# Banking Watch

US

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Economic Analysis

US
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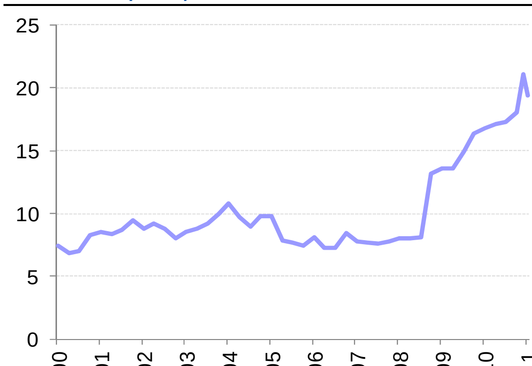
## Can US Commercial Banks Avoid Another Crisis?

- **Commercial banks have plenty of on-hand liquidity and hold huge reserves at the Fed, so the likelihood of a liquidity crisis is minimal**
- **A run on deposits seems unlikely unless depositors lose faith in government backing of depositor's insurance**
- **The US banking system is gradually recovering and remains strong compared to foreign counterparts**

The global banking system is currently under close watch as fears of another crisis spread through Europe and the US. Unnerving sovereign debt crises in Europe have sparked concerns of distress among banks and have scared investors away from financial markets. European banks that once saw little risk of holding sovereign debt are now at a huge disadvantage with balance sheets comprised mostly of Euro-zone government bonds. Now that banks seem reliant on weak sovereigns, panic is steadily increasing. The potential for significant losses has caused a credit crunch that has severely limited the short-term financing available to European banks. The question now is whether banks outside the Eurozone are capable of withstanding spillover effects from a potential systemic event.

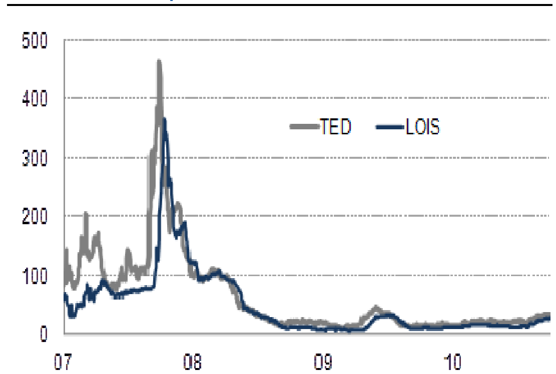
In the US, financial markets are showing increased signs of volatility and risk aversion in response to the situation in Europe. The aftermath of the 2008 financial crisis has continued to weigh on the economic recovery and the recent debt ceiling debacle and credit rating downgrade have increased concerns of financial instability. Increased strains in credit default swaps are already underway for selected broker-dealers that may hold exposure to stressed European markets. However, unlike their foreign counterparts, US commercial banks have more diversified portfolios and hold a much smaller proportion of government funds. Furthermore, deposit insurance and government backing provide a stronger backbone in the case of failure as investors continue to have faith in the ability of the US government to meet its obligations. This is evidenced by today's extremely low Treasury yields. Although the banking system is gradually recovering, what is the potential for either a new liquidity shock or a run on the shadow banking system?

Chart 1
**On-hand Liquidity to Total Liabilities (%)**




Source: SNL Financial

Chart 2
**TED and LOIS Spreads ($Bn)**

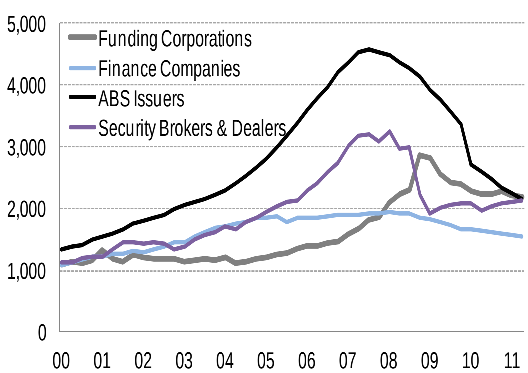



Source: Bloomberg

The concept behind a liquidity crisis is that when liquidity is scarce, asset prices are determined by the amount of liquidity in the market rather than by an asset's discounted cash flows. As asset prices fall, banks are often forced to liquidate their assets, accelerating the price declines to below their fundamental value, sometimes referred to as a "fire sale" of assets. This is also the effect of a leverage cycle: increasing margins and haircuts during a crisis accelerate the need to find collateral through asset sales. Fortunately, it appears that the current state of the US banking sector illustrates little concern over a liquidity crisis. Banks have plenty of on-hand liquidity (Chart 1) and hold huge reserves at the Fed, so the likelihood is very low that they will need to sell less liquid assets or use market funding sources to meet immediate liquidity demands. Additionally, banks have shifted to more use of deposit funding over the past several quarters. In the past three months, deposit accounts at US commercial banks have increased 10%, almost twice as much as the annual increase throughout 2010, and the loan-to-deposit ratio is very high. Furthermore, TED and LOIS spreads remain extremely low compared to the recession spike (Chart 2), indicating high liquidity in the markets and minimal perceived credit risk.

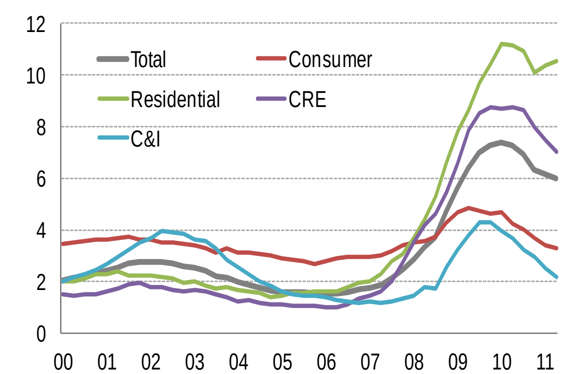
Given this abundance of liquidity, the US banking system is unlikely to experience a crisis unless we see increased vulnerability in shadow banking or new pressures severely hit the real estate sector, which remains a major source of nonperforming assets for commercial banks. With regard to shadow banking, disruption in the unregulated shadow banking system was a key trigger to the 2008 financial crisis. Many of the Federal Reserve's special liquidity facilities specifically targeted the fact that the shadow banking system, through financial innovation, essentially created a new form of deposits that required some kind of backstop against the equivalent of a bank run. Real estate, as mentioned before, remains a source of vulnerability, but the mortgage market is already so troubled that the potential for another "toxic asset" scenario is very low. However, in a risk scenario where home prices fall another 10%, the charge-off on real estate loans would increase and create more stress in the sector. A more plausible scenario would be if employment reverts back to negative growth and consumer spending drops off significantly. However, for this to occur it would require sustained payroll losses to further discourage the already-disheartened consumers. While economic conditions remain weak, it appears that credit levels in major shadow banking categories are returning to pre-recession trends (Chart 3) and therefore pose less of a threat given new shocks to the system. Since the recession ended, policies have been targeted towards preventing excessive leverage and maturity mismatch, both of which can undermine financial stability. Furthermore, the Fed's commitment to keeping interest rates low through mid-2013 will limit interest rate volatility and help keep the shadow banking system in check at least for the short-term.

Chart 3
**Shadow Banking System Aggregates ($Bn)**




Source: Federal Reserve Board

Chart 4
**Commercial Bank Delinquency Rates (SA, %)**

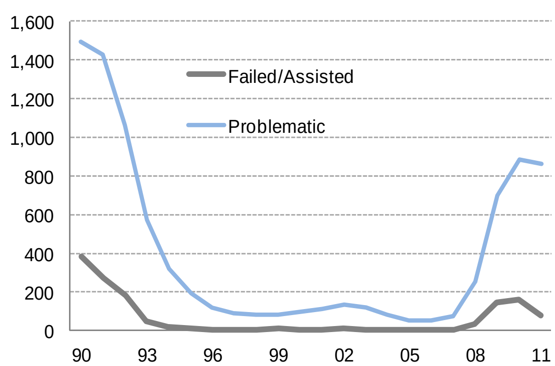



Source: Federal Reserve Board

Mounting uncertainties surrounding the US fiscal situation may leave banks vulnerable to a run on deposits. Bank runs generally occur in times of financial turbulence, when depositors anticipate that future loan defaults will make it impossible for banks to repay their deposits. While deposit insurance was established in the 1930s to protect against traditional bank runs, no form of insurance exists to protect against alternative forms of deposits. Unfortunately, this was the trigger in the recent financial crisis, when investors rushed to withdraw their capital from shadow banking institutions, which had no equivalent of depositor's insurance. In the case of traditional bank runs, with the government bail-outs as an added backing to deposit insurance, the potential for another crisis in the near future seems minimal.

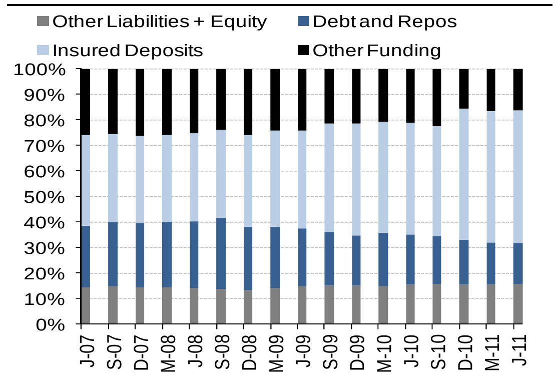
Other major areas of exposure for the US commercial banking system do not present an imminent risk. Consumer and C&I asset quality are nearly back to normal (Chart 4). The banking sector is becoming stronger as the weak and problematic institutions fail (Chart 5) and banks shift their funding sources to become more reliant on deposits (Chart 6) rather than more risky forms of funding. Ultimately, the FDIC is not at risk of entirely depleting the Deposit Insurance Fund and would be a reliable resource for banks.

Chart 5
**Number of Failed and Problematic Banks (Units)**




Source: FDIC

Chart 6
**Commercial Bank Sources of Funding (% of total liabilities)**




Source: FDIC

## Bottom line: US commercial banks can avoid another crisis, at least in the short term

In general, the US banking system appears to be stabilizing and remains relatively strong in terms of portfolio composition compared to foreign banks. Europe, in particular, has been grappling with worries of funding, reserve, and solvency issues stemming from sovereign debt crises that the US has just barely avoided. While the US banking outlook may be better than Europe, the financial crisis is still fresh in all our minds and regulators and depositors alike have become much more sensitive to any signs of weakness. Worries of another Lehman Brothers-type disaster are dominating financial markets; however, given the current state of the shadow banking system, another crisis is unlikely to have the same trigger as in 2008. Although the risk of negative job growth and declines in consumer spending impact business investment, US commercial banks are capable of withstanding this shock. The global economy also poses its risks, particularly if the European bailout strategy fails and sovereign default becomes a reality. Furthermore, slowdowns in China could send shockwaves through the developed world. In both cases, demand for American goods and services would fall, pushing the US even closer to a double-dip recession. Fortunately, the 2008/2009 stress tests forced US banks to raise more capital and strengthen their balance sheets, so the impact may be less severe than in 2008. While the global financial system is not yet in the clear, sufficient liquidity, improved depositor confidence, and the recovering shadow banking system should keep US banking crises at bay for the near future.