Lessons To Be Learned From 2023's Bank Failures

By **Juliette Mills and Alix Prentice** (December 19, 2023)

Juliette Mills

Alix Prentice

In scale and scope, 2023 saw the most significant systemwide banking stress since the 2008 global financial crisis.

The collapse of four regional and global banks coupled with significant rises in interest rates, inflation and seismic geopolitical instability have raised questions around the adequacy of prudential and regulatory frameworks.

This article looks at the major themes emanating from the consequent period of self-reflection by regulators across the world. It will examine the U.K. perspective while drawing on the universal themes that have, understandably, been reiterated across the major global economies.

Background

On March 8, Silvergate Capital, a fintech and cryptocurrency uninsured, nondepository bank in California, announced it would be winding down its operations and liquidating its bank.

Two days later, following a bank run, Silicon Valley Bank, one of the most prominent lenders in the start-up world, failed.

On the heels of Silicon Valley Bank's collapse, the contagion caused Signature Bank, another prominent regional bank, to be taken into receivership by the Federal Deposit Insurance Corp. on March 12.

The rapid collapse of these three banks was caused by classic bank runs precipitated by rising interest rates and apparent poor interest rate risk management, according to Vice Chairman Travis Hill of the Federal Deposit Insurance Corp.[1]

Meanwhile, in Europe, on March 15, in the wake of the failures in the U.S., Credit Suisse, a global systemically important bank, was on the verge of collapse, having been severely affected by issues including capital sufficiency and investor confidence, and subsequently entered into a rescue merger deal with UBS AG.

Risk and Governance

The banking turmoil highlighted a number of weaknesses in the way risks are being managed and the need for more robust governance, supervision and risk culture.

The report on the 2023 banking turmoil from the Basel Committee on Banking Supervision identified shortcomings in basic risk management and a lack of appreciation of how buildups of different risks are interrelated and have a compounding contagion effect.

Business models were found to remain overly focused on growth and short-term profitability, which became unsustainable, and were compounded by poor risk culture and insufficient oversight.

Following the 2008 global financial crisis, there was a concerted effort to improve banks' financial resources, most importantly the levels of capital available to allow losses to be absorbed before a bank becomes insolvent.

One of the key reforms following this period was the introduction of central bank stress testing. This remains a vital part of how the Bank of England and other global regulators promote financial soundness.

Stress testing assesses the ability of banks to withstand severe but plausible stress by looking at capital adequacy and measuring the resilience of banks by identifying their vulnerabilities. The purpose of stress testing is to establish that banks, insurers and their counterparties have the strength to withstand another financial crisis.

On an annual basis, stress testing is carried out by the Bank of England on the largest U.K. banks and building societies. Firms that are not captured within this scope will be given a hypothetical adverse scenario to test themselves against, via computer simulation, to see whether they can withstand extreme economic scenarios.

Every other year, the Bank of England will probe the resilience of the banking system by testing it against an exploratory scenario that is not directly linked to the financial cycle.

Recent events, however, have led the Bank of England to carry out systemwide stress testing across banks, insurers, pension schemes and clearing houses to explore how they would collectively cope under severe — but plausible — market stress.

Not only is the Bank of England testing to observe how market players cope with huge demands on liquidity, but it will also be looking at more severe, wide-ranging, and persistent conditions than the so-called dash-for-cash in March.

As well as stress testing, regulators will be relying on the implementation of the Basel III reforms — the Basel 3.1 Standards — to ensure they have the ability to adapt and react quickly and appropriately to external factors, including environmental, economic and market, to avoid risks and maintain financial stability across the board.

Liquidity and Risk-Weighted Assets

One of the main causes of the 2008 global financial crisis was a failure by banks to adequately monitor and control liquidity risk.

In response, regulators around the world designed and implemented extensive reforms, notably those implemented by the Basel committee to address a number of shortcomings within the pre-global financial crisis regulatory framework.

The Basel committee is in the process of implementing the final limb of the Basel 3.1 Standards, with the goal of creating a resilient banking system where market participants remain adequately capitalized and have sufficient liquidity to absorb any risks in times of challenge.

Basel 3.1 Standards introduced a number of risk management measures including liquidity coverage ratio and risk-weighted assets to improve resilience against short-term liquidity shocks.

Liquidity coverage ratio dictates the proportion of highly liquid assets that must be held by financial institutions, designed to ensure that financial institutions possess suitable capital preservation to meet short-term obligations in a period of significant liquidity stress — 30 calendar days — and is calculated by way of a generic stress test.

Risk-weighted assets calculations are used in the risk-adjusted capital ratio, which determines a bank's ability to continue operating under stress and seeks to strengthen bank capital requirements by assessing levels of liquidity and leverage depending on the level of risk a bank has, and ensuring it has enough capital to outweigh such risk.

These changes will improve the comparability and credibility of the risk-based capital ratios of firms and their products.

Unsurprisingly, the report published by the Financial Stability Board in October on the events of 2023,[1] focuses on resolution mechanisms for banks in crisis, but it is worth noting the board's emphasis on the need for credible liquidity backstops in an environment where liquidity can come under rapid and intense stress.

In the U.K., in a speech published on Oct. 16,[2] Deputy Governor for Prudential Regulation and CEO of the Prudential Regulation Authority Sam Woods discussed the year's banking failures, the lessons learned therefrom and priorities going forward in the work that needs to be done to "improve and refine the regulatory regime for banks."

While dismissing the idea of a zero-failure regime, the speech does examine the efficacy of tools to accommodate the Prudential Regulation Authority's "zero appetite for systemic financial crises."

These tools include measuring risk correctly: Woods points to the variability of risk-weights across firms and jurisdictions as being a drain on confidence in the banking system that upcoming Basel 3.1 refinements are intended to address.

Supervision

One of the Bank of England's aims is to be at the forefront of identifying new and emerging risks in order to be prepared to supervise the financial system of the future — this is, of course, true of other globally focused regulators.

In light of recent events, banks will need to enhance their standards around how they manage and identify risks in order to achieve such goals.

Additionally, banks will need to apply a level of supervision and maintain financial stability, which will require supervision and cooperation at both a local and global level.

The Basel committee report highlights a number of important points to be examined further in order to achieve effective implementation of the international resolution framework. These include:

- Strong and effective supervision: The analysis of banks' business models, and the identification of outliers, remains core to supervisory efforts, including the assessment of the viability/sustainability of those models; and

- Robust regulatory standards: Including those addressed to ensure robust corporate governance and internal risk management and controls. The need for tools that can drive real change and for concrete action is also stressed.

From the information gathered in the aftermath of the bank collapses earlier this year, it was clear that clients had been withdrawing their funds and assets for some time prior to the runs on the banks in question, suggesting that the risk indicators being used were no longer suitable to identify such a crisis of confidence in a timely manner.

Market signals as well as regulatory metrics should be used by banking supervisors and regulators in their evaluation of a bank's viability. Regulatory indicators alone do not provide a complete assessment of the levels of capital and liquidity available in banks.

Market Sentiment

Although recent episodes of banking system stress can be blamed on the culmination of risk build-ups over years, it is important to note that any institution engaged in liquidity and maturity transformation can be subject to a run.

Due to the unprecedented speed and scale of deposit runs, it is clear that market sentiment will need to be monitored more closely.

Capital and liquidity are clearly both fundamental to banks; however, the size and pace of outflows earlier this year would suggest they are not the only elements required for banks to survive, and that market sentiment plays a much more pivotal role that translates into hard numbers.

On the surface, each bank's offering is essentially the same as that of another, i.e. liquidity, safekeeping and low interest, which means that if a bank's soundness comes into question, most depositors will have little conceptual difficulty in changing to a bank they perceive as being more trustworthy.

Now more than ever, in a world of 24/7 mobile banking and social media, most customers can easily communicate with one another and what can start off as a hint of uncertainty can quickly lead to a rush of withdrawals, causing runs of extraordinary speed and widespread financial disruption.

There is a strong correlation between credibility and profitability for depositor and investor sentiment. Again, in light of recent events, the importance of nonfinancial regulation and supervision of issues that can affect credibility and profitability like risk culture and governance needs to be reasserted, and supervisors should be asking whether business models are viable and sustainable.

Summary

Following the collapse of three regional banks in the U.S. and the near collapse of a global systemically important bank in Europe, the economic turbulence unraveling across the globe was a startling display of the speed at which perceived weaknesses can be exposed in the current environment and highlighted issues around financial stability.

While it may not always be possible to control reactions to external factors, regulators and banks have learned that they need to make sure they have the adequate tools to respond appropriately.

Being able to adapt in a timely manner and ensure they can be resilient to the wide range of risks they could face at an operational level are essential to this.

While markets and their participants are clearly keen to move on from the banking failures of 2023, it is likely there will be a ripple effect from these events that will roll well beyond the new year.

However, there is room for optimism about developments in the form of agile, yet robust, risk frameworks created by regulators, which will have the ability to evolve in tandem with an ever-evolving global market.

Clearly, there exists an intention to prepare the global economy and banking sector to manage any future adverse events and protect it from another financial crisis.

Juliette Mills is an associate and Alix Prentice is a partner at Cadwalader Wickersham & Taft LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] https://www.fdic.gov/news/speeches/2023/spapr1223.html.

[1] https://www.fsb.org/2023/10/2023-bank-failures-preliminary-lessons-learnt-for-resolution/.

[2]https://www.bankofengland.co.uk/speech/2023/october/sam-woods-speech-at-the-city-banquet-mansion-house.