KEY REFLECTIONS FROM SPRING 2023 BANK FAILURES

In March 2023, Silicon Valley Bank (SVB) collapsed within a mere 48 hours after four decades in operation in the United States (US). Across the Atlantic, Credit Suisse (CS), a 167-year-old global systemically important bank (G-SIB), was acquired by another G-SIB following long-standing difficulties and extreme episodes of liquidity stress.

These failures, known as "Spring 2023 Bank Failures", unleashed shockwaves that reverberated across the global financial landscape. However, on the home front, our member banks remain unscathed amid the banking stress in the US and Europe. Their resilience was anchored by sound fundamentals and strong buffers.[1]

The Spring 2023 Bank Failures have shown that failures can be unexpected, costly, fast-paced and contagious (i.e. can spread across the financial system to other banks).

- **Unexpected nature of failures**
  Failure can happen anytime, regardless of how strong the numbers seem to show. The unfolding of trouble in SVB and CS showed that even banks with seemingly strong financials can yield to a confidence crisis, where runs can happen quickly and overnight.

- **Costly ramifications**
  When bank failures morph into a crisis, massive resources and support are often required to stabilise the financial system. These resources could include deposit insurance or resolution funds, government backstops, and provision of market-wide support to stabilise the system during a crisis.

- **Fast-paced dynamics**
  In the current age of digital access, social media and herd behaviour bias, bank runs happen at an unprecedented rate. In the case of SVB, 25% of its deposits were withdrawn overnight and 62% expected to be withdrawn by the next day. This was in contrast with the total deposit outflow of 10% in the two weeks leading up to the largest failure of Washington Mutual during the 2008 Global Financial Crisis.

- **Contagion impact**
  The case in the US showed the spread of contagion from SVB to other regional banks which were performing well. One of the key aspects of contagion was the flight to safety for deposits from other healthy mid-sized banks to bigger banks, causing liquidity problems in these mid-sized banks which required immediate intervention by the US authorities. Some even viewed that this contagion could have also triggered the series of events at CS.

Why did SVB fail?

- *Rapid growth and poor risk management of business model and balance sheet strategies.*
- *Deposit run due to loss of confidence among depositors, resulting in the sale of SVB's available-for-sale securities at a loss.*

How was SVB resolved?

- *The Federal Deposit Insurance Corporation (FDIC) initially set up the Deposit Insurance National Bank of Santa Clara to assume and reimburse SVB's insured deposits.*
- *Due to an escalated confidence crisis, the FDIC invoked the 'systemic risk exception' and transferred substantially all of SVB's assets and some liabilities, including all deposits, to a bridge bank, before selling these to First Citizens Bank & Trust Company on 26 March 2023.*

For more details on the SVB failure and other case studies, please refer to the PIDM Resolution Case Studies booklet at www.pidm.gov.my.

[1] *Refer to "The operating environment continues to be conducive for resolution planning and crisis preparedness as member institutions remain resilient" article in this Part*

Why was CS failing?

CS was weakened by a series of events over the last two decades, including allegations of money laundering, corruption, and tax evasion. The failure of SVB, the delayed publication of CS's financial statements and a widely publicised statement by a large shareholder created additional concerns about CS's franchise and triggered a confidence crisis. CS experienced serious liquidity outflows from mid-March 2023.

How was CS dealt with?

CS was acquired by another G-SIB, UBS Group AG under a private contractual transaction, facilitated by the Swiss authorities (including a public liquidity backstop and loss guarantee from the Swiss government). Additional Tier 1 bondholders of CS experienced write-offs as part of the transaction.

KEY REFLECTIONS

The Spring 2023 Bank Failures have sparked discussions at the international standard-setting bodies on its implications and areas for further review in enhancing the design of the deposit insurance system and resolution regime. These failure cases also demonstrated that regulatory discipline from prudential regulation and supervision, an appropriate level of deposit insurance protection and an effective resolution regime are crucial elements to promote depositor protection and financial system stability.

Broadly, the lessons learnt upheld the importance of an effective deposit insurance and resolution regime as well as crisis preparedness – which always remain as key focuses for PIDM. In PIDM's context, there are a few key takeaways arising from the reflections of these failure cases.

1. Early preparation through resolution planning for all member banks contributes to crisis preparedness and resolution readiness.

As a resolution authority, PIDM has a comprehensive toolkit that enables it to take pre-emptive measures and resolution actions. However, recent cases have shown us that a bank failure can happen very quickly and undertaking preparatory actions only during times of crises may not be adequate. Undertaking preparation in advance through resolution planning could help to minimise disruption and preserve financial system stability in a bank failure. Through resolution planning, resolution authorities will be able to: (i) understand banks better (e.g. their different components and interconnectedness to the financial system) to ensure critical banking services can continue during resolution; and (ii) work with banks to develop resolution capabilities during good times (e.g. ability to generate information for valuation and maintain other operational continuity capabilities in resolution).

In the case of CS, resolution planning equipped the authorities with an in-depth knowledge of the bank as well as provided them with flexibilities and options to deal with the bank, such as facilitating a transfer strategy that was better suited for the bank during crisis instead of the bail-in strategy as planned. In the aftermath of SVB, it was noted that if resolution planning had been properly and adequately implemented for SVB prior to the crisis, the bidding and sale process for SVB could have been completed more expeditiously by FDIC.[2] Hence, this shows that applying resolution planning for each bank, regardless of asset thresholds, brings great value. This has substantiated PIDM's resolution planning approach for Malaysia, where it will be rolled out to all PIDM's member banks. Resolution planning will enhance feasibility and credibility of resolution actions and provide optionality to deal with crisis in a technologically-driven and fast-paced operating environment.

[2] *Remarks by FDIC's Vice Chairman, Travis Hill, at the Bipartisan Policy Center on the Recent Bank Failures and the Path Ahead, 12 April 2023*

2. Adopting the "transfer-ready" approach as the preferred resolution strategy.

In Malaysia, the preferred resolution strategy contemplated for all member banks is the transfer strategy. The transfer strategy is preferred as it seeks to achieve the resolution objectives of PIDM, namely to: (i) ensure the continuity of a bank's important functions in resolution; (ii) minimise loss and disruption to the financial system; (iii) protect depositors (e.g. by ensuring continued access to deposits, both insured and uninsured); (iv) maintain public confidence; and (v) preserve financial system stability. It also serves as a private sector solution where the failed bank will be acquired by another healthy bank or institution. This will minimise the risk of moral hazard by avoiding the possibility of using public funds to manage and save the failed bank. Moving forward, PIDM will work closely with member banks through resolution planning to ensure that they are "transfer-ready". In order to be "transfer-ready", banks should possess the operational capabilities to support PIDM in executing a prompt and effective transfer in a resolution.

Enhanced Differential Premium Systems (DPS) framework paves the way for effective resolution of member banks

In 2025, PIDM will implement the enhanced DPS framework that incorporates resolvability criteria to incentivise orderly resolution of member banks. Particularly, the enhanced DPS framework has included a new "composition of core funds" (CCF) criterion which aims to capture the risks associated with deposit base that are less sticky arising from a high proportion of uninsured deposits. These failure cases provided opportunity for PIDM to back test the reasonableness of the criterion, with encouraging observations where a swift private sector solution could be achieved in an institution with significantly higher sticky funds.

3. Fostering interagency readiness to ensure crisis preparedness.

As we have learnt from the failure cases, strengthening crisis preparedness is of the essence and has emerged as an area for continuous enhancement internationally to achieve an effective interplay of all safety net components. In PIDM's context, this encompasses having optimum preparedness, processes and infrastructure in place that will allow PIDM to manage the crisis effectively, including strengthening of financial safety net collaboration and readiness.

In our efforts to continuously improve PIDM's readiness, we have conducted various internal and interagency simulations to test decision-making and coordination with safety net players. Simulations provide us a safe environment to practise, make mistakes and identify gaps for further improvement. In addition to simulations, we are jointly developing an interagency crisis preparedness binder that aims to document the interagency collaboration and guide us in making decisions during a crisis. The binder will also be tested and refined as we progress.

CONCLUSION

A bank failure can be unexpected, and it is very hard to tackle once things begin to unravel. With fast-paced failure, the time-to-act is significantly shortened. Things can spiral out of control leading to failures, if not dealt with quickly. The dynamics of contagion impact should not be overlooked. The good news is that substantial work can be done during good times to reduce the scrambling for solutions in a crisis. By intervening early enough and tackling the problem decisively, some of the costs associated with failures can be avoided. Preparation for worst-case scenarios is key, regardless of how strong the institutions are – **a mantra of "just-in-case" for PIDM**.