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Back to basics: sound risk management and strong supervision

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The recent banking turmoil has once again shown us that we cannot be complacent and that there is always room for improvement and lessons to be learned (or remembered) when it comes to banking sector-related risks. In this particular case, there is a general consensus that deficiencies in the banks' risk management and governance lay behind the turbulence that arose in some banking ecosystems, especially in the United States. Supervisors have also identified some weaknesses in the implementation of the supervisory framework.

The banking sector is highly leveraged by nature, and it is very prone to bank runs if there is an outbreak of turbulence. Therefore, a sound and well-established governance and risk management framework is a cornerstone for business sustainability. This must include the assessment and implementation of a reliable, viable and profitable business model, which was not the case at the banks concerned.

As has been acknowledged by the US authorities, Silicon Valley Bank's collapse was due to mismanagement. Management was unable to duly manage the extraordinary balance sheet growth, mainly on the liabilities side, improperly exposing the bank to interest and liquidity risks. This unsustainable business model, highly concentrated in deposits, together with unprofitable investments and liquidity mismatches, eroded solvency and trust, triggering a massive withdrawal of deposits. This had a contagion effect to other banks with similar weaknesses. As has been quoted many times, "it takes years to build a reputation and minutes to ruin it".

This is where tough, intrusive and pro-active supervision comes in. As we often point out, supervisors are not bank managers, and sole responsibility for a bank's management lies with its board of directors and senior officers. Nevertheless, the supervisors' oversight role is extremely important. We have to challenge banks' business models, specifically whether they are profitable, reliable and sustainable over the years. We must understand and agree on the multiyear business plans, including the risk appetite framework and capital projections. Such plans should include how banks will adjust to the new environment, not only in terms of macroeconomic forecasts, but also vis-à-vis trends such as digitalisation and the emergence of new competitors and risks.

Moreover, in the event of deficiencies, the supervisory authorities must be empowered and determined to dissuade banks from certain types of risky or unsustainable activities/business lines and, if necessary, enforce all the required measures on time so as to avoid or mitigate these activities.

Although some considerations are being discussed about the need to fine-tune the regulations, at this point in time we must recognise that, without such deficiencies, these recent events would not have occurred. Regardless of regulations, management should run banks in a prudent manner, taking into account and properly addressing all the risks that the banking sector faces. For this reason, I would put management and supervision at the forefront of the causes of this turbulent episode.

Aside from the general principle that robust management and a strong supervision framework are two of the main pillars of banking sector stability, there are some takeaways that the EU authorities could consider:

- Assess how liquidity management and supervision could be boosted. We must acknowledge that liquidity has probably changed more than we think. Therefore, supervisors must consider a wide range of tools and metrics, including funding plans and counterbalancing capacity.
- Better assess how factors such as high deposit base concentration and reliance on uninsured deposits could be considered in our supervision and if they could trigger new qualitative or quantitative liquidity measures in the SREP.
- Continue to work on coordinating and collaborating with international authorities.
- Enhance the crisis management framework. The current CMDI review is an opportunity we should leverage to manage crises in a more efficient and harmonised way.

In conclusion, although this turmoil has led the authorities to reflect on its potential regulatory implications, the main focus should be on ensuring an adequate management culture and a strong supervisory framework. These are basic elements and the cornerstone of a sound banking system. Experience time and again shows us that liquidity is the deathblow that triggers banking failures. For that reason, it is an aspect that can never be underestimated. Indeed, sound liquidity management and risk-based supervision are essential.