The banking crisis that didn't happen

Agnès Bénassy-Quéré, June 2023

After the pandemic, and the energy crisis, Europe could have faced a banking crisis in March. Indeed, the banking world was rocked by the successive failures of several US regional banks and the emergency takeover of Credit Suisse, a globally systemic bank, by UBS (Chart 1). Bank share prices were hit in both the euro area and the United States, but they quickly recovered, although without returning to pre-March levels. So how was it possible to prevent the domino effect so often observed during financial crises?

As the Banque de France's latest report on [Assessment of Risks to the French Financial System](#) (June 2023) points out, contagion did not occur for two main reasons: (1) The crisis was addressed extremely quickly by the US and Swiss authorities, and (2) the European banking system was well prepared to withstand turbulence, following the major regulatory and supervisory reforms implemented in the wake of the global financial crisis.

Chart 1 A tough spring for certain US and Swiss banks

Source: Banque de France, Assessment of Risks to the French Financial System, June 2023.

Cure: a rapid response by the US and Swiss authorities

Silicon Valley Bank (SVB) and Signature Bank each suffered a run on more than 20% of their deposits in a single day, and the US authorities placed them in 'resolution' the following day. Banking resolution covers a range of instruments designed to ensure the continuity of a bank's critical functions and prevent contagion to other institutions. It can take the form of divestments, balance sheet restructuring, asset transfers or bailouts, or a combination of these instruments. In the United States, resolution is overseen by the Federal Deposit Insurance Corporation (FDIC), which is also responsible for deposit insurance.

The vast majority of the temporary deposits in these two banks were from very large clients, often investment funds or Silicon Valley start-ups. Many deposits exceeded USD 250,000 and were therefore uninsured above that threshold. However, by way of a systemic risk exception, the FDIC announced on 12 March, jointly with the Federal Reserve and the Treasury, that all SVB and Signature Bank deposits would be covered by the deposit guarantee scheme. The Federal Reserve also introduced temporary measures to boost liquidity across the whole US banking sector.

In Switzerland, the authorities also acted swiftly to limit the risk of contagion from the failure of Credit Suisse. First, on 16 March, they granted it a credit line of CHF 50 billion. Then, in response to persistent investor wariness, the Swiss authorities backed its takeover by UBS on 19 March by guaranteeing a substantial share of potential losses and by granting additional liquidity.

As a result of this takeover, holders of Credit Suisse convertible bonds lost their entire investment. To avoid the risk of contagion on convertible bond markets, the European authorities and the Bank of England were quick to clarify that, in their respective jurisdictions, losses would systematically be borne first and foremost by shareholders.

Prevention: the benefits of regulation and supervision in the euro area

The failures of these US regional banks primarily reflect the unsustainable mismatches in interest rate and liquidity risk management. Neither SVB nor the other failed regional banks were subject to the international rules established in the wake of the Great Financial Crisis (Basel III) designed to make banks more resilient in the face of these risks. Conversely, all banks in the European Union, even the smallest, are subject to these requirements. Furthermore, a robust regulatory framework must also be accompanied by strong supervision. This is the case in the euro area, with active and intrusive supervision within the Single Supervisory Mechanism.

French banks display comfortable liquidity ratios. In particular, their eligible assets are all marked-to-market when calculating these ratios, so there are no nasty surprises. Furthermore, uninsured deposits account for only 29% of total liabilities in France, compared with 85% in the case of SVB.

In France, unrealised capital losses on securities not yet recognised in banks' income or equity totalled EUR 8.4 billion at the end of 2022, or 2.2% of the CET1 capital of the six main French banking groups combined. If these banks were forced to sell these securities and take the hit, their CET1 ratio - the ratio of their equity capital to their risk-weighted assets - would drop by 33 basis points (0.33 percentage point). The aggregate CET1 ratio of the main French banks, which stood at 15.55% at the end of March 2023, would therefore remain well above the minimum requirements.

Moreover, like their European counterparts, French banks must assess the sensitivity of their economic value to an interest rate shock: if, in the event of a 200 basis point rise across the whole yield curve, the bank's economic value falls by more than 15% of CET1 capital, an alert is triggered. Based on the assessment conducted at the end of March 2023, no French bank was considered to be in this situation.

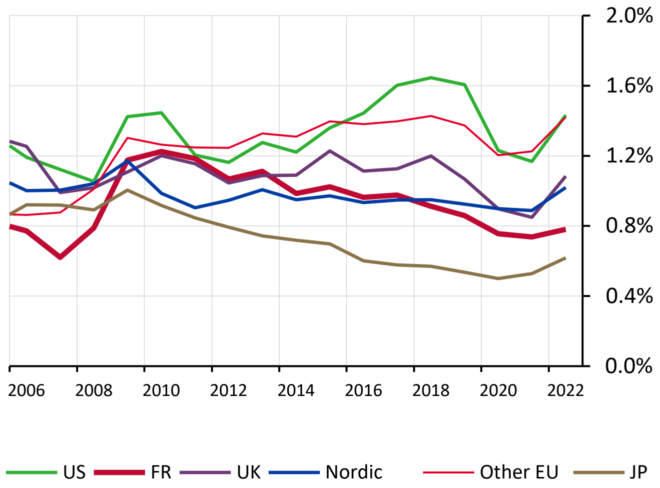
French banks and rising interest rates

If you are a borrower, you may think that banks are taking advantage of the rise in interest rates, since your repayments are higher but your sight deposit does not earn any interest. This is partly true. However, banks do not only finance themselves through our deposits, but also on the markets, in particular by issuing bonds. They also offer regulated savings accounts and fixed-term deposits, whose rates have increased in line with the rise in interest rates, pushing up their funding costs. Conversely, their portfolios on the asset side include long-term loans and bonds acquired in recent years at interest rates that are usually fixed and very low. The return on these assets is insensitive to increases in market rates. True, banks could now enhance the returns on their assets as customer loans mature and are replaced by new loans, as well as gradually renewing their financial securities portfolios. However, this is a slow process. The upshot is that their net interest margins (the difference between the average rate at which they lend and the average rate at which they borrow) have increased in line with interest rates, but less rapidly in France than in other European countries (see Chart 2).

Chart 2 Net interest margins, France and international comparison

Change in net interest margins

x: time axis / y: net interest margin / total assets



Sources: Bank's financial reporting, ACPR.

Therefore, French banks are not vulnerable to the same type of catastrophic chain of events that led to SVB's failure, however they must manage their profitability in such a way that markets do not consider it to be insufficient, compared with competing banks abroad.

Similarly, life insurers, which are major players in France (see table below), have to manage the risk of a mismatch between the profitability of their assets, largely determined by the financial securities acquired in recent years when interest rates were very low, and the returns expected by their policyholders, which are rising. In the short to medium term, however, they will be able to draw on their provisions for profit-sharing to boost returns. Moreover, their liabilities are relatively stable, despite a slight increase in policy redemptions. Other segments of non-bank finance do not enjoy this stability.

Closely monitoring areas without lampposts

It's customary to mock the tendency of economists to "look for their keys under the lamppost": focus their research on areas where they have reliable data. This bias is one of the reasons behind the 2008 global financial crisis, as the development of 'shadow finance' was overlooked. Today, we no longer speak of "shadow finance" but of non-bank financial institutions (NBFIs), because these institutions are not only legal but also partly regulated.

At the end of 2021, these NBFIs held almost half of total financial assets worldwide, and a third in France (see table). Financial stability depends increasingly on these institutions, particularly investment funds, which may be pension funds, money market funds, real estate funds, hedge funds, etc. Our knowledge of these different segments, and their links with banks, is still imperfect, but this is no reason to overlook them as a potential source of systemic risk.

Table. Share of non-bank finance in total global financial assets at end-2021

	World	Euro area	France
Financial assets (in USD billions)	486,600	110,700	22,000
NBFIs	49%	51%	32%
Insurers	8%	9%	16%
Pension funds	9%	3%	0%
Other institutions, O/W investment funds	32%	39%	16%
Narrow measure of NBFI*	14%	14%	8%

* financial intermediaries exposed to risks similar to those of banks (e.g. maturity transformation).
Source: Financial Stability Board.

Some of these funds are exposed to substantial liquidity risks that cannot be guaranteed by the central bank as lender of last resort, which provides liquidity only to banks. If a fund's urgent liquidity needs cannot be met, it may have no choice but to engage in a fire sale of part of its assets, with investors potentially incurring losses if such sales take place at a bad time or if the assets are illiquid (real estate, private equity, etc.). If several funds were to sell at the same time, the fall in prices could exacerbate this phenomenon through two channels:

- Investors may pull out of these products because they fear heavier losses;
- All holders of these assets would suffer unrealised capital losses, which could trigger sales of other assets.

The risk is particularly acute in periods when equity and property prices are considered high relative to their economic fundamentals. It is also high in times of market volatility due to increased margin calls by central clearing houses (as was the case during the UK's "mini-budget" crisis of autumn 2022). The most exposed funds are those that offer their clients perfect liquidity, as they can enter and exit immediately and without incurring any costs.

The regulation of non-bank, non-insurer financial institutions needs to be enhanced to take better account of their potential impact on global financial stability. Due to their size and interconnections with the rest of the financial system, these institutions play an important role in the smooth functioning of international financial markets, but they are particularly sensitive to asset and liability liquidity mismatches. Their assets are often invested in financial and real products such as property or long-term, illiquid 'private' equity, whereas their liabilities are liquid if their customers can exit freely. Regulation must enable them to meet the liquidity needs of investors and savers without generating negative externalities for other financial institutions (including banks). It is simply a matter of recognising the systemic dimension of these financial players, as was the case for banks after the 2008 financial crisis.