

Are banks in trouble?

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There has been much discussion in the financial media over the weekend about the supposedly perilous state of Credit Suisse and the not much better state of Deutsche Bank. Both have share prices that suggest the bank as a whole is worth about a quarter of the supposed net asset worth of their balance sheet.

This tweet makes it clear that they are not alone in having this undervaluation:

https://twitter.com/nsquaredmacro/status/1576579593494204417?s=21&t=cP8we_lwSHQbn7BkdQ8h3A

What this does, of course, imply is that rationally the shareholders demand that the bank be broken up and that the assets be returned to them. That demand is not being made.

That implies something else. That something else is that the shareholders do not believe the asset valuations on the balance sheets of these banks, whatever their auditors might have to say about them.

The reason for this disbelief is not hard to find. The banks in question will hold the assets on their balance sheet at supposed market value. Whilst for some assets market value is relatively easy to find, for others it is not and discounted cash flow models based on expected future rates of return and expected interest rates will be used to determine these values. And that, in the current market environment is where the problem lies.

We know two things about expected future returns and interest rates right now. The first is that future returns are increasingly uncertain and need to have an increasing risk factor applied. The second is that interest rates are rising, pretty much everywhere, although not as much (maybe) as in the UK. In that case whatever market values were estimated not long ago could now be drastically overstated.

Three thoughts follow. One is that it is entirely possible that many banks are now sitting on entirely bogus balance sheets and that massive provisions against values are

required.

Second, this means that the collateral many of these banks have to offer is severely diminished, potentially significantly increasing their cost of capital.

Third, mark to market accounting can exacerbate this trend by potentially reinforcing falls in value once poor market conditions as a result of increasing interest rates become ever more apparent.

What is the right policy response? First, to prepare to nationalise banks with no intention of returning them to the private sector.

Second, to cut interest rates as soon as possible as the policy of increased rates is clearly not working on inflation and is proving massively costly elsewhere.

Third, anticipate chaos because there is a real chance that a major bank might fail and they are all massively interwoven with each other, meaning the risk of contagion is high.

The chance of 2008 happening all over again looks to be significant as a result.

The real answer? Sound accounting and the ending of the use of many financial instruments that spread rather than mitigate risk in a downturn. Or to put it another way, go back to basics. This may be the only way out of this mess.