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Q&A: Implications of Banking Sector Risks With Mark Carney

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Investors have become increasingly concerned about whether current banking sector risks will spread to the larger economy and markets.

Here, Mark Carney, Chair of Brookfield Asset Management and Head of Transition Investing, answers some key questions about the implications of bank struggles on financial stability, monetary policy and the investment environment.

Q: As a former Governor of both the Bank of England and the Bank of Canada, do you think this current situation rises to the level of a crisis?

Mark Carney:

I would argue that this is not a full-blown crisis, and certainly not a repeat of 2008. The financial sector is much stronger and much more resilient. Central bank liquidity support is also much more immediate and much more comprehensive than it was in the last crisis.

So far, this has been a panic, and panics happen when widely held assumptions are disabused. In this case it was the scale of interest rate risk in banking books—particularly U.S. regional banks—and the stability of corporate deposits.

Let's take a step back and look at what happens in a classic banking crisis. And here I would quote Jacob Frenkel, who served as Governor of the Bank of Israel from 1991 to 2000 and was the first Deputy Managing Director of the International Monetary Fund. During the height of the subprime debt debacle, he said this about the banks' balance sheets: "on the left, there's nothing right, and on the right, there's nothing left."

In other words, banking crises have asset quality problems at their heart. And it's those asset quality problems and impairments that exhaust bank capital and feed the bank runs that turn liquidity crises into solvency crises.

I would argue that this is not the case with regional banks today. Looking at the left side of bank balance sheets, they're full of high-quality credit assets. And on the right side, their liabilities appear solid, with an unweighted (not risk-adjusted) capital-to-asset ratio of over 9% and liquid, safe assets at almost 40% of total assets.

Q: At the start of March, the Federal Reserve had concluded that the system was strong and that funding risks at domestic banks remained low. A little over a week later the Fed would be loaning over $300 billion to banks to stem the funding panic. What happened?

Carney:

There are two main vulnerabilities that the Federal Reserve bank supervisors, and most importantly bank management, failed to appreciate at that time. The first was that the bond holdings of regional banks rose by more than $300 billion in a little over a year to $700 billion. This had limited credit risk. These were highly liquid U.S. treasuries and mortgage-backed securities, but obviously their market value fell significantly with the rapid Fed tightening. And that wouldn't have mattered if the banks had been able to hold these bonds to maturity as planned.

But those plans didn't work out due to a second, more significant problem. The funding risk for many small to midsize banks turned out to be much higher than expected. And that was a consequence of the surge in the uninsured deposit base across the U.S. banking system. That uninsured base went from a low of 30% of total deposits to more than 45% at the start of this year. Some outlier banks—particularly Silicon Valley Bank and Signature Bank—rose to ~90% or higher.

The run risk of deposits went up substantially, and this was reinforced by the advent of fintech and the ease of withdrawing deposits with a click, along with the ability of social media to spread news rapidly. That combination created a bank run with breathtaking speed.

Q: How are the banking problems affecting monetary policy?

Carney:

Monetary policy was already at a tricky juncture. Central banks were probably about three-quarters of the way through their tightening cycle, but only about one-third of those policy rate moves transmitted to the economy. And at that time, central banks cared a lot more about the risks of persistent inflation than the risks from overtightening.

We'll never know, but I would argue that coming into March there was a material possibility that the federal funds rate would have topped out near 6%. Now, central banks are in a position where they are appealing to what's called the separation principle—in which they will use multiple instruments, such as interest rates and liquidity facilities, to achieve their multiple mandates of price and financial stability.

Q: What is the likeliest outcome from this new monetary policy back-drop?

Carney:

I think the most likely path is that this is largely a liquidity crisis that accelerates the monetary policy transmission mechanism. That means that the level of central bank policy rates needs to be lower and the rate increases will be shallower and more tentative—but they will still happen.

To get this right, central banks need to provide large-scale liquidity against a very broad range of collateral. And they also need to correctly forecast the intensification of the transmission of higher interest rates through a more constrained financial system.

Q: How might this look for the European Central Bank and the Fed?

Carney:

In Europe, going into the start of March, it was reasonable to expect a peak deposit rate of 4%. Now, it's more likely that the ECB will tighten rates by about 25 basis points over each of its next few meetings, possibly reaching a peak of ~3.5% around midyear.

The Fed faces the toughest challenge in many respects because the major problems are in its backyard. It put a dividing line between monetary policy and financial stability in its most recent decision, still emphasizing that inflation is too high. Fed Chairman Jerome Powell has made it clear that the Fed is not penciling in rate reductions this year and, in fact, “some firming” is expected. The current median dot plot forecast is for the fed funds rate to top out between 5% and 5.25%. I think that's probably a reasonable outcome now, but that would put the cost of the banking turmoil thus far at around 50 basis points off of the peak rate. That's probably consistent with the impact the banking problems have had on the economy.

Q: What implications do you see for the markets?

Carney:

Liquidity support from the Fed and other jurisdictions will help contain the near-term damage and severity of the funding constraints, but markets are rightly incorporating higher funding rates over the medium term. This is reducing the franchise value of banks with large, low-interest-rate books. This will weigh on credit conditions and financial conditions going forward.

In the financial sector, I expect that the assumptions in bank business models and regulations addressing the stability of uninsured deposits in a digital and social media age will change. Bank funding will likely become more competitive, and I would argue that central bank liquidity backstops will have to become more pervasive. And the pass-through of monetary policy decisions will become more immediate and significant.

Q: And what are the regulatory implications?

Carney:

Liquidity buffer definitions are likely to be significantly tightened to reflect the newfound flightiness of corporate deposits, with the macroeconomic impacts somewhat softened by more generous standing central bank facilities.

It's possible, and will certainly be debated, that seemingly perennial issues with liquidity and open-end funds will be reopened with the renewed promotion of swing-pricing gates in exchange for access to more central bank liquidity.

Q: From an investment standpoint, what market do you see as being the biggest beneficiary of all this?

Carney:

This episode will likely lead to greater credit differentiation among banks and, over the medium term, higher costs. This will improve the relative competitiveness of private credit on the margin. The risk-reward balance overall in credit is deteriorating along with the economy, although opportunities for private credit will likely increase as the bank channel pulls back on new lending.

Q: Could the banking trouble impair renewable energy and transition financing?

Carney:

The availability of capital for clean-energy investment is very robust and is not slowing. In fact, we've seen an acceleration. To put a headline figure on it, the ratio of clean-energy investment to conventional-energy investment has gone from 0.5:1 to over 1:1 over the last five years. More than 90% of global energy investments over the next five years will be in clean energy. From our perspective, Brookfield just announced a large, clean-energy transaction and we already have bank financing in place for that. Indeed, that process went well and was straightforward. So I would say that the clean-energy financing markets are very, very healthy.

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