Unfinished US banking crisis portends systemic disruption

A number of financial outlets are warning of a new round of the US banking crisis that commenced earlier this year. Within the space of just three months—from March to May— the second, third and fourth largest US bank failures in history occurred. First Republic, Silicon Valley Bank and Signature Bank had total assets worth US$532 billion, which is more than all the federally insured banks that collapsed in the 2008 crisis, combined. Then came the revelation that deposits had been fleeing the 25 largest US banks since April 2022, to the value of US$920 billion, due to fear of bank failure and more attractive interest rates to be found elsewhere.

The crisis was precipitated by the Federal Reserve's rapidfire series of interest rate rises (from 0 per cent to 5.5 per cent) to fight inflation, on the back of a massive monetary expansion. Higher rates eroded the value of bank assets in the form of US Treasury bonds and federal agency-issued MortgageBacked Securities with lower fixed interest rates. This weighed heavily on banks as investors moved into newly issued Treasuries that earned them a higher rate of interest.

This phenomenon has continued. Since US President Joe Biden raised the federal debt ceiling on 3 June, rates on all categories of Treasuries, from 6-month bills to 30-year bonds, have risen by more than one per cent. MarketWatch financial news on 27 and 28 September reported that global insurers see "The potential for more cracks to emerge in the banking sector", based on a survey by asset manager BlackRock. Strategists from TD Securities warned about "the risk of 'breaks' similar to those seen during the UK's liability-driven investment crisis of last year and this year's collapse of Silicon Valley Bank”.

Far from having resolved their vulnerabilities, banks have made the problem worse by hiding their losses. They mark the devalued assets as being "held-to-maturity" so they can be valued at their original purchase price (using their "amortised" cost) rather than their current market value (what they are worth if the bank tries to sell them on the secondary market). As Pam Martens and Russ Martens from *Wall Street On Parade* explained 25 September, that could be 20-30 per cent less than the bank is valuing them at. The biggest US banks, the Martens write, are transferring multi-billions of dollars of assets into this held-to-maturity category. JPMorgan Chase, for instance, has herded US$425.3 billion into this corral, assets which have an actual market value of US$388.6 billion, marking an unrealised—and unreported—loss of US$36.7 billion.

America's Federal Deposit Insurance Corporation (FDIC) at 30 June calculated these unrealised losses at US$558.4 billion, but figures are now only available on a quarterly basis because the Federal Reserve suddenly stopped publishing regular statistics in March 2022. According to Wall Street On Parade, this coincided with unrealised losses of securities at the 25 largest US banks "approaching the levels they had reached during the financial crisis in 2008".

Danger zone: Hedge funds

An article in the 26 September London *Financial Times* raised concerns about the build-up of speculative activity in the US$25 trillion dollar US Treasury bond market (up from US$5 trillion in 2008), which underpins the US-dollar based financial system. It points to something *AAS* has been exposing since at least mid-2021—the growing role of highrisk hedge funds as market-makers for US Treasuries (including repurchase or "repo" markets for Treasuries that ensure bank liquidity).

Headlined "The debt-fuelled bet on US Treasuries that’s scaring regulators", the article invokes the panic that rattled UK bond markets one year ago, which had "enough force to topple a prime minister and draw the Bank of England into an emergency rescue". Now the much larger US government bond market is in the firing line, it warned.

FT summarised recent concerns about hedge funds acting as go-betweens in the Treasury market using “arbitrage"—that is, exploiting the difference between current Treasury bond prices and "futures contracts" on Treasuries. As of late August they had nearly US$1 trillion invested in short positions on futures contracts. (The *AAS* of 5 April 2023 showed how this practice already blew up in March 2020.)

This so-called “basis trade”, explains *FT*, "works by exploiting the gap in prices between Treasury futures, which commit users to buying at a certain price on a future date, and on cash bonds. Hedge funds sell the futures and buy the cash bonds, which they can deliver to the counterparty when the futures contract comes due." Hedge funds do all this with borrowed money—on both sides of the trade—sometimes leveraged up to 500 times says *FT*. The bottom line is that the US Treasuries market has been turned into one big gambling den.

FT warns of a "collision of heavy leverage with sudden and unexpected market movements, and the speed with which that can cause potentially serious problems." In the past "the Fed has said the strategy poses a ‘financial stability vulnerability’ while the BIS [Bank for International Settlements] said it had the potential to ‘dislocate’ trading."

Matthew Scott, head of rates trading at AllianceBernstein told *FT*: “My biggest concern is that if we get a big unwind in this leveraged trade, it could really cause liquidity to dry up in the Treasury market”. But, said an unnamed senior executive at one of the world’s largest hedge funds: “If hedge funds stopped buying Treasuries, I don’t know who would buy them.”

Any number of hiccups can collapse this house of cards, says *FT*: Banks may cut back leveraged lending to hedge funds, or ramp up charges; clearing houses facilitating futures trades may increase collateral for trading positions (as happened earlier this year); repo market rates could spike, leading to reduced bank lending for hedge fund trades. All would inhibit hedge fund profits and could cause them to unwind positions, with other market players following suit in a "doom loop". This would dry up liquidity, disrupting Treasury markets with potentially global impacts.

By Elisa Barwick, Australian Alert Service, 4 October 2023
