Are we at the start of the next banking crisis?

The 2022 Nobel Prize for Economics went to three researchers, Douglas Diamond, Phil Dybvig, and Ben Bernanke (also a former Chair of the Federal Reserve) for their research on banks and financial crises. The Chair of the Prize Committee stated that "the laureates' insights have improved our ability to avoid both serious crises and expensive bailouts".

Such ability depends on good bank regulation and supervision, and major improvements have been made in those areas since the Global Financial Crisis (GFC) of 2007-09 in the form of the Basel III reform agenda. In Australia, the "motto" is to ensure our banks are "unquestionably strong".

Time will tell whether the laureates' insights and the regulatory reform agenda have been sufficient to prevent a crisis arising from the failures of some large US banks (SVB and Signature Bank) and the public problems of the large European bank, Credit Suisse. I would anticipate that regulatory firepower and determination to avoid a major financial crisis will prevent one happening. But the events to date have certainly called into question some fundamental tenets of the conventional regulatory wisdom.

First among these is the view that Deposit Insurance Schemes (such as the Financial Claims Scheme in Australia) should reduce the incidence of bank runs and taxpayer funded bail-outs of banks. The US experience shows that protecting retail depositors up to a limit such as $250,000 dollars is clearly not sufficient to prevent runs. Larger depositors can be "runners" particularly in a world where social media leads to rapid diffusion of information (or misinformation) and electronic technology enables withdrawal of deposits at the push of a button.

The US government's blanket guarantee of all depositors of SVB and Signature demonstrates several things. One is the resolve of government and regulators to prevent contagion in the form of runs on other banks, and a financial crisis. (The Nobel Laureates showed, *inter alia*, that depositor fears can, rationally, lead to runs on even solvent banks). But perceived willingness to provide blanket guarantees increases the spectre of creating the moral hazard problem that large depositors (including other banks) will no longer focus on bank risk-taking - removing the important role of market discipline as a constraint on excessive bank risk-taking.

The second tenet is that requiring banks to make regular, accurate, information disclosures about capital strength and risk positions will encourage market discipline (by both stock markets and deposit and bond

markets) and inhibit excessive risk taking. As interest rates have climbed, regular disclosures of mark-to-market losses incurred on fixed interest portfolios (of government debt and fixed rate mortgages) would not have led to a sudden information shock, precipitating a run by depositors (which is market discipline at its worst – and too late). Rather, an orderly exit, or resolving of problems, of a troubled bank would be facilitated.

But information can be a two-edged sword, as the case of Credit Suisse in Europe suggests. It can "spook" the market which, for example, interpreted a regulatory constraint on a foreign shareholder from increasing its equity position in the bank above 10 per cent, and thus not providing additional equity capital, as indicative of more general fund-raising concerns (although that may also have been the case).

The third tenet is that regulators should enforce minimum risk-weighted capital ratios for a bank based on assessments of their risk-taking (such as credit, operational, and market risk) and, for larger systemically important banks, ability to demonstrate survival under hypothetical "stress tests". The US situation illustrates the problem of governments acquiescing to bank lobbyists and reducing the number of banks viewed as systemically important. It seems highly likely that a stress test which assumed a significant outflow of deposits and markedly higher interest rates would have shown SVB facing significant problems in raising cash via liquidating assets at a loss, or by raising new equity.

In the case of Credit Suisse, the Swiss Central Bank was one of the first to dramatically increase bank capital requirements following the GFC. This means that Credit Suisse, despite its litany of problems, should be well capitalized and solvent – unless forced into a fire-sale of assets. Loans from Central Banks aim to prevent such fire-sales, which if substantial can lead to downward spirals in asset market prices.

A fourth tenet is that liquidity problems can sound the death-knell for even solvent banks. Here there are two accepted roles for policy. One is that banks should be required to meet stringent minimum liquidity requirements (formalized since the GFC in the Liquidity Coverage Ratio and the Net Stable Funding Ratio). The second aspect is that if a solvent bank faces a liquidity crisis, the old adage should be followed of providing Central Bank loans at a penalty interest rate secured against good quality assets from the bank's portfolio. The actions of both US and European regulators have conformed to this. But the US approach of providing loans equal to the face value of long-term bonds taken as collateral (rather than the substantially lower market value) has meant a transfer of risk to the Federal Reserve.

The fifth tenet is that bank supervisors must properly supervise banks under their remit. In this regard, it seems fair to say that Australia, Europe, the UK and other major countries have adopted "tough" supervisory approaches, much more so than the US. In the US, supervisory responsibilities are spread

across a range of State and Federal organisations with differing levels of “toughness”. Moreover, the US has been less rigorous in applying the “best practice” Basel regulatory standards to non-systemically important banks, partly at the behest of bank lobbyists.

A sixth tenet is that individual bank failures should not be allowed to lead to substantial spillovers of losses to other bank counterparties. There has been substantial regulatory investment in reducing the interlinkages between banks (including requirements for Central Clearing Counterparties for derivative markets and higher bank capital requirements for exposures to other banks). But whether these changes are sufficient to prevent spillovers in the form of lack of confidence in other banks (contagion) is another question. Equity market reactions indicate two things. Declines in market indices suggest that there is nervousness about the ability of regulators to prevent some form of crisis dragging down economic activity. Larger declines in bank share prices suggest that concerns still exist about possible spillovers and contagion (or that there are other banks with problems due to the ending of the easy money regime which have been hidden up till now).

Finally, the experience of the GFC is still sufficiently fresh in mind to ensure that regulators and governments will do everything possible to avoid a repeat of a systemic banking crisis. (They did this in the case of the Covid pandemic). Combined with the post GFC regulatory reforms which have strengthened bank financial positions, it should be the case that rapid action to provide liquidity support to solvent banks will prevent a new financial crisis. But hopefully this will not prevent regulators ensuring that poorly managed banks deserving to die will exit the industry in a “graceful”, orderly, non-disruptive way.

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