Preventing a New Global Financial Crisis

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1.1 General considerations

- partial disruption of the global supply chain due to the **pandemic crisis**;
- severe **geopolitical tensions**;
- combined effect:
  - gradual move to a partial "deglobalisation" through fragmentation of international trade;
  - **historically very high inflation** ("inflation crisis") in several jurisdictions (inflation differentials existing), leading to
  - the sharp and within a short period of time **raising of official interest rates** – in a synchronised way – by major central banks on a global basis since mid-2022;

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

1.1 General considerations

- in respect to the latter development, please note:
  - inflation has been mainly triggered by the disruptions in supply and not by an extraordinary increase in demand for goods and services; noteworthy, that central banks can only directly influence the second leg and not the first;
  - the mechanism for the transmission of monetary policy effects has performed efficiently (**unlike in the preceding period of very low – and in the case of the deposit facility negative – interest rates**), since banks have also increased their lending rates;
  - however: the full impact of monetary policy measures always has a time lag
- the amount of debt issued by governments, corporates (financial and non-financial) and households has exponentially increased over the last decade – hence, there is a higher sensitivity to official interest rate increases

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

1.2 The impact of higher official interest rates on financial stability

- return to normality in terms of banking intermediation – manifest increase in profitability (very positive, to the extent that – in certain cases – bank capital quality is not optimal);
- across the board **decrease in market value of bonds** – negative impact also on central banks' portfolios (especially when marking-to market of positions is required and there is an exposure to foreign exchange risk as well – see the Swiss National Bank case);
- Correction of prices in stock exchanges (at variable rates);
- negative impact on other asset categories as well;

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

1.2 The impact of higher official interest rates on financial stability

- cost of funding for governments, as well as for non-financial corporates, households, and bank themselves has increased; hence:
    - non-financial corporates may: (a) also be unable to refinance their own bank debt; (b) face an increased debt-servicing burden (especially if the debt is based on floating interesting rates – the amounts manifestly vary across jurisdictions); (c) see the value of collateral provided be negatively affected;
    - consumers' debt may also be exposed to the problems under (b) & (c) above;
    - banks may not be able to issue bonds, as a source of external financing, at reasonable interest rates – this may become a problem if they have to meet regulatory capital requirements or resolution authorities' requirements (MREL) with subordinated debt which is acceptable for these purposes

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

2. Monetary policy: objectives, strategies, instruments, and international cooperation

- still, major central banks have **different statutory objectives**, sometimes (as in the euro area) on a hierarchical basis (price stability, contribution to growth, employment and other (mainly) economic objectives);
- new: environmental considerations;
- even though the preservation of financial stability is (in almost all jurisdictions) one of the key tasks of central banks, and the spillover effects between monetary policy and financial stability are well established, **monetary policy is** – typically – **not considered as the appropriate means to safeguard financial stability**;

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

2. Monetary policy: objectives, strategies, instruments, and international cooperation

- new: several major central banks have gradually shifted the focus of their monetary policy strategies' to "medium-term" inflation targeting;
- resort to "unconventional" monetary policy instruments during the period from the GFC to the pandemic crisis – currently: **gradual exit strategies**;
- enhanced international cooperation among major central banks

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

3. Financial regulatory framework: new institutions and rules due to the **Global Financial Reform Agenda** (and in the EU, to the **Banking Union and Capital Markets Union** projects)

3.1 Prudential rules

- **"Basel III regulatory framework"** of the Basel Committee on Banking Supervision (BCBS)
  - enhanced bank capital adequacy rules;
  - new: introduction of a leverage ratio for banks;
  - new: micro- and macroprudential buffers for banks;
  - new: introduction of two liquidity ratios for banks ("Basel III framework");
- **enhanced rules on corporate governance of banks targeted at financial stability**;

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

3.1 Prudential rules

- enhanced powers of supervisory authorities – including on early intervention; however: still, different models relating to bank supervisory agencies (central banks *vs.* independent administrative authorities under three different models);
- new: **macroprudential oversight of the financial system**;
- enhanced international cooperation among supervisory authorities;
- new: in the EU in particular: **Europeanisation of banking supervision and macroprudential oversight** (SSM and ESRB, respectively);
- enhanced and new rules for regulation and supervision in capital markets and the insurance sector (IOSCO and International Association of Insurance Supervisors, IAIS);
- new: (partial) measures to regulate and supervise "shadow banking" entities

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

3.2 Crisis prevention and management framework

- new: **setting up of bank resolution regimes and frameworks** ("Key Attributes" of the Financial Stability Board, FSB);
- new: in the EU in particular: Europeanisation of banking resolution (SRM);
- enhanced rules on the operation of deposit guarantee schemes (International Association of Deposit Insurers, IADI);
- in the EU in particular: **stricter rules for the (exceptionally) provision of State aid to credit institutions** (bail-out)

A. Differences in comparison to the environment at the outbreak of the 2007-2009 global financial crisis (GFC) – "this time is (again) different"

4. New elements (thus, new risks and rules to mitigate them)

- digitalisation of financial services ("online" bank runs);
- impact of artificial intelligence (fintech, reg-tech & sup-tech);
- **climate change and environmental risks**;
- enhanced operational risks ("cyber risk" in particular)

B. What is not different, even this time, as concerns the banking sector

- banks are structurally exposed not only to credit risk but also to liquidity risk;
- liquidity is as essential as capital; bank runs and panics of depositors can manifest themselves in periods of lack of confidence to a single bank (in the first case) or the entire banking system (in the second case);
- *inter alia*, banks may also be exposed to the so-called “disaster myopia” (i.e., exposure to low-frequency risks, the occurrence of which may cause disproportionally significant losses);
- effective risk management was and remains an essential tool for avoiding exposure to illiquidity or insolvency – this is a responsibility of bank managers and the Board of Directors which oversee them;
- appropriate corporate governance arrangements are also of primary importance;

B. What is not different, even this time, as concerns the banking sector

- the generic issue relating to the adequacy of business models and the capacity of the banking sector was and remains a point of concern;

- the failure of individual banks (large and small) can be controlled (and even so more under the post-GFC regulatory framework) as long as the stability of the entire banking sector and financial system as a whole is not under threat;

- **however**, under their “paybox function”, deposit guarantee schemes – which in most cases (including the EU) are exclusively funded by contributions of the participating banks – continue to provide sufficient but still limited coverage in terms of (a) counterparties covered and (b) amount of compensation;

B. What is not different, even this time, as concerns the banking sector

- banking failures (as failures of any category of enterprises) have always and in all jurisdictions occurred and the probability of this not happening is low – however, we have repeatedly witnessed that such failures – including corporate governance failures – may also be due to:
  - **regulatory and/or supervisory failures**; as well as
  - **macroeconomic** (in terms of sub-optimal fiscal and/or monetary policy) **failures**.

C. The two most important bank failure episodes in March 2023

1. Silicon Valley Bank (SVB, US)	
Causes	
Business failure	**(a)** highest-risk deposit base among U.S depository institutions; nearly half of all US venture capital-backed startups were holding banking relationships with SVB; **(b)** poor risk-management (asset-liability mismatch): purchase of bought long-duration fixed-income securities ($80 billion in bonds with an average yield of 1.5%) without hedge and instead of resort to safer alternatives (e.g., short-term T-bills or deposit with the Federal Reserve) – hence, **failure induced by a bank run due to liquidity issues**

C. The two most important bank failure episodes in March 2023

1. Silicon Valley Bank (SVB, US)	
Causes	
Regulatory failure	**(a)** since 2018: medium-sized US depository institutions were exempted from some prudential rules, including liquidity requirements and annual stress-testing; **(b)** chronic: multiple bank supervisory authorities
Supervisory failure	under investigation by the Federal Reserve – to be noted: **(a)** the bank was operating for months without a Chief Risk Officer (CRO); **(b)** apparently, supervisory authorities did not manage to ensure that some banks were verifying appropriate risk management in light of the Federal Reserve's change in monetary policy

C. The two most important bank failure episodes in March 2023

1. Silicon Valley Bank (SVB, US)
Result
(a) Prompt resolution by the Federal Deposit Insurance Corporation (FDIC) by **application of the bridge bank tool** – the bridge bank's deposits and liabilities were sold (under a purchase and assumption agreement) **within a very short period of time** to First-Citizens Bank & Trust Company;
(b) No significant spillover effects (as yet) to the entire banking system, especially among large depository institutions (which also 'benefitted' from this by taking market share)

C. The two most important bank failure episodes in March 2023

1. Silicon Valley Bank (SVB, US)
Further related actions
1) The **bridge bank resolution tool** was applied as well by the FDIC in the case of the Signature Bank NY on 12 March – the bridge bank's deposits and certain loan portfolios were sold (under a purchase and assumption agreement) within a very short period of time to Flagstar Bank, National Association, Hicksville, NY, a wholly owned subsidiary of New York Community Bancorp, Inc., Westbury, NY.

C. The two most important bank failure episodes in March 2023

1. Silicon Valley Bank (SVB, US)

Further related actions

2) By **application of its resolution powers** (as well), and in consultation with the Prudential Regulation Authority (PRA), the HM Treasury and the Financial Conduct Authority (FCA), the Bank of England (BoE) sold the UK subsidiary of SVB (Silicon Valley Bank UK Limited) to HSBC UK Bank Plc.

3) The Federal Reserve, the Bank of Canada, the BoE, the Swiss National Bank (SNB), the ECB and the Bank of Japan implemented a coordinated action to enhance the provision of liquidity through the **standing US dollar liquidity swap line arrangements**.

C. The two most important bank failure episodes in March 2023

2. Credit Suisse (Switzerland)	
Causes	
Business failure	**(a)** belated implementation of required restructuring plan; **(b)** multiple involvement in investigations for severe violations of financial regulations; **(c)** failed investment decisions; **(d)** governance problems; **(e)** wrong incentives deriving from a high variable renumeration; **(f)** triggers: massive outflow of clients' funds (some 140 billion CHF) *and* refusal of key shareholder to participate in an additional necessary capital injection in March 2023.

C. The two most important bank failure episodes in March 2023

2. Credit Suisse (Switzerland)	
Causes	
Regulatory failure	**(a)** no full implementation into Swiss banking regulation of the post-GFC Global reform agenda: higher minimum capital requirements for "systemically" important banks (18% capital requirement), BUT no pre-funded resolution and deposit guarantee schemes and no resolution authority; **(b)** relatively limited (in comparison to EU law) intervention powers of the single financial supervisory authority (FINMA).
Supervisory failure	under investigation

C. The two most important bank failure episodes in March 2023

2. Credit Suisse (Switzerland)

Result

(a) “Forced” emergency merger with the largest bank in the country (UBS) – **NO RESOLUTION CASE** – high concentration in the Swiss banking system as a result.

(b) Enactment by the Swiss Federal Council, on 16 March and with immediate effect, of emergency legislation (Ordinance, amended on 19 March) – based on Articles 184(3) (on foreign relations) and 185(3) (on external and internal security) of the Swiss Constitution and relating to:

(i) liquidity assistance loans from the SNB to systemically important banks or to a part of a systemically important financial group, consisting of (anymore): (a) “emergency” liquidity assistance loans; (b) “additional” (secured) liquidity assistance loans (capped); and (c) **liquidity assistance loans**, under conditions, “**with a federal default guarantee**” to the SNB;

C. The two most important bank failure episodes in March 2023

2. Credit Suisse (Switzerland)

Result

(ii) in relation to the provision of liquidity assistance loans with a default guarantee:

- at the time of the credit approval, the FINMA did order the borrower and the financial group to **write down Additional Tier 1 capital** (note: in the case of Credit Suisse, the prospectuses of the relevant instruments provided that these bonds could be written down even if shares would not);
- by derogation from the Mergers Act, and inter alia, the performance of transactions in accordance with that Act – and upon agreement with the FINMA – **does not require decisions by the General Meetings of the merged banks;**

C. The two most important bank failure episodes in March 2023

2. Credit Suisse (Switzerland)

Result

(iii) in case of a transaction under the Merger Act between banks which are systemically important and internationally active, provision, under conditions, of guarantees to the acquiring bank in order to protect against losses on the assts of the acquired bank which are to be wound up (“loss protection guarantee”);

(iv) the preferential rights in bankruptcy proceedings relating to liquidity assistance loans;

(v) the exchange of information between the Federal Department of Finance, the SNB and FINMA.

(c) On 2 April, the Swiss Federal Prosecutor has opened an investigation into the takeover of Credit Suisse by UBS, which will investigate potential breaches of national criminal law by government officials, regulators and bank executives.

C. The two most important bank failure episodes in March 2023

TWO IMPORTANT NOTES

ON A SIGNIFICANT DIFFERENCE WITH EU LAW

European supervisory/resolution authorities have boldly announced that the latter could happen under EU law. HOWEVER:

(1) The EU rules on the hierarchy of bank creditors and shareholders apply if an EU credit institution only in resolution cases (including for its winding-up) under the BRRD/SRMR framework (e.g., the Banco Popular Español case).

(2) If no resolution is involved (as in the Credit Suisse case) but – in the course of precautionary recapitalisation – State aid is granted to a credit institution, applicable are the quasi-equivalent provisions of the 2013 Commission's "Banking Communication" – however, according to the judgement of the Court of Justice of the EU (CJEU) of 19 July 2016 in Case C 526/14 (Kotnik case), the Communication, as a soft law instrument, is not binding upon the Member States.

IS THERE A NEED FOR STRUCTURAL REFORMS?

The case for separation or quasi separation of commercial and investment banking has re-emerged – note: US "Glass-Steagall Act"-type legislation has never been enacted in Europe.

D. Risks to financial stability amidst the current phase of the inflation crisis

(1) In the wake of the above-mentioned episodes, all major central banks have further increased their official interest rates (unlike during and in the wake of the GFC) in their effort to control the higher than expected and persistently intensive inflation pressures; in that respect, and amidst the highly uncertain global environment:

- this reinforces the argument that monetary policy is – typically – not considered as the appropriate means to safeguard financial stability; but
- the **trade-off between high inflation and financial (in)stability** is evident ("balancing act");
- hence, when setting interest rates, central banks need to integrate into their monetary policy economic analysis, *inter alia*, the impact of (further) increased interest rates on the lending activity of banks and on capital markets (without prejudice to any potential conflicts of interest).

D. Risks to financial stability amidst the current phase of the inflation crisis

(2) The efficiency of monetary policy can be negatively affected by prolonged and non-targeted fiscal expansion (meaning that, while higher official interest rates are aimed at dampening demand, fiscal expansion may lead to the opposite direction) – hence, **the monetary policy – fiscal policy mix is of predominant importance**

(3) In autumn 2022, the IMF (**"Global Financial Stability Report"**), the European Systemic Risk Board (ESRB, Warning "on vulnerabilities in the Union financial system", **ESRB/2022/7**) and the ECB ("Financial Stability Review") identified several sources of risk to financial stability amidst the inflation crisis:

D. Risks to financial stability amidst the current phase of the inflation crisis

- financial vulnerabilities are elevated for both governments with mounting debt (including some within the euro area) and for non-bank financial institutions (such as insurance companies, as well as pension, hedge, and mutual funds);

- rising interest rates – in combination with risk-aversion on behalf of investors – have a negative impact on several classes of assets held, *inter alia*, by banks (such as stocks and bonds, bond yields rising broadly across credit ratings), leading to notable declines in financial asset prices (across regions and asset classes);

- an increase in market volatility, and (to a certain extent) strained market liquidity, in conjunction with **pre-existing vulnerabilities**, could amplify any potential rapid, disorderly repricing of risk and the borrowing cost for many companies are already rising to the highest levels in decades

D. Risks to financial stability amidst the current phase of the inflation crisis

(4) The (further) raising of official interest rates and the tightening of financial conditions may – albeit in a differentiated way across jurisdictions (taking into account the vulnerabilities of more-indebted sovereigns, households and corporates), especially if also combined with a deterioration of the macroeconomic outlook leading to conditions of anaemic growth (an economic environment of **"stagflation"**) or even recession:

- lead to further (and eventually sharp) correction in asset prices with a (potentially further) negative impact on banks' portfolios (exposure to market risks);

- have implications for asset quality and the profitability outlook of banks, whose resilience is also affected by structural factors, competition from new (and, in several cases, still non-regulated) providers of financial services, and exposure to climate change-related risks;

D. Risks to financial stability amidst the current phase of the inflation crisis

- activate vulnerabilities in the residential and the commercial real estate sectors;
- affect medium-term sovereign debt dynamics;
- potentially lead to a (new round of) increases of non-performing loans (NPLs) and non-performing exposures (NPEs);
- overall, expose banks to rising medium-term risks due to deteriorating growth prospects, despite the benefits from short-term gains derived from higher interest rates and margins

D. Risks to financial stability amidst the current phase of the inflation crisis

(5) Since the probability of 'tail-risk scenarios' materialising has increased since the beginning of 2022:

- relevant authorities and market participants should continue preparing for scenarios in which tail risks materialise;
- there is a case for close coordination between relevant authorities and prudent risk management practices across all financial sectors and market participants to effectively address vulnerabilities, in order to avoid market fragmentation and negative externalities;
- **banks' prudent risk management practices** should be complemented by micro- and macroprudential capital buffers that are consistent with the prevailing level of risk;
- need to address financial stability risks beyond the banking sector.

D. Risks to financial stability amidst the current phase of the inflation crisis

(6) Finally, according to a most recent (5 April 2023) IMF blog:

- **geopolitical tensions** are transmitted to banks through the *real economy*;

- the effect of disruptions to supply chains and commodity markets on domestic growth and inflation could **exacerbate banks' market and credit losses**, hence:
  - further reducing their profitability and capitalisation,
  - diminishing their risk-taking capacity, and
  - prompting them to cut lending, further weighing on economic growth;

- the financial and real-economy channels are likely to feed off one another, **with the overall effect being disproportionately larger for**, *inter alia*, **banks with lower capitalisation ratios**

E. Selected issues pertaining to the adjustment of the financial regulatory framework to prevent a new Global Financial Crisis

(1) Financial stability in internationally highly interconnected systems is a "global public good" – hence, the importance of international rules and their proper transposition into national law remains significant (in particular, to avoid regulatory arbitrage and an increase in financial fragmentation)

(2) Adequacy of the bank prudential rules

- do the rules on corporate governance need to be further enhanced at least in relation to remuneration and risk management (in which case, the cost of an even higher regulatory burden is confined)?
- how can the quality of own funds (in terms of loss absorbency) be improved?

E. Selected issues pertaining to the adjustment of the financial regulatory framework to prevent a new Global Financial Crisis

- a “vicious circle”: higher capital requirements for listed banks negatively affect their return on equity, exactly at the time when they seek for more own funds (regulatory capital) – a clear disadvantage to shareholders in comparison to other categories of listed companies or **exposure to “adverse selection”**
- to what extent and towards which direction(s) should the powers of supervisory authorities be broadened?
- how can the problem of **overcapacity** in the banking sector be addressed?

E. Selected issues pertaining to the adjustment of the financial regulatory framework to prevent a new Global Financial Crisis

(3) At EU level: Are there any appropriate (legislative?) means to ensure **full respect of the hierarchy of creditors and shareholders** outside resolution?

(4) Means to mitigate supervisory failures

(5) Adequacy of the bank resolution framework (where existing)

- is the bail-in tool appropriate in times of economic slowdown?
- can the MREL targets be met in periods of high interest rates without severely undermining banks’ profitability (a requirement for stability)?
- is the overall resolution framework tailor-made for “systemic crises”?

E. Selected issues pertaining to the adjustment of the financial regulatory framework to prevent a new Global Financial Crisis

(6) Adequacy of the deposit guarantee scheme's framework

- should the level of coverage be increased? – cost-benefit analysis required;
- should deposit guarantee schemes be required to also serve crisis prevention functions?
- at EU level: how urgently do we need the creation of the European Deposit Insurance Scheme and Fund (EDIS/EDIF)?

(7) Prudential regulation of (still) unregulated entities providing services in the financial system

E. Selected issues pertaining to the adjustment of the financial regulatory framework to prevent a new Global Financial Crisis

(8) Selected issues relating to capital markets/insurance sector

- are prudential rules in the regulation of the insurance sector adequate?
- is there a case for totally prohibiting the distribution of complex financial instruments (e.g., Additional Tier 1 and Tier 2 bonds) to retail investors?
- what if such instruments are on the portfolios of insurance companies and pension funds, in which case unsophisticated persons would bear losses?
- is short selling in times of a turmoil a rather destabilising factor? How could this be best addressed?