Box 2.2

RECENT BANKING CRISES: CAUSES AND SOME LESSONS FOR SUPERVISION[1]

Between March and May 2023, there was the chain crisis of several US regional banks (Silicon Valley, Signature and First Republic) and of the Swiss bank Credit Suisse which, due to its size and complexity, was classified as a global systemically important bank according to BIS international standards.

The interest rate rises against a backdrop of inflationary pressures and the uncertainty about macro-financial conditions that stems from existing geopolitical risks were the main trigger for this crisis, which affected institutions with weaknesses that made them especially vulnerable in this context.

The crisis started in Silicon Valley Bank (hereafter SVB). This institution showed a significant concentration of liabilities in deposits with high average balances, not covered by the deposit guarantee fund and concentrated in the technology and venture capital sectors; on the asset side, long-term debt portfolios classified as held-to-maturity, and acquired before the rise in interest rates, had a significant weight. The tightening of monetary policy led to significant decreases in the valuation of these debt portfolios, which SVB was forced to materialise in order to try to alleviate the liquidity pressures arising from the deposit outflows it had been experiencing. Negative news further accelerated this process, favoured by the concentration of depositors and the rapid spread of these concerns on social media.

Following this event, markets focused on institutions showing weaknesses of some kind, leading to significant deposit outflows and liquidity problems that fed off each other, in cases such as Signature Bank and First Republic. The Swiss bank Credit Suisse was affected by the mistrust generated in the markets by the US bank crises, as it had been showing weaknesses in its governance and risk management, which affected its liquidity and posed a significant threat to its viability.

The affected institutions found themselves needing to turn to the markets to maintain their liquidity levels, which further stimulated scrutiny and doubts about their situation, and revealed significant shortcomings in their interest rate and liquidity risk management which, far from being the result of a temporary situation, had been developing over time.

Deposit withdrawals and contagion effects affected institutions that shared, to varying degrees and with some different characteristics, certain underlying factors: i) lack of sustainability of their business models and of a comprehensive business perspective, with their activity strongly linked to certain sectors (e.g., SVB with the technology and venture capital sector; Signature with the crypto sector); ii) poor management of liquidity in relation to their liability structure, and inadequate management of collateral available for use in markets or with the central bank; iii) inappropriate interest rate risk management, with a high concentration of liabilities in deposits susceptible to high volatility and a concentration of assets in long-term debt portfolios classified as held-to-maturity; and iv) inadequate governance, with weak risk control and monitoring by the institutions' management bodies.

Liquidity pressures prompted swift reactions by the authorities, which provided additional liquidity lines to those already in place and took certain extraordinary measures aimed at curbing contagion effects. However, these actions could not stop the major, rapid outflows of funds from the affected institutions and, therefore, the supervisory and resolution authorities had to intervene to safeguard the stability of the banking system.

Subsequent reports prepared by US and Swiss supervisors and by some international bodies revealed that certain vulnerabilities had not been detected and, where identified, they had not always been addressed effectively.[2] These analyses suggest some important areas of improvement in supervision, including most notably: a) the need to ensure that the structure and focus of supervision provide a holistic picture of institutions' risks, with greater emphasis on the sustainability of the business model and on liquidity and interest rate risks; b) the need to improve the supervisory decision-making process, streamlining its management and establishing clear processes for the escalation of supervisory measures; and c) the need for

1 For further analysis of these crises and the lessons learned, see the Financial Stability Review Autumn 2023 article The 2023 banking crises: The causes and the role played by bank management, supervisors and regulators.

2 See Basel Committee on Banking Supervision. Report on the 2023 banking turmoil.

swift corrective measures to address identified shortcomings (enforcement).

These areas for improvement are a point of reflection for all supervisors, although they are not equally applicable in all jurisdictions. There are significant differences between the supervisory structure and approach in the United States, Switzerland and the European Single Supervisory Mechanism (SSM). Thus, for example, in the US, unlike in Europe, the Basel standards do not apply in full to smaller institutions, such as those affected by the crisis. In the case of Credit Suisse, as a globally systemically important institution, its supervision has faced greater complexities than those existing at medium-sized institutions.

In short, the crises mentioned above show the significance of confidence and the contagion effects in the development of crises, especially in environments such as the current one, where the speed of communication and the dissemination of information is high. Also, as is becoming the norm in all crises, the institutions that show the most weaknesses and shortcomings in internal control and risk management are the most sensitive to these contagion effects and the consequent withdrawal of funds. These institutions are the most prone to liquidity pressures that feed off each other and can eventually render an institution unviable.[3] This crisis also offers valuable lessons for the supervisory approach. In particular, it has highlighted the importance of a holistic analysis of business models and of attention to asset and liability management, and it has revealed the need to act swiftly to remedy detected shortcomings, with the focus on the effectiveness of supervisory measures (see Box 2.3).

3 See, on this subject, A. Enria. (2023). *Well-run banks don´t fail-why governance is an enduring theme in banking crises;* Federal Reserve Board. (2023). *Review of the Federal Reserve Supervision and regulation of Silicon Valley Bank*, and Federal Deposit Insurance. (2023). *Remarks on Oversight of Financial Regulators: Financial Stability, Supervision, and Consumer Protection in the Wake of Recent Bank Failures.*