Funding the Future

The Bank of England is warning a financial crash is com...

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The Bank of England has issued a stark new Financial Stability Report — and beneath the cautious language lies a clear message: the global risk environment has deteriorated sharply. From AI bubble valuations to fragile shadow banking systems, from overstretched credit markets to potential contagion across sovereign debt, a systemic crisis now looks more like "when" than "if".

In this video, I explain what the Bank is really saying, why markets are repeating 2008 mistakes, and why the UK is deeply exposed.

https://www.youtube.com/watch?v=NMDdkEZhNbI?si=qfPcXu8wa1WUKEpn

This is the audio version:

https://www.podbean.com/player-v2/?i=esf88-19e156f-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a

This is the transcript:

The Bank of England has issued a new Financial Stability Report, which they do every quarter or so, and this one is important because it says one overwhelming thing, which is that the risk environment around the UK economy has deteriorated. And when people as conservative, as prudent, as cautious, and frankly as banker-like as the Bank of England are, say that the risk environment has deteriorated, what you really know is that things are looking pretty grim.

Their assessment is that the global economic uncertainty ratios remain high, geopolitical tensions, trade fragmentation, and stressed sovereign debt markets are all increasing the probability of global shocks, in their opinion. Whilst cyber risks are rising as geopolitics worsen, and most especially, they're worried about AI asset valuations.

So let's start there. As the Bank of England points out, the current share prices for AI companies are near dot-com bubble price-bursting situations in the USA. In the UK, share prices are at their highest level since the global financial crisis in 2008. So we are looking at comparisons either with, in the USA, 2000, or here with 2008, and on both those occasions, share prices subsequently fell by around 40%.

What the Bank of England says is that a sharp correction, which is another way of describing a crash, is becoming increasingly plausible. They say this matters. They say this matters because AI infrastructure investment is now being financed by rapidly rising corporate debt. That could therefore give rise to a direct spillover into the banking market, and the deepening link between AI firms and credit markets means losses could spread rapidly if anything goes wrong with AI investment. In fact, they say a setback in any one part of the AI ecosystem could now ripple through interconnected lenders and investors in a way that is very hard to imagine, but which could be catastrophic.

This is making credit markets look fragile beneath the surface. Everything's looking fine right now. There is a smooth situation, but corporate leverage is high. There are also, and the Bank of England admits this weak loan underwriting standards going on right now, and complex and opaque structures are being used to facilitate finance in exactly the same way as happened before 2008.

In other words, if you read between the lines - and you have to with the Bank of England, because they are diplomats - they are saying basically that everything that they saw happen before the global financial crisis is now happening again with regards to weak appraisal of lending situations, poor potential returns arising, and all of that being hidden within bank and other balance sheets by the fact that complex legal structures are being used, which means risk appraisal is really now very hard.

And as they say, two recent high-profile debt defaults in the USA show how losses can suddenly hit multiple debt market participants all at once. Everybody in this sector is related, in other words, just as we discovered in 2008. When Lehman failed in September 2008, it was not an isolated incident. They tipped over everyone else because every single participant in the banking, finance, and related sectors are all essentially one web of interconnected funding.

What the Bank of England is saying is that in this situation, investors must understand their real risk exposure and not rely on credit ratings that have recently proven too slow to react. Again, they're flagging up something which we know is a real risk. In 2008, markets failed because credit rating agencies said that banks were stuffed full of debt, which was high quality, and it turned out to be something pretty worthless, close to rubbish, and obviously, the bank is indicating that this risk really is there again.

They're also flagging something else, and this one cannot be emphasised enough. They're saying that last time the problems were in the banking sector, but this time they're also in what we should properly call the shadow banking sector. That's private equity funding, private credit, and associated insurance operations, and in hedge funds. These have expanded massively since 2008, and - and this is the key point which the Bank of England makes - they have never been through a macroeconomic downturn of this potential size before. In other words, whilst the Bank of England knows there's a risk, even they have not appraised the possibility that it is the private equity shadow banking sector that will bring markets down now and effectively, they're admitting that in the face of this potential crisis, they are flying blind. That is not reassuring.

What is more, and I don't agree entirely with this analysis by the Bank of England, but they think it, and so therefore will markets, they are claiming that because many governments already have high debt to GDP ratios, their capacity to borrow is limited; aided and abetted by the fact that many are at the moment pushing borrowing to the limit as a consequence of demographic change and defence spending pressures, which means, in their opinion, but not necessarily in mine, that fiscal capacity to actually extend further funding to the banking sector if it decides to collapse again may be limited.

Now that is worrying because if that attitude prevails - and I suspect it wouldn't if a crisis emerged - but if that attitude even prevails now, the likelihood that any risk could be massively amplified through sovereign debt markets is just going to be significant. The risk is real that we could have a bond market shock as a result, and that would help no one when we're also facing the risk of a credit and, frankly, share market meltdown at the same time.

In all of this, the Bank of England says the UK is highly exposed to global contagion. In other words, even if we've got all our ducks in a row, and the Bank of England is effectively saying we haven't, because we are so intimately connected to US, European, Japanese, Australian, and other markets, then if there is a risk in one major financial centre or stress in one market, then that could very easily spill over into others.

The risk of this is that if, as a consequence, banks decided to panic, and banks do have that habit, they could go in for the most destructive forms of reaction possible, including fire-sales and reducing access to finance for households and businesses at the very point where a fire-sale will be totally counterproductive by reinforcing the scale of a downturn; when households will need money, as will businesses, but banks won't be lending it. In other words, they're saying the risk of panic and meltdown is growing very high, and we in the UK are exposed to it.

Now they claim as a counter-argument to that, that UK banks are, at this point of time, supposedly resilient according to the tests that the Bank of England imposes upon them. But then they would say that, wouldn't they, because after all, they design and impose those tests. Do I really believe them? I don't, and the reason why is that they're testing the wrong thing. They're testing banks, but as they also admit, the risk that we are facing is not really in banking at all; it's in shadow banking. Therefore, they're actually saying that the part of the sector, which is resilient, doesn't matter because it will fail if the shadow banking sector does, and so their reassurance is to me, well, almost worthless.

At the same time, they're saying that the real purpose of banking, which is to provide loans to business to actually drive investment in the real economy so that people can get jobs and prosperity can increase; well, that's not happening. That activity is most important in the small and medium-sized business sector in the UK because they are the real drivers of growth and employment in this country. And as they admit, they are not getting access to money at present; that is still not happening. So whilst the finance sector and our large companies, banks, and others are putting us all at risk, where there is a prospect of growth in our SME sector, there is no finance being provided. You couldn't make up a situation so absurd if you tried. The finance sector is doing everything it can to bring down the real economy right now, and the Bank of England is beginning to panic about it as the messaging of this report makes clear.

They also say, as if it's a reassurance, that right now household debt is stable in the UK, but they say that with a decided number of caveats attached. Whilst the mortgage market does look under control at present and the number of defaults is relatively low, the fact is that they know that households are stressed, and they are particularly aware that renters remain heavily exposed to cost-of-living pressures and interest rate sensitivity in the broader economy. In other words, what they're flagging up is this: if we do get a crisis because of AI and a share meltdown, or a private equity meltdown, or a banking meltdown, or anything else, then everybody who's actually trying to pay their mortgage or pay their rent is going to be under severe stress as well because landlords, mortgage companies, banks, and everybody else are going to try and put up prices.

This crisis is not going to be contained within the finance sector; in other words, it's going to hit you, it's going to hit me, and that matters. We are exposed to systemic risks and the Bank of England identify one of those risks. They do, for example, identify that maybe £100 billion is at present being gambled in UK gilt markets by hedge funds simply to try to make short-term profit. But if there was a sudden movement in the value of these funds as a consequence of an AI meltdown, they have no idea what might happen as a result; in other words, that market could melt down too.

This is how a crisis starts. It's the cross-contamination that literally brings the system down. And what I'm getting time and time and time again out of this Bank of England report is that the cross-contamination now is so high that they can't work out what the scale of the risk is, but they're petrified of it.

Financial innovation is just exacerbating that. New innovations like stablecoins and distributed ledgers, or whatever we wish to call them behind Bitcoin and everything else, might look as though they're resilient, but again, they've never been tested. The bank is continuing to monitor crypto asset risks, but once again, they are basically admitting they are way behind the curve with regard to this. The risk could be there, and they aren't even aware that it exists. My belief is that's exactly the situation they're describing. Crypto remains fundamentally risky. We've seen its prices tumbling already; that's going to continue. It isn't what is going to pull the whole edifice down, but it could just exacerbate the problems when it happens, and the Bank of England, I think, is admitting that they're not on top of all of this.

There's another area where they admit that as well. They have suddenly realised, or perhaps not suddenly, but certainly are emphasising more realistically than they have done for a long time, that climate risk is becoming more direct and decidedly more financial. We are seeing climate risk being played out in real time all around the world now, whether it is fires or floods or high temperatures, meaning crop failures or whatever it might be; those things are turning into real financial risks as well as catastrophes for the people involved. The impact is rendering many assets uninsurable, and that has massive consequences for financial markets and for bankers who can't lend against uninsurable assets, whilst the risk is being shifted onto households, some of whom now find they can't move as a result of all of this. And ultimately, the state is picking up the bill. The bank knows that. They can see it. They recognise it's happening, but they're unable to quantify it yet again, and still, we are doing nothing about the risk that they identify.

So what's the overall conclusion? The overall conclusion, according to the Bank of England, is that the core banking system is strong but that the risks are increasing. They're increasing because of overpriced AI tech markets, because of leveraged non-bank finance and hedge fund activity, which is creating opacity in markets, which look as though they could be vulnerable, but nobody's sure by how much, and they stress that, in their opinion, there is sovereign debt fragility, which is being exacerbated by the activity of speculators; whilst in the real world, there's too little money going into actual investment, and climate shocks and geopolitics are all presenting fundamental risks that are not being addressed or even properly appraised.

The Bank of England might be saying that everything is resilient, but frankly, when I read between the lines, I think they're saying we're in it up to our necks with risk right now. We have no way of knowing how big those risks are, but they look to the Bank of England, the most cautious of people, to be substantial, and they're flagging up, "Be careful because this may well come and bite us."

To put it another way, they think we're in for the most massive crash. They failed to notice 2008 coming. The Queen, notably, drew attention to their failure during the course of a visit she made to the Bank of England after that crash happened, and they don't want to be caught out again.

So, how do I really read this financial stability report? I read it as a signal that we aren't facing financial stability at all. We are facing massive financial instability, and everything I have been saying for some time about the fact that a crash is coming is true. We're only discussing when, not if, now. The Bank of England are saying it will happen. And in that case, I think we can pretty much bet on this being a certainty.

So what do you think? There's a poll down below. I'm feeling pessimistic. You may not. What's your mood right now? Let us know.

Poll

[poll id="271"]

Taking further action

If you want to write a letter to your MP on the issues raised in this blog post, there is a ChatGPT prompt to assist you in doing so, with full instructions, **here.**

One word of warning, though: please ensure you have the correct MP. ChatGPT can get it wrong.

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