Four Lessons Learned from Recent Events: Do not miss the real issues

Speech by Tomoko Amaya, Vice Minister for International Affairs, Financial Services Agency, Japan, at the "Eurofi High Level Seminar 2023" on April 26, 2023

(Introduction)

What can and should bankers and authorities learn from recent events? Let me take this opportunity to share with you my preliminary thoughts, preliminary because further consideration is needed as more information become available, including U.S. authorities' reports expected in a week.

1. Rapid Outflow of Deposits in the Digital Era

Depositors connected through social media acted all together, withdrew their deposits, and as a result, Silicon Valley Bank (SVB) suffered a huge outflow of deposits in less than 24 hours.[1] Many people, including me, were shocked with the speed. Existing liquidity risk management practices cannot address such rapid outflow in the digital era.

What should we do?

We need to differentiate market driven liquidity stress from stress due to the loss of confidence in a specific bank.

In the case of market driven liquidity stress, as we saw in the Global Financial Crisis (GFC), higher liquidity in normal periods would help as it enables banks to withstand the stress until markets start functioning again.

However, in the case of liquidity stress due to the loss of confidence in a specific bank, once a deposit run has started it will continue until very decisive measures, such as full public support or back-up by strong big banks, are announced. Outflow tends to accelerate and in the recent case social media and the high proportion of uninsured deposits exacerbated the speed.

More liquidity in normal periods could buy some time but would not make a bank viable. It only provides a few more hours of survival which is too short to take remedial actions. Banks need to monitor various qualitative and quantitative indicators and take appropriate measures before a devastating run starts.

In the good old days, late at night when people were asleep in bed, bankers sat in a meeting room discussing the measures to be announced the next morning. These days, late at night, people are in the bed disseminating information and withdrawing their deposits with smart phones. Therefore, agility is required.

Thorough review is needed on the adequacy of the operational aspects of liquidity risk management, i.e., whether banks' contingency plans, action plans and monitoring points are fit for the challenges of the digital era and whether they are well prepared to carry out the plans when necessary.
The same applies to the crisis management practices of financial authorities as well.

2. Interest Rate Risk (mark to market loss) and its Interaction with Depositors' Behaviors

Next, let me turn to the interest rate risk and its interaction with depositors' behaviors.

Due to rapid increases in interest rates, the levels of unrealized loss on available- for-sale and held-to-maturity (HTM) securities have risen significantly. At the same time, on the liability side, higher interest rates have brought an end to the influx of cheap funds to venture firms, and the total amount of deposits started to decline as firms made their operational payments.[2] Therefore, banks needed to sell bonds to accommodate liquidity needs, and the unrealized losses had to be realized.

Interest rate risk and unrealized losses should not be ignored, but they should be managed in the context of comprehensive asset liability management (ALM). If SVB has had illiquid assets like loans instead of HTM government bonds, they could have avoided unrealized losses but would face a liquidity shortage as venture firms made their operational payments. Effective and dynamic ALM integrating interest rate risk and liquidity risk, taking into account the concentration of deposits in terms of the business model, was indispensable.

In ALM practices, on the liability side, the stickiness of deposits is usually analyzed by attributes such as "corporate" and "small retail" as well as by experience.[3] However, in the recent cases, the concentration of depositors combined with the nature of the funds concerned was a source of volatility.

There has been other cases where banks need to pay enough attention to the nature of funds with respect to deposits. For example, regional banks in agricultural areas may experience seasonal fluctuation of total deposit amount, or after natural disasters local banks may experience a temporary increase of deposits during the period between insurance payment and reconstruction.

Banks are required to carefully analyze possible depositors' behavior and manage their assets accordingly, reflecting their business models.

Furthermore, the categorization of risks such as liquidity risk and interest rate risk is convenient, but does not represent the full picture of risks. If we focus on those risks individually, we would lose sight of the real vulnerabilities of the bank. We should look at the bank and not the risk.

3. Business Model, Outliers

These bring me to my third point: business models and outliers. The vulnerabilities I mentioned so far are derived from banks' unique business models. In addition, Credit Suisse ran into crisis even with its high capital and liquidity ratios as the market lost confidence in its business model.

It has been long stressed that regulatory and supervisory approaches should reflect the features of each bank's business model.[4]
The uniqueness of business models sometimes appears as outliers of the key indicators,[5] rapid growth of balance sheets, high proportion of uninsured deposits, and long duration in bond portfolios. Uniqueness can be identified through both more qualitative and sometimes rather simple quantitative analysis, such as the concentrated composition of customers.[6]

Regulatory metrics are there for all banks and good for banks with somewhat "standard" business models. However, regulatory metrics could not and should not address all the unique features of different business models. We may pretend that they can, but we will end up creating a false sense of security. Regulatory requirements would become overly complex or conservative if we tried to address the risks in all the possible business models. Tailored approaches are needed to regulate and supervise banks with unique business models, and discretion is necessary.

In addition, the case of Credit Suisse clearly shows us that a high level of capital may absorb financial losses but not a loss of confidence in business models. The viability of a business model needs to be a key perspective of supervision and to be addressed by management expeditiously.

4. Effective Supervision

The SVB case raises various issues in supervision. Because it was a mid-sized bank it was not subject to stringent supervisory/regulatory standards, and after it crossed the threshold, transition took time. Furthermore, even where deficiencies were identified and communicated to the bank they remained unfixed.

This tells us that reliance on banks' size may overlook the risk of banks with non-traditional business models and that we need to pay attention to banks that have rapidly expanding balance sheets and often change business models as well.

It is banks' responsibility to develop effective risk management and sustainable business models. But it is supervisors' responsibility to protect public and financial systems from the consequences of poor bank management. There should be no blind spot. The problems identified should be followed up. Material deficiencies need to be fixed promptly.

Regulators and supervisors have tools to constrain banks. But I have to confess that compelling banks to do something is not an easy task, especially when bank managers are unwilling to do so or incapable of understanding the problem and taking corrective measures. One of the key tasks and skills for supervisors is to engage with banks' management, persuade them tenaciously and sometimes cultivate them.

(Concluding Remarks)

The post-GFC regulatory reforms have made the banking system resilient, and the implementation of the finalized Basel III will further enhance the resilience.
At the same time, the recent events have revealed new challenges calling for new perspectives. If we look at new challenges through the lenses we are used to we may miss the real issues.

Today, I focused on lessons learned from recent events. However, they also have shown us that the landscape of banking business has been evolving. We need to understand, more broadly and deeply, the evolving nature of banking business due to social media, digital banking, and other technological development, and the implications for financial stability.

Now, let me finish with a regular disclaimer: all the views and opinions expressed here are of my own and not attributable to JFSA.

Thank you very much for your attention.

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[1] According to Barr (2023) and Gruenberg (2023), depositors withdrew $42 billion from SVB on 9 March, which is more than 20% compared to its total deposit liabilities at end-2022. Deposit outflow from Credit Suisse was reported to have topped CHF10 billion ($10.8 billion) a day in mid-March 2023 (see Financial Times (18 March 2023)).

[2] "…the bank (SVB) failed to manage the risks of its liabilities. These liabilities were largely composed of deposits from venture capital firms and the tech sector, which were highly concentrated and could be volatile. Because these companies generally do not have operating revenue, they keep large balances in banks in the form of cash deposits, to make payroll and pay operating expenses." (Barr, M S (2023); *Bank Oversight*, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 28 March)

In the case of Signature Bank, its focus on the digital asset industry was the cause of the deposit withdrawal. "In the second and third quarters of 2022, Signature Bank… experienced deposit withdrawals and a drop in its stock price as a consequence of disruptions in the digital asset market due to failures of several high profile digital asset companies. (…) Signature Bank was subject to media scrutiny following the bankruptcy of FTX and Alameda Trading in November 2022, as the bank had deposit relationships with both. Subsequently, in December 2022, Signature Bank announced that it would reduce its exposure to digital asset related deposits." (Gruenberg, M J (2023); *Remarks by Chairman Martin J. Gruenberg on Recent Bank Failures and the Federal Regulatory Response before the Committee on Financial Services, United States House of Representatives*, 28 March)

[3] "Non-maturity deposits must be segmented into retail and wholesale categories. Retail deposits are defined as deposits placed with a bank by an individual person. (…) Deposits from legal entities, sole proprietorships or partnerships are captured in wholesale deposit categories." (BCBS; *Standards - Interest rate risk in the banking book*, paragraph 111 (April 2016))

[4] "The assessment of business models requires the supervisor to both develop an understanding of the viability of the bank's current business model and form a view of its sustainability, given the strategic choices that the bank is making and/or the impact of changes to the business environment in which it operates." (*BCBS; Guidelines for identifying and dealing with weak banks*, paragraph 38 (July 2015))

[5] "At year-end 2022, SVB reported uninsured deposits at 88 percent of total deposits versus 90 percent for Signature Bank." (Gruenberg, M J (2023); *Remarks by Chairman Martin J. Gruenberg on Recent Bank Failures and the Federal Regulatory Response before the Committee on Financial Services, United States House of Representatives*, 28 March)

[6] "When conducting business model analysis, supervisors rely on various sources, including but not limited

to: banks' financial reporting; banks' business plans; internal reporting; relevant surveys and studies; and dialogues with internal and external stakeholders of the banks. All these sources help to understand the details of banks' lines of business, their sources of revenue and profit, their customer base, their operating approach, and the direction of the board management." (BCBS; *Overview of Pillar 2 supervisory review practices and approaches* (June 2019))