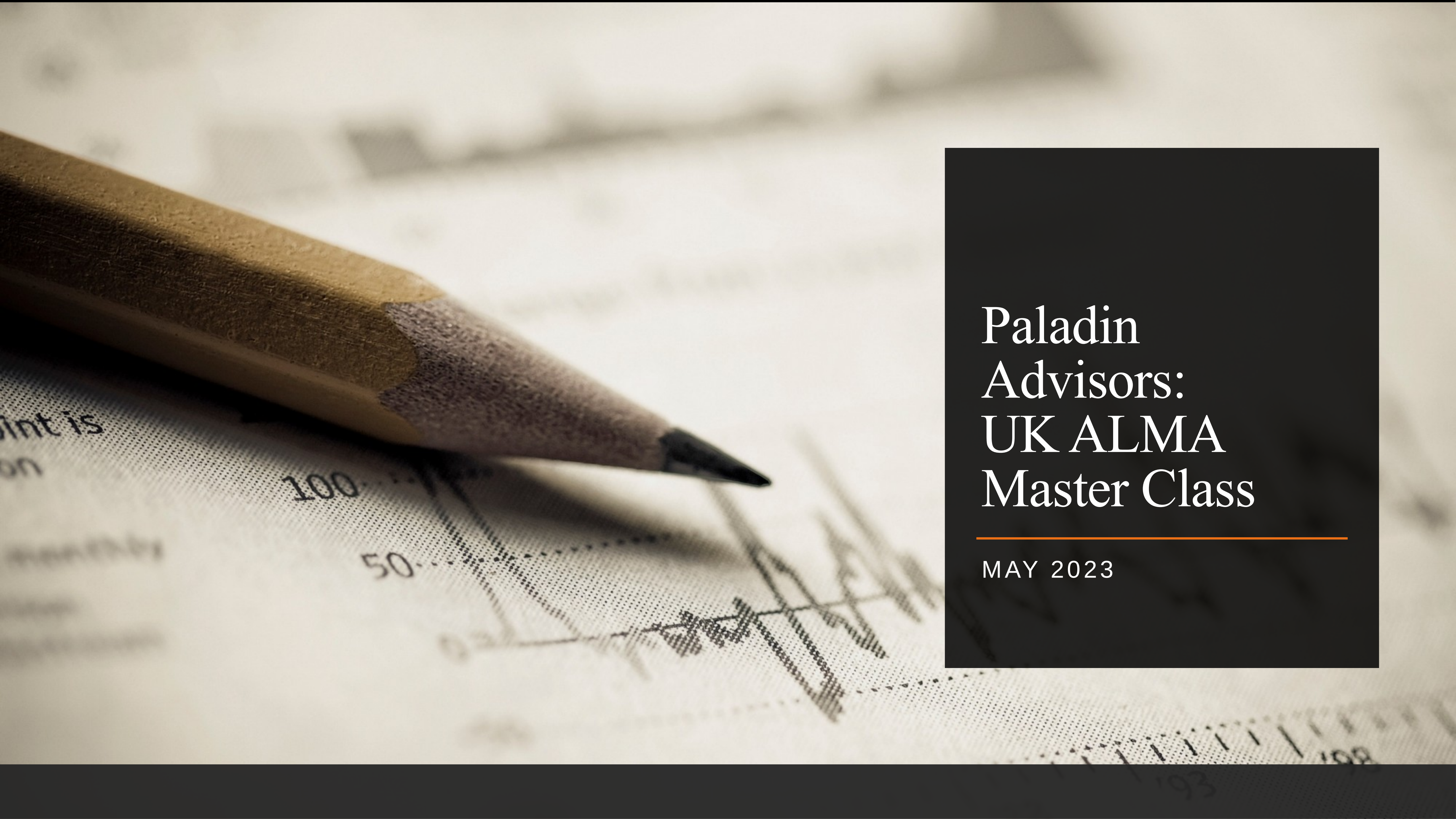
Paladin Advisors: UK ALMA Master Class
MAY 2023

Introduction

- Bank failure – and resolution and recovery considerations – are back at the forefront of the industry after nearly ten years of no significant meltdowns
- Three significant failures in the US – brought on by ALM and liquidity failures and compounded by slow regulatory actions – required resolution through the US deposit insurance fund
- Credit Suisse – the first G-SIFI to fail in the post-GFC era – required emergency legislation and an effectively forced merger with UBS to resolve
- While the UK banking system is well-capitalized, now is a good time to examine these recent failures and examine how the UK system might respond to a local event

Masterclass format

- This week will focus on themes instead of the actual resolution events:
  - Deposit runs: new concerns and areas of analysis
  - The strengths and weaknesses of the bail-in capital regime
  - Timing and contagion issues highlighted by US failures and a comparison to similar potential issues in the UK
  - BCBS coverage amounts and potential areas of concern

- Realtime moderated Q&A using the Zoom chat room feature
- One hour overall

Uniquely US issues

- Before we examine other factors, first let’s highlight how the US failures were somewhat unique to the American banking system
  - **Banking industry macrostructure** in the US has maintained a significant number of large, but not systemically important, regional banks
  - **US regulatory reporting** allows banks under $250 billion in assets to not recognize AFS losses in Tier I / tangible capital numerators
  - **US ALM is fundamentally different** due to much more fixed rate customer lending on balance sheet, and US GAAP accounting rules which create mismatches between income timing for derivatives versus customer assets and AFS / HTM securities portfolios

- These are not present in the UK – but other factors which contributed to the US failures can be readily found here

Good lessons learned

- In general, the failures of all institutions indicate that the efforts to build R&R playbooks was time well spent
  - Regulators had a clear line of sight for the mechanism of resolution to be used for each failed institution
  - With the exception of certain emergency legislative requirements for CS, relating to corporate voting requirements, regulators had the correct array of hard-wired and discretionary tools to wind up the failed institutions
  - While the market at large experienced an immediate crisis of confidence, the actions taken averted any broader systemic impacts
- The UK regime has, if anything, been more robust in requiring living will or resolution playbook planning – especially for the G-SIFI and D-SIFI banks
- **However, while the actions were ready, key assumptions about timing did not work out at the time of resolution**

The rise of electronic transfer tools

- The UK sector is much like the US in that **electronic funds transfers have become a dominant form of customer activity** since the last crisis
- US regulators – and treasurers – were caught off guard at how many customers used EFT avenues to quickly move their funds to other banks
- They were also caught off guard by the fact that many customers had immediately available deposit accounts at other banks – something that was unusual during the 2007-2008 deposit runs
- Account portability in the UK likely has exacerbated the impacts of a future run on a UK depository – especially for the emerging branchless sector, which (at least at set up) require an existing banking relationship
- Recovery playbooks were not written in contemplation of the speed of these electronic flights to the exit – and will now demand serious reconsideration

Important secondary considerations

- Basing outflow expectations on the 2007-2008 cases – Northern Rock or B&B for the UK – would likely create similar recovery playbook failures in the UK
  - Branch runs involved days or weeks of evolution, and included critical delays between branch withdrawals and deposits at new institutions, during which time due-to money was "in flight" and could act as a temporary cushion for the failing bank and for the CB to create liquidity
  - The SVB failure, on the other hand, happened so quickly that SVB could not physically reposition collateral to facilitate CB discount window access – the run happened within a securities settlement cycle
- Potential impacts: CBs may require more prepositioned collateral against uninsured deposits, and may need to harden NSFR methodologies against not just traditional "hot" customer types, but include a higher proportion of uninsured call accounts as well – especially those that pay interest

Deposit stickiness in 2023 has changed

- Another issue in common with the UK is that deposit pricing, after being effectively floored at zero for nearly 15 years, is now again subject to ongoing pricing elasticity pressures
  - Few bank executives remember how to manage rates, however, except to manage profitability – managing to avoid cannibalisation by competition is a lost art
  - Depositor behaviour modelling, moreover, has lost much of the older data from the 1990s which could inform statistically-driven modelling
  - And while depositors may have also gotten lazy, it takes little prodding regarding bank safety to get them to realise they’re leaving interest on the table

- **Banks and regulators need to re-tune models of deposit stickiness for a new era of pricing curves and depositor rate preferences**

Did the bail-in regime work?

- The biggest test of the SIFI bail in regime was at Credit Suisse, and it appears today that it was all-in a mixed success

AT1 securities used to make sure no taxpayer funds were required

HOWEVER

Regulators granted common equity a small recovery, despite full wipeout of AT1 investors

- While somewhat conjectural, it appears as though political considerations for the broader retail shareholder base of CS played a role
- While UK AT1 securities do not generally grant regulatory discretion in suspending strict hierarchy of bail-in, that lack of discretion could emphathise local UK contagion by fully transmitting losses to UK insurance, pension, and retail shareholders

Contagion is local and global

- The bail-in and G-SIFI rules were put in place due to the rapid capital markets contagion transmission following the failures of AIG and Lehman
- However, as SVB and CS both showed, contagion can be highly localised if a bank has a concentrated shareholder or depositor base
  - **For SVB,** its concentration in the tech and HNW sectors resulting in a cascade of perceived risk for other banks in the same sector – magnified by the ready use of social media to disseminate fear among those sectors
  - **For CS,** while the mechanisms to allow for resolution largely held true, regulators rightly identified that if Swiss local investors bore the entire burden of bail-in, there could be catastrophic impacts on local markets – local macroeconomic impacts were mitigated by wiping out non-Swiss institutional AT1 holders
  - **For the UK,** one can easily imagine a run on one challenger or fintech bank causing a run on all similar institutions – much as SVB led directly to First Republic's run
- **Regulators will need to carefully assess these new concepts of "contagion" in writing resolution and recovery playbooks – and in envisioning the BoE and PRA response to an idiosyncratic, non-systemic failure**

SIFIs and the size of a currency zone

- The UK's G-SIFIs – if they were to experience an accelerated deposit run – could easily swamp the BoE's instantaneous ability to create discount window liquidity - much as occurred in the CS case
- While central banks maintain swap lines with one another to ultimately tap non-local reserves (ultimately with a Fed backstop), putting those arrangements in place takes time – and faces practical limits based on the size of a currency zone
- G-SIFIs and their central bank lenders of last resort in countries like the UK and Canada – with sizeable but still limited currency areas – will need to look closely at the CS failure and the SNB's experience, and examine whether more robust backstop planning is warranted

Deposit coverage

- Lastly, a critical lesson of the most recent crisis is that the new era of fast-money bank runs puts severe pressure on corporate treasury customers
  - While "excess" funds in overnight interest bearing accounts ran quickly from SVB and CS, corporate treasurers were stuck in place, unable to move operating accounts given their entanglement with payroll, AP/AR, and other core processes
  - Most deposit coverage regimes, including BCBS, make no distinction between account types when applying coverage limits
  - While the UK bail-in regime explicitly places operational deposits at the back of the bail-in stack, the SVB and CS experience has revealed that that may be too esoteric an approach when reducing contagion risk among corporate depositors
- **US regulators are increasingly advocating carving out non-interest bearing current accounts from interest-bearing corporate balances, and expanding DIF coverage to include them**

Key takeaways

- While the US failures had uniquely American features which are not present in the UK, other factors can be easily mapped to the UK landscape
  - Acceleration of outflows due to the rise of electronic transfers
  - Stale deposit modelling after 15 years of no-interest-rate pricing
  - Fintech concentration of similar depositors in "new school" innovator or challenger banks
- The Credit Suisse failure highlighted several risks facing the major UK D- and G-SIFI institutions as well
  - Political risks of local shareholder bases
  - The potential exhaustion of the liquidity creation resources of central banks in smaller currency regimes
- Importantly, the whole system has tested the basic assumptions of the R&R playbook concept – the next stage will be to update for lessons learned.