

# BUILDING TRUST TO PREVENT BANKING CRISES

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SINGLE RESOLUTION BOARD

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### Abstract

Banking crises are a feature of the modern financial system. However, their impact and probability can be mitigated by building trust in the banking sector. This is primarily achieved by banks themselves. However, with vigilant ex-ante monitoring and swift and decisive action when a banking crisis emerges, regulators can shore up trust in the banking sector. The Single Resolution Board, as the banking union's central resolution authority, is a key element of the post-global financial crisis regulatory framework and has been promoting trust in the banking sector by making banks more resolvable.

**Keywords:** banking crisis, resolution, Single Resolution Board, banking union.

## 1 Introduction

The US bank failures and UBS's acquisition of Credit Suisse in March 2023 have once again demonstrated the importance of trust for banking system stability. Credit Suisse's situation was not prompted by a breach of supervisory requirements but by a loss of confidence. It followed a string of misconduct complaints, the announcement of the refusal of one of the bank's largest investors to provide additional support and the belated publication of its annual report.

The European banking union was established in the wake of the global financial crisis. In the last few years, banking union banks have been exposed to a number of external shocks such as the COVID-19 pandemic, the Russian invasion of Ukraine and, most recently, a significant increase in inflation affecting borrowers' ability to repay their loans. These events have thoroughly tested the European regulatory framework and, so far, banking union banks have proven to be resilient. Clearly, the banking union has contributed to building trust in the region's banks.

Banks themselves are ultimately responsible for building trust by pursuing sustainable business strategies and implementing good governance mechanisms and risk management processes to ensure they are resilient to unexpected shocks. Regulators support and monitor these efforts in several ways. One of them is to set a strong and resilient supervisory framework to ensure banks could withstand a crisis. Another way is to ensure that beyond the supervisory requirements, the resolution framework could handle a bank failure, minimising its impact on financial stability and the real economy, and restore confidence post-resolution. In both cases, confidence in the system requires transparency and predictability so stakeholders are aware of the measures that could be taken by authorities in the event of turmoil.

## 2 Banking crises and evolving risks

In most cases bank failures are originally caused by a deterioration in a bank's assets, which may also result in liquidity problems. During periods of high economic growth or loose monetary policy, credit standards may be relaxed, which can produce asset bubbles. When they burst, credit risk materialises, assets are repriced and banks suffer losses. For instance, in the global financial crisis, problems arose when US subprime mortgages started to suffer from defaults. As a result, securities (such as mortgage-backed securities) and derivatives (such as collateralised debt obligations, linked to US subprime borrowers) were downgraded from investment grade to junk. These assets became illiquid and difficult to value. Liquidity problems quickly surfaced as institutions which were perceived to have high exposures to problematic assets saw their access to wholesale markets severely limited. In 2008, several large US financial institutions such as Bear Stearns, Washington Mutual, AIG and Lehman Brothers either failed or had to be rescued. The resulting loss of confidence and the general economic slowdown further fuelled the contagion.

The crisis quickly spread to Europe, where some banks were heavily exposed to US subprime loans. In June 2008, the Dexia Group had to be bailed out by the French, Belgian and Luxembourgish Governments. In September 2008, it became a full-blown crisis when, in the wake of the failure of Lehman Brothers, a large UK bank (Northern Rock) further destabilised EU banking systems, forcing governments to step in. Following the acute stage of the US subprime mortgage crisis, the European debt crisis emerged, peaking between 2010 and 2012. While the crisis had multiple causes, high deficits linked to the cost of bank bailouts were an important contributing factor. Hence, after the crisis one of the key objectives of the regulatory reforms was to protect taxpayer funds by preventing bank bailouts.

The failures of US banks that occurred in spring 2023 followed the outlined banking crisis pattern, although the asset deterioration was driven by interest rate risk, rather than credit risk. The situation at Silicon Valley Bank (SVB) is the most illustrative, although several other banks, including Signature Bank and First Republic Bank, failed. In 2019, unlike in the EU, US authorities introduced lighter prudential regulations for smaller and medium-sized banks, including exempting them from some liquidity requirements, e.g. the liquidity coverage ratio.<sup>1</sup> This allowed banks like SVB to invest heavily in long-term Treasury bonds while its liabilities were essentially made up of short-term deposits. Long-term bonds plummeted in price following the materialisation of interest rate risk, which created large unrealised losses on SVB's balance sheet. As depositors started withdrawing their money, SVB was forced to raise liquidity by selling their Treasury holdings on the secondary market. It announced a capital increase to offset the resulting losses, but then failed to raise the funds. This resulted in a complete loss of confidence and a run on SVB and other banks with a similar business model. The speed at which the SVB crisis unfolded and initially spread to other US medium-sized banks prompted the US authorities to step in by securing all the failing banks' deposits, including non-covered ones, to restore confidence in the US banking sector.

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<sup>1</sup> Board of Governors of the Federal Reserve System (2019).

In recent years, climate, cyber, operational and reputational risks have increased in importance and may weaken the level of trust in banks. In particular, climate and cyber risks have taken centre stage. They are different from the traditional banking risks because they can materialise on a different time scale. Credit risk typically materialises over the short to medium term. In contrast, climate risk has a medium-to-long-term horizon, while cyber risk can materialise immediately. The materialisation of physical and transition climate risks may lead to banks' assets becoming impaired and lower recovery rates in liquidation. This could increase the costs for national deposit guarantee schemes (DGSs) and affect the resolution strategies for banks.<sup>2</sup> The immediacy of cyber risk (for instance, a ransomware attack) could cause even a bank with high capital and liquidity buffers to fail overnight, and requires a high degree of crisis readiness. It is therefore important for regulators to adopt a proactive stance to deal with these emerging risks.

The timeline for the materialisation of existing risks has also shortened. In particular, the SVB case shows that deposits are less sticky than before due to digital innovation, the role of social media and other factors. At the end of 2022, SVB held around USD 170 billion of customer deposits, of which over 90% were not covered by a DGS.<sup>3</sup> Then on 8 March 2023, SVB sold off a large part of its Treasury portfolio to raise liquidity and announced a recapitalisation, which failed. The following day about USD 40 billion of deposits were withdrawn. More than USD 100 billion of withdrawals were expected the day after, which prompted the Federal Deposit and Insurance Corporation (FDIC) to resolve the bank. SVB had a very particular business model. It focused on venture capital (VC) funded technology companies in California, which held large uninsured cash balances at the bank.<sup>4</sup> This made the bank more vulnerable to a deposit run. There is some evidence that social media amplified the run,<sup>5</sup> with prominent VC investors suggesting to companies they invested in to withdraw funds from SVB to avoid suffering losses in the event the bank failed.<sup>6</sup>

While the ubiquitous presence of social media and increased digitalisation, e.g. the rise of online banking and instant payments, were expected to speed up bank runs, how much they would do so was not anticipated. SVB was on track to lose all of its deposits in less than a week. In 2008 the fastest bank run, suffered by National City, led the bank to lose about 13% of its deposits over the same period (see Table 1). For comparison, Washington Mutual, which suffered the largest run (in absolute terms) at that time, saw roughly a three times slower rate of deposit outflows than National City.<sup>7</sup>

Regulatory actions were also exceptionally fast. For example, UBS's acquisition of Credit Suisse occurred over the span of a few days. Credit Suisse weathered the global financial crisis relatively unscathed, but had more recently been hit by a string of scandals. In 2021, the

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2 Calice and Palermo (2021).

3 SVB Financial Group (2023).

4 Board of Governors of the Federal Reserve System (2023a).

5 Cookson, Fox, Gil-Bazo, Imbet and Schiller (2023).

6 Griffith and Copeland (2023).

7 Rose (2015).

Table 1

**Deposit outflows for selected US banking institutions during the global financial crisis (2008) compared to SVB (2023) (a)**

Share of deposits (%)	Wachovia (15 September 2008)	Washington Mutual (8 September 2008)	National City (15 March 2008)	SVB (9 March 2023)
Daily rate (hypothetical)	0.50	0.80	2.50	23.10
Weekly rate (b) (hypothetical)	2.70	4.20	12.60	100.00

**SOURCES:** Board of Governors of the Federal Reserve System (2023a) and Rose (2015).

**a** The daily and weekly rates were recalculated based on the data in the sources by assuming that a month has 20 working days.

**b** The rate is capped at 100%.

bank suffered a USD 5.5 billion loss related to its prime brokerage relationship with the hedge fund Archegos Capital. This came only shortly after the bank closed four funds with around USD 10 billion of assets linked to Greensill Capital (a now defunct supply chain financing company). Over 2021 and 2022 the bank was also found guilty of money laundering for a Bulgarian drug ring and of a bribery scandal in Mozambique. When on 8 March 2023 the bank delayed the release of its annual report, confidence in the bank was already severely dented.

The publication of Credit Suisse’s annual report, which disclosed that the bank’s financial controls contained “material weaknesses”, and the subsequent announcement of the refusal of Saudi National Bank, one of its largest shareholders, to provide further capital support appear to have been the final straw. A negative market response was imminent, forcing the Swiss authorities to swiftly publish a statement affirming that Credit Suisse satisfied capital and liquidity requirements.<sup>8</sup> The bank also obtained a CHF 50 billion collateralised liquidity lifeline from the Swiss National Bank (SNB).<sup>9</sup> However, with investor confidence in the bank gone, the run on the bank quickly escalated and by Sunday 19 March, UBS’s acquisition of Credit Suisse was agreed.<sup>10</sup> The authorities supported the acquisition with CHF 200 billion of liquidity assistance. Half was guaranteed by the government,<sup>11</sup> while the remaining CHF 100 billion was backed by the privileged creditor status of the central bank in bankruptcy. The Swiss government also used taxpayer funds to provide a CHF 9 billion guarantee to UBS to backstop the potential losses on the sale of some non-core Credit Suisse assets,<sup>12</sup> while the regulators wrote down about CHF 15 billion of Credit Suisse’s Additional Tier 1 (AT1) bonds (and preserved a portion of the equity stock, see below).

The US authorities also responded swiftly. In the case of the crisis of the US banks the systemic risk exception was invoked, which allowed the FDIC to guarantee all the deposits at

<sup>8</sup> FINMA and SNB (2023).

<sup>9</sup> Credit Suisse (2023).

<sup>10</sup> Englundh (2023).

<sup>11</sup> SNB (2023).

<sup>12</sup> UBS (2023).

the failing institutions even if that meant higher costs of resolution, i.e. deviating from the least cost test.<sup>13</sup> This decision left the FDIC exposed to losses estimated at over USD 20 billion,<sup>14</sup> which will be recouped by a special levy imposed on other US banks.<sup>15</sup> The systemic risk exception exists to provide the FDIC additional flexibility to deviate from the framework in cases where adherence to the least cost test could have a negative impact on financial stability. In conjunction with the activation of the systemic risk exception, a bridge bank was set up before SVB's assets were ultimately sold to a private sector buyer. Hence both in the United States and in Switzerland the authorities were able to use the high degree of flexibility afforded to them under the regulatory framework to quickly and effectively resolve the crises.

### 3 What can be done to build confidence in such an evolving context?

As demonstrated by the recent examples, decisive regulatory action is often necessary in a crisis to restore confidence to financial markets. To make this possible, the market has to believe that the foundations of the financial system are sound. Between 2008 and 2013 European governments spent about 3.5% of GDP (average) to recapitalise their banking systems.<sup>16</sup> As a result, the sovereign deficits and debt levels increased. For instance, the euro area gross debt-to-GDP ratio rose from around 69% in 2008 to 93% by 2013.<sup>17</sup> Moreover, debt sustainability concerns ignited the European sovereign debt crisis. Following the global financial crisis, a global agreement was reached that future bank bailouts should be avoided if possible. Every bank should have a resolution plan which would specify, among other things, how to resolve the bank if it failed and would try to ensure that banks build up sufficient loss absorbing capacity.

If a bank is resolved, its creditors and owners are subject to burden-sharing and have to bear the losses and contribute to the recapitalisation of the institution. In this process, their losses should not be higher than if the bank had been liquidated (no creditor worse off principle). The strengthening of the resolution framework was just one part of the regulatory reforms undertaken in the EU. Indeed, in parallel, the international banking authorities decided to reinforce the prudential framework, focusing on quality and amount of capital, liquidity and the specific treatment of macroprudential risks. Moreover, following the global financial crisis and the European sovereign debt crisis, the banking union was established to avoid the bank-sovereign nexus and to protect financial stability in the participating countries (see Box 1).

In recent years, the process to secure the confidence in the financial system has continued as legislators and regulators have increasingly focused their attention on emerging risks such as

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13 Labonte (2023).

14 Gruenberg (2023).

15 FDIC (2023).

16 Eurostat (2022).

17 International Monetary Fund (2023).

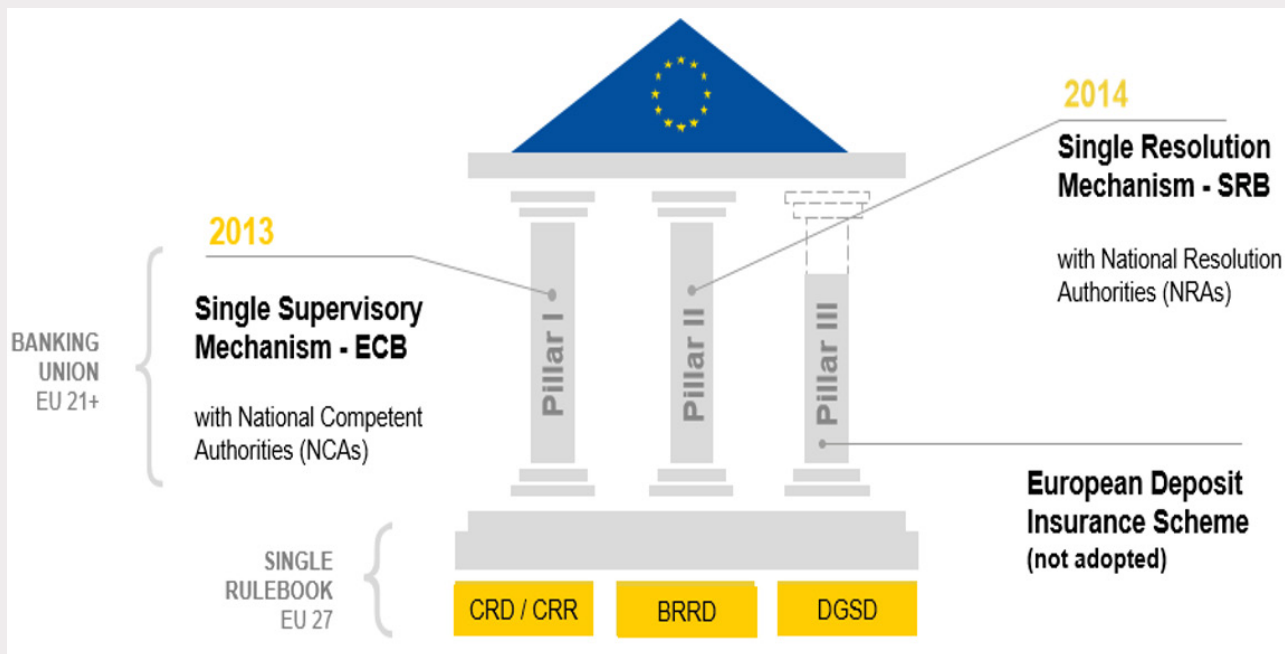
**THE EUROPEAN BANKING UNION**

After a political agreement on the topic was reached in 2012, the European banking union was gradually established. It entails a partial transfer of supervisory powers from national to European level. The ultimate objective is to create a banking union that rests on three pillars (see Figure 1).

The first pillar of the banking union is the Single Supervisory Mechanism (SSM), which became operational in November 2014. It is comprised of the national competent authorities (NCAs) of the euro area member states and other participating European member states and European Central Bank (ECB) Banking Supervision. It is tasked with the supervision of all banks, the largest banks being directly supervised by the ECB. The second pillar of the banking union is the Single Resolution Mechanism (SRM), which

became fully operational in 2015. It is composed of the Single Resolution Board (SRB) and the national resolution authorities (NRAs) and is tasked with the resolution of banks. The European Deposit Insurance Scheme (EDIS) is envisaged as the banking union’s third pillar, but discussions regarding its implementation are pending. Nevertheless, the two existing pillars of the banking union have established a level playing field for the supervision and resolution of euro area banks and have been an important step forward in ensuring Europe has a strong and resilient banking system. The progress related to development of the banking union was also recognised by the Basel Committee on Banking Supervision in its review of the assessment methodology for global systemically important banks, which allowed a more favourable treatment of intra-banking union exposures.<sup>1</sup>

Figure 1  
THE THREE PILLARS OF THE EUROPEAN BANKING UNION



SOURCE: SRB.

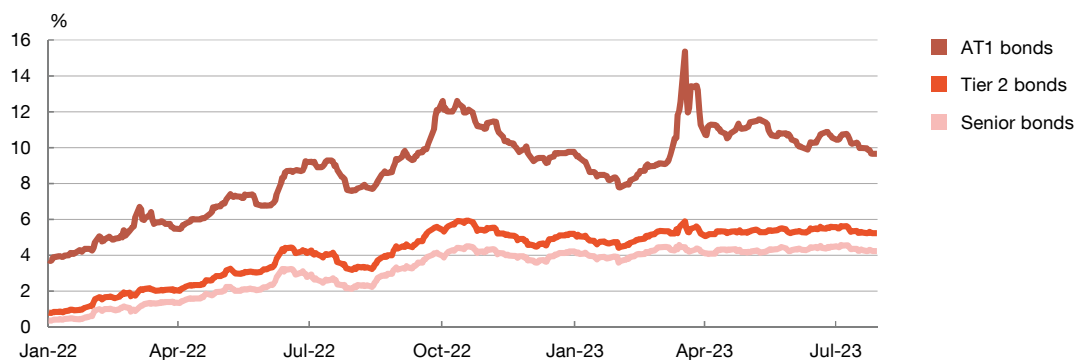
<sup>1</sup> Bank for International Settlements (2022) and ECB. (2022).

cyber and climate risk. On both fronts, significant work has already been done. For example, in November 2022, the EU passed the Digital Operational Resilience Act, which will strengthen the cyber resilience of the financial infrastructure.



Chart 1

### AT1 bond yields for European banks before and after UBS's acquisition of Credit Suisse compared with Tier 2 and senior bond yields



SOURCE: Bloomberg.

Note: The chart shows the yields to worst call for various instrument types. The spike in AT1 yields corresponds to UBS's acquisition of Credit Suisse.

While a robust regulatory framework is important, institutions themselves play a pivotal role in building trust in the banking system, supplemented by a culture of intensive supervision by the competent authorities. Through benchmarking and oversight of their financial situation, their risk profiles, the progress made on different fronts, including resolvability, the prudential and resolution authorities are not only ensuring a more level playing field, but are also helping the banks to revisit their business models, risk tolerance, risk management and crisis readiness. All in all, banks are and will remain ultimately responsible for the management of their risks. The prudential and resolution frameworks reinforce the necessity to constantly adopt and improve banking management, hence also providing confidence in banks' resilience.

## 4 Lessons learned by the Single Resolution Board from recent banking crises

The recent crises have highlighted a number of lessons, which include three of particular importance for the Single Resolution Board (SRB): the significance of the ex-ante transparency of the resolution regime; the importance of crisis readiness; and the vital role of liquidity in resolution.

Regarding the first lesson, the resolution framework having clear ex-ante rules is key. In the Credit Suisse case, some AT1 investors were bailed in before common equity holders. This created temporary stress in the AT1 markets (see Chart 1). In response the SRB, the European Central Bank (ECB) and the European Banking Authority (EBA) issued a joint statement clarifying that under the EU resolution framework common equity holders would be the first to bear losses and only afterwards would AT1 instruments be bailed in.<sup>18</sup> This helped to calm the financial market and reaffirmed the key role of AT1 instruments in bank funding in the EU. In the banking

<sup>18</sup> SRB, EBA and ECB Banking Supervision (2023).

union the systemic risk exception does not exist and an international debate is taking place about the necessity to introduce it. From a solvency perspective, this does not seem necessary in the EU as the rules for absorbing losses are well established. Even non-covered deposits, subject to different safeguards, could be expected to contribute towards funding a potential bank resolution. Hence, with strong enforcement of clear rules, there should be no need to introduce a systemic risk exception to safeguard all deposits as the US authorities did. The SRB considers that the current level of depositor protection strikes a good compromise, and helps maintain financial stability by taking into account all other elements. Nevertheless, the SRB supports the European Commission's proposal to reform the Crisis Management and Deposit Insurance framework. This proposal would, among other things, increase the usability of the DGS in resolution, which would help to increase bank resolvability.

The second lesson the latest crises have highlighted is the importance of crisis readiness. With the increased prominence of emerging risks and, particularly, with the unstable macroeconomic and geopolitical environment, the potential speed of bank failures has increased. This was demonstrated already last year by the Sberbank Europe resolution,<sup>19</sup> where the bank failed suddenly just three days after the Russian invasion of Ukraine. Since its establishment eight years ago, the SRB has focused on developing bank resolution plans and bank resolvability. The banks under the SRB's remit are progressing towards their resolvability and by the end of 2023 the SRB's Single Resolution Fund (SRF) will have reached its steady state with assets of around EUR 78 billion. Going forward, the focus will be testing the operationalisation and the capacity of the banks to implement existing resolution plans. This will be done through dry runs, deep dives and on-site visits to banks' premises to ensure that banks are resolvable and progressing adequately on developing their crisis readiness. Moreover, the recent crises have once again highlighted the importance of being able to face unexpected circumstances. As an example, bail-in is the preferred resolution strategy for a large number of SRB banks; however, it may not be the best tool if the bank is failing due to a liquidity crisis. Bail-in can effectively help to recapitalise the bank, but it cannot generate additional liquidity. In this vein the SRB considers it important to develop credible alternative resolution strategies, including the combination of different resolution tools, that can be successfully applied depending on the circumstances.

Finally, the recent crises have also changed our understanding regarding the liquidity needs in resolution. The Swiss and US authorities have leveraged the ability of their fiscal and monetary arms to work hand in hand. In the United States, the Federal Reserve System (Fed) introduced a Bank Term Funding Program to support the going concern liquidity needs of the banking system. The facility provided banks with a source of funding in exchange for high quality collateral, which would be valued at par. To avoid potential losses to the Fed, the US Treasury agreed to backstop the program with USD 25 billion.<sup>20</sup> In Switzerland, the SNB and the Swiss Government acted jointly to ensure sufficient funding. In the banking union, the lack of a centralised fiscal body limits the scope of similar actions.

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19 SRB (2023).

20 Board of Governors of the Federal Reserve System (2023b).

Sufficient liquidity back-up is an important factor for the credibility of the resolution regime. The SRB has sufficient resources to cover banks' liquidity needs in a number of cases thanks to the SRF. Furthermore, when the amendment to the Treaty establishing the European Stability Mechanism (ESM) is ratified, the SRB will also have access to the ESM backstop of up to EUR 68 billion. However, in a tail risk event the current arrangements could prove insufficient. For a large bank, such as a global systemically important bank, or if several crises involving liquidity needs coincide, a larger amount of money will be necessary to restore market confidence.

This is why the SRB has been actively working on liquidity in resolution. Our key assumptions are:

- 1 Liquidity is provided temporarily. In the Credit Suisse case, UBS mentioned that the liquidity support was phased out in June 2023.
- 2 The amount of the liquidity support can be much higher than the amount of liquidity drawn, hence reducing the risks actually taken by lenders.
- 3 The risk to this liquidity support is directly connected to the success of the resolution action.

If the resolution action is credible and properly implemented, it will succeed and the liquidity support will be reimbursed. Lenders can trust the EU resolution framework and the SRB to implement successful resolution schemes, as demonstrated twice already, in 2017 and again in 2022.

## 5 Conclusion

Trust in the banking system is crucial for preserving financial stability. While banks themselves are ultimately responsible for building and maintaining trust, a strong regulatory framework and a proactive regulatory stance can support this aim. Since the establishment of the banking union, banks have demonstrated strong resilience to unexpected shocks. This has undoubtedly increased trust in banks. The SRB, as the banking union's central resolution authority, has also been taking steps to improve the resolvability of banks and to promote trust in the sector. One of the key activities in this regard is to ensure the ex-ante transparency of the resolution rules. This is heavily dependent on good communication. Second, the SRB will be placing greater importance on emerging risks and on testing resolution strategies. Finally, the SRB has been working on the topic of liquidity in resolution to ensure that there is sufficient capacity in place to support the liquidity needs of banks in a tail risk event. It is our belief that all these measures will provide additional confidence to safeguard financial stability and to protect European taxpayers.

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