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European Banking after the 2023 Crisis

KEY MESSAGES

- **The 2023 banking turmoil had limited effects on banks in the euro area and the EU. Nevertheless, there are important lessons to be learned**
- **Business models matter. Specific banks in the US were hit, with a funding structure relying on sectorally concentrated large and related depositors**
- **Bank runs have become faster due to less sticky deposits in an internet-based banking model and social media**
- **Fragility is a feature, not a bug, of banking. There is no simple, one-size-fits-all solution to the prudential regulation of interest rate risk in the banking book**
- **Basel III allows for the implementation of several policy options without major reforms in order to emphasize supervisory intervention, such as the introduction of criteria for risk-based pricing of deposit insurance premiums**

The 2023 banking turmoil in the US and the failure of Credit Suisse were a stark reminder of the fragility of banking but also the importance of effective regulation and supervision. And while this turmoil did not affect banks in the euro area or the European Union, it would be wrong to be complacent. Even though European banks have indeed been shown to be resilient, and some of the credit for this goes to the Single Supervisory Mechanism (SSM), which has dramatically improved supervision over the past ten years, there are always lessons to be learned from bank fragility in other countries. This paper discusses some of these lessons and different policy options that have been raised to make banks safer beyond the already implemented regulatory reforms, most prominently Basel III.

BUSINESS MODELS MATTER

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The banking fragility of 2023 hit specific US banks, with business models relying on sectorally concentrated large and related depositors. While bank regulators and supervisors often focus on asset concentration, it has become clear that concentration in the funding structure can also be an important source of fragility. In addition, Silicon Valley Bank (SVB) and other failed banks had experienced rapid growth due to high deposit inflows from its client base during the pandemic (mostly tech companies). But rapid growth tends to be a good predictor of future fragility, and this also held for SVB, which invested primarily in government bonds, which in turn lost market value when interest rates increased dramatically starting in late 2021. While not reflected on its balance sheet (under the assumption of held-to-maturity), rapid deposit withdrawals forced SVB to sell these bonds at a loss, which ultimately triggered insolvency. Similarly, Credit Suisse had been suffering from risk management and governance problems for many years. The trigger in this case for rapid loss of access to funding markets was the forfeiture of confidence by a large equity investor.

This brings me to the broader point of banks' business models. The SSM has put an emphasis on banks' business models to gauge the sustainability of the banks it supervises beyond compliance with specific regulatory norms. This is a healthy approach, as lack of viability is a clear warning signal that goes beyond the compliance with (mostly static) regulatory norms.

The other important lesson to be learned is that of the application of Basel III. SVB was in the group of banks not subject to Basel III regulation after the threshold was increased in 2018, and therefore did not have to comply with Basel III liquidity ratios. Further, it was not subject to the more rigorous stress testing and supervision applied to large banks in the US. Nonetheless, supervisors had pointed out weaknesses in SVB's governance structure, including the absence of a chief risk officer, but the follow-up was insufficient as the bank's situation deteriorated.

BANK RUNS HAVE BECOME FASTER

One important lesson is that bank runs have become faster. The SVB failure highlights that sectoral concentration in funding and social networks can increase the speed of runs; in this specific case, the heavy concentration of depositors in the tech sector and the interconnectedness between them, relying on the same venture capital funder. In addition, fast retail payment systems (instant payments) and payment applications allow depositors to move funds away from a deposit account in a question of seconds and without limitations. More generally, the move from a branch-based towards an internet-only banking model has made deposits less sticky and more prone to withdrawal in times of crisis (Erel et al. 2023; Benmelech et al. 2023). Social media can also play a significant role, as shown by Cookson et al. (2023), who find that negative sentiment tweets about specific banks are associated with greater outflows of uninsured deposits in those banks in the first quarter of 2023.

INHERENT FRAGILITY

The 2023 fragility was also a reminder of the inherent fragility of banking. It is important to note that this fragility is a feature, not a bug, of banking, as liquidity and maturity transformation are at the core of banking. So, the challenge is not to eliminate the risk (which would amount to "throwing the baby out with the bathwater"), but rather to manage the corresponding risks. Drechsler et al. (2021) provide evidence that the deposit franchise provides a natural interest rate hedge: banks finance a part of their activities with deposits that pay interest rates that are lower and react significantly less than one-to-one with reference market rates, which constitutes a hedge against the impact of interest rate fluctuations on the rest of their balance sheet. However, this hedge is likely to break down in the worst possible moment, as the bank failures witnessed in the US in early 2023 clearly illustrate.

The optimal prudential treatment of interest rate risk might therefore interact with banks' funding structure. Suarez (2023) shows that the minimum equity buffers required for banks to remain solvent when interest rates unexpectedly spike decrease with the importance and stability of the deposit franchise. Thus, the more stable the deposit base of a bank and the less likely depositors are to withdraw, the lower the minimum capital required to ensure a bank's solvency even in an adverse interest rate scenario.

There is thus no simple, one-size-fits-all solution to the prudential regulation of interest rate risk in the banking book, with the preferred prudential measure as well as its detailed calibration depending on the value of the bank's deposit franchise, the stickiness of its deposits, the cost of increasing loss absorbing capacity, and the term premium earned on long-term assets. The treatment of interest rate risk under Pillar 2 is thus preferable to a one-size-fits-all approach under Pillar 1.

RESOLUTION AND RECOVERY

The banking fragility of 2023 has also reminded us that the way bank failures are managed rarely corresponds to what was planned and announced ex ante. While SVB was initially sent into liquidation and uninsured depositors were not reimbursed, a systemic risk exception was later applied to compensate uninsured depositors. And while there was a resolution plan in place for Credit Suisse, it was not followed; rather, Credit Suisse was forced into a shotgun merger with UBS, and with the support of the Swiss government, creating an even larger too-big-to-fail financial institution.

Given the absence of bank failures in the EU during the 2023 turmoil, the resolution framework (most prominently within the euro area) was not put to the test. But it is safe to say that if an institution the size of SVB, not to mention Credit Suisse, had turned out to be fragile and required intervention, it would most likely have failed the test. The options and conditions for resolving banks within the euro area are currently very restrictive, and the effective baseline assumption is that of precautionary recapitalization by national governments, as in several previous cases. While a recent reform package (CMDI) has proposed strengthening options for resolution in the EU, it is not clear whether the ultimate legislation will fulfill these ambitions.

In the absence of a strong and effective resolution framework, more emphasis on recovery options is needed, i.e., supervisory interventions before a bank is about to fail. This includes enhancing the capacity to recapitalize banks on an ongoing basis, i.e., before resolution or liquidation becomes necessary. Contingent Convertible (CoCo) bonds enable capital to be raised in times of stress when other options are impossible, either owing to unfavorable market conditions or because they are unattractive to shareholders (Pazarbasioglu et al. 2011).

In the EU, banks issue CoCo bonds as AT1 instruments, which, depending on their design, may absorb losses or be fully or partially converted into equity. However, conversion relies mostly on a book equity trigger, usually set by CoCo issuers at a very low level (most often at 7 percent of CET1 to risk-weighted assets, considering that the minimum regulatory level is 5.125 percent), which in practice means that conversion would be triggered when the bank is already insolvent.

Activating the conversion of CoCo bonds by a regulatory trigger upon a proper stress test assessment, by a higher trigger based on risk-weighted assets, or by a trigger determined by market prices, could increase the usefulness of CoCo bonds during episodes of banking stress (Calomiris and Herring 2013) and might work best in combination with measures to contain run incentives, such as contingent charges on uninsured outflows or enhanced liquidity backstops (Perotti and Martino 2024).

MORE RADICAL REFORM PROPOSALS

There are other more radical options, some of which have been discussed previously, meant to address the underlying fragility of banking (Beck et al. 2024). Most of these proposals seem not only impractical, at least in the short run, but would involve major changes to the current concept of banking.

Narrow banking proposals are usually brought to the fore after banking crises and vary from subjecting banks to a 100 percent reserve requirement to milder forms equivalent to imposing stricter versions of existing liquidity requirements. A related proposal is to require banks to have their uninsured deposit funding fully backed (after applying appropriate haircuts) by collateral prepositioned at a central bank discount facility, a proposal first formulated as the "Pawnbroker for All Seasons" by King (2016). However, this would imply that the collateral framework of central banks plays a central role in determining the provision of bank credit to the economy and might lead to conflicts with the price and financial stability objectives of central banks.

Another proposal aims at imposing temporary redemption charges upon uninsured deposit outflows, thus targeting incentives to withdraw at par and directly reducing run incentives (Perotti and Martino 2024). Critically, such charges may also shift expectations about further withdrawals by others, avoiding an escalation driven by fear of dilution rather than solvency concerns. Measures that discourage or slow down bank runs would buy time and reduce supervisory concerns about triggering unstoppable runs by activating timely recovery measures.

However, departing from the par value conversion of uninsured deposits would imply a fundamental change in the nature of bank deposits as a money-like instrument. In addition, very high charges may be needed to affect run incentives, and tightening convertibility conditions for uninsured deposits may simply not stop the outflows if the depositor is asked to choose between paying a fee and losing access to his entire deposit in the event of the failure of the bank.

A final proposal is to extend deposit insurance to all deposits, regardless of their size (Heider et al. 2023), in order to avoid bank runs.[1] However, extending deposit insurance to all deposits will further increase the volume of large deposit accounts on bank balance sheets (attracting funds now outside the banking system), thus removing any incentives for their holders to consider the stability and risk profile of their chosen banks. However, competition for such funding by riskier banks is also likely to destabilize more prudent banks and encourage them to increase their risk-taking. Finally, a significant extension of deposit coverage is likely to increase the opposition to creating a common deposit insurance scheme in the euro area, as it would raise the concerns about the socialization of losses due to excessive risk-taking.

LOOKING FORWARD, BEYOND THE CRISIS

While European banks have shown resilience in 2023, their price-to-book ratios are still below one, pointing to investor pessimism about the long-term profitability of European banks. The difference between European and US banks can be explained by different factors, including the more favorable macroeconomic growth prospects for the US.

One important element is the lack of a European single market in banking. The completion of the banking union with an effective resolution framework and a European deposit insurance system is a necessary but not sufficient condition for the creation of such a single market. We will only have arrived at a single market in banking when we no longer refer to French, German, or Italian banks (or champions), but to European banks. The main barrier to both the completing of the banking union and a truly European banking market is national politics. Unless national governments are willing to take a backseat when it comes to their banking systems, limited progress seems feasible.

Stronger capital markets are also an important ingredient of a more effective European banking system. A thriving single capital market can help banks by allowing them to raise funds more easily, securitize assets, and sell off non-performing assets, as well as enable an easier resolution and exit process for failing banks. Ultimately, a strong European banking system, where large banks are no longer tied to specific sovereigns, and a single capital market can not only provide the necessary efficiency and scale for financial service provision in Europe, but also reduce dependency on large US investment banks.

POLICY CONCLUSIONS

The 2023 banking turmoil had limited effects on banks in the euro area and the EU. Nevertheless, there are important lessons to be learned. Effective regulation and supervision is a moving target, adjusting to changing circumstances and banks' business models. There are several incremental policy changes that can provide supervisors with the necessary data and tools to strengthen the resilience of the European banking system, even without major reforms.

A forthcoming report by the ESRB's Advisory Scientific Committee discusses some of the policy options that have been put forward in the aftermath of the 2023 turmoil (Beck et al. 2024). These include:

- amending the supervisory reporting framework to provide clearer information on the structure of banks' deposit funding (mostly by implementing regular weekly reporting for the largest banks and further granularity in the concentration of funding by business sector) and complementing accounting-based information with market-based information in the (confidential) supervisory assessment of banks.
- revising the assumptions on the run-off rates of uninsured deposits that underpin the computation of the liquidity coverage ratio (LCR); while the LCR is not designed to cover all tail events, including bank runs, the higher speed with which liquidity stress has unfolded recently calls for a review of these outflow assumptions.

[1] The argument by Heider et al. (2023) focuses on the disciplinary effect that TLAC/MREL have on banks' risk-taking incentives. If market discipline via TLAC/MREL works, an increase in large deposits and more risk-taking would come with costs, like higher interest rates on MREL bonds.

- including criteria for risk-based pricing of deposit insurance premiums, related to depositor concentration or the share of uninsured deposits; deposit insurance premiums do not only have the function of accumulating reserves for depositor payouts in the case of failure or resolution, but also impact risk-taking incentives by aligning premiums with bank-specific risk.

These policy options could be implemented without major structural changes to the current regulatory and supervisory framework and within the margins of discretion of Basel III.

The question of a profitable banking system that can support economic and societal transition processes, however, can only be addressed through the creation of a single market for banking and the establishment of a capital market union, steps for which there seems to be limited political support at the moment.

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