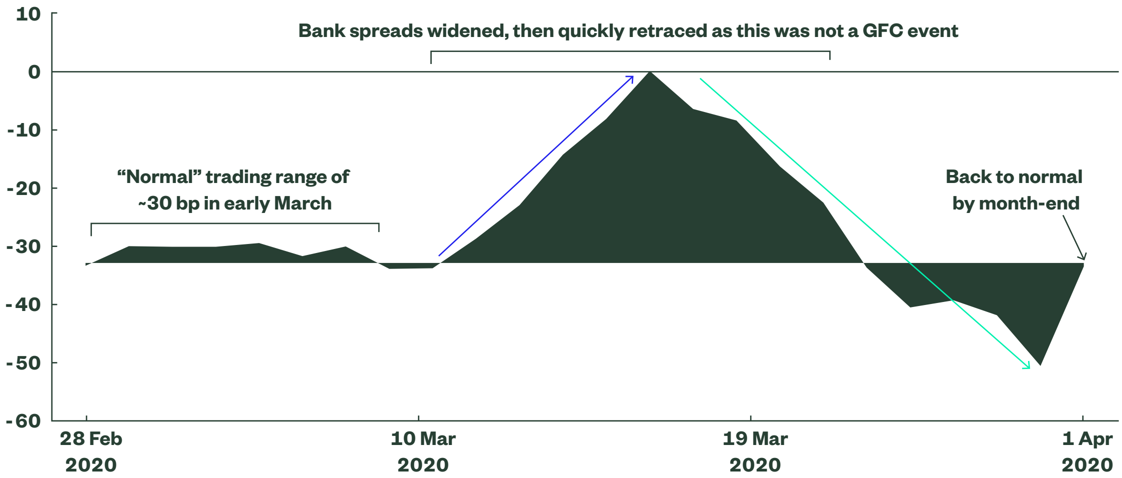
Banks Acted as a Cushion, Not a Cause

Driven by strong bank fundamentals and the role of fiscal and monetary policy, the initial shock accompanying the pandemic normalised in fairly short order as capital markets participants realised that authorities would support proper functioning. Under this backdrop, banks were allowed to fulfil their role as a source of strength to the economy, contrasting starkly to 2008. For example, as the threat of a global pandemic began to loom, corporate borrowers tapped their bank lines as a proactive, defensive posture to build liquidity and make up for revenue and funding disruptions. In the US, banks saw an unprecedented US$480B increase in commercial and industrial (C&I) loans in March 2020, the largest monthly increase in history and dwarfing the US$90B increase in the six weeks following the Lehman Brother's collapse.[3] Despite immediate capital and liquidity implications for banks, the sector proved well-able to stomach this simultaneous growth. Banks also acted as de-facto agents of government policy by offering borrower deferrals on loan repayments in order to compliment fiscal stimulus and allow for borrowers a bridge and get to the other side of the pandemic. Note that banks were able to offer these deferrals in part due to temporary regulatory changes.

How Banks Were Viewed in Credit Markets

Despite acting as a support mechanism, an economic shock like the one in 2020 is often met with investor caution around the sector. While this also occurred in March 2020, it was short-lived. Just prior to the pandemic, banks traded an average of ~29bp inside of industrials in January/February 2020,[4] an indication that the sector was considered more creditworthy in debt markets. When March 2020 hit, banks temporarily underperformed and widened towards parity with industrials. Within weeks, however, the pendulum had more than fully retraced before normalising to start April 2020. Reflecting the sector's resiliency, banks then proceeded to modestly outperform industrials on average until a vaccine announcement in early November 2020.

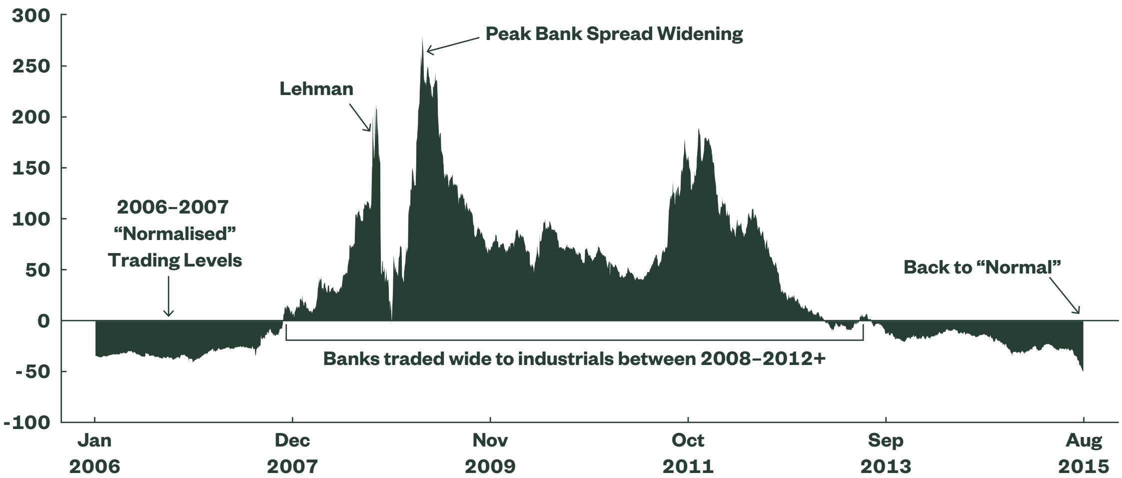
Figure 1
Banks vs. Industrials: Bank Widening in March 2020 was Short Lived



Source: Bloomberg Finance L.P. Data is the Bloomberg U.S. Credit Index (Industrial and Banking categories).
Period: 28.02.2020 through to 01.04.2020.

By comparison, the GFC saw much more of a violent, long-tenured underperformance of the banking sector. Using the 2006–2007 average spread of 26bp as a proxy for the pre-crisis spread between bank vs. industrial investment grade (IG) issuers, it took until late 2014 for bank spreads to revert back to "normalised" levels. This includes five full years of banks trading wide to industrials between 2008 and 2012. Though banks did widen about 30bp relative to industrials in March 2020, this compares to GFC widening of over 300bp from 2006–2007 normalised levels, as shown in Figure 2.[5]

Figure 2
GFC-Era Bank Underperformance Lasted Years… Not Weeks



Source: Bloomberg Finance L.P. Data is the Bloomberg U.S. Credit Index (Industrial and Banking categories).
Period: 03.01.2006 through to 27.08.2015.

There Was No "Lehman Moment" this Cycle

Though problems in the banking sector typically start on the asset side of the balance sheet, financial crises like the GFC that occurred during 2008–2009 are typically liability-side driven as funding providers pull away. This is precisely what occurred at Lehman Brothers in 2008 when market participants refused to face the firm as a counterparty or extend credit. The last line of defense would have been a US sovereign backstop of Lehman's liabilities or the injection of new equity, but this did not happen and a full-fledged financial crisis emerged.

There was no "Lehman moment" in 2020 because the risk-taking ills that plagued the banking sector in 2008 were not an issue in 2020. Unlike the GFC, the sector did not require direct capital injections from the government to sure up balance sheets. Though some countries such as Australia introduced programmes to benefit bank funding and the free flow of capital, no government guarantee programmes were established for bank-issued debt and wholesale debt markets were open for business. Overall, this allowed the government to carry out its necessary function of supporting the economy instead of grappling with the moral hazard of bailing-out large banks.

A Stamp of Approval from Rating Agencies

Rating agencies shouldered a large part of blame during the GFC for being too rosy on ratings and behind the curve on credit quality weakness. This resulted in many investors that blindly followed third party ratings to feel blindsided when uber-high ratings on debt instruments became impaired. So when the pandemic hit, the agencies were a bit quicker to take rating actions globally. However, this mostly was comprised of negative outlooks placed on a sector level and on individual banks instead of a knee-jerk reaction to the credit ratings themselves. Over time and as fundamentals held up well, outlooks were slowly revised back up to 'stable' or, in some cases, have even gained traction towards an upgrade. This "ratings cycle" contrasts strongly to the severe downgrade cycle that persisted for years during and after the GFC and illustrates the sectors fundamental strength.

What about Market Liquidity for Bank Paper?

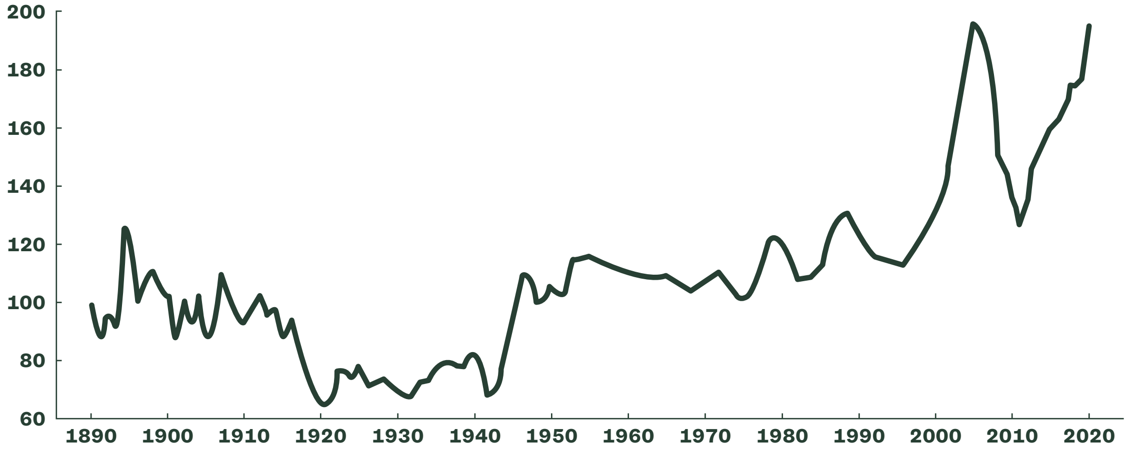
Market behaviour and liquidity conditions in Australia during the March–April 2020 timeframe were much different than during the GFC. As banks came into this crisis flush with liquidity and with solid capital, this put them in a materially better position to intermediate. While there was a brief time in which certain funds and clients began to implement a GFC-style playbook in anticipation of a drawn-out, illiquid money market environment, that proved to be short-lived. Indeed, once the Reserve Bank of Australia (RBA) and other central banks reacted quickly, it became apparent that banks were not only bidding on their own paper but also other debt trading at a deep discount.

From a market liquidity standpoint, the strength of the banking sector acted as a relief valve, in stark contrast to the GFC. During the GFC, it was relatively easy to find assets in the secondary markets to purchase due to a hectic spate of selling and a limited willingness or ability of banks to take on risk. This time around, the early realisation that banks were not the root cause of any dislocation made it difficult to find investable assets. Whereas debt prices were dislocated for many months during the GFC until it became clear that emergency programmes and government support would be successful, they did not stay dislocated for long in 2020.

Ongoing Concerns: Asset Bubbles and the Housing Market

Looking ahead, we are maintaining a watchful eye on the potential development of asset bubbles given the impact of massive money printing globally. While rapid growth in home prices across Australia and New Zealand has caused renewed concerns, this trend is unsurprising given the backdrop of ultra-low rates and massive stimulus. Moreover, it has become a global phenomenon that is occurring in many other countries globally including the United States, as shown below in Figure 3.

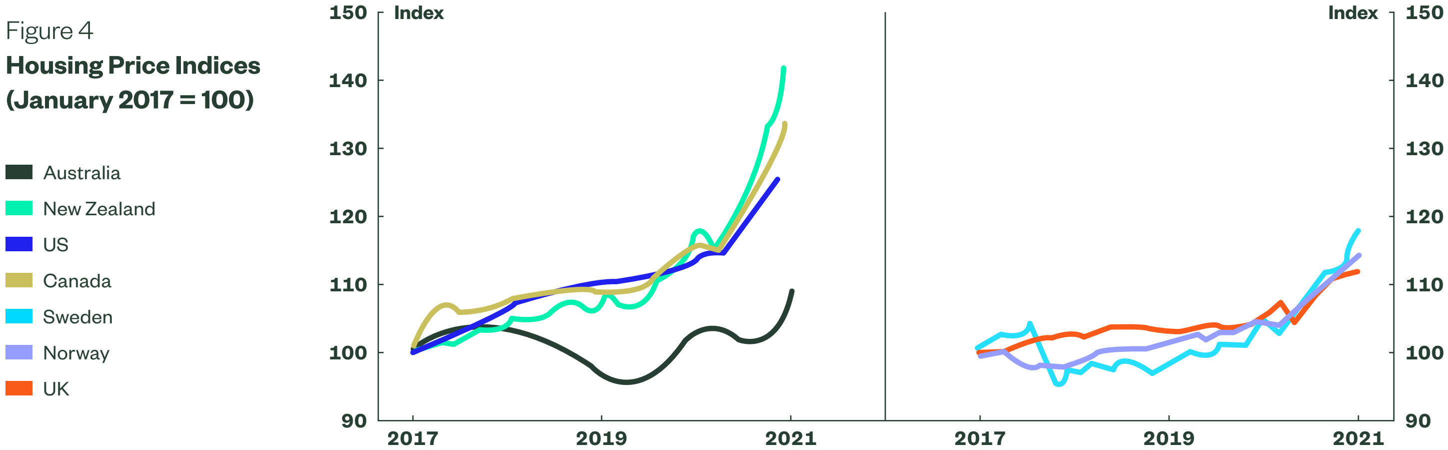
Figure 3
Real Home Price Index in United States (Index, 1890 = 100)



Source: Grebler et al., S&P/Case-Shiller, Warren & Pearson, BLS, Deutsche Bank.

Concerns around the housing market are not new in Australia given its importance to the economy. Over the years and across many cycles, we have observed the market to be a consistent topic of discussion and often a cause of unease, whether prices are rising or falling. This cycle, low rates and a shift to remote work has fueled demand which has helped to offset the impact from lower net overseas migration. Prices have also been supported by the impact of temporary shortages in materials and labour, which has impacted construction activity, and the availability of land for construction due to land use regulation.

Figure 4
Housing Price Indices (January 2017 = 100)



Source: CoreLogic; CREA; Eiendom Norge; Nationwide; REINZ; S&P Global; Vanguard. Taken from RBA Financial Stability Review Report. April 2021.

The risk from housing is not just about prices but about the financial stability risks that arise from developments in the market itself. Australian banks are very exposed to the housing market with more than 60% of loans related to housing. As well, collateral from small and medium-sized business loans is often housing assets. Positively, recent evidence suggests that lending standards have been maintained of late in the face of strong housing demand as compared to a deterioration in standards leading up to the GFC from 2004–2007. In part, this has been driven by regulations which have bolstered lending standards and curbed growth to higher-risk segments.

Fundamentally, enhanced capital levels in the banking sector provide comfort as a loss absorber. APRA recently stress tested the banks and concluded that a very severe recession with a substantial fall in property prices would still leave the banks with capital above their regulatory minimums.[6] In fact, its reverse stress test of what would be required for bank capital levels to fall below 6% includes property prices down by 50%, GDP falling 20% and unemployment rising to 20%, or something not observed since the Great Depression, suggesting a very low likelihood.

Conclusion

Global banks acted as a source of strength to the broader economy during this most recent downturn, in stark contrast to the GFC and in line with our prior expectations. While support from authorities to the broader economy was necessary, this is a core function of a government. Looking ahead, we remain confident about the banking sector's fundamentals but also cautious given the potential for loose monetary and fiscal policies to promote asset bubbles. Changes to post-crisis regulations do not preclude another financial crisis from occurring, but the risk of it occurring has been mitigated substantially.

Endnotes

1 V-shaped recovery is a type of economic recession and recovery that resembles a "V" shape in charting. A V-shaped recovery involves a sharp rise back to a previous peak after a sharp decline.

2 https://reports.jpmorganchase.com/investor-relations/2020/ar-ceo-letters.htm.

3 https://federalreserve.gov/econres/notes/feds-notes/how-did-banks-fund-c-and-i-drawdowns-at-the-onset-of-the-covid-19-crisis-20200731.htm.

4 Bloomberg U.S. Credit Index.

5 Source: Bloomberg Finance L.P. Data is the Bloomberg U.S. Credit Index (Industrial and Banking categories). Period: 03.01.2006 through to 27.08.2015.

6 https://rba.gov.au/publications/fsr/2020/oct/pdf/financial-stability-review-2020-10.pdf.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of June 30, 2021 and includes approximately $63.59 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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ID768156-3858496.1.1.ANZ.RTL 1021
Exp. Date: 31/10/2022