Why Counterparty Risk Is So Important for Corporate Treasuries Right Now

Events in the first half of 2023 served, or at least should have served, as a timely reminder of the importance of counterparty risk. Over the course of just five days in early March of that year, three small-to-mid size U.S. banks failed, triggering a sharp decline in global bank stock prices. Silicon Valley Bank (SVB) was the first to fall after a fire sale of its treasury bond portfolio at a large loss triggered widespread loss of depositor confidence, ultimately culminating in a fatal bank run.

Failing US banks

The bank's clientele consisted primarily of technology companies and wealthy individuals holding large deposits, and any balances exceeding $250,000 were not insured by the Federal Deposit Insurance Corporation (FDIC). The result of the collapse was widespread panic in the US's regional banking sector, as companies and individuals began realising that most of their funds were not protected. In short order, two other mid-sized lenders, Silvergate Bank and Signature Bank, failed.

In response, US federal bank regulators announced that extraordinary measures would be taken to ensure that all deposits at Silicon Valley Bank and Signature Bank would be honored. But, even that wasn't enough to stop the failure of New York-based First Republic Bank on 1 May. Like Silicon Valley Bank, First Republic was heavily exposed to uninsured deposits exceeding $250,000. Its collapse meant that in the space of just two months, the US suffered the second and third largest bank failures (Silicon Valley Bank and First National Bank) in its history.

A worldwide problem

The banking crisis was not restricted to the US. In mid-March, Credit Suisse (CS), the second-largest bank in Switzerland and one of 13 global systemically important banks in Europe, failed following a string of scandals and the collapse of two investment funds in which the bank was heavily involved. The fast-moving fallout from the bank collapses in the US was the final straw for CS, accelerating a slow-burning run on deposits. In the end, Switzerland's largest bank, UBS, bought CS in a shotgun merger, a move intended to prevent the too-big-to-fail bank from collapsing altogether.

While a systemic banking crisis may have been averted through last-minute mergers and the mass mobilisation of central bank funds, these events were a stark reminder that the global banking system is still dangerously fragile. They also reminded us of an oft-forgotten truth: money in the bank carries counterparty risk.

Money in the bank carries counterparty risk

We all have insurance on our homes, even though the risk of a fire or flood causing catastrophic damages is miniscule. Yet some companies have all their money in just one or two banks, exposing themselves to acute levels of counterparty risk. In the UK, the Financial Services Compensation Scheme insures individual and business depositors for up to £85,000 in total across *all* accounts held within a bank or banking group. As we saw in the US, if bank regulators had not stepped in to protect all deposits, even unsecured ones, at the affected banks, high net worth and corporate depositors would have lost the lion's share of their funds.

This underscores the importance of diversifying one's funds across multiple banks and asset classes. Though, even that doesn't guarantee that your money will be safe in the event of a systemic crisis.

Not always low-risk, low-return

If you invest in a highly-liquid money market fund, your money will be spread across hundreds of banks and companies that need short-term liquidity. Because of their high levels of diversification and liquidity, money market funds are generally considered to be less risky than their stock and bond counterparts, and they have an important role to play within a company's reserves. Often thought of as cash and a safe place to park your money, they offer a low-risk, low-return investment in a pool of highly secure, highly-liquid, short-term debt instruments – in normal times. But in the event of a systemic crisis, they, too, can suddenly become fraught with counterparty risk.

During the financial crisis of 2008-09, money market funds in the US faced significant losses on commercial paper and notes issued by Lehman Brothers.[i] In the pandemic-induced market crash of 2020, money market funds in the EU showed vulnerabilities to liquidity risk on both their asset and liability sides.[ii] In the third week of April 2023, money market funds suffered their worst weekly outflow since 2008.[iii] This could be a possible warning sign.

Counterparty risk is on the rise these days for several reasons including persistent high inflation across the global economy, which we discussed in our previous article in this series, "Inflation or Disinflation: What Lies in Store in 2025?" As happened in the 1970s, inflationary forces could come in a series of ever-higher waves, making it nigh-on impossible for central banks to cut interest rates.

Inflation, interest and debt

The link between inflation, interest rates and credit events (bankruptcies, payment defaults and debt restructuring) is well established. As inflation rises, central banks begin hiking rates in a bid to tame surging prices, which makes it more difficult for heavily indebted households, businesses and governments to service their debts. At a global level, total debt (public, household and corporate) was at a historic peak of $313 trillion in early 2024, according to the Institute of International Finance. One of the world's biggest debtors, the US government, is now paying annual interest rate charges of over $1 trillion to service its debt, up from $587 billion in 2019.

As debtors increasingly struggle to service their debts, the risk of recession and credit events rises, heaping yet more pressure on the world's already fragile banking systems. Could more banks in the US and/or Europe buckle as they did in 2023? It's impossible to know, but the fact that the Federal Reserve and other central banks are in the process of withdrawing many of the emergency funding programs that helped to steady the ship last year, while inflation remains high and financial conditions continue to tighten, is hardly confidence inspiring. And, that is why finding assets with near-zero counterparty risk is so important for corporate treasuries right now.

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[i] https://www.imf.org/external/pubs/ft/fandd/basics/pdf/dodd-money-markets.pdf
[ii] https://www.esma.europa.eu/sites/default/files/trv_2021_1-vulnerabilities_in_money_market_funds.pdf
[iii] https://www.bloomberg.com/news/articles/2024-04-18/money-market-assets-drop-most-since-2008-as-tax-day-takes-toll

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