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Contacts

Atsi Sheth +1.212.553.7825
Managing Director - Credit Strategy
atsi.sheth@moodys.com

Alastair Wilson +44.20.7772.1372
Chief Credit Officer
alastair.wilson@moodys.com

Elena H Duggar +1.212.553.1911
Managing Director-Credit Strategy
elena.duggar@moodys.com

Colin Ellis +44.20.7772.1609
MD-Credit Strategy
colin.ellis@moodys.com

Laura Perez Martinez, CFA +34.91.768.8216
Associate Managing Director
laura.perezmartinez@moodys.com

Michael Taylor +61.2.9270.8199
MD-Credit Strategy
michael.w.taylor@moodys.com

Scott Phillips +44.20.77721.740
Associate Managing Director
scott.phillips@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Credit Conditions – Global

Policymakers have responded promptly to bank stress but spillover risk is rising

Over the last two weeks, financial regulators and other policymakers have acted swiftly to try to contain ripple effects from stress at individual banks. Our baseline expectation is that they will broadly succeed in doing so. However, in an uncertain economic environment and with investor confidence remaining fragile, there is a risk that policymakers will be unable to curtail the current turmoil without longer-lasting and potentially severe repercussions within and beyond the banking sector.

Even before bank stress became evident, we had expected global credit conditions to continue to weaken in 2023 as a result of significantly higher interest rates and lower growth, including recessions in some countries. Looking ahead, the longer that financial conditions remain tight, the greater the risk that stresses spread beyond the banking sector, unleashing greater financial and economic damage than we anticipated in our baseline.

These spillovers likely would occur through one or more of three channels (see exhibit).

Exhibit 1
Spillovers to broader credit and macro conditions would flow through three main channels

	Exposure to troubled banks	Increased risk aversion	Policy support and risks
Debt issuers' credit exposure determined by	• Magnitude of exposure via deposits, loans, other services, or holdings of the entities' equities or bonds • Indirect exposure via customers or vendors with exposure to the banks	• Liquidity risk • Exposure to tighter bank lending standards • Interest-rate risk, asset-liability mismatches, concentration, poor governance and vulnerable business models	• Level of confidence sensitivity • Size and resilience of credit buffers • Links to multiple confidence-sensitive sectors • Credit profiles that straddle the border between resilient and risky
Macro-economic effects	• Likely limited, unless stress spreads widely across banking systems	• Macro risk increases with crystallization of risk in multiple pockets simultaneously	• Inability to calibrate policy to evolving trends could raise systemic financial risks, deepen recessions

Source: Moody's Investors Service

The first and most immediate channel would be spillover effects on entities with direct and indirect exposure to troubled banks. The second channel, and potentially the most potent were it to result from broader problems in the banking sector, would be through a retrenchment in credit by banks and greater risk aversion by financial market participants. While this would affect liquidity-constrained entities most directly, investors and lenders could become increasingly cautious with particular regard to entities that are exposed to risks similar to those of the troubled banks. Thirdly, there is policy risk. For policymakers who had focused primarily on combating inflation over the past year, the recent banking sector turmoil poses additional challenges in navigating the economy smoothly to a new equilibrium. High leverage and complex financial linkages across sectors add to the policy challenges.

Direct and indirect exposure to troubled banks could come in many forms

Financial and nonfinancial entities in the private and public sector could have direct exposure to banks via deposits, loans, other transactional facilities or holdings of the troubled banks' equities or bonds. They could also be reliant on a troubled bank for the provision of essential services. Indirect exposure could be via customers or vendors with exposure to a troubled bank.

The magnitude of exposure would vary by entity. Monitoring and evaluating the direct and indirect links at the entity level will be a key focus of our credit analysis over the coming weeks and months.

Bank stress may have especially negative effects by regional economy or sector as we have seen with respect to the crypto assets and technology sectors. Based on what we know today about entity-level exposure to the US banks that have failed or closed, while there might be negative impact at the regional or sector level, it appears that the broader economic and financial impact of these events will be limited given the size and diversity of the US economy. The protection offered by policymakers to depositors of the closed banks will also limit the negative effects.

The consequences of UBS' recent takeover of Credit Suisse are still unfolding. Given the size and systemic importance of Credit Suisse, there likely will be varied consequences of its takeover for a range of financial actors with direct exposure to the bank. Thus far, however, the rapid completion of the deal appears to have avoided widespread contagion across the banking sector.

If additional stress were to threaten to extend across more banks, or to larger financial institutions, in the US or elsewhere, this spillover channel would have significant macro effects. In such a scenario, we would adjust our macro forecasts and credit assessments to reflect these risks.

Credit will tighten, risk aversion will remain elevated and assets could reprice

Banking stress will likely lead to banks themselves taking a more cautious stance and tightening lending. In addition, recent stress has contributed to a more general increase in risk aversion among financial market participants, evident in market volatility and tighter liquidity conditions. Over the course of 2023, as financial conditions remain tight and growth slows, a range of sectors and entities with existing credit challenges will face risks to their credit profiles.

In this environment, as the recent bank failures exemplify, there is a potential for shocks arising from interest rate risk, asset-liability mismatches, high asset or liability concentration, poor governance, low profitability, higher leverage and vulnerable business models. Banks are not the only type of entities with exposure to such shocks.

Following the recent banking sector developments, market scrutiny will focus on those entities that are exposed to similar risks as the troubled banks. Creditors, investors and counterparties may become more cautious toward sectors or debt issuers that share these risk characteristics, potentially pulling back funding or withholding additional funding to those deemed most at risk in the current environment. Tighter credit conditions and emerging liquidity pressures could result in the crystallization of risk that might have been avoided in a looser credit environment; for example, if these challenging conditions force entities to sell assets, that could lead to unrealized losses becoming actual losses.

Our focus will be to identify entities and sectors that are broadly exposed to tightening financial conditions, both for the implications for particular issuers and for the broader impact on economic and credit conditions. The larger and more prevalent that such pockets of risk become, the greater the chance that the combination of fundamental credit challenges and heightened risk aversion would weaken macro and credit conditions beyond what we already anticipate in our baseline forecasts.

Policy actions will play a critical role as challenges abound

How policy actions anticipate and respond to unfolding events in the coming weeks and months will determine the direction of financial and macro trends. Policy actions and expectations will also shape market sentiment. In our baseline forecasts, we expect policy responses to be rapid as risks emerge, thus preventing entity-level risks from becoming systemic. But calibrating policy remains challenging, which raises the risks that policy missteps, limitations or unintended consequences could result in a further deterioration of the credit environment.

One key policy challenge is how policymakers will address both inflation and financial stability risks. With inflation still high and labor market strength continuing in the US and Europe, the failure to rein in inflation now could lead to de-anchoring of inflation expectations and increased nominal bond yields, forcing even more tightening later to restore monetary policy credibility. However, as the recent banking sector developments show, financial stability risks could materialize in unexpected places as policymakers seek to steer the economy toward a lower inflation path. The dilemma for monetary authorities is that interest rate increases to address inflation could spur financial stability risks, while measures to preserve financial stability, such as enhanced liquidity facilities, would undercut the objective of tamping down inflation through tighter financial conditions. Meanwhile, uncertainty around policy itself could tighten conditions in unexpected ways, accompanied by volatility. This, in turn, could steepen the economic downturn, raising unemployment significantly.

Recent actions by central banks, financial regulators and other policymakers indicate that they recognize the importance of agility and coordination to address these challenges, while also preventing stress in individual banks from spiraling into a systemic crisis.

Their efforts are made more challenging as a result of several factors. The build-up in leverage on balance sheets over several years of looser financial conditions poses fundamental credit risks that are difficult to alleviate at this stage of the credit cycle. Moreover, there is still some opacity in pockets of finance outside the banking sector, such as private credit, where growth has been rapid but risks are not widely known. This makes taking proactive policy measures difficult. In addition, financial interlinkages have grown considerably, with risks transmitting quickly across entities, sectors and countries, heightening the possibility of contagion. Lastly, when market sentiment is precarious, as it is now, volatility around every new announcement or development is greater, adding to liquidity and contagion risks.

The recent events in the banking sector demonstrate how a turn in the cycle can lead to the rapid crystallization of risks at the entity level. Whether persistently tighter credit conditions will tip the economy into a deeper economic downturn, or prompt systemic financial risk, will be contingent on the interplay between preexisting credit risks, policy actions and market sentiment.

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