Fast and furious …but tameable: Lessons from the recent banking turmoil for the EU

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Healthy banks are critical to safeguarding financial stability. The recent collapse of three US banks and one in Switzerland has sent shockwaves through global financial markets, with tremors continuing to this day. The speed with which these entities folded, and the strength of the market reaction, cast doubt on the ability of the current frameworks to contain the fallout of such events.

Although not all bank failures can be fully avoided, European banks and supervisors have made great strides in reducing risks and strengthening the system's resilience to shocks. Completing banking union and capital markets union will help prevent crises, by enhancing risk-sharing, and contain their aftershocks, thanks to a stronger safety net. Fully implementing the Basel III reform will also bolster the existing EU regulatory framework, which has proven instrumental in buttressing the financial sector through the pandemic as well as in limiting contagion from the turmoil in the US.

The fastest monetary tightening cycle in recent history

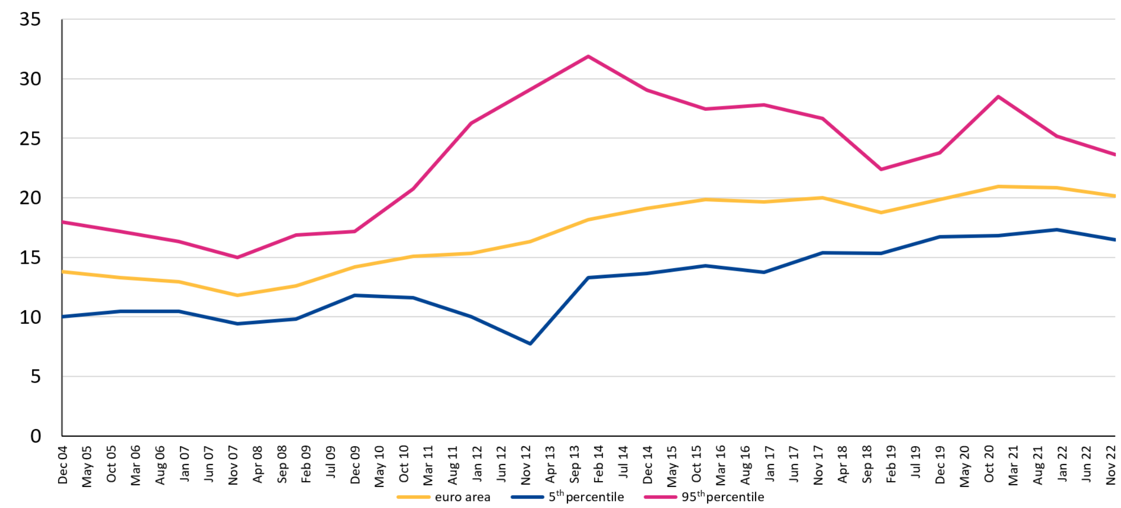
We are living through the fastest tightening in recent monetary history. In the span of little more than a year, the Fed has raised interest rates by 500 basis points, the Bank of England by 400, and the European Central Bank by 375 (see Figure 1). Understandably, after over a decade of ultra-low rates, financial institutions are struggling to adapt to the rapid changes: financial conditions continue to tighten due to persistent expectations of inflation and increasing real interest rates.

Source: Bloomberg

With strong capital buffers, a balanced liquidity position, and very low impaired assets, euro area banks seem solid – even when looking at the weakest entities (see Figures 2a, 2b, 2c). Higher monetary policy rates have also alleviated some pricing pressures on banks, allowing them to increase net interest margins and expand their equity by retaining earnings.

Figure 2a: Euro area banks have boosted their capital positions since the Global Financial Crisis…

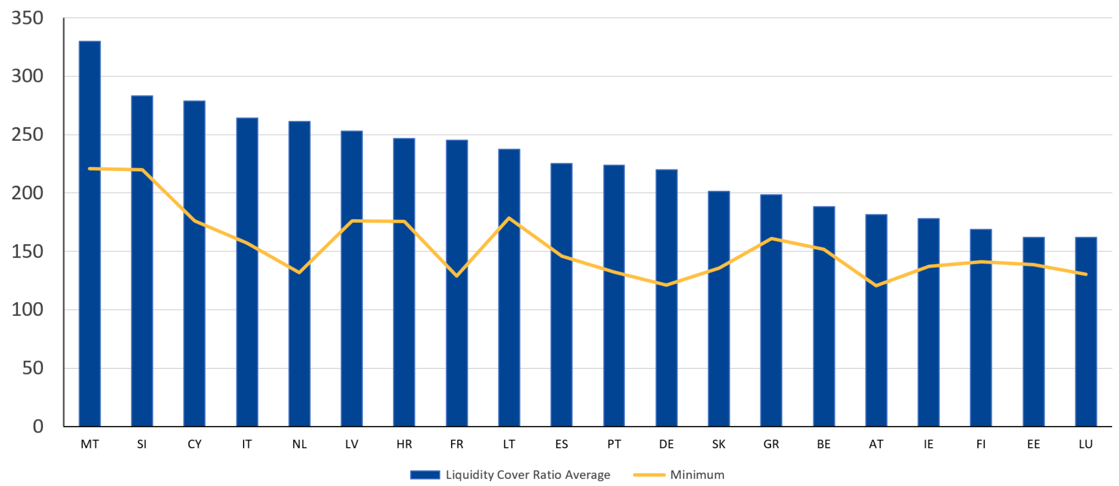
(in %)



Note: Total Capital Ratio, cross country distribution over time

Source: ESM based on Capital IQ Pro and Fitch Solutions data

Figure 2b: ...and hold also ample liquidity buffers

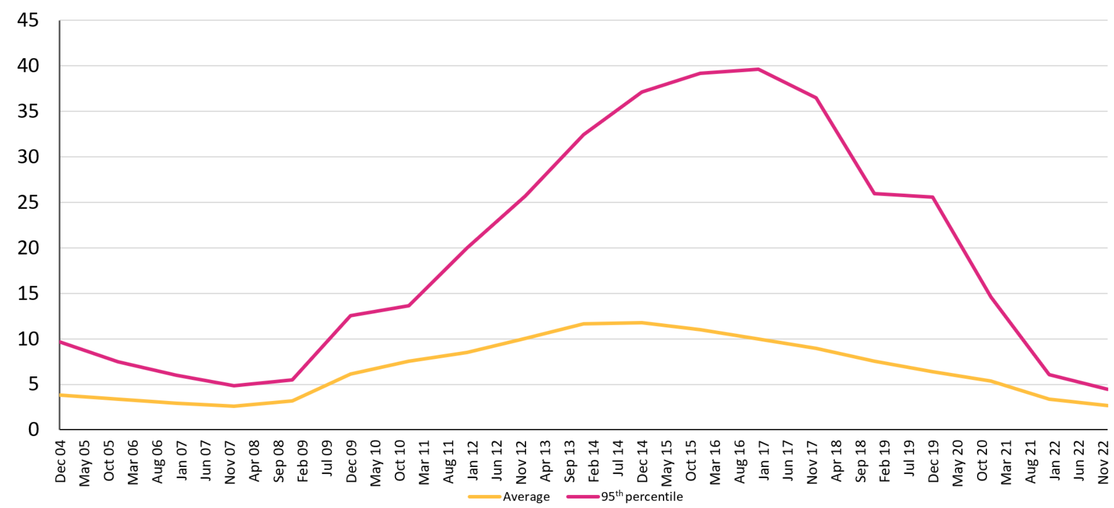


Note: Liquidity Coverage Ratio (LCR) per euro area country, Year-end 2022

Source: ESM based on Capital IQ Pro and Fitch Solutions data

Figure 2c: Non-performing loans remain very low, even compared to historical standards

(in %)



Note: Impaired loans/gross loans, euro area cross-country distribution over time

Source: ESM based on Capital IQ Pro and Fitch Solutions data

Still, high interest rates and rapid changes can expose vulnerabilities in banks' asset and liability management. And tight financial conditions in the euro area will continue to stifle credit demand and cloud the risk outlook, hampering banks' operations. Under such circumstances, it would be naïve to exclude new challenges for the banking sector.

Some business models unravel in the face of rate hikes

Post-mortem inquiries into the recent financial turmoil affecting the US and Switzerland, including the self-critique by the Federal Reserve Board, offer insights for Europe.[1]

The three US banks collapsed due to an overreliance on cheap funding from large uninsured deposits combined with investment strategies vulnerable to sharp interest rate spikes. Poor governance and reduced supervision failed to detect and curtail business strategies doomed to fail in a tightening cycle, exacerbating the situation. As soon as investors and depositors suspected something amiss, they swiftly withdrew their trust and their money.

The fate of Credit Suisse unfolded somewhat differently, but a similar issue of an overly lenient risk management culture, compounded by protracted poor profitability, eventually sapped confidence in the bank and led to its demise.

In the end, market discipline worked by eliminating unfit entities. The process has been arguably costlier than need be, as large deficiencies cannot be left to the sanctioning behaviour of market participants. Regulation, risk governance, and supervision should all do their share first.

Although the turmoil in the US and Switzerland has not spread to euro area banks, complacency would be unwise and could lead to disregarding important warnings for Europe.

What are the lessons one can draw?

Lesson 1: Trust matters more than size. The turmoil in the US involved entities not counted among the largest in the country. Yet, their size was enough to spread concern about the viability of other banks and the safety of deposits elsewhere. Restoring confidence needed strong support statements and bold actions. The line separating "too big to fail" institutions from non-systemically important institutions may be meaningless during a crisis when depositors' money is at stake.[2] Additionally, resorting to bail-out solutions and overriding rules in a crisis can undermine public trust in the existing safety net and decrease incentives for banks to guard against risks, potentially creating a moral hazard.[3]

Lesson 2: Speed is of the essence. The bank runs took place at unprecedented speed. For comparison, the demise of Washington Mutual – the largest bank failure in US history – came after a nine-day deposit outflow amounting to 9% of deposits (or USD 16.7 billion). Silicon Valley Bank, on the other hand, was contemplating a loss of 80% of its deposits in less than two days (USD 142 billion out of USD 175 billion). Bank runs in the digital age could occur in a matter of hours; regulators will need to adapt to this speed.

Lesson 3: Sticking to the rules pays off. In its review of the supervision and regulation of Silicon Valley Bank, the Federal Reserve Board admits that the 2019 partial rollback of regulations prevented more stringent oversight of the bank. Accordingly, the tailoring of rules resulted in the bank being subject to "lower supervisory and regulatory requirements".[4] Stricter rules (akin to Basel III) would have helped identify risks earlier.

Lesson 4: Close coordination is necessary. The swift resolution of all entities has relied on the tight collaboration of three actors:

I. deposit insurance agencies that fulfilled their fundamental mission in restoring confidence, by reiterating—and even expanding—their commitment to the safety of deposits.

II. central banks that coordinated vital liquidity support either with direct liquidity injections or by orchestrating support from other lenders. Governments also stepped in as a backstop.

III. national champions, like other large banks from the same jurisdiction, that eventually stepped in and acquired the failed entities.

All actors came from the same jurisdiction and were able to rapidly create immediate and partly new solutions and mobilise resources to stabilise the crisis. In Europe, action across different governance levels and countries is by nature more rules-bound and complex, requiring an even higher level of preparedness and foresight.

A call to action

These lessons underscore the importance of pursuing the completion of banking union with renewed energy. A fully fledged banking union over the medium term would greatly enhance the ability of the system to absorb shocks and contain risk propagation.

In pursuing this endeavour, we see the following actions as priorities:

Action 1 – Enhance deposit insurance and funding in resolution across the euro area. While member states already feature national functional deposit insurance schemes, more homogeneous rules and practices would provide greater legal certainty to depositors and market participants. The implementation of the new crisis management and deposit insurance legislative proposal put forward by the European Commission would ensure a more harmonised and credible framework across all member states.[5] Robust back-up arrangements, based on banks' contributions, are also essential to avoid resorting to public money to tackle banking crises. Once in place, the ESM's common backstop for the Single Resolution Fund will contribute to this aim.

Action 2 – Adjust regulations to prevent digital bank runs. The digitalisation of customer–bank relationships changes the dynamics of bank runs, requiring the adaptation of some regulatory tools. For example, the liquidity coverage ratio is currently designed to bolster banks' resilience against deposit outflows. However, the time span considered (30 days) is much longer than that of digital runs, where deposit outflows may materialise at a speed of 40% in 24 hours. In addition, when envisioning crisis scenarios, innovation in payments and digital currencies should be looked at.

Action 3 – Finalise Basel III implementation. Full implementation of Basel III needs to be faithful across jurisdictions and across entities of different sizes. This is a painful lesson of the recent experience in the US, where the distinction between risks stemming from large vs medium-sized banks has proven fallacious.

Action 4 – Reduce overreliance on national champions. The "too big to fail" issue came to the fore again after a US giant had to intervene to absorb the latest failing bank. A more complete banking union would further reduce the remaining national barriers across banking systems and increase the choices available to authorities when considering potential buyers for an embattled bank.

Recent turbulences in the banking sector have revived public attention concerning vulnerabilities in the banking system. While euro area banks continue to show strong resilience, we cannot exclude problems ahead. The completion of banking union is essential to mitigate the potential impact of the fault lines exposed by the recent failures.

In addition, a more diversified pan-European financial system would reduce the reliance of European companies on bank lending, as firms would have more options to raise funding in equity and debt markets.

Advancing capital markets union will allow for a greater variety of financing sources and, in turn, greater risk-sharing away from the current bank-centric system, thus further reducing the impact that banking crises would have on the economy.

Acknowledgements

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Footnotes

[1] Federal Reserve (2023), Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank.

[2] Definition: "A bank, insurance company, or other financial institution whose failure might trigger a financial crisis." See also European Banking Authority for definition of systemically important institutions: Systemically important institutions (europa.eu).

[3] Moral Hazard: a party has incentives to take risk, knowing that it will be protected by the consequences of their risk or bad decision making as these consequences will be borne by others.

[4] Federal Reserve (2023), Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank.

[5] European Commission (2023), Reform of bank crisis management and deposit insurance framework (europa.eu).

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