International Finance, Spring 2024
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2023 Banking Turmoil: Materials for Class on Monday March 25 2024

For the third class this semester we will look at some issues in banking regulation. I am assigning as readings for this class session a publication by the Basel Committee on Banking Supervision,[2] and another by the Swiss financial regulator, FINMA.[3] Recently, New York Community Bank announced significant losses on its commercial real estate portfolio, raising concerns again about smaller banks.[4] New York Community Bank is linked to last year's events as it acquired assets from Signature Bank.[5] The bank failures in early 2023 mostly involved US regional banks—Silicon Valley Bank,[6] Signature Bank of New York and First Republic Bank—as well as Credit Suisse, a very large internationally active Swiss bank. But the Basel Committee on Banking Supervision, a body which works on harmonizing bank regulation, includes all four banks in its assessment. This document describes what happened in early 2023 and identifies some issues banking regulators need to be focused on as a result.[7] The documents include a number of acronyms and technical terms, and these notes address some aspects of these

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[2] Basel Committee on Banking Supervision, Report on the 2023 Banking Turmoil (Oct 2023).

[3] FINMA Report, Lessons Learned from the CS Crisis (Dec. 19, 2023).

[4] *See*, *e.g.*, Nupur Anand, Pete Schroeder & Matt Tracy, NYCB Stock Rout Prompts US Bank Regulators to Conduct Health Checks, Reuters (Feb. 20, 2024).

[5] Rob Copeland & Emily Flitter, Big Dreams Come Back to Bite New York Community Bank, NY Times (Feb. 8, 2024)("The pain stems largely from a weakening commercial real estate market that impelled NYCB — which operates more than 400 branches under brands including Flagstar Bank — to admit to mounting losses. In a piece of symmetry with last year's crisis, the bank said its newfound size after the acquisition of Signature Bank, had accelerated its troubles by forcing it to keep more money on hand, crimping its profitability and prompting it to consider selling distressed assets sooner than it might have preferred.")

[6] SVB had a UK subsidiary. *See* Basel Committee on Banking Supervision, Report on the 2023 Banking Turmoil (Oct 2023) at 6. SVB UK was sold to HSBC. *Id.* at 10.

[7] In particular: "novel elements... include: the unprecedented speed of deposit withdrawals that were experienced, particularly among uninsured (high value) depositors; outlier business models that aggressively take on risks; and the way in which concerns about banks in one jurisdiction, including ones that were not considered internationally active, affected confidence in banking sectors and markets in a much wider range of other jurisdictions." Report on the 2023 Banking Turmoil at 18.

technical details.[8]

The Basel Committee on Banking Supervision has been operating since the 1970s, originally established by central bank governors of G10 countries[9] after a bank failure and now comprising 45 members.[10] Note that this is a very much smaller membership than the IMF. The Standards the Basel Committee develops are among the standards the IMF and World Bank focus on in their FSAP program.[11]

Since the Global Financial Crisis, banking regulators have been concerned to identify risks to financial stability which may be created by pandemics, political events and economic developments.[12] Because of the many linkages between financial markets and financial institutions in different jurisdictions, risks that develop in one place may be transmitted very easily around the world.

Banks are significant as potential spreaders of risks through the payments system.[13] They process large amounts of payments all the time, and the failure of one bank could lead to an

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[8] *See* Notes on terminology below at p.6.

[9] Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

[10] *See* https://www.bis.org/bcbs/membership.htm?m=79. 4 US Banking Regulators are represented on the Basel Committee: the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

[11] *See* https://www.imf.org/external/standards/index.htm.

[12] *See*, *e.g.*, Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, Consultative Document (Jul. 2023) at 3 ("Recent events such as the Covid-19 pandemic, Russia-Ukraine war and turmoil in the global banking system have reinforced the importance of bank and banking system resilience to a range of different shocks, as well as the need for effective supervision.")

[13] In addition to the issues we are looking at here, the Basel Core Principles for Effective Banking Supervision mandate characteristics of the legal regime for banking supervision with operational independence, effective governance, adequate resources and credibility for the supervisor, which should be empowered to co-operate with other regulators. In addition, the Core Principles set out criteria for licensing of banks. For example: see Principle 5: "The licensing authority has the power to set criteria for licensing banks and to reject applications where the criteria are not met. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of board members and senior management) of the bank and its wider group, its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home supervisor is obtained." A banking group should be supervised on a consolidated basis, with adequate monitoring of all aspects of the business worldwide, including the application of prudential standards (Principle 12).

inability to make payments which would have a knock-on effect on other banks.[14] Banks traditionally are involved in maturity transformation, taking in short term deposits and lending out money for longer terms. This involves risks, for example that the interest rates charged on existing loans may be too low to allow the bank to attract deposits when general interest rates rise,[15] and that depositors may decide to withdraw their funds.[16] The prevention of bank runs is a major focus of bank regulation, and deposit insurance is designed to prevent bank runs by ensuring that depositors do not need to worry about the solvency of their bank. Questions about the optimal design of deposit insurance schemes were among the issues the 2023 banking turmoil surfaced.

Banks also face risks associated with how they lend money: are they lending to risky borrowers, are they lending too much to borrowers with similar characteristics so that they are over-exposed to particular geographic or industry risks?

Complex capital adequacy requirements apply to banks,[17] to address a range of different risks, including credit risk (the risk that a counter-party will default), interest rate risk, market risk (the risk that assets will decline in value), liquidity risk (the risk that a bank may be unable to meet obligations when they come due without incurring unacceptable losses), operational risk (risk of losses associated with people, processes, systems, external events and legal risk). Capital requirements mean that banks are required to have capital, meaning that investors have invested

[14] We regulate payments systems as financial market infrastructures to limit these risks. *See*, *e.g.*, Committee on Payment and Settlement Systems & Technical Committee of IOSCO, Principles for Financial Market Infrastructures Apr. 2012). On interconnectedness, *see*, *e.g.*, Michael Barr, Vice Chair for Supervision at the Federal Reserve, Supervision with Speed, Force, and Agility (Feb. 16, 2024) ("The nature of banking—and the interconnectedness of the system—pose vulnerabilities to individual banks and to the banking system. Deposit insurance and other forms of governmental support help to protect depositors, banks, and the broader economy, but also add to moral hazard, in that banks do not internalize the full costs of their risks. Regulation and supervision help to make it more likely that banks manage their risks prudently given the costs that their failure can pose on society, and that banks have the capacity to support the economy through good times and bad.")

[15] Interest rate risk.

[16] The prevention of bank runs is a major focus of bank regulation.

[17] Michael Barr, *supra* note 3, ("Through regulation, the Federal Reserve Board sets the minimum requirements for banks. These regulations require banks to have systems to manage their risks, and to maintain capital and liquidity in light of those risks. Regulations are tiered depending on bank risks, with the larger, more complex banks subject to more stringent requirements. We need to get regulation right, so that the baseline level of resilience in the system is strong enough. The requirements set in regulation, however, may not be sufficient for banks with activities or profiles that are different from or are riskier than a typical bank. Supervision helps to fill in these gaps.") (footnote omitted).

in the bank's equity securities[18] to the extent necessary given the risks associated with the bank's business. Capital adequacy requirements are designed to provide a cushion to protect the deposit insurance systems from losses when a bank fails, because the losses will fall on equity investors who rank after the deposit insurance system in a bankruptcy.

The Basel Committee document refers to Basel III,[19] which is the most recent version of Basel capital adequacy requirements. The requirements are organized under 3 Pillars: Pillar 1 relates to capital requirements, Pillar 2 relates to firm wide governance and risk management, and includes additional capital requirements, and Pillar 3 relates to disclosure.

The Basel Committee document refers to some scandals that affected Credit Suisse before its collapse, and which are seen as contributing to a loss of confidence. Credit sSuisse was affected by the failures of two firms: Archegos and Greensill. Archegos Capital Management was a private investment firm founded by Bill Hwang which used total return swaps[20] to take aggressive positions in securities, and which was unable to meet margin calls when stock prices fell. Credit Suisse was one of the banks that incurred large losses as a result of its relationship with Archegos,[21] and in 2023 the Federal Reserve, the UK's PRA, and FINMA announced enforcement action relating to unsound counterparty credit risk management.[22]

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[18] Common Equity Tier 1 (CET1) includes equity shares and retained earnings and should represent at least 4.5% of the bank's risk-weighted assets. *See*, *e.g.*, https://www.federalreserve.gov/supervisionreg/large-bank-capital-requirements.htm .

[19] https://www.bis.org/bcbs/basel3.htm?m=76. There is a summary table here: https://www.bis.org/bcbs/basel3/b3_bank_sup_reforms.pdf .

[20] A total return swap is a transaction in which one party agrees to make payments based on the return of an underlying asset and the other party makes payments based on a specified fixed or variable rate.

[21] Board of Governors of the Federal Reserve System, Order to Cease and Desist and Order of Assessment of a Civil Money Penalty Issued Upon Consent Pursuant to the Federal Deposit Insurance Act, as Amended, In the Matter of UBS Group and Credit Suisse (Jul. 21, 2024) at 4. ("Archegos defaulted on Credit Suisse's margin calls, causing Credit Suisse, which lacked adequate margin, to liquidate its positions in the underlying names and suffer approximately $5.5 billion in losses.")

[22] Board of Governors of the Federal Reserve System, Federal Reserve Board Announces a Consent Order and a $268.5 Million Fine with UBS Group AG, of Zurich, Switzerland, for Misconduct by Credit Suisse, which UBS Subsequently Acquired in June 2023 (Jul. 24, 2023); Prudential Regulation Authority, The PRA Imposes Record Fine of £87m on Credit Suisse for Serious Risk Management and Governance Failures in Connection with Archegos Capital Management Exposure (Jul. 24, 2023) ("The PRA action is part of a co-ordinated global resolution, incorporating action by the Swiss Financial Market Supervisory Authority ("FINMA") and the Federal Reserve Board, which provides for combined penalties in excess of $387.5 million being imposed by the PRA and

Greensill Capital provided supply chain finance, which involves a lender paying money to a supplier to a business (at a discounted rate) on the basis that that business will then make payments to the lender. The lender is exposed to credit risk, the risk that the business will not be able to pay the money it owes.[23] Greensill financed its lending by packaging invoices into notes that it sold to investors through a Luxembourg registered SPV (special purpose vehicle).[24] Where the buyers were not investment grade, Greensill would acquire insurance policies to address the credit risk. [25] These issues of securities were not treated as securitizations under UK law, and were not subject to requirements applicable to securitizations.[26] In addition, some of the funding seemed to relate to "prospective receivables," that is, where there was no existing supplier contract in place.[27] Greensill's main insurance provider decided not to renew its insurance, and Credit Suisse accelerated a loan it had made to Greensill entities, which Greensill was unable to pay.[28] Greensill was subject to AML/CFT regulation but was not regulated as a sfinancial firm by UK regulators.[29]

The case studies in the Basel Committee document illustrate serious failures at the financial institutions with respect to governance and risk management, and also serious failures by regulators in their supervision of these firms. The document characterizes these banks as "outliers" and suggests that supervisors need to be aware of specific characteristics of the bsuiness models of banks they are supervising.

Federal Reserve Board."); FINMA, Archegos: FINMA concludes proceedings against Credit Suisse (Jul. 24, 2023).

[23]*See*, *e.g.*, House of Commons Treasury Committee, Lessons from Greensill Capital, HC 151 (Jul. 20, 2021) at 13.

[24] *Id*. at 14.

[25] *Id*. at 15.

[26] *Id*. at 16.

[27] *Id*. at 16-18.

[28] *Id*. at 19.

[29] *Id*. at 20. The holding company was registered in Australia and there was a Greensill bank regulated in Germany. *Id*. at 21.

Notes on terminology:

AT1 instruments: AT1(additional tier 1) bonds, or contingent convertible bonds are debt securities designed to be converted to equity or written off; they were introduced after the Global Financial Crisis to encourage investors with high potential returns, but on the basis that they incur losses when the issuing bank is in trouble. When UBS took over Credit Suisse FINMA announced a complete writedown of its AT1 bonds, although equity investors would receive some consideration for their shares. Regulators in the EU and UK announced that owners of AT1 bonds would only suffer losses after shareholders had been wiped out.

NSFR: net stable funding ratio measures the stability of a bank's funding profile over a one-year time horizon and complements the liquidity coverage ratio (LCR), focusing on whether the bank has sufficient long-term stable funding to fund its long term assets.

HQLA (e.g. p 24): high quality liquid assets—cash or assets that can be converted into cash quickly with no loss of value

LCR: liquidity coverage ratio—under Basel III banks should have sufficient HQLA to fund cash outflows for 30 days—i.e. enough to risde out short term disruptions to liquidity

IRRBB: interest rate risk in the banking book— "the current or prospective risk to the bank's capital and earnings arising from adverse movements in interest rates that affect the bank's banking book positions. When interest rates change, the present value and timing of future cash flows change. This in turn changes the underlying value of a bank's assets, liabilities and off-balance sheet items and hence its economic value. Changes in interest rates also affect a bank's earnings by altering interest rate-sensitive income and expenses, affecting its net interest income (NII). Excessive IRRBB can pose a significant threat to a bank's current capital base and/or future earnings if not managed appropriately."[30]

HTM/AFS assets: are assets owned by banks defined as held to maturity (HTM) or available for sale (AFS). Unrealised losses on HTM assets can cause significant problems when those losses are realized with implications for the bank's capital adequacy.

[30] https://www.bis.org/basel_framework/chapter/SRP/31.htm.