S&P Global
Ratings

Global Credit Conditions:
A More Difficult Way Out

March 20, 2023

This report does not constitute a rating action

Key Takeaways

- The abrupt demise of Silicon Valley Bank (SVB) and Signature Bank, and UBS' hasty takeover of Credit Suisse (CS) are reminders of banks' sensitivity to confidence and liquidity. Emergency liquidity measures by central banks and the expedited takeover have likely lowered the odds of broader banking system contagion, although the decision to write-off CS' AT1 bonds may contribute to a higher cost of capital for banks.
- Broader credit risks remain elevated. U.S. bank failures are the latest episode of financial volatility partly brought about by rising interest rates. We think it unlikely that this episode will prevent policymakers from sticking to the task of taming inflation and expect rates to remain higher for longer. We think it's likely financing conditions will continue to tighten and bring further episodes of credit market turbulence.
- Although this year has seen some credit supportive developments in terms of growth, supply chains, and energy costs, we still expect credit quality to come under pressure as rates rise and growth slows. Downgrades are outpacing upgrades and default rates are ticking higher.

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Emerging Markets, Europe, and North America). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary provides an interim update of views.)

No easy way out. In Outlook 2023: No Easy Way Out, we assessed that finding a way out of the strains weighing on credit leaves little room for error and in the near term we expect credit pressures to intensify. The collapse of SVB represents the second-largest bank failure in U.S. history and UBS' state-brokered takeover of CS brings an end to a systemically important financial institution. These events provide a stark illustration of risks markets face dealing with multiple difficulties: higher interest rates and inflation, war in Europe and the energy crisis, the continued reverberations and costs from COVID-19, and geopolitical tensions. Here we provide a quick update on our views in the wake of banking sector volatility.

Global banks are much better capitalized than in the past, but risks have not been eliminated and liquidity matters as well as solvency. U.S. bank failures have been rare recently (chart 1), there were none in 2021-2022. However, the abrupt failure of SVB and forced closure of Signature Bank are reminders of how quickly a loss of confidence can trigger a bank run and the financial pressures exerted by a rapid shift from an extended period of near-zero interest rates. Social media and app-based deposit withdrawals are additional amplifying mechanisms that didn't exist during the global financial crisis. Banks remain highly leveraged, confidence-sensitive institutions, but global regulation has strengthened over the past 10 years and for the largest global banks (BIS group one), liquidity has improved, and Tier-1 capital ratios have approximately doubled to about 14.5%.

Central banks have shown a willingness to act quickly to bolster confidence. In the U.S., the emergency measures the Federal Reserve announced on March 12 have, in our view, equipped banks, including regional lenders, with additional liquidity sources if needed and most likely

Contacts

Gareth Williams
London
Head of Corporate Credit Research
gareth.williams@spglobal.com

Alexandre Birry
London
Chief Analytical Officer, Financial Institutions Ratings
alexandre.birry@spglobal.com

Nick Kraemer
New York
Head of Ratings Performance Analytics
Deputy Chair, Global CCC
nick.kraemer@spglobal.com

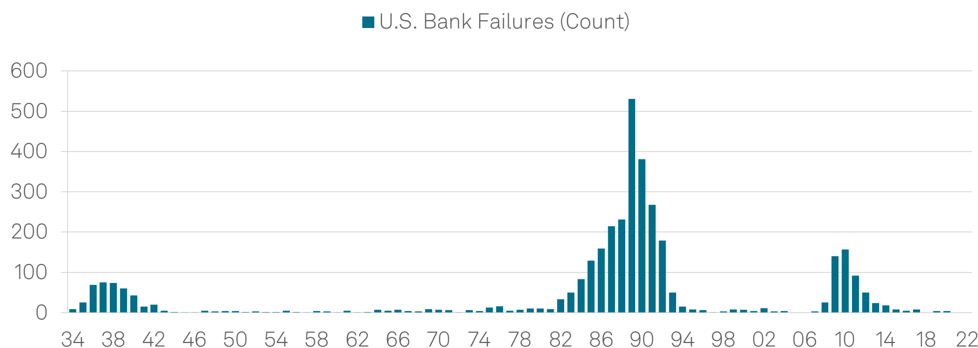
Alexandra Dimitrijevic
Global Head of Research and Development
Co-Chair, Global CCC
London
alexandra.dimitrijevic@spglobal.com

Gregg Lemos-Stein
New York
Chief Analytical Officer, Corporate Ratings
Co-Chair, Global CCC
gregg.lemos-stein@spglobal.com

lowered the odds that confidence-sensitivity issues become relevant for many banks. While conditions remain fluid, we have not seen evidence that the unmanageable deposit outflows experienced at a few banks have widely spread across rated banks, including rated regional banks. Still, the need for liquidity at some banks was highlighted by the record amount of $153bn lent to depository institutions through the "discount window" from the Federal Reserve last week, substantially higher than the peak of $111bn seen in 2008 during the global financial crisis. Banks that need to replace some level of deposits with secured funding could experience profitability pressure and see their franchise strength erode. On March 19, the Fed and five other central banks also announced coordinated action "to enhance the provision of liquidity via the standing U.S. dollar liquidity swap line arrangements" in an effort to limit any broader international contagion. Markets remain volatile and tightening funding conditions could yet expose financial fragilities and require further careful and pragmatic handling by authorities.

Chart 1

U.S. Bank Failures 1934-2022



Source: U.S. Federal Deposit Insurance Corporation, FRED

Broader banking contagion appears unlikely at present. In Europe, financial sector credit default swaps have widened but remain below last year's peak (chart 3). Rated European banks are unlikely to have any meaningful direct exposure to SVB and Signature Bank, and we do not see any rated European banks exhibiting the same funding and business profiles as these entities. As for CS, we believe the business and risk management deficiencies that led to its take-over by UBS are quite unique in nature and scope compared with other European banks. Although some other global European banks had to restructure their operations in the recent past, these restructurings are now largely completed putting these banks on a more solid footing. The decisive actions by Swiss authorities allowing a quick take-over by UBS and providing a massive liquidity backstop to the banks are likely, in our view, to limit the risk of contagion to other European banks. We continue to see European banks as resilient and overall well-positioned to benefit from the rise in interest rates.

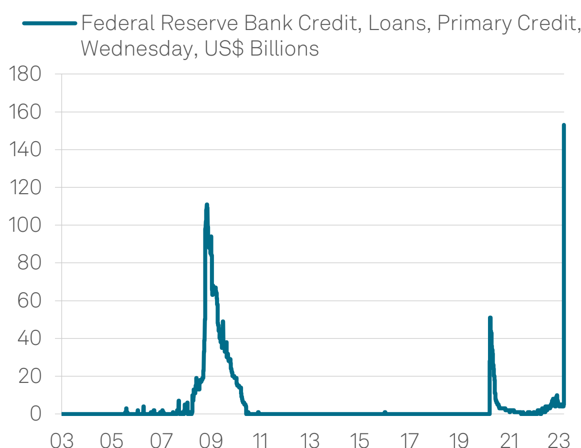
We do not believe the decision to write-off CS' additional Tier 1 instrument (AT1) holders will lead to material contagion risk for European banks even if we expect that the cost of regulatory capital will come under pressure. Banks typically don't hold other banks' hybrid instruments and AT1 markets raise funds relatively infrequently. AT1 instruments account for less than 15% of regulatory Tier 1 capital on average and are capital instruments that are typically perpetual in nature. While non-Swiss AT1 instruments don't have the exact write-down triggers as Swiss ones, AT1 investors have been reminded of their extreme vulnerability if a bank gets into trouble, and of their dependency on decisions taken by public authorities. One surprise to some market participants is that the CS AT1 holders will be written down to zero even though common shareholders will retain some value--a different outcome than we usually expect given typical

creditor hierarchies even if it is one that is clearly possible under the documentation for these AT1. We note EU and U.K. authorities have been quick to remind investors that they see common equity instruments as the first to absorb losses, and only after their full use would AT1 instruments be required to be written down in the EU or U.K.

Asia-Pacific banks are also well-placed to absorb potential contagion effects emanating from the SVB collapse. Direct exposures are negligible, and secondary impacts are manageable. Some Japanese banks, which have large holdings of U.S. government bonds are among the most exposed to weakened market sentiment because of SBV, but not to the extent where we anticipate any imminent rating changes. **Direct exposures for Latin American banks are also negligible**, **and we see more risk of indirect effects through elevated risk aversion raising funding costs.**

Chart 2

Federal Reserve Discount Window Borrowing Surges



Source: U.S. Federal Reserve, Refinitiv, S&P Global Ratings. Data to March 15, 2023.

Chart 3

European Financial Credit Default Swap Spreads Widen

Source: Refinitiv, S&P Global Ratings. Data to close March 17, 2023.

Broader credit risks remain elevated as financing conditions tighten. Although we view prolonged banking system contagion as unlikely, we are mindful that U.S. bank failures are the latest episode of financial market volatility following sharp losses last year, difficulties for crytpocurrency markets, and the U.K.'s pension scare. Most central banks remain engaged in a sustained effort to reduce inflation, and the assumption that banking sector volatility will lead them to retreat from this objective are misguided, in our view. U.S. and European interest rates are likely to continue to rise as a result and, in conjunction with intensified caution over bank lending, this will likely lead to further tightening of financing conditions. Sovereign borrowing needs also remain high and we estimate will reach $10.5 trillion in 2023, nearly 40% above the pre-pandemic average. This will add to upward pressure on funding costs. Risks of further financial market volatility are consequently elevated. Housing markets, commercial real estate, and relatively opaque private asset markets are all areas we are watching closely.

Beyond the stress in the banking system there have been some encouraging developments this year. A mild northern hemisphere winter has helped lessen the impact of the war-related surge in energy prices. The ending of most COVID-19 restrictions in China has contributed to a rapid easing of supply chain strains, one of the primary contributors to the inflation surge. Nonfinancial corporate results continue to demonstrate that companies have successfully navigated soaring cost pressures, boosting profitability and deleveraging as a result. Partial data from the first quarter of the year suggests that GDP could again surprise on the upside

Nevertheless, we continue to expect credit quality to deteriorate and for default rates to rise. Strains in the banking system and the resilience described above complicates the task of central banks in combatting inflation. However, we suspect the imperative to curb inflation will likely result in interest rates remaining higher for longer. This will exert continued pressure on corporate funding costs and we expect lending standards to tighten in response to banking sector volatility. Growth is weakening in most regions and yield curve inversions point to continuing risk of recession. There appears little prospect of a rapid end to hostilities in Ukraine and energy cost pressures will likely be sustained. Profit margins are likely to come under pressure as companies find it more difficult to pass on higher costs. These pressures are starting to be reflected in default trends. This year's global corporate default tally rose to 23 as of Feb. 28--the highest year-to-date tally since 2009. We expect the U.S. trailing-12-month speculative-grade corporate default rate to reach 4% by December 2023, from 1.7% in December 2022. Downgrades continue to outpace upgrades.

We plan to publish our updated macro and credit views later this month at the end of our current Credit Conditions forecasting round and will continue to assess the macro ramifications and monitor contagion risk in the broader financial system (see "Global Banking Risk Monitor").

Related Research

- Research Update: Credit Suisse Placed On CreditWatch Positive On Acquisition By UBS; Tier 1 Hybrids Downgraded To 'C', March 20, 2023
- Research Update: Outlook On UBS Group Revised To Negative On Execution Risk From Credit Suisse Acquisition; Ratings Affirmed, March 20, 2023
- U.S. Structured Finance's Exposure To Silicon Valley Bank, Signature Bank, And Silvergate Bank Appears To Be Minimal, March 17, 2023
- Economic Research: The Macro Fallout From The Silicon Valley Bank Collapse Appears Limited For Now, March 16, 2023
- Credit FAQ: Why Most GCC Banks Can Manage Contagion Risk From SVB, March 16, 2023
- SVB Default And Asia-Pacific Banks: Secondary Effects Are The X-Factor, March 16, 2023
- Unrealized Losses: The Rate-Rise Risk Facing Banks, March 16, 2023
- Latin American Banks To Face Secondary Effects Of SVB Turmoil, March 15, 2023
- Stablecoin Depegging Highlights DeFi's Exposure To TradFi Risks, March 15, 2023
- Rated U.S. Banks Haven't Seen Widespread Deposit Outflows But Uncertainty Continues, March 14, 2023
- European Banks See Limited Contagion Risk From SVB, March 14, 2023
- The Fed's Plan For U.S. Banks Should Reduce Contagion Risk, March 13, 2023

Copyright 2023 © by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&Ps opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.spglobal.com/ratings (free of charge) and www.ratingsdirect.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.spglobal.com/ratings/usratingsfees.

STANDARD & POOR’S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor’s Financial Services LLC.