16 April 2024

THE BANKING TURMOIL OF 2023

ROUNDTABLE BULLETIN[1]

Beginning in March 2023, a series of significant bank failures occurred in the US (Silicon Valley Bank (SBV) and Signature Bank, followed by First Republic Bank in May) and in Switzerland (Credit Suisse). It was the first time that the crisis management and resolution framework put in place after the Great Financial Crisis (GFC) of 2007-9, had been put through a serious test. These episodes have been the subject of much commentary and several official reports aimed at understanding the causes and evaluating the consequences.[2] In turn we have considered what broader policy lessons there may be from these episodes and reflected on the questions they raise.

History repeats itself

At one level this experience was déjà vu. Rapid growth, undiversified funding strategies and toxicity in managerial culture are repeated harbingers of financial distress. Bad management can, and arguably should lead to a bank failing. The state should only step in to prevent loss to retail customers and to limit systemic spill overs, whilst making sure that public money is not lost.

Bank management that is supposedly financially literate is often myopic; the US banks at least, seem to have been lulled into a false sense of security about the durability of low interest rates. Deposit runs can happen very quickly, including on the back of rumours or single pieces of news, with funds being transferred to banks perceived to be safer.

Every time a bank's own actions lead to failure, supervisors are apportioned some blame, with greater or lesser justification depending on circumstances. Regulatory complexity, particularly in the US, has been noted for decades. In the case of SVB, supervisory failures admitted have been acknowledged, not least because oversight arrangements did not keep up with the rapid growth of the bank (FSB, 2023).

In Switzerland, Credit Suisse was known to have been a problem bank for some years. A series of increasingly bad senior management decisions had led to worsening profitability, and ultimately a business that could not be saved. The financial sector has been here before. Yet, when history repeats itself, it always does so with a new twist.

---

[1] Synopsis of themes considered at roundtable discussions on 16 January 2024. The views expressed do not necessarily reflect those of the participants. Roundtable discussions take place semi-annually. Participants have included Vitor Constancio, Jon Cunliffe, Jacques de Larosière, Erkki Liikanen, Donald Kohn, Guillermo Ortiz, Andrew Sheng, Masaaki Shirakawa, Dr Zeti Aziz, Oliver Wuensch. The discussions are moderated by Dr Gavin Bingham, Paul Fisher and Sir Andrew Large.

[2] See FSB (2023) '2023 Bank Failures: Preliminary lessons learnt for resolution', October 10. and Swiss Finance Ministry Expert Group (2023) 'The Need for Reform after the Demise of Credit Suisse', 1 September; https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf; https://group30.org/publications/detail/5264; https://centerforfinancialstability.org/research/CFSRegPaper101623.pdf;

What was new?

Apart from the complacency of policymakers and bankers following the period of interest rates being 'low for too long', in the US the lessons were mostly centred on the role of technology and the tech sector itself. The immediate cause was particularly virulent bank runs, triggered by large losses on unhedged fixed-income portfolios in the face of unexpectedly rapid rises of interest rates. In addition, the concentration of clients flush with cash that had ultimately been injected by central banks, meant that depositors behaved in herd-like fashion – another well-known risk. Nothing new there and even deposit runs via electronic access, 24/7, have been seen in previous crises. It is worth noting, however, that despite all the new regulations post-GFC, the 2016 Basel standards for interest rate risk in the banking book did not retain a minimum capital requirement but emphasised disclosure[3]. This remains a significant shortcoming despite recent proposed adjustments.[4]

In summary, there were at least four new features observed in the US episode:

- Failure of the public authorities, and in particular monetary policymakers to take account of the financial stability consequences of the rapid rises in interest rates as inflation took off, following the long period of low rates and the monetary and fiscal responses to the Covid-19 pandemic.

- The existence of large wholesale deposits from the flush with cash tech sector, which proved to be more flighty than traditional corporate deposits.

- Deposit withdrawals which were sparked and then propagated by social media.

- Changes at the Federal Reserve from 2013 which had allowed certain non-banks (money market funds for example) to have access to their Reverse Repo Facility and so deposit cash with the central bank. Such access created the ability of deposits to flee the banks completely, not just to become skewed towards the safest banks. Some changes were made to partially shut the stable door in April 2023.[5]

There is a big difference in prudential supervision of interest rate risk in the banking book between Europe and in the US. Because of the failure to agree on a common Basel provision (under Pillar I), the rules on such risk are left to national supervisory discretion and intervention (Pillar II). The US has never applied (will they in future?) a rule which forces banks to mark to market any portfolio from which they start to sell. This prescription amounts to the immediate provisioning of portfolios affected by increases in interest rates. The stability of the European banking system has been fostered by applying such rules.

The Credit Suisse episode was 'new' in the sense that it constituted the first failure of a globally significant bank (G-SIB) since the designation was created and extra capital requirements imposed on such firms. There had been long-standing problems with management, organisation and culture at Credit Suisse, which led to significant losses, a gradual erosion of confidence and eventually depositor flight.

---

[3] See e.g., Moody's Analytics Whitepaper: "Interest Rate Risk in the Banking Book (IRRBB): Meeting the Practical Challenges". N. Kungheheian (2017). Available at: https://www.moodysanalytics.com/-/media/whitepaper/2017/interest-rate-risk-in-the-banking-book-meeting-the-practical-challenges.pdf

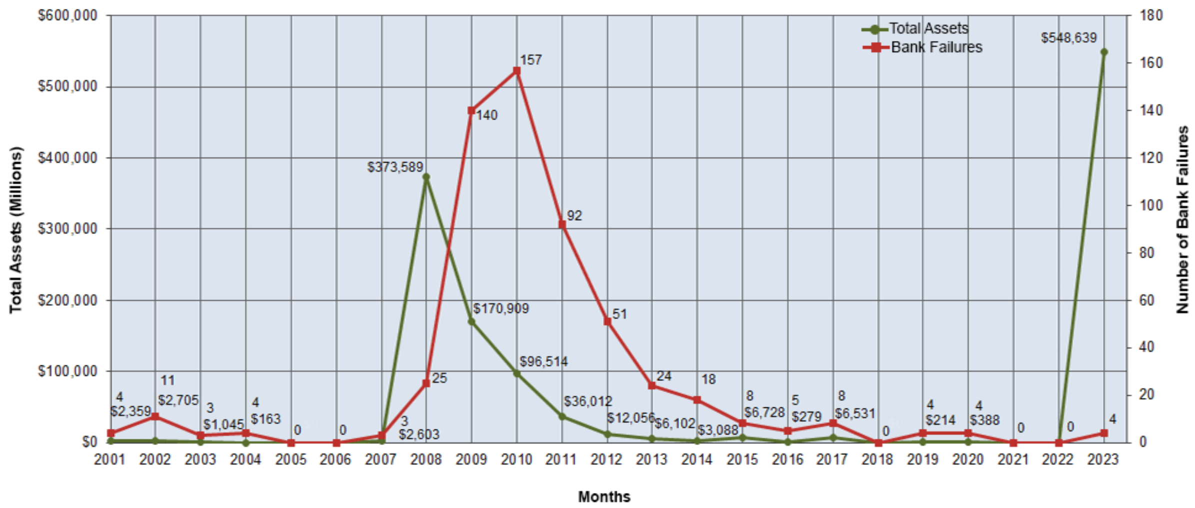
[4] BIS December 2023, Recalibration of shocks for interest rate risk in the banking book. Available at: https://www.bis.org/bcbs/publ/d561.htm#

5 See Reuters, April 25 2023: "NY Fed limits types of firms that can access its reverse repo facility". Available at: https://www.reuters.com/markets/rates-bonds/ny-fed-limits-types-firms-that-can-access-its-reverse-repo-facility-2023-04-25/

What was also noteworthy in both the US and Switzerland, was that the authorities did not follow the expected playbook.

At one level, these were standard and successful interventions. The US authorities applied time-tested tools for resolving the three banks that failed. It is noteworthy that the combined size of their balance sheets was larger than that of the US banks that failed at the time of the GFC (Figure 1). The twist was that the deposit insurance protection limit was raised to cover all deposits, not just those which were guaranteed.

Figure 1: Total assets and number of failing US banks.



Source: https://www.fdic.gov/bank/historical/bank/

The unexpected aspect in the Swiss case was that the authorities, did not use the planned Recovery and Resolution processes, which have been prepared internationally after the GFC. Instead, the Swiss changed course over the final weekend and implemented a buyout by UBS. In the process, that provoked a waterfall of losses that differed from what the market had expected, in particular wiping out 100% of the AT1 bond holders.

The swift and decisive action of the Swiss authorities and the Swiss government stabilised the Swiss banking system without immediate systemic repercussions.[6] But it has led to a situation where a similar course of action is no longer feasible with UBS remaining the sole large bank based in the country.

All options for Credit Suisse would have been messy. Had the Swiss concluded that the firm could have been resuscitated, the country would still have two G-SIBS. Two banks would have been better than one. The judgement must have been that even wiping out subordinated debt and existing shareholder equity would not have eliminated doubts about the Credit Suisse brand and the long-term sustainability of its business model. This bank was dead and nailing it to the perch would not have worked for long.

[6] See FSB (2023) ‘2023 Bank Failures: Preliminary lessons learnt for resolution’, October 10. and Swiss Finance Ministry Expert Group (2023) ‘The Need for Reform after the Demise of Credit Suisse’, 1 September.

What does this imply for the future?

Deposit insurance:

In each episode a proximate cause of the turmoil was depositor flight. That raises the question of whether more complete deposit insurance arrangements would help avert crises. Although about 98 per cent of depositors and deposit accounts are covered by deposit insurance in the jurisdictions that are members of the International Association of Deposit Insurers [IADI], there has been a gradual erosion in the value of deposits covered, as banks have increased their wholesale deposit funding. Only 6% of SBV's domestic deposits by value were insured.[7]

That reduction reflects at least two factors under the authorities' control. Central banks in the US and Europe, and some elsewhere, massively expanded their balance sheets and thus the narrow money supply following the GFC. In the first instance this created more deposits as the cash injection must end up, one-for-one, with the banks collectively. But deposit insurance limits were not raised despite continuing expansion of the deposit base. And the extra deposits created principally accrued to large companies and high net worth individuals. Hence a growing proportion would have been uninsured even if limits had been raised. To make matters worse, certain banks in the US seem to have targeted these deposits for their core funding.

The potential for conflict or lack of coordination between monetary and financial stability:

These episodes may provide a financial stability argument for central banks to reduce their expanded balance sheet size. Going forward there must be a question of whether deposit insurance limits need to be set holistically in the context of the supply of central bank money. And one might expect supervisors to 'join the dots' and be more vigilant about the source of rapid deposit growth.

We have witnessed a clash between monetary and financial stability objectives, at least a failure in coordination and understanding between authorities. Arguably, monetary policy helped to create the conditions for rapidly rising inflation, which it then had to respond to with higher rates. This must have been a known risk, even if not the central expectation. The possibility of sharply raising interest rates should have been a known risk to supervisors (and the banks of course) even if the monetary policy setting committees were surprised by the speed and extent of the actual pick-up in inflation. It is surprising that the risk seems to have been ignored.

The future for public sector guarantees:

In both Switzerland and the US, public funds were put at risk, in the former through emergency legislation and guarantees, and in the latter through the invocation of the systemic risk exception set out in the 1991 legislation. No publicly managed money has been lost so far, although the FDIC costs may ultimately be borne by the US banking industry and its customers. The key issue is whether repeated extension of public support creates the expectation of a sovereign guarantee on all bank deposits next time round. And there will be a next time.

If the implications of contingent increases in sovereign debt were too painful for governments and their taxpayers or if their exercise would bankrupt a small state with big banks, restrictions may have to be put in place in advance that move the system towards narrow banking.

[7] https://www.iadi.org/en/assets/File/Speeches%20and%20Remarks/EBI_Global_Academic_Conference_EHupkes.pdf

Capital and liquidity:

For some, the events of 2023 demonstrated the point that mandatory capital requirements do not do much to prevent bank failures. Rather the system is 'safer' in that there is more residual value to make creditors whole when a bank fails. Capital requirements are 'gone concern', and their imposition on an idiosyncratic basis could stigmatise an institution rather than make it less likely to fail. Only voluntarily held excess capital can be used to absorb losses in a going concern.

The speed of the deterioration demonstrates the need for massive amounts of liquidity, in addition to adequate capital, to minimise failure risk. And that liquidity must be immediately available to use, not tied up in mandatory reserve requirements else the same 'gone concern' considerations arise. Unlike capital, central banks can provide large amounts of extra liquidity at short notice, as long as enough good quality collateral is available at the right time and in the right place. In general, a stressed firm will have depleted its most liquid collateral by the time it needs liquidity support from central banks. It may still have good quality assets – in its loan books for example. That speaks in favour of ensuring that liquidity is available when needed by 'prepositioning' in normal times portfolios of less liquid but high credit quality assets as collateral with central banks. But for international firms there is the risk of central banks in different jurisdictions all wanting to take security of the best quality collateral in a crisis. And it must be available immediately and in the right place to allow the appropriate central bank to lend – for example when markets open at different times in each jurisdiction after a stressful weekend - otherwise failure may be inevitable.

The Credit Suisse example may serve to re-emphasize the primacy of the home regulator and the potential dominance of 'single point of entry' in resolution. Nevertheless, preparation of cross border and multi-currency liquidity provision requires thorough coordination amongst central banks before a crisis emerges, not in the final death throes.

Playbook vs ad hoc resolution:

Despite far more thorough preparation for managing crises than before the GFC, markets were surprised by the actions taken. If investors and depositors believe that planned and announced policies will not be followed through in the precise circumstances when they are most needed, then confidence in those policies will be lost. Ad hoc approaches can lead to a dead end – now that Switzerland has only one large bank, the commercial buyout option by a domestic bank no longer exists. Still, the authorities cannot anticipate and create a playbook that covers every eventuality, and excessive precommitment could rule out the optimal solution. And whilst it may be good for the pricing of risk for markets to know what to expect, individual firms can also 'game' the authorities if the latter are too predictable. As with monetary policy, the challenge is to find the right balance between rules and discretion.

Digitalisation and disintermediation.

Digitalisation not only enables instantaneous deposit flight and speeds the spread of rumours that spark it, but it also opens the way to disintermediation of the banks by the private and public sector. The future of fractional reserve banking may be in question in a world of potentially almost instantaneous bank runs and artificial intelligence's capacity to erode the comparative informational advantage of fractional deposit banks in borrowing short and lending long.

If digitalisation is the new source of risk, it could also be a new source of mitigation. Private deposits could be increasingly held in stable coins or similar asset-backed securities. Tokenized, these could be used for payments. Such assets could after suitable operational preparation also be taken by central banks as collateral.

More broadly, the financial system does not strictly need banks to provide credit. AI could perhaps substitute out the banks' traditional advantages in credit assessment for households and SMEs. In such a world, banks might revert to the narrow banking model that permitted the Bank of Amsterdam to offer its services over a span of two centuries. The loss would be the ability to leverage deposits in the traditional way, making the allocation of capital less efficient.

CBDCs could also lead to disintermediation of the traditional banking model unless suitable safeguards are put in place. As it stands, in most countries, only banks or similar institutions have accounts at the central bank. That means that under stress, deposits may flow out of one bank but they stay in the system and accumulate at the safest banks. Authorities can step in to recycle liquidity as needed. But if other financial agents can obtain claims on the central bank, then the commercial banks can be bypassed.

CONCLUSIONS

The single most important lesson from the banking turmoil of 2023 is the importance of sufficient, immediately available liquidity. Not just in the trivial sense that bank runs cause crises but in the sense that central banks and other authorities must be able to provide it in sufficient amounts, at a moment's notice, and in a manner that avoids losses for the public sector. For globally active banks it means that liquidity must be available in multiple currencies across numerous jurisdictions at all hours of the day. The dollar swap lines introduced in the GFC have helped but are not sufficient. Prepositioning of collateral can help, but only if the issue of competition across jurisdictions for adequate security does not scuttle coordinated action.

This is the fiftieth anniversary of the Basel Committee. In this half century the issue of the coordination of capital standards has been front and centre. It is now high time for the same degree of attention to be given to coordinating the provision of liquidity in a banking crisis.