Can the World Deal With a New Bank Crisis?

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As Europe braces for the release of its bank stress tests on Friday, the world could be on the verge of another banking crisis. The signs are obvious to all. The World Bank estimates the ratio of non-performing loans to total gross loans in 2015 reached 4.3 percent. Before the 2009 global financial crisis, they stood at 4.2 percent.

Stress Tests

If anything, the problem is starker now than then: There are more than $3 trillion in stressed loan assets worldwide, compared to the roughly $1 trillion of U.S. subprime loans that triggered the 2009 crisis. European banks are saddled with $1.3 trillion in non-performing loans, nearly $400 billion of them in Italy. The IMF estimates that risky loans in China also total $1.3 trillion, although private forecasts are higher. India's stressed loans top $150 billion.

Once again, banks in the U.S., Canada, U.K., several European countries, Asia, Australia and New Zealand are heavily exposed to property markets, which are overvalued by historical measures. In addition, banks have significant exposure to the troubled resource sector: Lending to the energy sector alone totals around $3 trillion globally. Borrowers are struggling to service that debt in an environment of falling commodity prices, weak growth, overcapacity, rising borrowing costs and (in some cases) a weaker currency.

To make matters worse, the world's limp recovery since 2009 is intensifying loan stresses. In advanced economies, low growth and disinflation or deflation is making it harder for companies to pay off what they owe. Many European firms are suffering from a lack of global competitiveness, exacerbated by the effects of the single currency.

Government efforts to revive growth -- largely through a targeted expansion of bank lending -- are having dangerous side effects. With safe assets offering low returns, banks have financed less creditworthy borrowers, especially in the shale oil sector and emerging markets. Abundant liquidity has inflated asset prices and banks have lent against this overvalued collateral. Low rates have allowed weak borrowers to survive longer than they should, which delays the necessary pain of writing off bad loans.

In developing economies, strong capital inflows, seeking higher returns or fleeing depreciating currencies, have contributed to a risky buildup in leverage. So have government policies encouraging debt-funded investment or consumption to stimulate aggregate demand.

What's most worrying, though, is the fact that the traditional solutions to banking crises no longer seem available or effective.

To recover, banks need strong earnings, capital infusions, a process to dispose of bad loans and industry reforms. Yet today, banks' ability to earn their way out of their problems and write off losses is limited.

Current monetary policy is partly to blame. Zero or negative rates drive down bank lending rates more than deposit rates, which can't be cut because of the need to maintain deposits and comply with regulatory requirements for stable funding. Traditionally, banks have built capital by earning the margin between low deposit rates and safe, longer-term fixed rate assets, such as government bonds. Today, the term premium -- the difference between short and longer-term rates -- has fallen sharply.

Attracting new capital requires that the industry's long-term prospects be sound. To the contrary, several structural factors are creating uncertainty about the future of banks and may have permanently reduced available returns. Bank business models in several countries are in need of major reform, which means consolidation and cost reductions ahead. Many countries where banks need assistance remain resistant to foreign ownership, capital and expertise that might help them become more efficient.

Poor institutional and legal frameworks, especially inefficient bankruptcy procedures, discourage new investment in banks or distressed assets. Foreclosures in Italy can take more than four years, compared to 18 months in the U.S. or U.K. In many emerging markets, the pervasive influence of the state among both banks and borrowers complicates the enforcement of claims. Politically connected borrowers can force loans to be rescheduled forever rather than recognized as unrecoverable.

Unanticipated political developments are added complications. Energy prices are affected by geopolitics as much as market forces. The Brexit vote has rippled through the banking system by driving down the pound and radically altering prospects for British financial institutions.

In Italy, political factors are impeding the recapitalization of banks. European Union procedures require progressively writing down equity, subordinated debt and then senior debt, protecting only insured deposits. But “bailing in” creditors in this way would result in writing down around $220 billion of securities held by retail investors, creating a political headache for the government. At the same time, EU banking regulations as well as budgetary and debt limits make it hard for the Italian government to intervene.

Whether a crisis might begin there, perhaps as some fear with the world’s oldest bank, Monte dei Paschi de Siena, is impossible to say. But regulators everywhere should be asking themselves some tough questions: Has the financialization of advanced economies gone too far? Does the role of banking need to be altered to ensure that such crises are less frequent? Increasingly, the answer to both would seem to be yes.