

Geneva Report n. 27

Much Money, Little Capital, and Few Reforms: The 2023 Banking Turmoil

Presentation by

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Bocconi, Milano, 28 November 2024

The report tells multiple stories

- A story about US banks. *Actually, two different stories:*
 1. *One about solvency*
 2. *One about about monetary policy*
- A story about euro area banks
 1. *Where the Banking Union succeeded*
 2. *Where it failed, and what to do about it*
- A story about a Swiss bank

THE BANKING TURMOIL IN THE UNITED STATES

The solvency interpretation

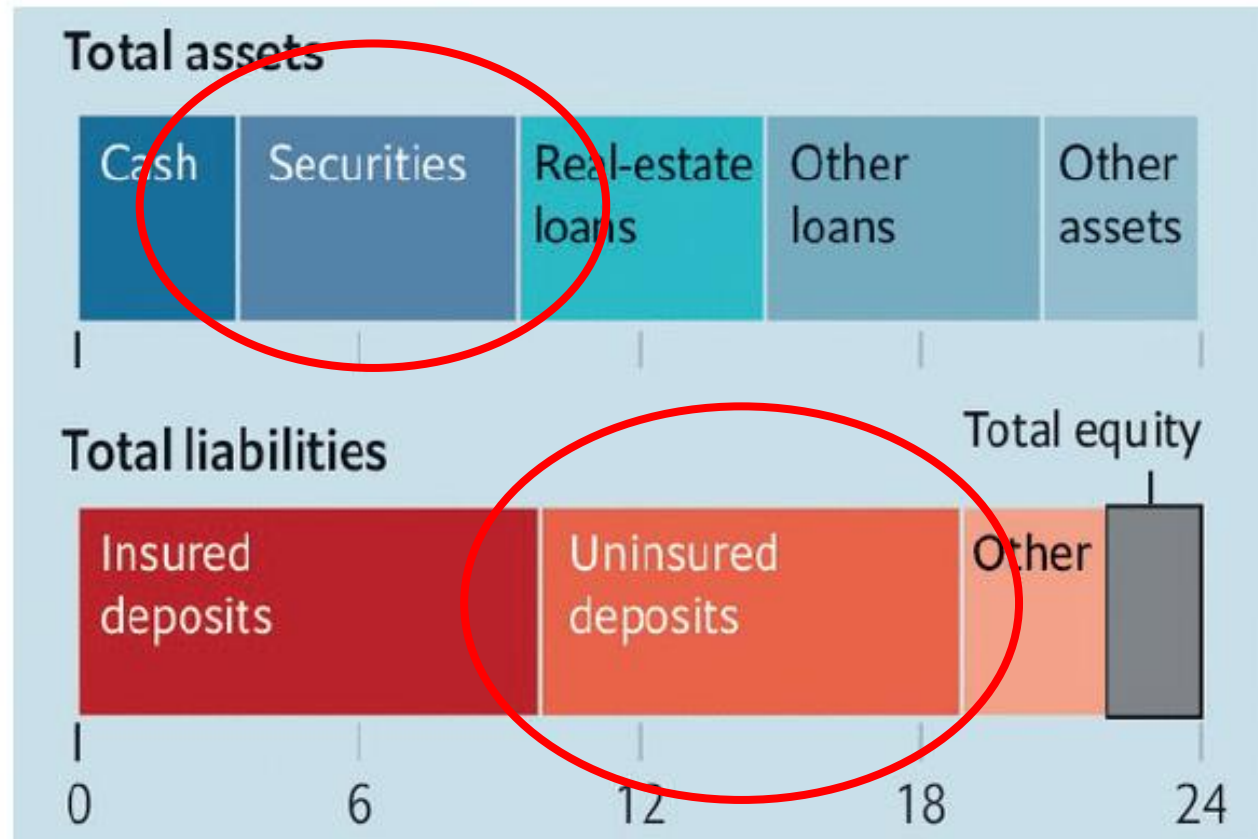
The banking turmoil in the US

TABLE 4.1 A CLOSER LOOK AT THE THREE FAILED BANKS

	Year of founding	Region	Business model	Asset price (pre-crisis)	Asset growth (2019 to 2022)	Type/ extent of exposure	Unisured deposits pre-crisis	Securities portfolio loss	Size of deposit run	Date of crisis (peak)
SVB	1983	California	Venture capital firms	\$209 bn.	350%	Long-term Treasuries (strong)	88%	104%	-42%	Wednesday 8 March 2023
Signature	2001	New York	Diversified retail	\$74 bn.	250%	Digital payments (moderate)	67%	30%	-20%	Friday 10 March 2023
First Republic	1985	California	Diversified wholesale	\$233 bn.	180%	Diversified credit mix (moderate)	70%	20%	\$100 bn. in 2023 Q1	Friday 28 April 2023

Source: FRB (2023), Gruenberg (2023) and FDIC (2023).

FIGURE 3.15 BETWEEN THE BALANCE SHEETS: THE AGGREGATE BALANCE SHEET OF US BANKS AS OF 2022 Q1 (US\$ TRILLIONS)



Source: Jiang et al. (2023a).

The “solvency story”:

- Banks collected an unprecedented amount of deposits very quickly, very concentrated – hence uninsured
- They carelessly invested in long duration securities
- A story of faulty interest rate risk management by banks (and partly of lax supervision)

FIGURE 3.17 DISTRIBUTION OF UNREALISED LOSSES

a) Histogram

b) A

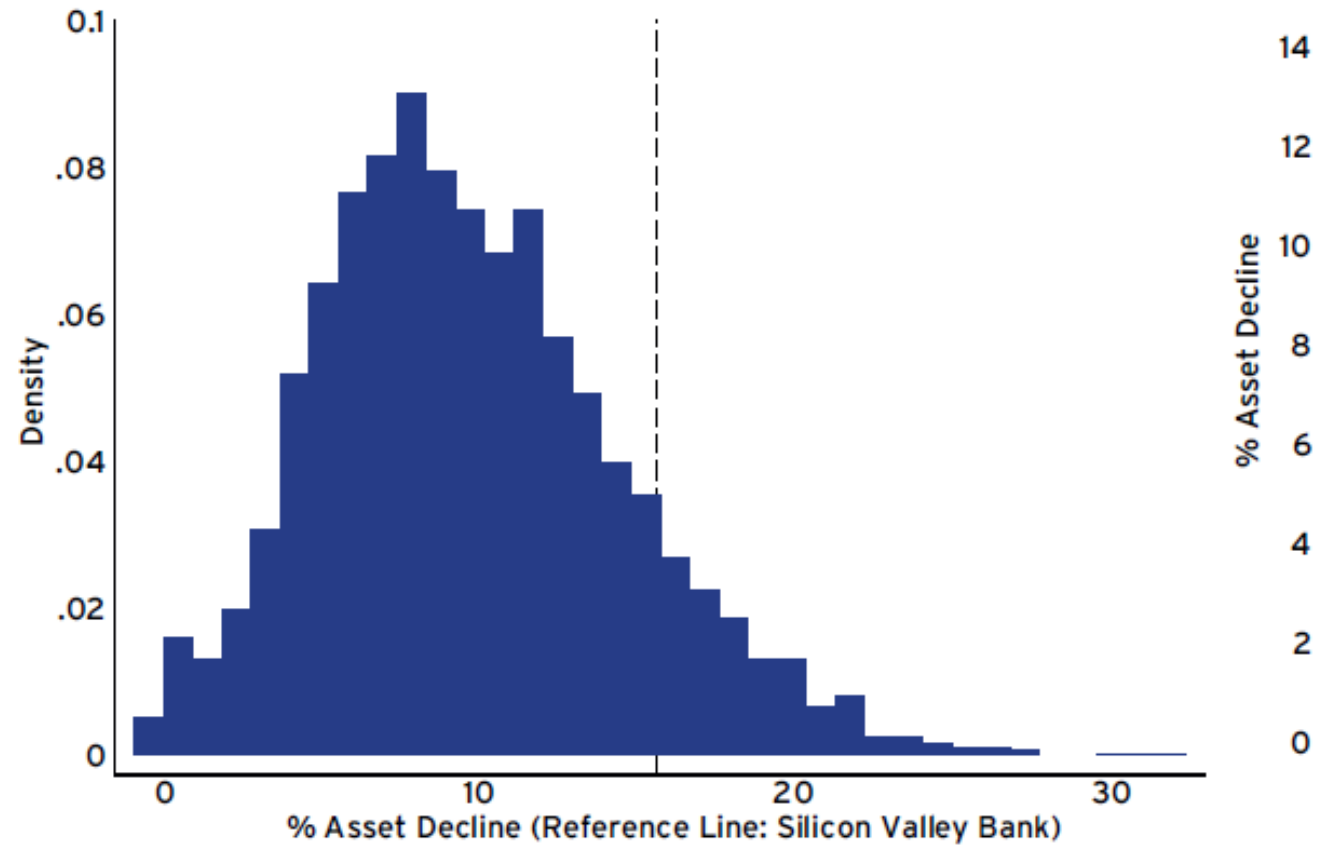


FIGURE 3.18 NOT AS MUCH INTEREST RATE HEDGING IN THE BANKING SECTOR AS YOU WOULD THINK

Duration of assets for banks that report these in their disclosures

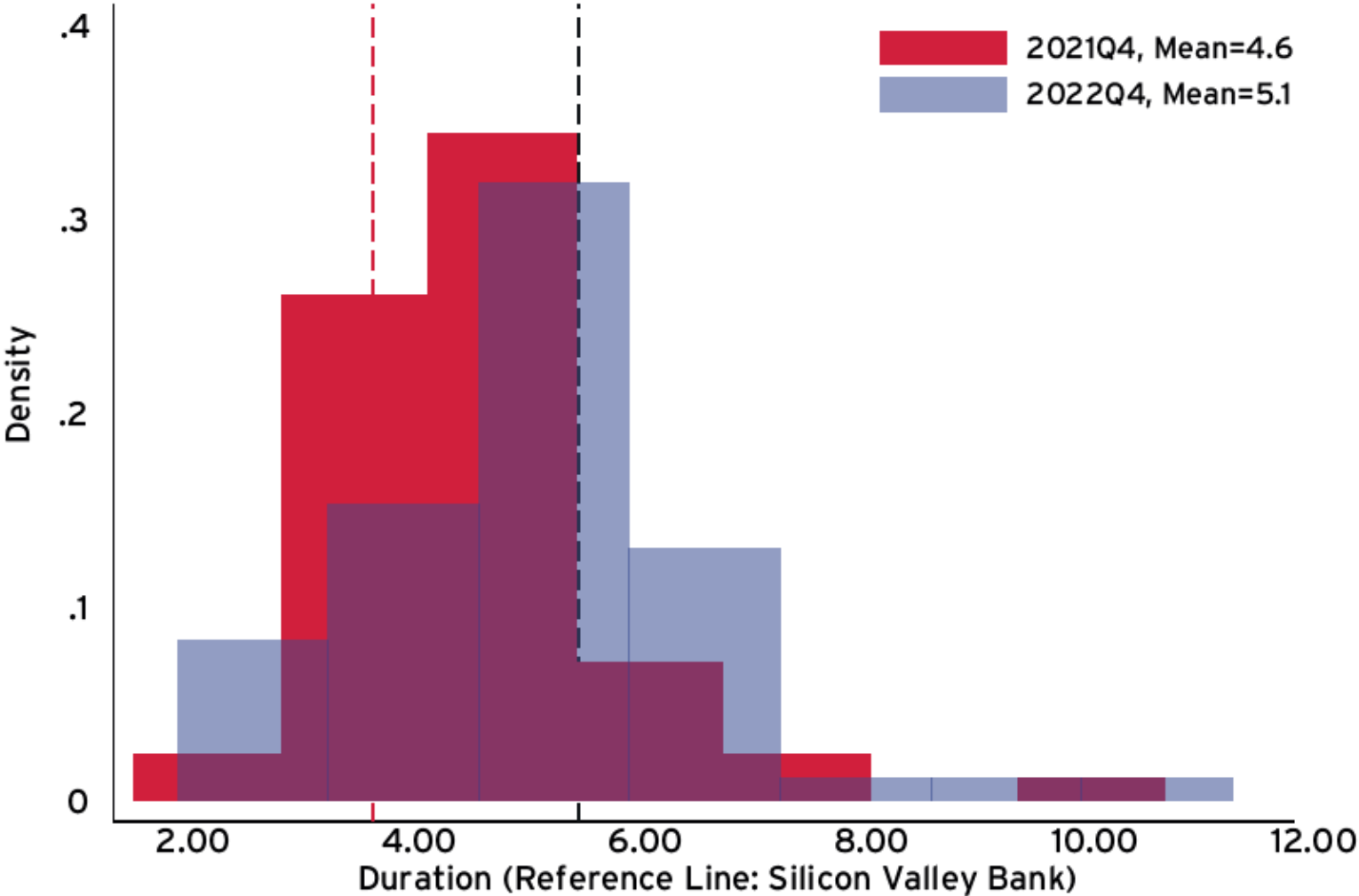


FIGURE 3.20 BREAKDOWN OF TOTAL SECURITIES BETWEEN HTM AND AFS BETWEEN 2021 Q1 AND 2022 Q4 (LEFT PANEL) AND ESTIMATED LOSSES ON RECLASSIFIED SECURITIES (RIGHT PANEL)

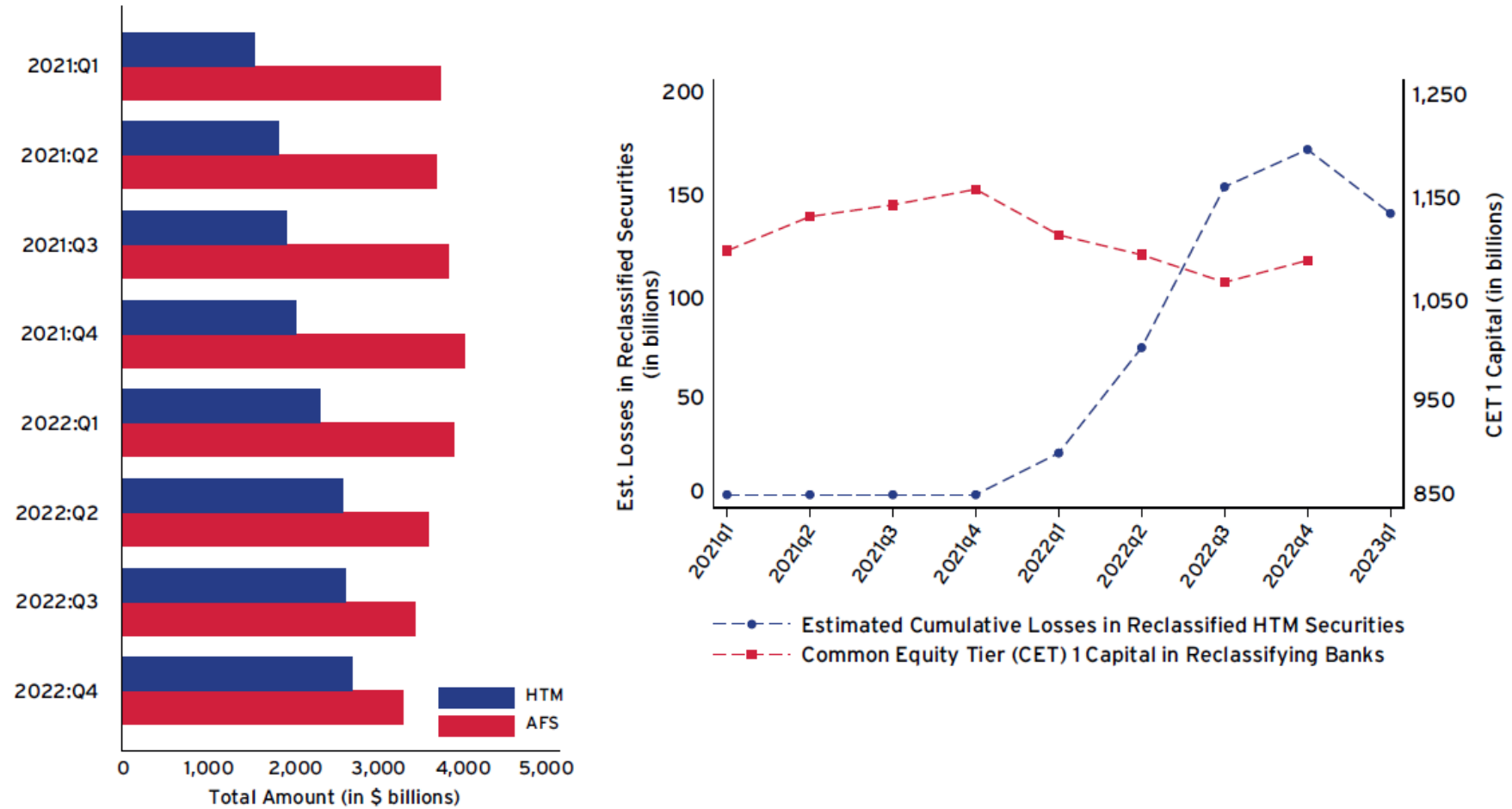


FIGURE 3.21 DISTRIBUTION OF UNINSURED LEVERAGE ACROSS US BANKS

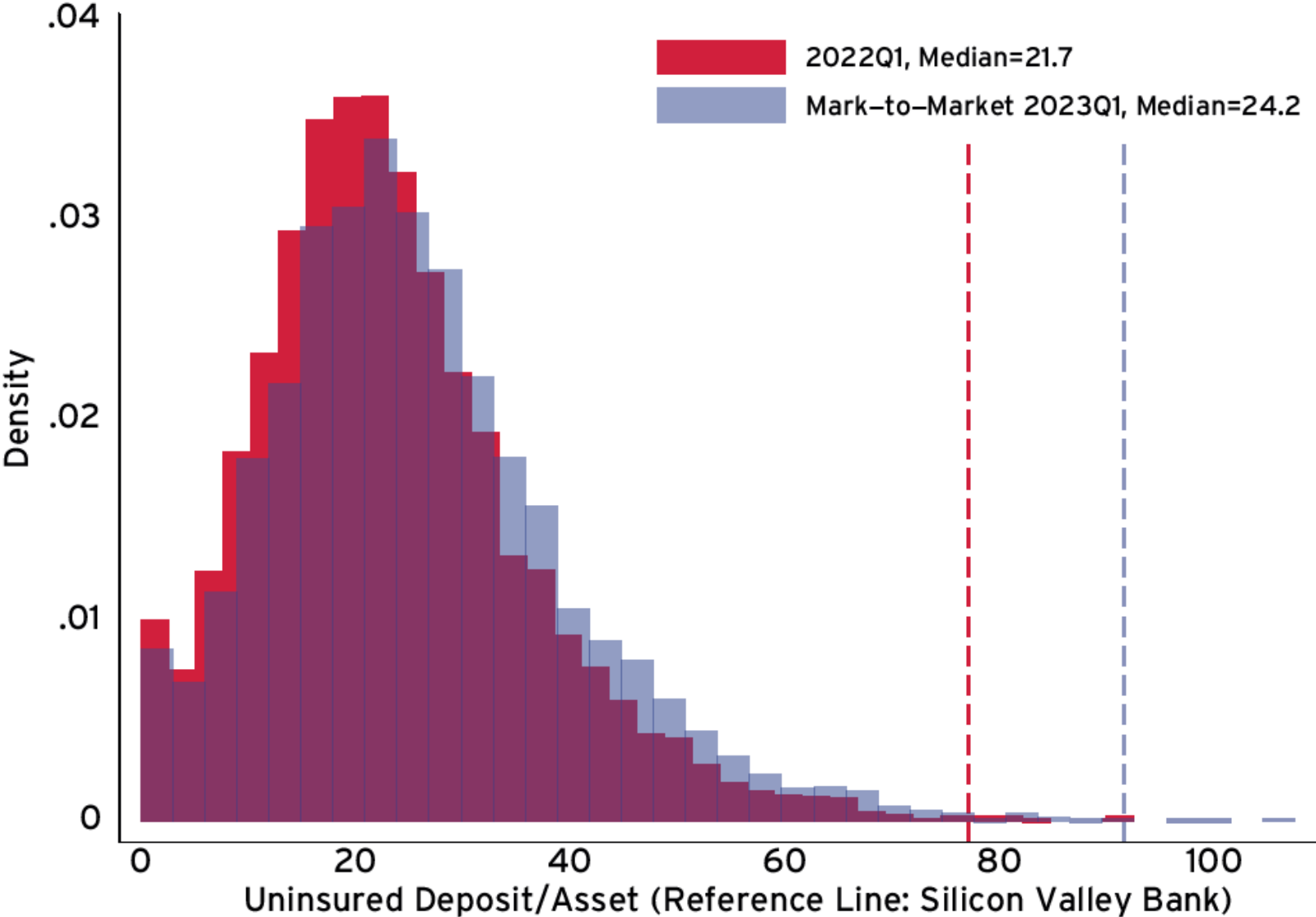
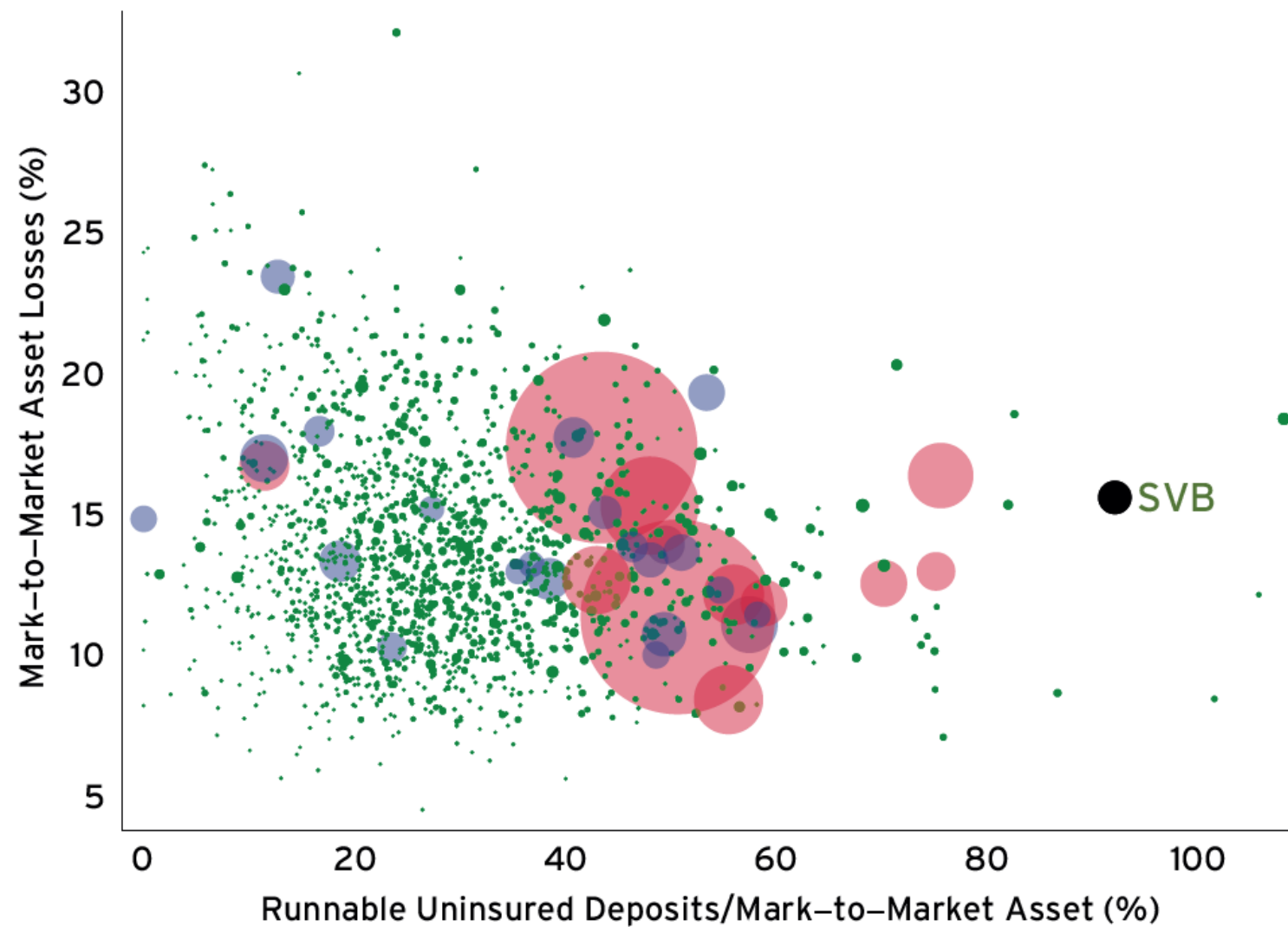


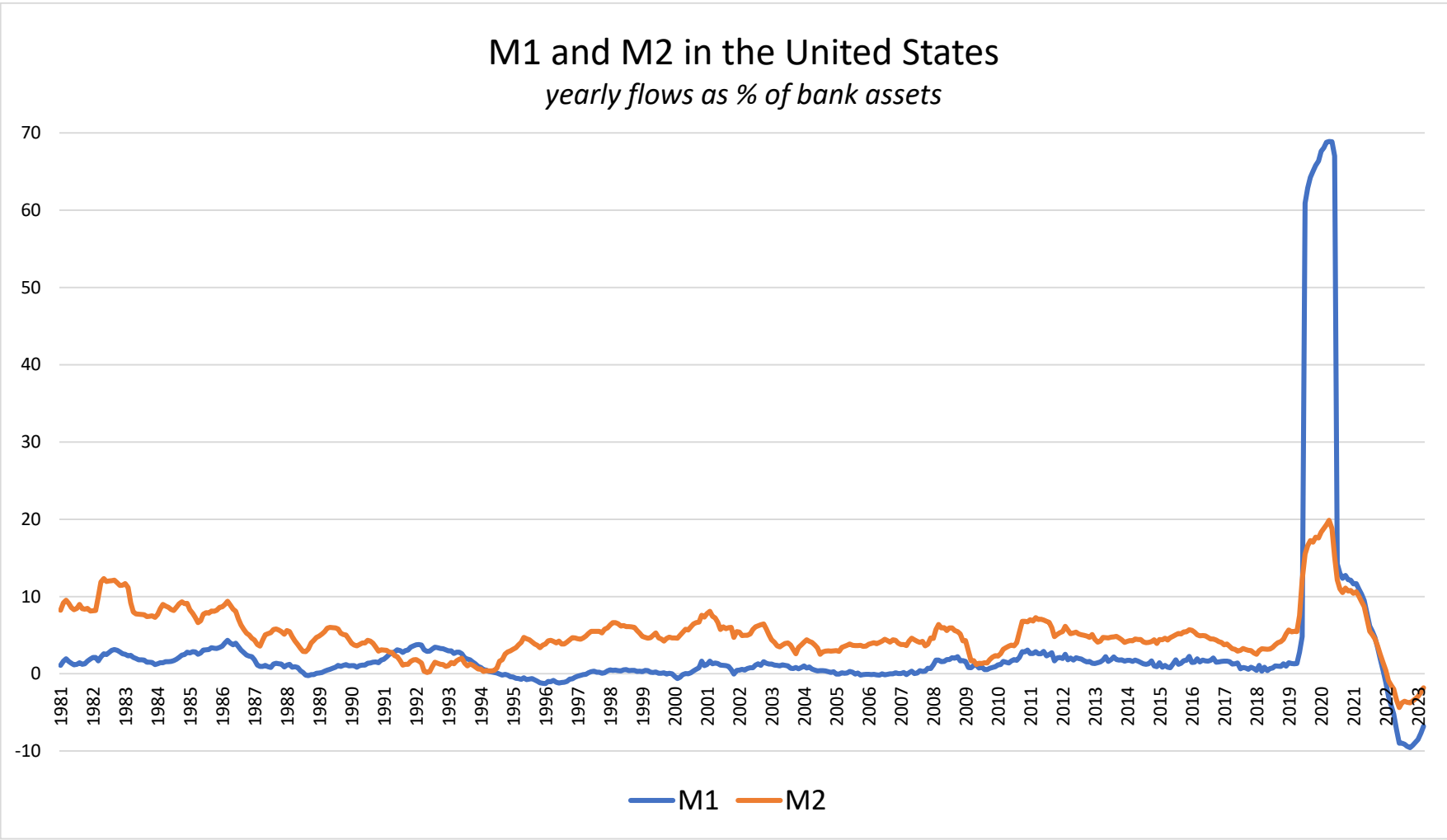
FIGURE 3.22 UNINSURED LEVERAGE AND UNREALISED LOSSES ('FLIGHT RISK' VERSUS 'TURBULENCE')



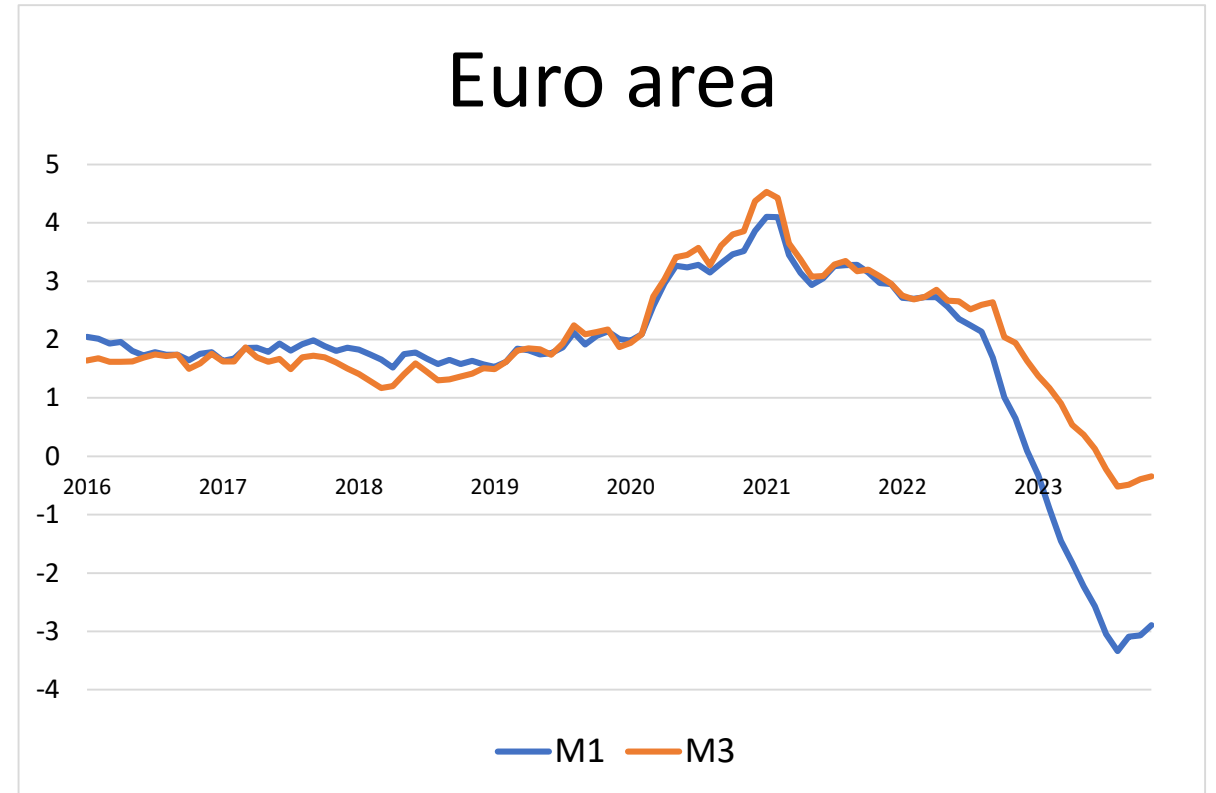
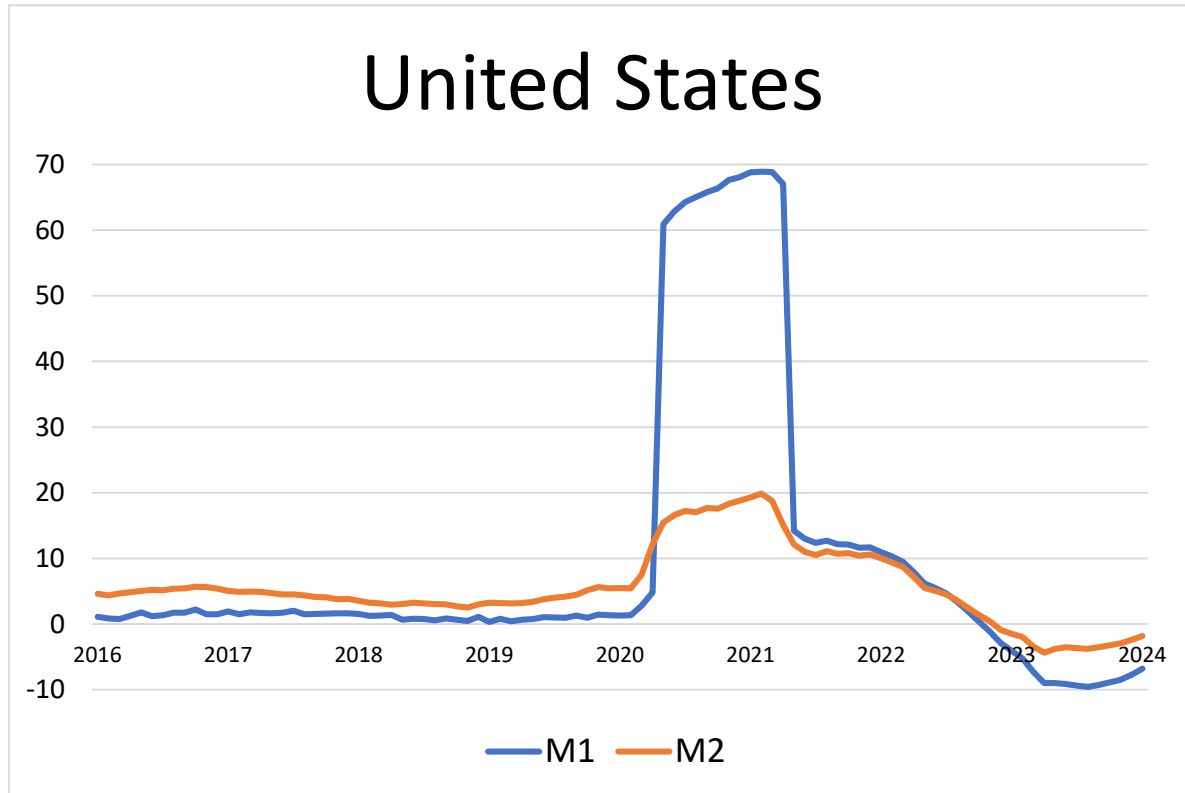
... is it entirely the banks' fault?

The monetary policy interpretation

An unprecedented US monetary shock



Money stock: US vs. euro area



US regulatory changes (March-April 2020)

- Eliminate reserve requirements on deposits in M1
- Eliminate limit to 6 monthly withdrawals on other deposits

Resulting in a major boost in M1 and M2 for given interest rates

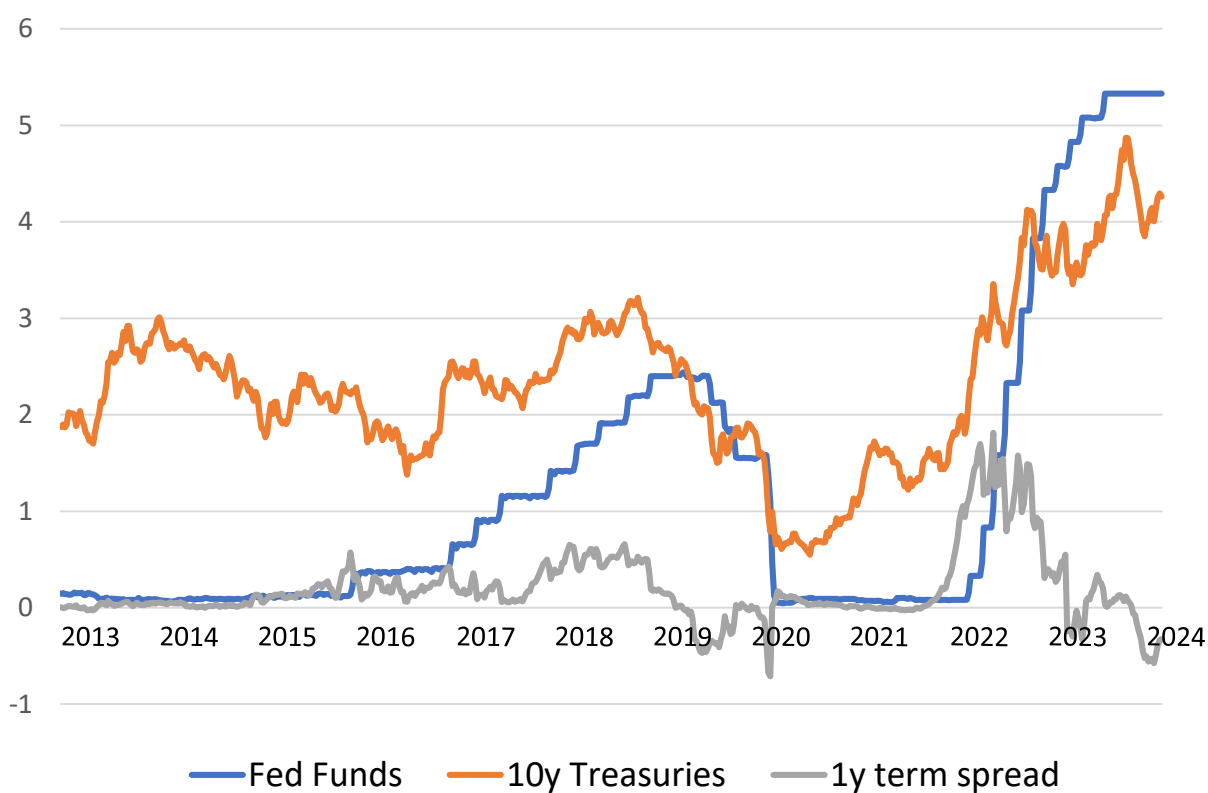
Details here:

<https://www.federalreserve.gov/monetarypolicy/reservereq.htm>

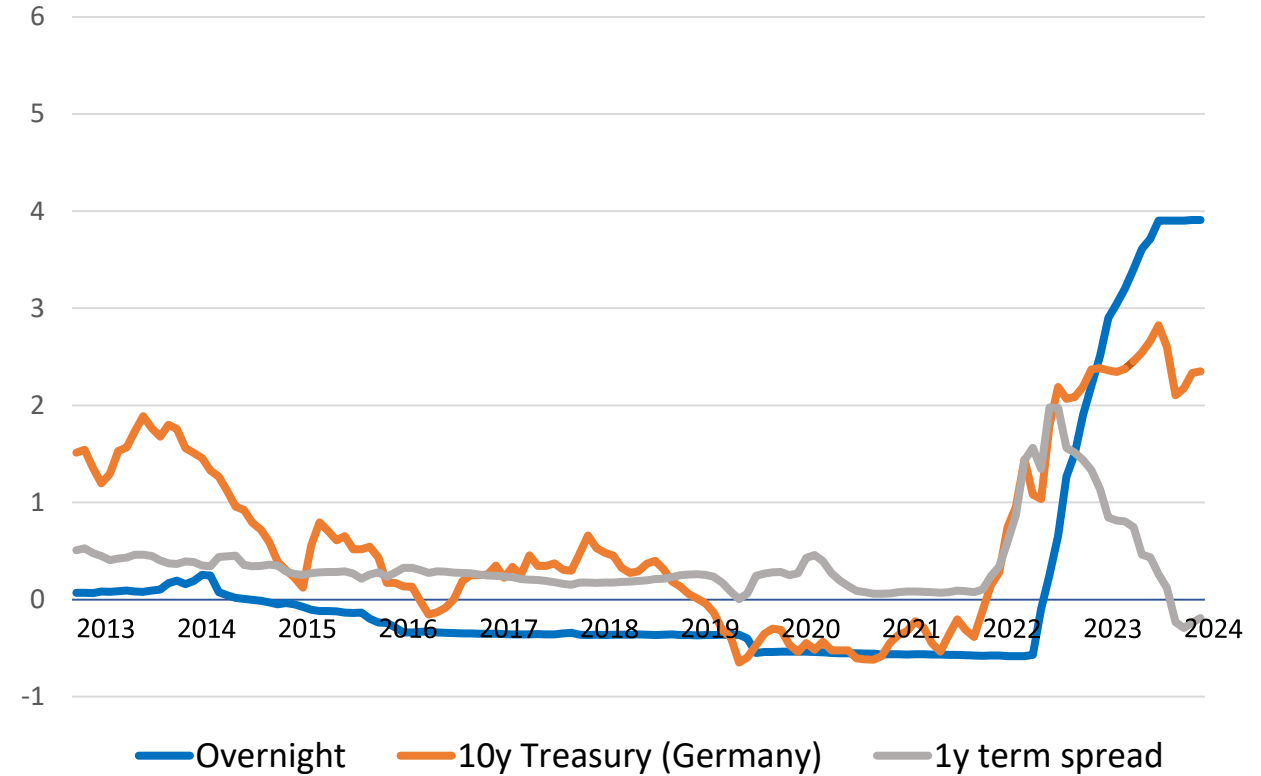
<https://fredblog.stlouisfed.org/2021/01/whats-behind-the-recent-surge-in-the-m1-money-supply/>

Sharp interest rate drop in the US

(unlike in the euro area)



USA



Euro area

Two differences:

- 1) There is no pre-2019 interest rate “hump”
- 2) ECB interest goes negative in 2014 -22, without an explicit ELB (unlike the Fed)

Lessons from James Tobin

- Money demand becomes highly elastic when interest rates approach zero (*or, as we would say today, the ELB*)
(*“Liquidity preference as behavior towards risk”, 1958*)
- Banks are price-makers and quantity-takers in deposit markets
(*“The commercial banking firm: a simple model”, 1982*)

US bank balance sheets

(tn. of USD and % changes)

Time intervals:	Securities	... of which: Treasury and Agency	Loans	Cash	Total assets	Deposits
	Flows, trillion of USD					
2020-2021	1,9	1,6	0,8	2,3	4,9	4,8
2022	-0,2	-0,2	1,2	-0,9	0,3	-0,2
	Percent changes					
2020-2021	49,6	53,3	7,5	134,9	27,9	35,9
2022	-3,6	-4,6	11,4	-22,8	1,3	-1,0

Two stories for the turmoil in the United States *(maybe complementary)*

- A story of faulty risk management by banks (and lax supervision)
- A story of a big monetary policy shock which upset the banks' balance sheets

EURO AREA BANKS

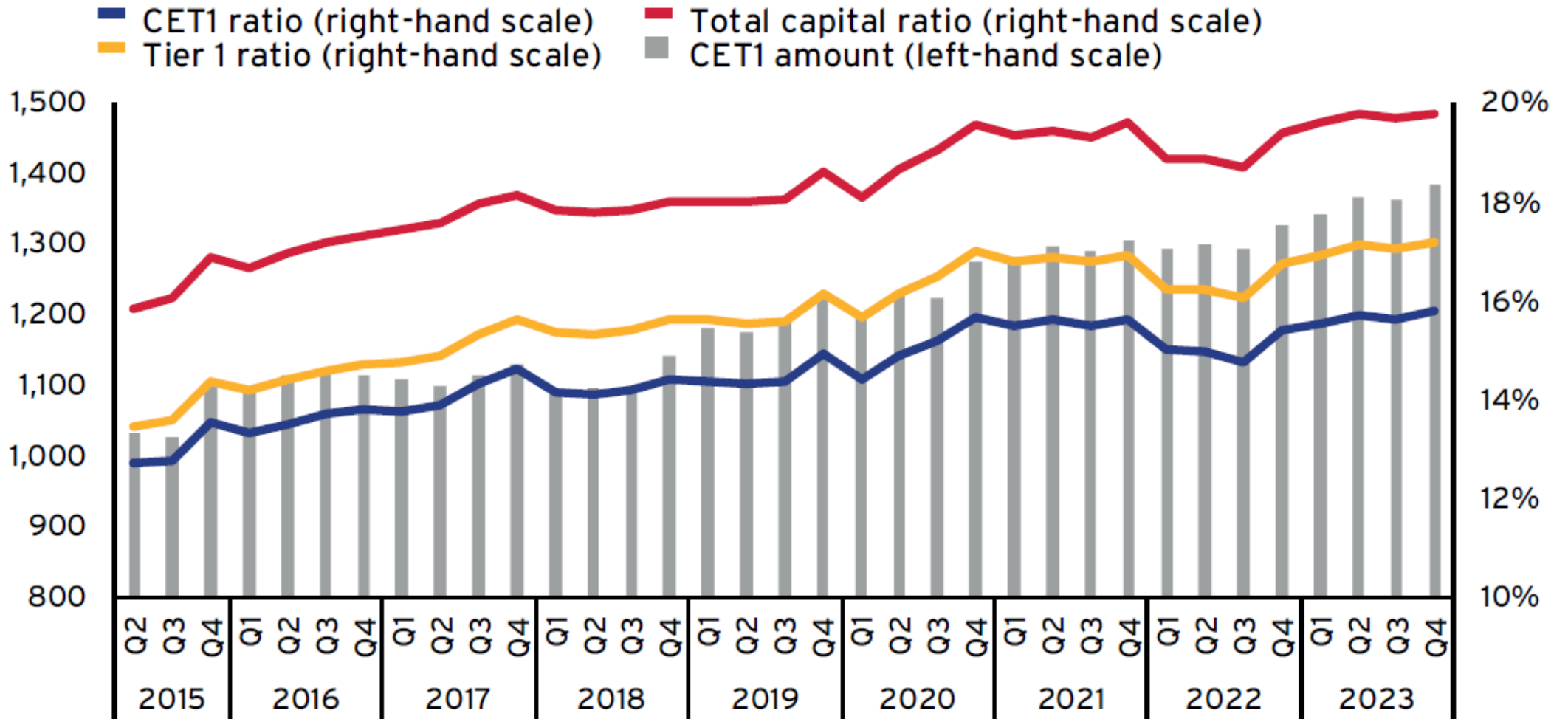
The banking union was:

- A prudential success (*better supervision, more capital and liquidity, NPLs largely removed*)
- A single market failure (*national champions, little or no cross-border banking, ringfencing of capital and liquidity, etc.*)
- As a consequence, little or no risk sharing via the financial sector as well as overall (*see e.g. the ECB estimates*)

The prudential success

FIGURE 3.1 CAPITAL RATIOS AND THEIR COMPONENTS

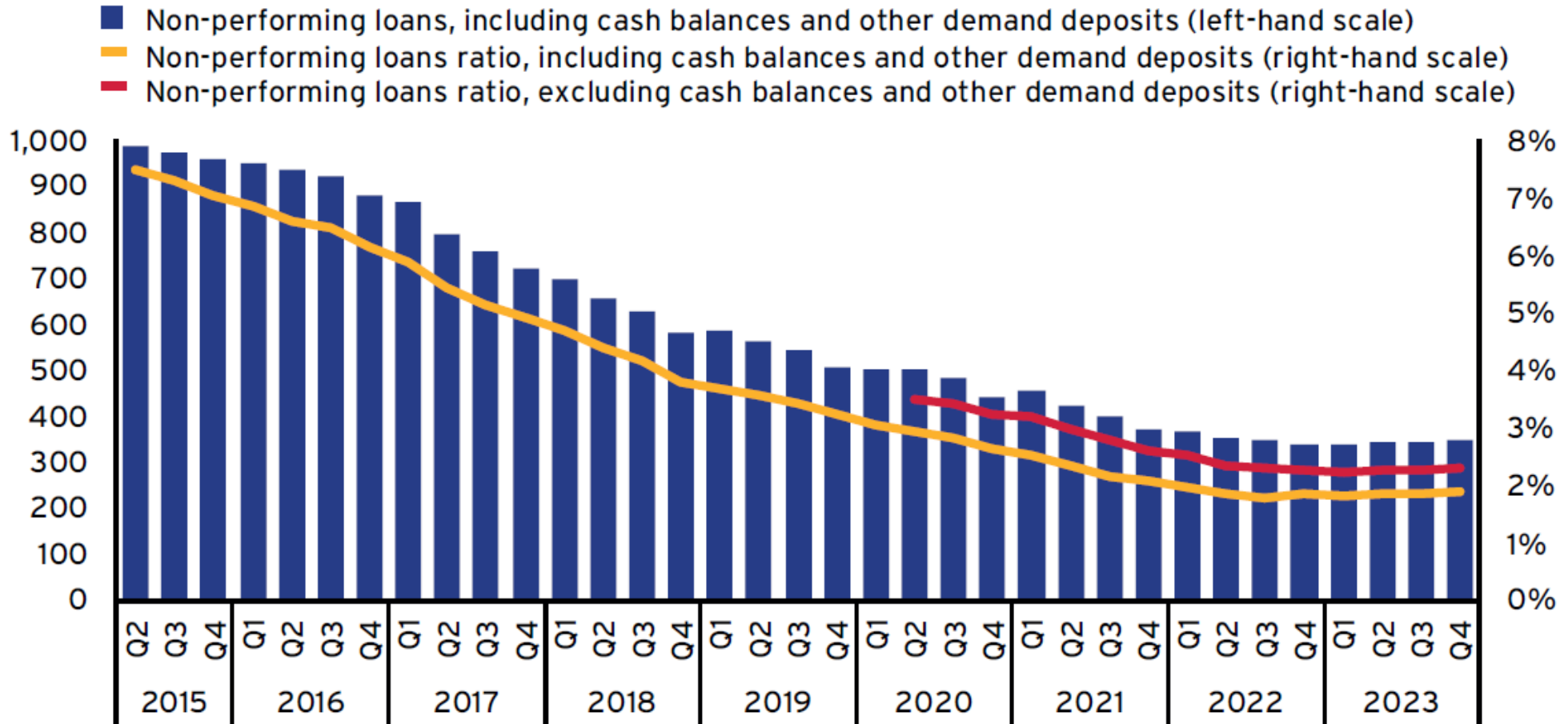
(€ billions; percentages)



Source: ECB press release on supervisory data, 10 April 2024.

FIGURE 3.2 NON-PERFORMING LOANS

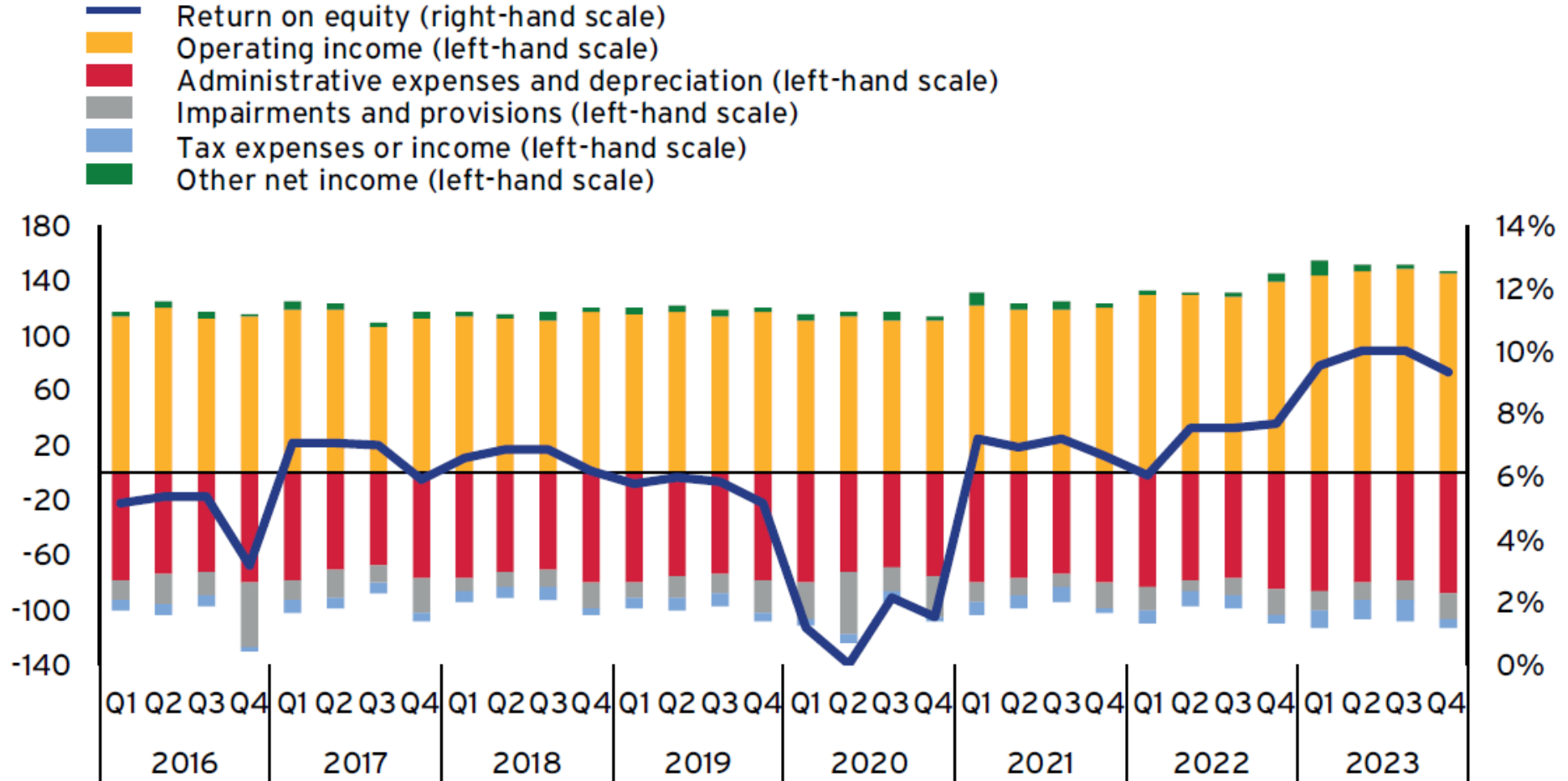
(€ billions; percentages)



Source: ECB press release on supervisory data, 10 April 2024.

FIGURE 3.3 RETURN ON EQUITY AND COMPOSITION OF NET PROFIT AND LOSS

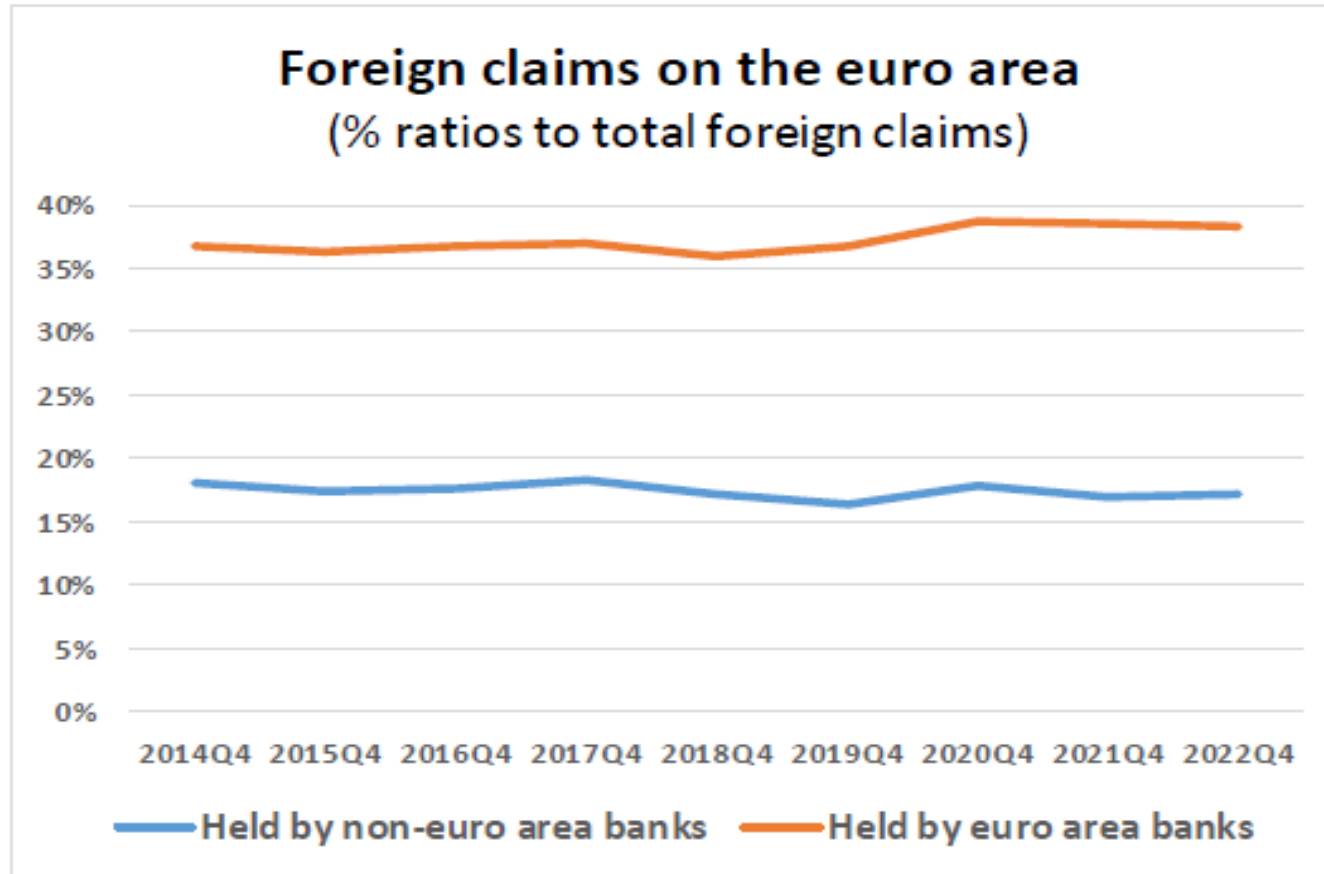
(€ billions; percentages)



Source: ECB press release on supervisory data, 10 April 2024.

The single market failure

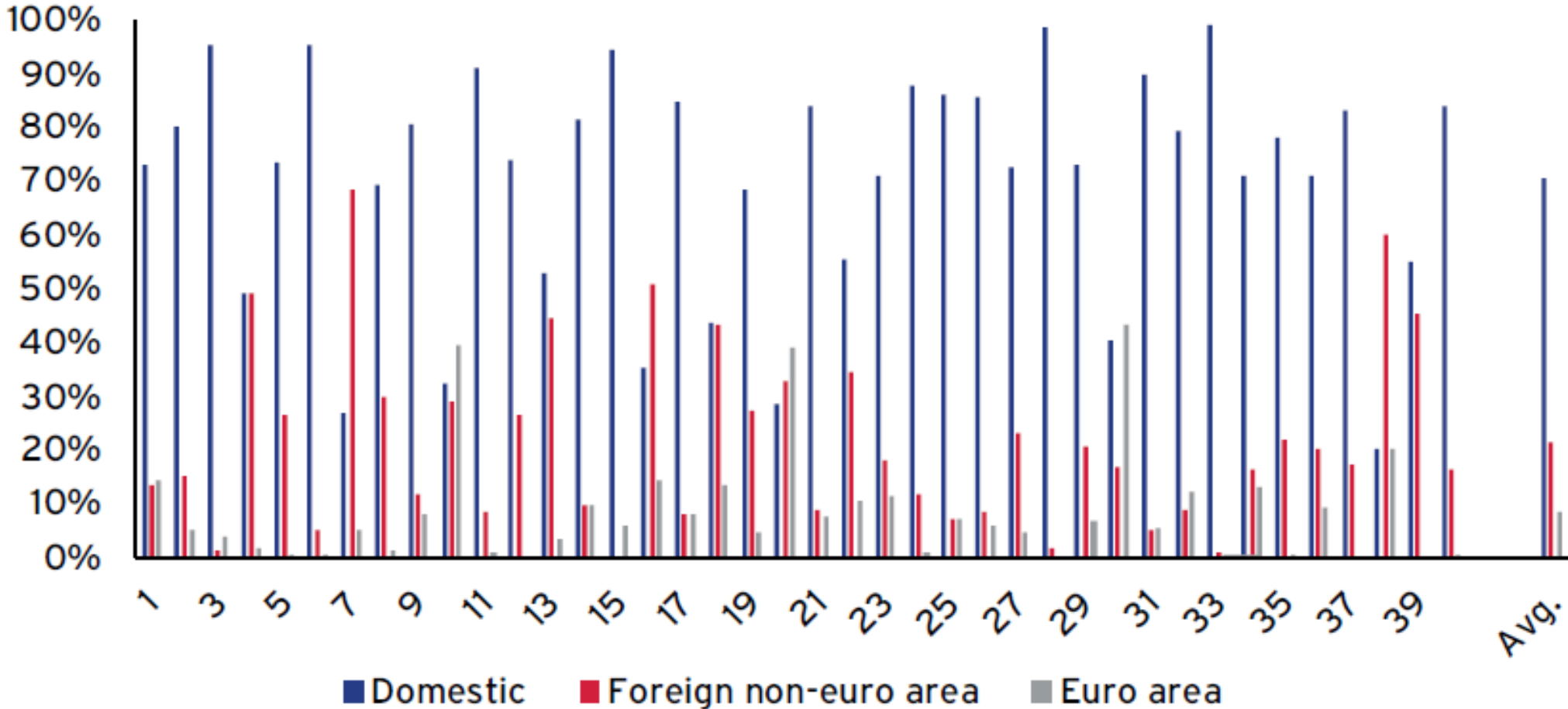
Foreign claims on euro area



Source: authors' calculations on BIS banking statistics.

FIGURE 4.1 CROSS-BORDER EXPOSURES OF THE 40 LARGEST EURO AREA BANKS

Percent ratio to total exposure



Banking regulation is cross-border unfriendly

- Capital requirements are set at national entity level
- Liquidity ringfencing by host countries is possible
- Intra-group exposures are subject to limits
- Deposit insurance and liquidation procedures are national (*this is a powerful incentive to ringfencing*)
- ESM backstop has not been ratified (yet?)

Our proposal: create a “cross-border club”

- Define a set criteria for cross-border players (internationally active, prudentially safe)
- Fully liberalize intra-group capital and liquidity movements among them
- Make intra-group support in them mandatory and enforceable
- Place those groups under exclusive European jurisdiction: only European rules and authority, a dedicated DGS, a European public backstop

Essentially: a regulatory carve-out so that the rules for those banks become “country blind”

Monetary policy recommendations

- Integrate monetary policy and financial stability work lines, within central banks, at multiple levels:
 - Promote joint analyses
 - Encourage staff interactions and exchanges
 - Explicitly consider monetary/financial interactions at the decision-making stage
- Remove internal “firewalls” (which exist e.g. in the ECB)
- Explicit communication on monetary/financial stability interactions
- Stronger role in monetary policy press conferences of:
 - ECB Vice President
 - Fed Vice Chair for Supervision