NOVA SCHOOL OF BUSINESS & ECONOMICS

Bank crises

2206 - Banking | 2025S2 | Session 10 | Carla Rebelo

Wells Fargo
Questions & Group distribution

1. What was Wells Fargo's strategy for competing in the community banking area?	**All groups**
2. What factors might have contributed to the questionable sales tactics taken by bank employees?	**All groups**
3. What should Sloan do to prevent similar actions in the future?	**All groups**

MENTI TIME ☺

Wells Fargo

The importance of Governance

Corporate governance + Add to myFT

JPMorgan succession rekindles US debate over 'imperial' CEOs

Bank raises prospect of splitting top role with Jamie Dimon staying on as non-executive chair

Source: FT, 13 April 2022.

Exam suggestion:
Write a short summary on:
. Why governance became in issue in in banking,
. What have been the main regulatory changes introduced in the aftermath of the financial crisis
. What is the main difference between supervisory and management roles
. What type of issues are at stake with a situation like that of Jamie Dimon?

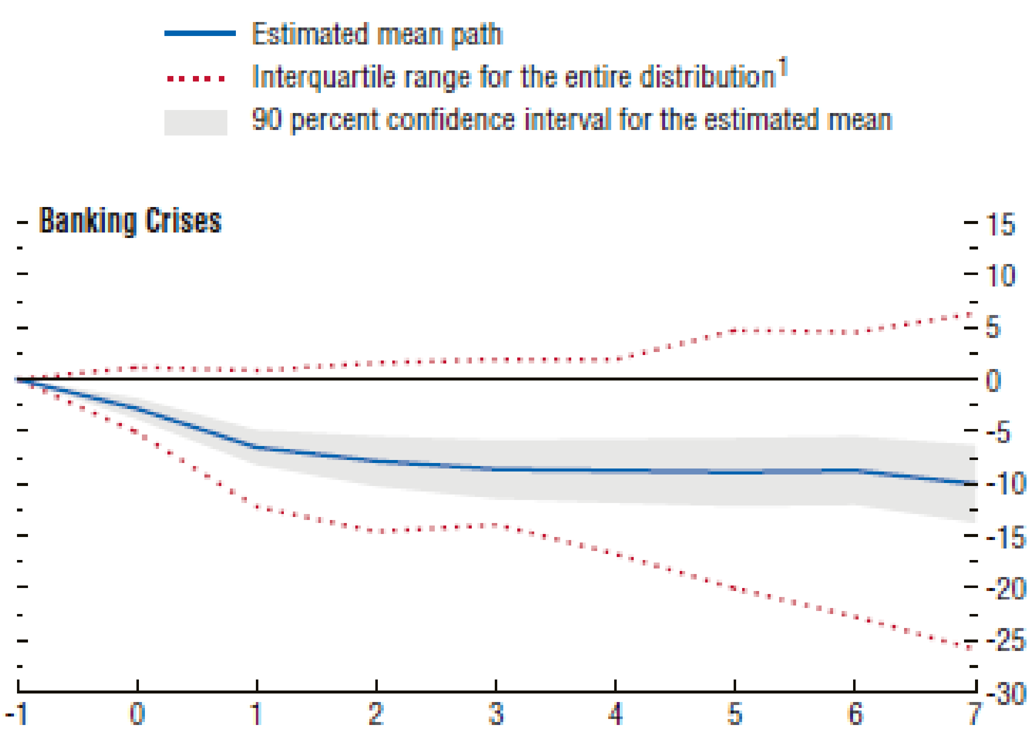
Why banking crises are so relevant

The case of the Great Recession

Financial crises affect long-term growth economic prospects in a structural way

Figure 4.4. Output Evolution after Banking and Currency Crises

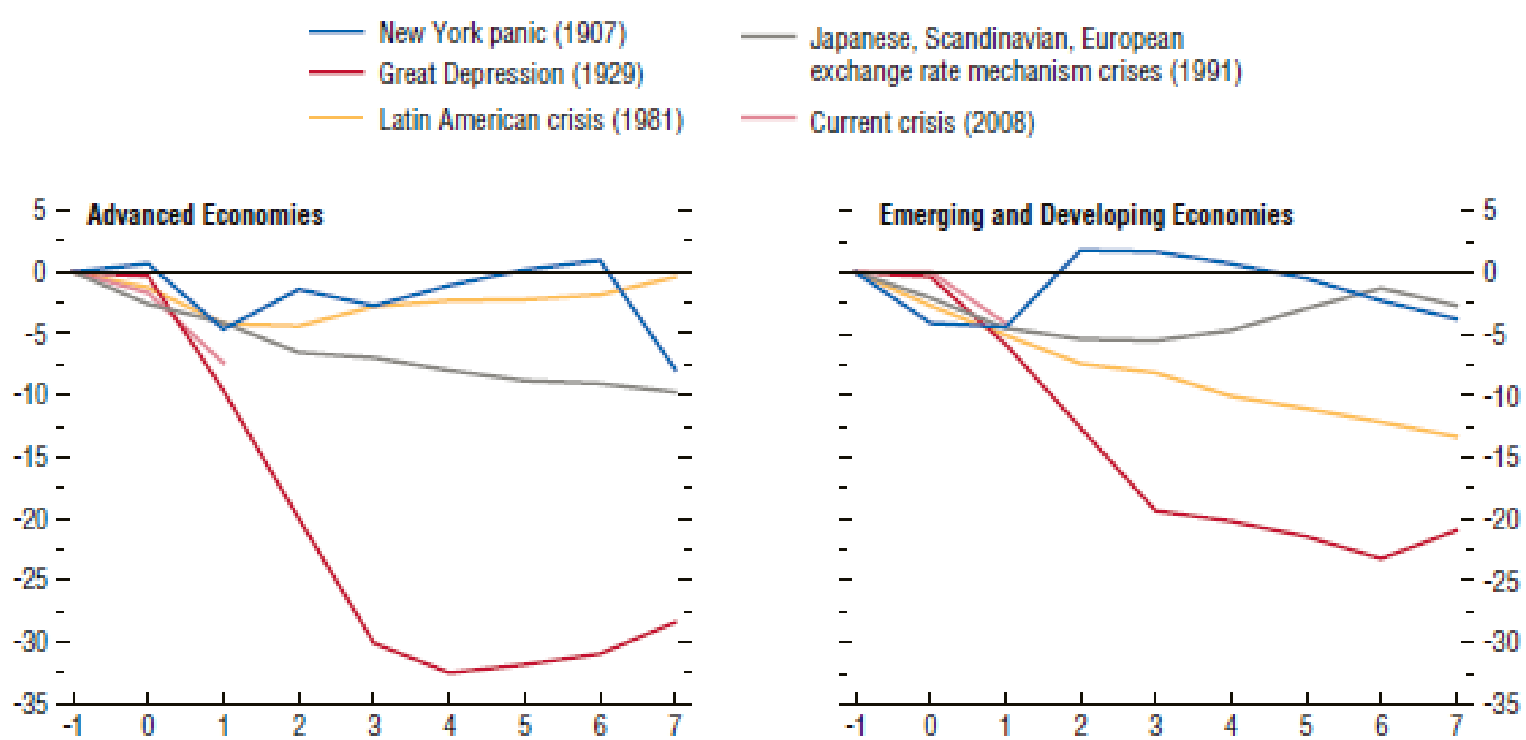
(Percent of precrisis trend; mean difference from year t = – 1; first year of crisis at t = 0; years on x-axis)



Source: IMF WEO October 2009, p.126

Output Evolution after Financial Crises

(Percent of precrisis trend; mean difference from year t = – 1; first year of crisis at t = 0; years on x-axis)



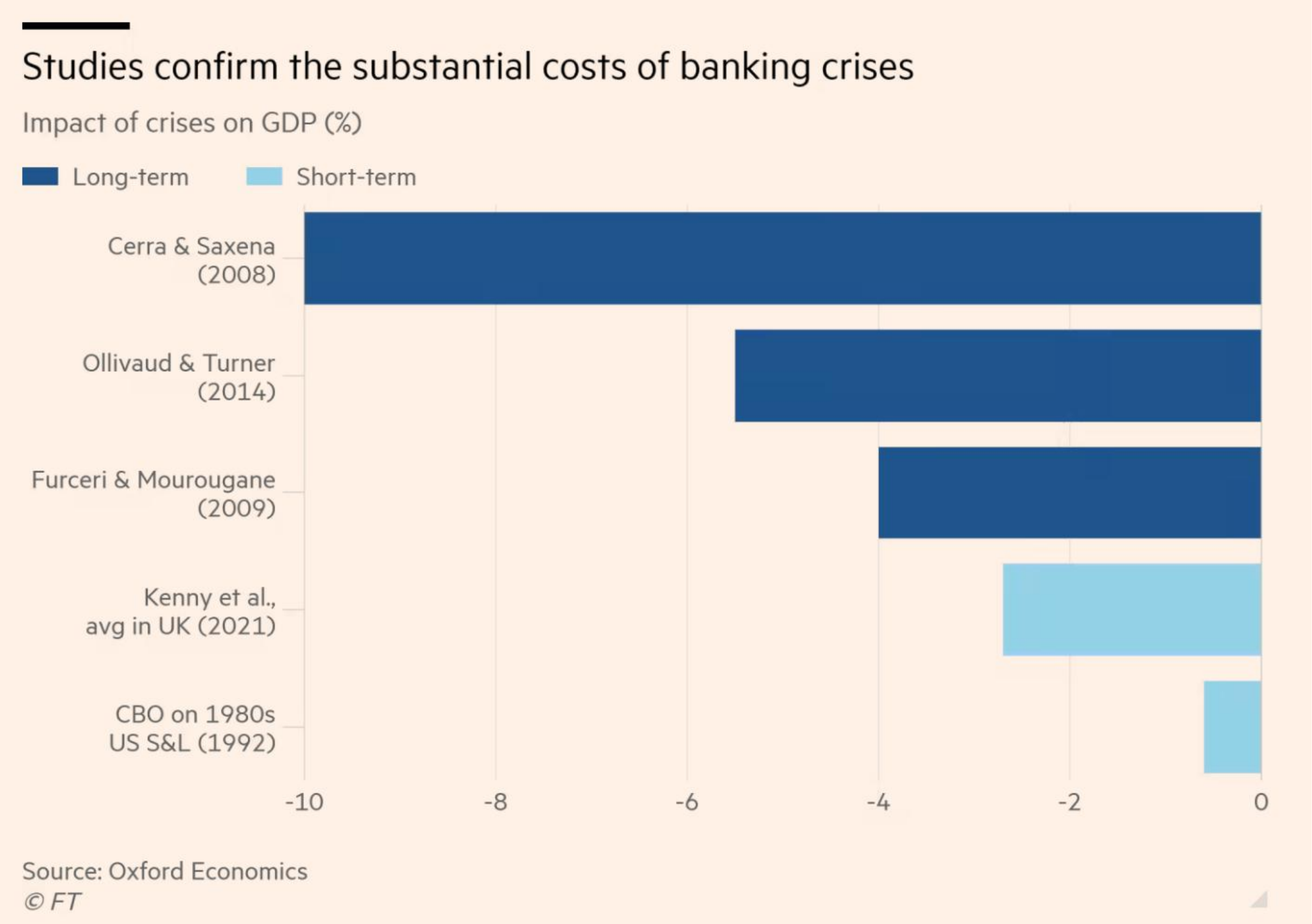
Sources: Angus Maddison, Historical Statistics Database; Bordo (2006); Conference Board, Total Economy Database; Reinhart and Rogoff (2008a and 2008b); and IMF staff calculations.

Source: IMF WEO October 2009, p.130.

Why banking crises are so relevant

The case of the Great Recession

Financial crises affect long-term growth economic prospects in a structural way



Source: FT, Four ways to fix the bank problem, *Martin Wolf, March 21, 2023*

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The Great Recession

The shockwaves across Europe

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Economic policy response
Increased fiscal spending;
Heavy liquidity injections

2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018

When / What

- GLOBAL FINANCIAL CRISIS *(Peak: Lehman's bankruptcy)*
- Greece bail-out
- Ireland bail-out
- Portugal bail-out
- Spanish Banking Bail-out
- Cyprus bailout
- Bank resolutions in Portugal
- Bank liquidations in Italy
- Banco Popular resolved (Spain)

Type of Crisis

Credit Crunch → Sovereign debt crisis → Full-Fledged Economic recession → 'Traditional' banking recession

When non-Performing Loans morph into ever widening non-Performing exposures

Maisn Risks involved

Credit Crunch	Sovereign debt crisis	Full-Fledged Economic recession	'Traditional' banking recession
. Liquidity . Off-balance . Counterparty	. Market . Credit	. Credit	. Credit . Real Estate . Operational

Crises compared

2008/9 vs 2020

Exhibit 1:

Characterisation of past recessions and our forward-looking scenarios

	Length *Time (in quarters) until earnings returned to pre-recession levels*	**Depth** *Total industry earnings in the worst quarter as % of pre-recession earnings*	**Severity** *Earnings lost (in no. of pre-recession quarter earnings) during recession*	**CIB Returns on Equity** *Returns on equity delivered by CIB divisions 12m after the downturn hits*
Rapid rebound	2-3Q	-50%	0.5-1Q	**8-9%**
Global recession	6Q	-150%	5-6Q	**<2%**
Deep global recession	8Q	-200%	10+Q	**-ve**
Euro Crisis (2010-12)	6Q	-100%	2Q	**~8%**
Global Financial Crisis (2007-09)	6Q	-500%	14Q	**-ve**
Dot.com, Enron (2000-01)	7Q	-50%	4Q	**~10%**
Asia, LTCM and Russia (1997-99)	2Q	-150%	1Q	**~14%**
Mexico (1994-95)	4Q	-300%	5Q	**~8%**
Junk Bond (1989-90)	6Q	-400%	7Q	**~7%**
Black Monday (1987)	1Q	-500%	4Q	**~9%**

Source: Oliver Wyman analysis, Coalition proprietary data, Oliver Wyman proprietary data

Source: Oliver Wyman/Morgan Stanley, Steering through the next cycle, April 2020.

Crises compared
2008/9 vs 2020

COVID-19 CRISIS

	COVID-19 Crisis	Global Financial Crisis 2008
Starting point before the crisis	• Already **weakened outlook for overall economic growth in 2020** of 2-3% • Growth rates in several **developed countries at low levels with downward trajectory** • **Global level of debt**: >320% GDP, >250trn/$	• Global **economy expected to grow strongly in 2008** with an overall GDP growth of >5% • Growth **trajectory mainly driven by emerging markets** and continuing global expansion • **Global level of debt**: >280% GDP, >170trn/$
Trigger of the crisis	• Massive contagion **containment measures brought the real economy to a standstill** • **Financial markets crashed as a result** of the uncertainty about virus spread and Authorities / Central Banks response effectiveness	• Starting with a depreciation of subprime assets, excessive Government debt and debt-fueled asset bubbles, **the financial service sector collapsed** • The shock in the financial system subsequently **spread to the real economy**
Chronological sequence	• The COVID-19 virus broke out in late 2019 and **spread globally within less then 3 months** • Outbreak caused an **immediate lock-down in nearly all affected countries**	• The **initial shocks spread** to the entire financial system **over a period of almost two years** • The real economy was affected in a **"domino effect" of continuous deterioration**
Speed	• **Fastest market crashes on record** • **"Lockdown" causes immediate stop in real economy and accelerate the speed** of diffusion of the crisis	• **The speed of "crisis transfer" to real economy was different for each country** on basis of financial structure of corporate / retail

The COVID-19 downturn of the banking sector is a result, not the cause of the current crisis

Source: Bain & Company, Impact of COVID-19 on Banking – Update #2, – April 2020.

Why could a bank colapse?

The fate of CS

Credit Suisse Group AG ✓ Added

Credit Suisse: the rise and fall of the bank that built modern Switzerland

How a national institution grew from local roots to a global force before a series of scandals sparked its fall from grace

Source: FT, 13 April 2023.

The Big Read Credit Suisse Group AG ✓ Added

How the Swiss 'trinity' forced UBS to save Credit Suisse

The takeover of its local rival could end up being a generational boon for UBS. But the government-orchestrated deal has angered many investors

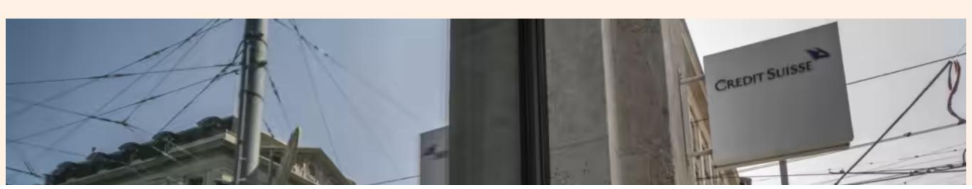
Source: FT, 20 March 2023.

Opinion The FT View + Add to myFT

A very Swiss bank rescue

UBS takeover of Credit Suisse eases market rout, but the deal will have repercussions

THE EDITORIAL BOARD + Add to myFT



Source: FT, 20 March 2023.

Exam suggestion:

Write a essay on the main reasons you think CS failed.

The essay should address:

- A quick timeline of the main events;
- The main risk categories at stake
- The appropriatness of the governance structure in place
- The measures that could have been taken to avoid the failure

Why could a bank colapse?

The fate of CS

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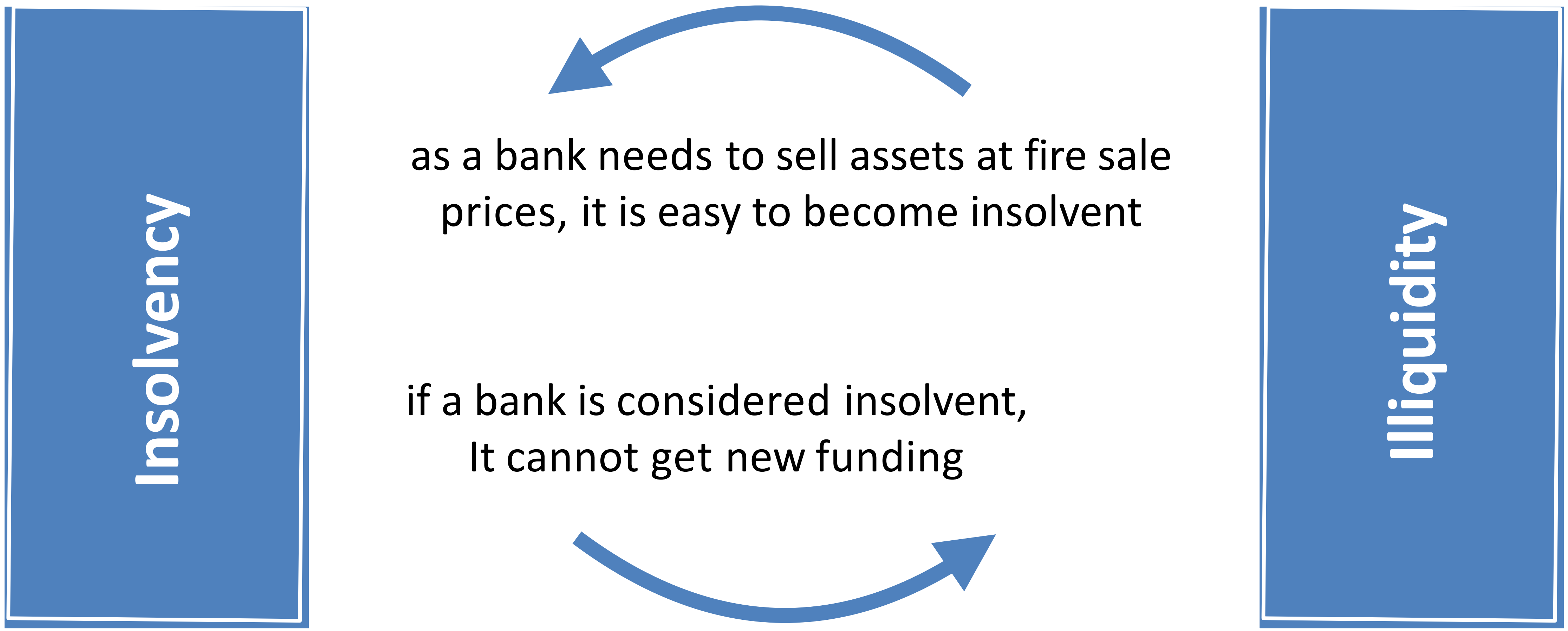
MENTI TIME ☺

A single bank colapse:
Liquidity or Solvency?



- when this auto-destruction system starts, it is irrelevant which started first. You can discuss egg and chicken, but it is irrelevant: the bank goes under anyway.

- as it was found in the Lehman case: “on the left side, there is nothing right; and on the right side, there is nothing left”.

A single bank colapse:
Liquidity or Solvency?

- A liquidity problem is triggered by a bank run, by depositors, money market, or investors that refuse to roll-over repos and commercial paper or ask for more collateral.
- The run can happen when depositors (or investors) find something about the bank (fundamental run) or about the run (speculative run).
- Banks can manage liquidity so as to prevent fundamental runs. For speculative runs, we need other tools, like deposit insurance, lender of last resort or withdrawal suspension.
- In any case, the run has a negative externality on the bank: the fire sale of assets can put the bank into insolvency.
- If the problem is insolvency, authorities should proceed to an orderly liquidation of the bank, usually with insured deposit protection.
- Even under insolvency, authorities might rescue the bank fearing to trigger a domino effect.

Why could a bank colapse?

- Poor lending practices
- Excessive concentrations (by geography or industry, funding concentration, investment portfolio concentration, products containing the same type of risk under different labels - structured products, off-balance, etc.)
- Structural imbalances in the bank's liquidity position (high loan-to-deposits ratio, low share of stable funding)
- Excess risk taking and speculative trading
- Excessive balance sheet growth => lower risk quality
- Overrides of constraints in existing policies and procedures
- Fraud, criminal activities and self dealing

Corrective actions

BRRD: A change in paradygm

Moving from a BAIL-OUT to a BAIL-IN approach

1988
- Disclosure of Basel I accord
- Definition of minimum capital requirements

Basel I accord **1996**

2003
- Disclosure of New Basel Accord (Basel II)

2005
- Disclosure by the EU of the proposal for Capital requirements directive (CRD)

2007
- Implementation of the new Basel accord: Basel II

2009
- Developments over Basel II accord
- First proposals for Basel III

CRD IV / CRR – European Capital Requirements Directive and Regulation

Basel III **2013**

2014
- **BRRD (<u>Bank recovery and resolution directive)</u>**
- "Guidelines on common procedures and methodologies for SREP" published by EBA

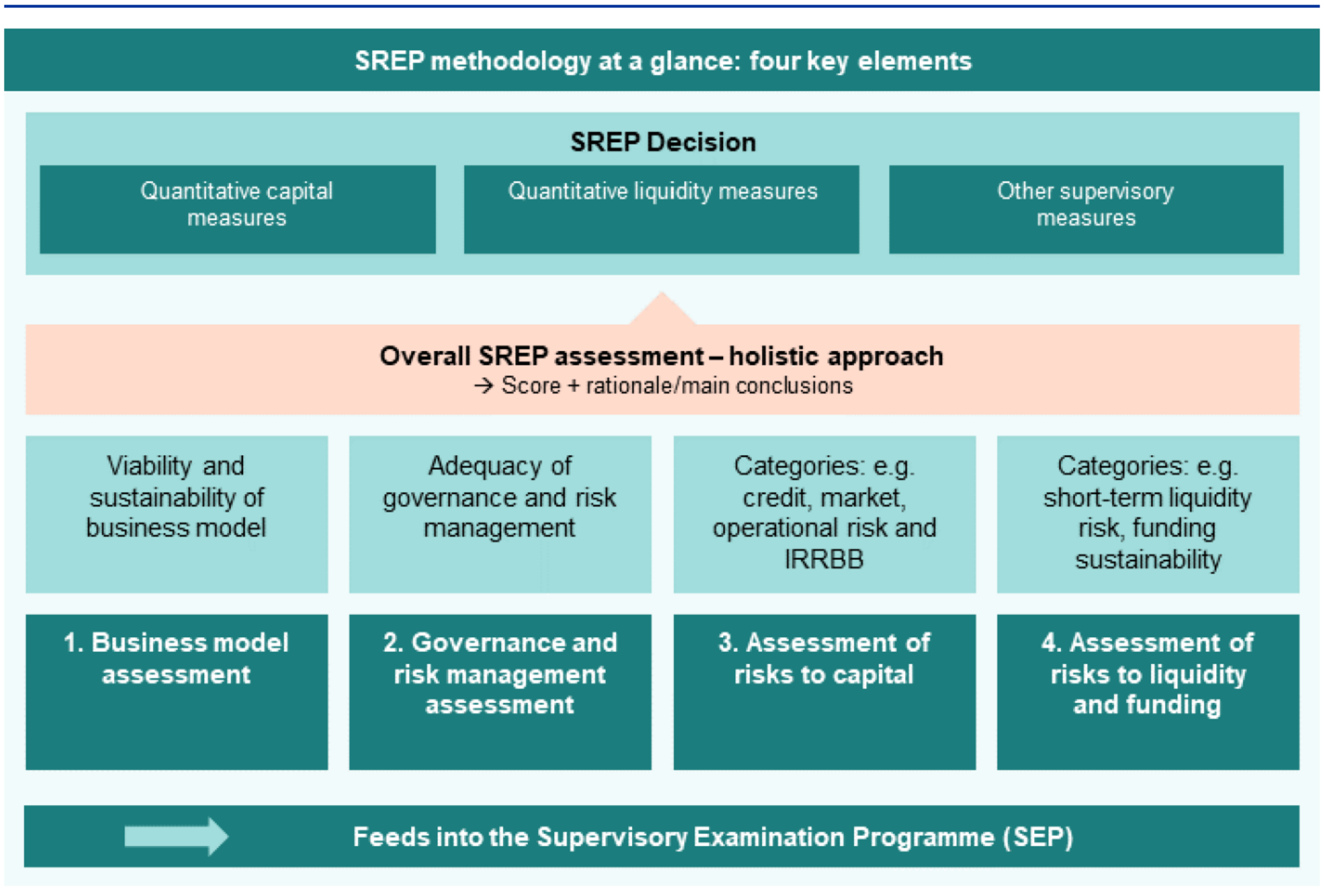
2016
- **CRD V / CRR II proposals**

2017
- **"Final" agreement on Basel III**

SREP
General overview

REMINDER from session 6

Figure 1
The SREP methodology



Source: EBA – SREP methodology.

SREP goals

- Guide harmonization of banking supervision at an European level
- Increasing the consistency and quality of supervision across the Banking Union.

SREP
General overview

SREP goals

- Guide harmonization of banking supervision at an European level
- Increasing the consistency and quality of supervision across the Banking Union.

SREP Methodology

A Categorisation of institutions

B Monitoring of key indicators

C Business model analysis

D Assessment of internal governance and institutional-wide controls

E Assessment of risks to capital

1. Assessment of inherent risks and controls
2. Determination of own funds requirements and stress testing
3. Capital adequacy assessment

F Assessment of risks to liquidity and funding

1. Assessment of inherent risks and controls
2. Determination of liquidity
3. requirements and stress testing
4. Liquidity adequacy assessment

G Overall SREP assessment

H Supervisory measures

I Early intervention measures

1. Quantitative capital measure
2. Quantitative liquidity measures
3. Other supervisory measures

"Guidelines on common procedures and methodologies for SREP", EBA, Dec 2014

SREP
Potential implications

G
Overall SREP assessment

- Components from C to F will be evaluated by the regulators on a scale from 1 to 4.
- Overall assessment (OA) results from a synthesis of all components (diferent from a weighted average) on the following scale:

H
Supervisory measures

Different supervisory measures, dependent on the impacted areas and the criticality level:

- *capital and liquidity measures*
- *changes to business plan,*
- *organizational changes,*
- *reduction of exposure*
- *etc.*

- **1: No discernible risk;**
- **2: Low risk;**
- **3: Medium Risk;**
- **4: High Risk;**
- **F: "*Failing*" or "*Likely to fail*".**

OA of 4 OR
OA of 3 with at least one component assessed as 4.

I
Early intervention measures

Potential resolution
(eg: OA of 4 of a bank which failed to implement early intervention measures).

Recovery plan
Prevention/early intervention

Bank operations	Cash availability	Governance	Shareholders' rights
• Enhance capital • Restrict concentration or expansion • Downsize operations • Sale of assets • Limit some lines of business, products or customers • Immediate provisioning	• Call for cash injection • New borrowing • Increase maturity of liabilities (roll-over, etc.)	• Change legal structure • Remove directors or managers • Limit compensation • Enhance internal controls and risk management	• Limit dividends • Force merger • Appoint administrator • Suspend shareholders rights (voting, preemptive rights, etc.)

Recovery plan
Escalation imposed by law

- Require **update** or **implementation of measures set out in the Recovery Plan**
- Require the management body to **draw-up an action program with measures** (incl. implementation timetable)
- Require a **meeting of shareholders**, set the agenda and the decisions for adoption
- Require one or more **members of the management body or senior management to be removed or replaced**
- Require the **drawing-up of a plan for negotiation on restructuring of debt** with creditors
- Require **changes to the business strategy**
- Require **changes to legal or operational structures**
- Acquire, and provide to RA, **information for updating the resolution plan and prepare for resolution**
- **Removal of senior management and management body** and subjecting the appointment of new managers conditional to the supervisor approval
- **Appointment of a temporary administrator** to remedy a situation where the replacement of management is considered as insufficient

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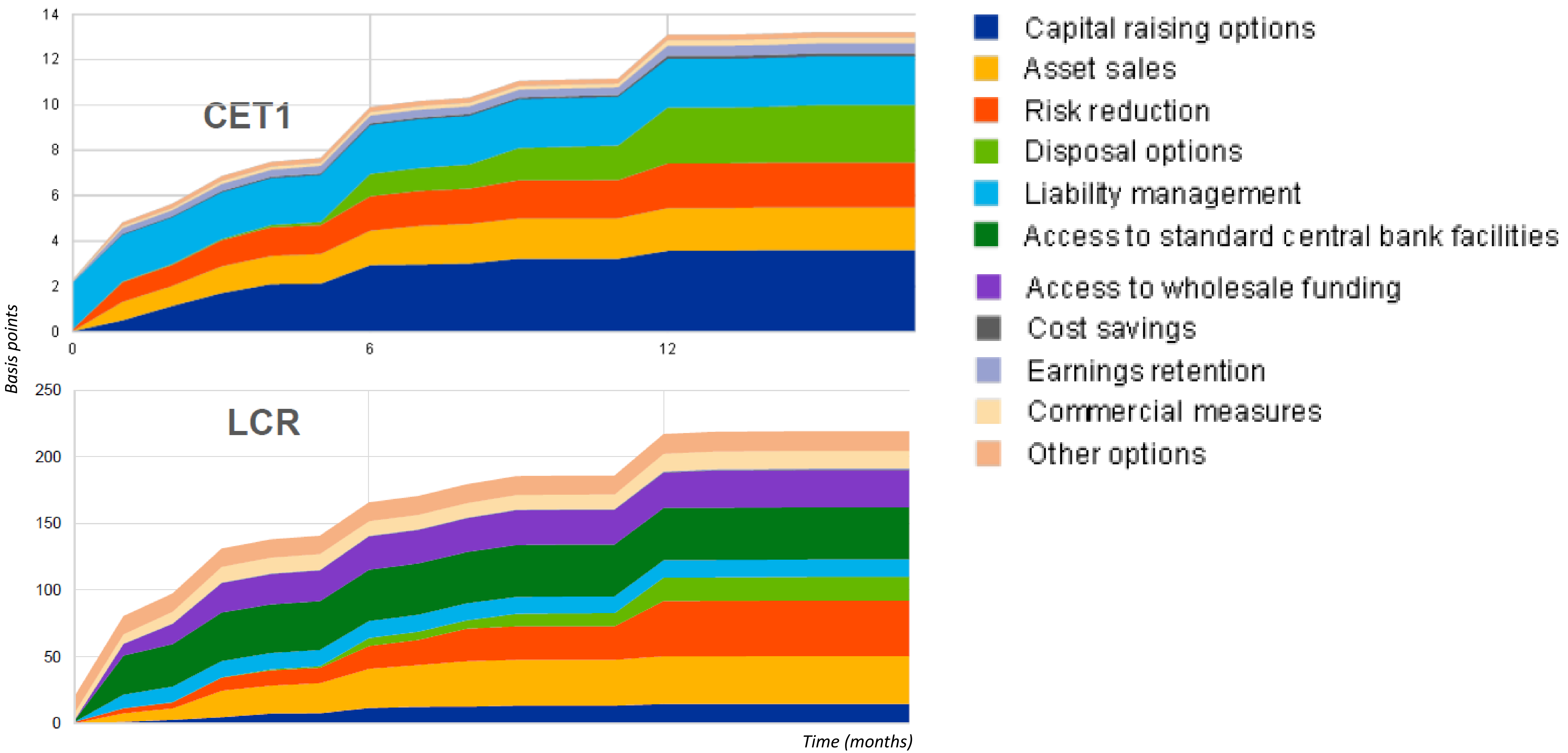
Source: BRRD, art 27-29, in 'ECB, Benchmark of cycle Recovery Plans (95 standardized templates)', May 2019.

Recovery plan

Most important measures



Source: ECB, 'Benchmark of cycle Recovery Plans (95 standardized templates)', May 2019.

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Why could a bank colapse?

The fate of SVB

Opinion **Unhedged**

SVB, resolved

How the story ends

ETHAN WU + Add to myFT

Source: FT, 28 March 2023.

This was a run on SVB's business model. And when a bank's business model no longer looks viable, then it starts mattering what the bank looks like from a liquidation perspective. In general, a bank is always going to look horrible through that lens, and the balance sheet grinds to a halt. So much of a bank's value is tied up in counterparty/depositor/borrower relationships, providing its balance sheet as a service, its employees, ongoing management of assets within that bank's corporate structure, long-term viability, etc. Capital ratios measure capital to assets, but the market measures capital ratios against a firm's business model.

Exam suggestion:

Write a essay on the main reasons you think SVB failed.

The essay should address:

- A quick timeline of the main events;
- The main risk categories at stake
- The measures that could have been taken to avoid the failure
- The main differences between CS and SVB failures

Resolution in the EU

- It is essentially a set of principles.
- It should be a credible set of tools to intervene sufficiently early (before bank is insolvent) and quickly (avoid damages and market speculation)
- Every member state can use its own mechanism, provided that European principles are respected.
- It is a recognition that previous methods used during financial crisis where not coordinated, legally strong (a lot of legal battles emerged from bail-outs), and attaining the goal efficiently, if at all…

Main source: European Commission, Memo on BRRD – FAQs, April 2014.

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When an institution is **'failing or likely to fail' (FOLTF)**:

- it has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe
- all other private sector or supervisory intervention measures have been proved insufficient to restore the bank to viability, and
- winding up the institution under normal insolvency proceedings would risk prolonged uncertainty or financial instability and therefore resolving the bank would be better from a public interest perspective.

Resolution does not include:

- emergency liquidity assistance *per se*
- state support for state owned institutions
- the need to inject equity by the State to a bank (due to stress test exercise, for instance) with frozen markets

Resolution
Main purposes

Minimize negative repercussions by preserving systemically important functions of the institution concerned

Keep uninterrupted access to deposits and payment transactions

Avoid destabilising financial markets

Minimise the cost for taxpayers

Continuity of critical functions

Preservation of financial stability

Restoration of viability

Resolution

Available tools

Business sale

Bridge bank

Recapitalisation

- *Bail-in*
- *Bail-out*

Restructuring

Closure of the bank

- *Insured deposits payoff/ transfer*

Resolution

Bail-out vs bail-in

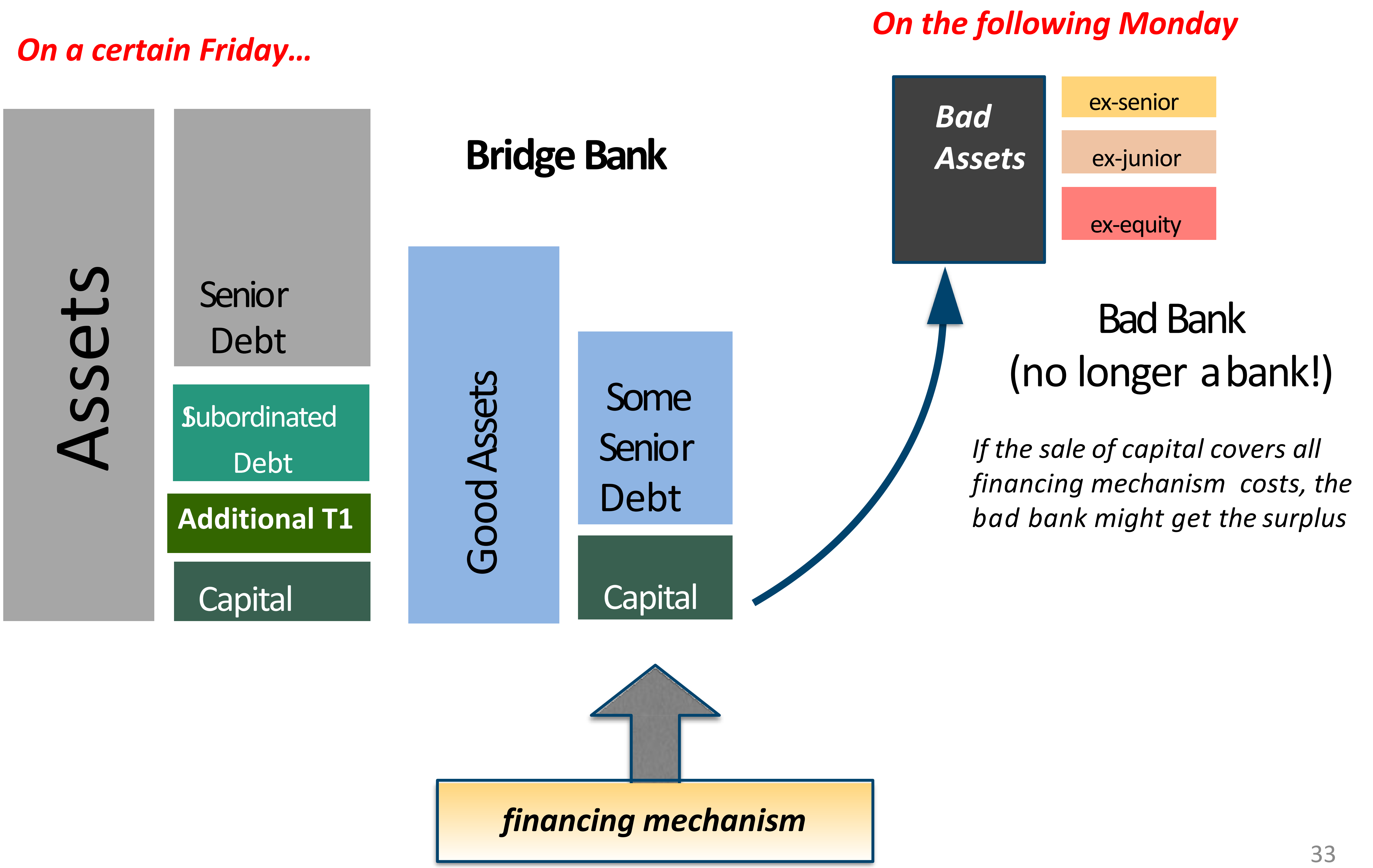
Bail-out

- The supervisor manages the resolution and the taxpayer puts the money.
- Supervisors always seem to be quite ineffective before the collapse; however, bank managers also have little incentive to reveal the true bank status.

Bail-in

- In a bail-in, the market manages the resolution and puts the money;
- To keep markets informed, supervisors should insist on better quality of information (Basel II third pillar).
- Part of the rationale behind a bail-in has to do with the probability of freezing markets (interbank, bonds). Is that reason or lobbying?

Bridge bank
How it works



Bail-in

Claims excluded

secured, collateralised or guaranteed claims	Creditors protected in an alternative insolvency proceeding
protected deposits	Deposit guarantee scheme should contribute to funding the resolution process so that creditors do not face more losses than over insolvency
institution pension schemes	Unless attributable to variable remuneration
participation in payment systems	With remaining maturity of less than seven days
liabilities to institutions	With an original maturity of less than seven days (money market), unless part of the group of the failing institution
other liabilities, to avoid spreading contagion	natural persons, micro, small and medium size companies that the resolution authority should be able to exclude (however, the resolution mechanism should provide alternative financing!)

Bail-in
Possible issues

- Some credits are forcefully converted into capital (by contingent capital, for instance) – the bank gains 'new shareholders'

- As a result, the orginal creditor rank is is not respected when you combine under the same "capital" the old shareholders and the converted creditors (junior and senior bond holders).

- Since assets need to be valued very quickly and under stressed conditions, the amount of debt that must be converted into capital is preliminary and may be subject to future revisions. However:

  - *an overestimation damages creditors*
  - *an underestimation may keep the bank under serious difficulties.*

- The bank is now owned by investors who had no intention or will to become shareholders.

- As some investors cannot hold equity positions, market demand for bank bonds will be lower (and convertible contingent bonds lose liquidity).

Resolutions
Other examples

AUGUST 2014: Good bank / bad bank

Banco Espírito Santo split in €4.9bn rescue

Shareholders and bondholders left holding toxic assets

DECEMBER 2015: (Good) assets sale / asset management company for sellable bad assets / bad bank

Portugal agrees €2.2bn Banif bailout, 2nd in 18 months

Joel Lewin DECEMBER 21 2015

Portugal has agreed a €2.2bn state rescue for Banco International do Funchal (Banif), splitting the Madeira-based lender into "good" and "bad" banks and selling its healthy assets to Spain's Santander for €150m in the country's second bank bailout in less than 18 months.

António Costa, Portugal's new socialist prime minister, said the bailout would involve "a high cost for taxpayers" but had the advantage of being "a definitive solution". Branches would open normally on Monday, he said.

Exam suggestion:
Read the news package and identify:
- the various models/instruments that can be used by official authorities to resolve banks;
- winners and losers.

Bridge & residual banks

- Only the bridge bank goes to resolution; the residual goes to normal insolvency proceedings

- Shareholders and creditors in the residual institution should be entitled to a compensation if their claim is less than it would be under a full insolvency process (aka as ‘No creditor worse off’ valuation)

  - and so a fair and realistic valuation should be performed before resolution

  - since this is a very quick exercise, EBA’s binding technical standards to valuation should be used

  - the compensation must be paid by the resolution arrangement, not the taxpayer

Comparison among FOLTF cases

	ABLV	Banco Popular	Vicenza/Veneto
Reason for FOLTF	Liquidity	Liquidity	Solvency
Crisis evolution	Very fast	Fast	Slow
Moratorium	Applied	Not available under national law	Not relevant
SRB decision	No public interest	Public interest	No public interest
Burden sharing	Possible under self-liquidation	CET1, AT1, T2	CET1, AT1, T2 *
Further proceedings	LV: request for self-liquidation; LU: suspension of payments regime/ administrators	Resolution action (application of sale of business tool and write down)	National insolvency including liquidation state aid
DGS involvement	Pay-outs in LV and LU	None (deposits transferred)	None (deposits transferred)

* Retail subordinated bond-holders subject to mis-selling were entitled to restoration measures

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Main source: ECB, May 2019.

Resolutions
Other examples

***JUNE 2017: Sale for €1** (shareholders and junior creditors bailed-in)*

Why Santander rescue of Banco Popular is a European test case

Unprecedented step under new rules for saving failing banks

nt/46b95636-686f-11ea-800d-da70cff6e4d3

***JUNE 2017: Liquidation** (shareholders and junior creditors bailed-in)*

ECB supervisor defends role in Italian banking crisis

Sabine Lautenschläger says watchdogs face 'question of balance' on when to intervene

Exam suggestion:
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Banking crises

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