Bundesbank Symposium, 12 June 2024

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30+ years of financial crisis management – lessons learned and priorities for supervision

Key points

1. Analysis of past financial crises shows that crises have always had a more severe impact when banks were involved in their role as providers of credit. That is why effective independent banking supervision is so important for financial stability and sustainable economic growth.
2. The experience of the SSM has shown that robust regulation and supervision that has teeth can mitigate crises such as the one in March 2023. This success is attributable to the SSM's solid Europe-wide regulatory foundations, its harmonised supervisory practice and the fact that it applies best practice and prioritises its supervisory activity.
3. We must all continue to strengthen regulation and supervision in the context of innovation and the cyclicality of financial markets. Among other things we need to ensure that bank-like credit intermediation outside the banking sector is brought within the ambit of regulation.
4. We need to drive forward qualitative supervision and early intervention on the basis of robust regulation. This applies particularly to the areas where problems usually begin at banks and other financial institutions, namely weaknesses in risk culture, governance and business models. Based on typical red flags, supervisors can identify problems in risk culture, governance or the business model at an early stage. Then they should act quickly and, if necessary, escalate with suitable instruments to resolve the problem. Supervisors can intervene early with targeted action without taking responsibility for these areas instead of the bank.
5. Based on the lessons of the financial crises of recent decades, we have to continue to develop regulation and supervision to become best-in-class – for everyone's benefit. We should never forget that a resilient financial sector is the foundation for a healthy economy.

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Ladies and Gentlemen

Let me start by saying how delighted I am to be taking part in the Bundesbank symposium.

Today I will take you on a journey through my over 30 years of crisis management experience in banking supervision. This period includes my 10 years at the SSM, coinciding with the 10th anniversary of centralised European banking supervision.

I am going to discuss three issues today and draw a number of lessons for the future:

- Firstly some observations and lessons from the financial crises deriving from over 30 years' experience in supervision.

- Secondly the importance and achievements of the first 10 years of the SSM, which was itself born out of a crisis, the euro crisis.

- Thirdly I discuss what supervision should focus on in future.

A point I want to make at the outset is that strong banking supervision is essential for a healthy economy. Therefore we have to strengthen qualitative supervision on the basis of robust regulation and concentrate on early intervention, particularly where most of the problems begin in the banks, i.e. weaknesses in risk culture, governance and business models. Given the backdrop of innovation in these areas, banking supervision and its instruments have to constantly develop.

Lessons from 30+ years of financial crises

Over the past 30 years I have worked at the Federal Reserve Bank of New York, the Basel Committee on Banking Supervision and the European Central Bank. During this time I directly or indirectly experienced almost all of the financial crises since the beginning of the 1990s.

The crises are listed in this slide. They extend across three continents in the US, Europe and Asia and encompass a broad range of asset classes: corporate and sovereign lending, commercial and residential real estate, capital markets and trading and derivatives activities. They are broken down on the slide into crises the banks were directly or indirectly involved in and crises they were not involved in.

	Banks involved: Role in financing or reinforcing	Banks not involved
2020s	SVB/CS UK LDI crisis Archegos	Crypto collapse
2010s	Euro crisis	
2000s	Global financial crisis	Collapse in tech stocks
1990s	Long Term Capital Management Asian crisis Tequila crisis Japanese banking crisis Commercial real estate crises	1994 interest rate shock and structured products Collapse of European Exchange Rate Mechanism
1980s	Savings and loans Texas oil Latin American debt crisis	1987 stock market crash

A clear picture emerges. Almost all of these crises were either directly financed by the banking sector or reinforced by them. The banking sector was directly exposed to the debts of less developed countries, the commercial real estate market and the euro crisis, for instance. In the LTCM crisis the banks financed the hedge fund sector with their prime brokerage services. During the global financial crisis of 2008 and 2009 the banks thought they had offloaded their direct subprime exposure, but it came back onto their balance sheets in the form of either asset-backed commercial paper vehicles or securitisations. It was ultimately the banks that built up and financed what we now know as the shadow banking system. Again these risks came back onto the banks' balance sheets during the market collapse. Some of these crises, such as the euro crisis, GFC and Japan had a large adverse impact on economic growth. There were of course often bigger macro trends in the background too, normally in the form of credit bubbles that were typically financed by the banks themselves.

The crises the banking sector was not involved in were relatively mild by comparison, or even insignificant. The bursting of the tech bubble in 2000 did not lead to any financial market instability and only caused a mild recession, while the collapse of the crypto bubble had no impact on the financial markets or economy at all, as there was practically no linkage to the banking sector. The stock market crash of 1987 only had a limited impact on the economy.

The biggest financial crises and their effect on the real economy therefore seem to be associated with banking crises. This is because banks are systemically important by virtue both of their role in maturity transformation and because they stand at the centre of the credit intermediation system. When the flow of credit is constrained, it is as if the heart is no longer supplying blood to the body. The effect can be aggravated by a systemic banking panic, if instantly accessible deposits are withdrawn and longer-term positions liquidated. This happened in 2008 and again in 2023.

Crises on this scale have usually led to large-scale intervention by governments to minimise the systemic spread of a crisis in the banking sector.

This experience is also the reason why additional regulation was imposed on systemically important banks. Higher capital buffers and credible resolution plans are designed to bring the system-wide risks under control. Politicians wanted to tackle the problem of moral hazard.

The centrality of banks to the occurrence and severity of financial crises is ultimately the reason why effective independent banking supervision is so important for financial stability and sustainable economic growth.

10 years of the SSM – a success story

I am now going to talk about the first decade of the single supervisory mechanism (SSM), which I had the privilege to be involved in. The SSM was itself the child of a major financial crisis, namely the euro crisis of 2010 to 2012. What made this crisis distinct were default risks on sovereign bonds combined with banks' exposure to these bonds, which created cluster risks on their balance sheets. This was referred to as the "sovereign-bank nexus".

The SSM, which was established in 2014, introduced eurozone-wide banking supervision. The aim was precisely to tackle the threat arising from combination of national indebtedness and the cluster risks of the country's banks and supervise the risks of banks with cross-border activities in the euro area on a unitary basis. The SSM is part of the banking union alongside the Single Resolution Mechanism and the yet to be introduced European Deposit Guarantee Scheme.

The SSM has proved to be a success in preventing future crises in the eurozone. This success is attributable to the following elements in my opinion.

First, the SSM introduced a strong regulatory framework at eurozone level that enables robust eurozone-wide supervision. Article 16 of the SSM regulation is worth noting here. It explicitly mandates intervention by SSM supervisors "at an early stage" when there are indications of problems. The article lists the full range of supervisory powers and tools supervisors can deploy to intervene early in the going concern phase. The regulations are backed up by a principle-based definition of when the SSM should intervene. The principle for intervening is that a bank's risk management, risk controls and capital and liquidity resources are no longer adequate for its risks. This gives the supervisory authority the leeway it needs to take the right steps at the right time.

The SSM has used these powers over the last 10 years and presided over a sharp fall in eurozone bank's non-performing loans and a sharp increase in their capital and liquidity buffers.

Second, the SSM has built up a strong, harmonised supervisory practice. It is based on robust processes that build on the best practices of national authorities.

Third, SSM supervision uses comparative analysis of the supervised entities, known as peer analysis. This allows best practice among the supervised institutions to be disseminated and enforced by supervisors. This promotion of best practice in the industry was further boosted in 2020 when the SSM was reorganised to introduce robust cross-sectional supervision.

Fourth, the SSM has successfully combined the macro perspective with microprudential supervision. This is integrated into planning at a strategic level, which means in practical terms that supervision can be prioritised in a more targeted way. Allow me to give an example. The SSM analysed in advance how an unexpectedly rapid monetary normalisation process would affect the banking sector's risk profile. This analysis resulted in the following preventive supervisory initiatives:

- Both earnings and economic value of equity were stress tested in relation to interest rate changes. As a result the EU banks only had EUR 78 billion of unrealised losses on available-for-sale assets in the banking crisis in 2023. Unrealised losses were ten times this amount in the US.

- Stress tests on liquidity outflows tested the length of time institutions would survive beyond thirty days.

- Counterparty risks were examined horizontally, i.e. on a comparative basis.

- Credit risks in business areas heavily affected by inflation were looked at closely on a case-by-case basis, for example leveraged finance, residential and commercial real estate lending and consumer lending.

These kinds of supervisory initiatives contributed to the eurozone banking sector successfully weathering the crises of the pandemic, Russia's war of aggression in Ukraine, the sudden surge in inflation and the resultant crisis in March 2023.

Lessons for future regulation and supervision

But we cannot rest on our laurels. Supervision has to constantly improve. Financial innovation means that the risks are constantly changing.

In terms of regulation, I would put the focus on the following areas:

First, implementing Basel III is key. We have seen how important a resilient banking system is to surviving financial crises, or avoiding them in the first place.

Weaknesses in the banking sector can quickly spill over to the real economy. There are some possible adjustments that could be made to Basel III to learn the lessons of 2023, for example the assumptions on liquidity outflows in the LCR.

Second, we need to understand how credit is intermediated in the real economy. We need to be able to capture bank-like lending with maturity transformation and leverage outside the banking system. For instance, the BIS could collect statistics globally on credit intermediation by non-bank financial institutions (NBFIs), just as it did for the derivative markets in the 1990s. At the moment this is a significant blindspot in the efforts by the authorities to prevent financial crises. Such data would put regulators in a better position to redraw the perimeters of regulation for the changing world of credit intermediation.

Third, we have to understand the interrelationships between banks and the highly leveraged NBFIs that provide credit. In 2008 the real economy issued credit through asset-backed commercial paper. This shadow banking sector was deeply intertwined with the banks. Nowadays we see growing links between banks and private equity companies and credit funds. In the future we will presumably also increasingly have to have links between banks and crypto companies on the radar.

If we see bank-like lending with maturity transformation and leverage outside the banking sector, regulation will have to respond to prevent future crises. After LTCM we tried what was referred to as “indirect” regulation. But then along came Archegos, for example. Now we have think about more direct regulatory approaches, as the FSB is currently examining for these and other kinds of NBFIs.

Within the framework of effective regulation we must ensure that banking supervision remains independent and has the power to intervene in the going concern early, i.e. in the period of calm.

The crisis of March 2023 showed that banks can quickly become distressed even when they meet capital and liquidity rules. It is often qualitative, multi-faceted and hard-to-measure factors that bring an institution down. Supervisors therefore need the full range of powers to intervene early in the going concern, in other words when we are still in the period of calm.

With the help of the necessary powers, supervisors must act preventively and effectively, identify problems early and if necessary escalate them quickly to eliminate problems and malpractice.

As I said at the outset, if we analyse the causes of the most serious banking problems, it almost always comes down to the following three: a weak risk culture, weak governance and weak business models. Therefore supervisors need to intervene early in exactly these areas, i.e. before these weaknesses are manifested in losses and weak capitalisation and liquidity. Because if things have gone this far, it becomes more and more difficult to stabilise the bank.

An objection that is sometimes made is that early intervention by the authorities would represent an excessive interference in the institution’s freedom to run its business as it sees fit, since supervisors cannot be responsible for an institution’s governance, culture or business model.

My reply is as follows. It is not a supervisor’s role to manage a bank or determine its business model, that much is true. The institution is responsible for this itself. But supervisors must be able to recognise if poor risk culture or governance or a poor business model are increasingly jeopardizing the security of the institution. One can identify a series of red flags which – if more and more of them start to appear – indicate that the risk culture, governance or the business model are not working properly. We can use a structured methodology for these red flags. These include for example:

- A board of directors without the necessary authority over the business model
- Dominant CEO figure without adequate checks and balances
- Management not challenged by the board of directors
- Compensation systems and bonuses that only incentivise growth and take no account of business conduct and risk controls. Even if these elements nominally exist, there is no action if they are breached by “rainmakers”
- No respect for regulation and supervision. For instance, information is not provided when requested or important notifications are not made on time
- Audit findings are ignored and not resolved
- Growth first, infrastructure and controls later
- Concentrated risk taking with high cluster risks outside the risk systems
- Involvement in criminal and enforcement proceedings

The list could be extended. The action supervisors take in response can be further improved with the help of comparative analysis of good and bad practice.

The more lights that flash red, and the more systematically the problems manifest themselves across an institution, the greater the risks for resilience and the more robustly supervisors have to respond to these red flags. Supervisors will never determine an institution’s culture, governance or business model. That is not their job. But they can take steps to address obvious malpractice or mitigate the resultant risks. These include for example:

- Imposing higher institution-specific capital add-ons for elevated risks and poor risk controls
- Directing that compensation systems are partly based on good risk management and controls, not just growth
- In serious cases of poor governance at an institution, prohibiting growth in business units that are badly managed and have weak controls
- Requiring improved stress tests of institutions that accurately capture the relationship between risk and profitability and ensure these are incorporated in the institution’s strategy
- Imposing fines where problems are not resolved

In particularly serious cases, supervisors need to review and withdraw the fit and proper designation of the institution’s executive bodies or ban individuals from working in the industry. A senior managers regime that allows poor risk behaviour to be linked to personal responsibility is helpful here. The value of a senior managers regime lies in it also having a preventive effect and contributing to avoiding breaches in the first place.

The important point is that supervisors identify problems early, act quickly and escalate with suitable instruments to resolve the problem if necessary. This has to happen in a structured, transparent and proportionate manner.

Conclusion

Allow me to summarise: 30+ years of financial crises have shown that the banking sector is almost always at the centre of a crisis.

Robust regulation and preventive supervision of the banking industry are crucial for financial market stability and sustainable growth.

The experience of the SSM, which is celebrating its 10-year anniversary this year and was itself a child of the financial crisis, has shown that robust regulation and supervision that has teeth can mitigate crises such as the one in March 2023.

But all of us must continue to strengthen regulation and supervision in the context of innovation and the cyclicality of financial markets. Among other things we need to ensure that bank-like credit intermediation outside the banking sector is brought within the ambit of regulation. We need to drive forward qualitative supervision and early intervention on the basis of robust regulation. This applies particularly to the areas where problems usually begin at banks, namely weaknesses in risk culture, governance and business models. Supervisors can intervene early with targeted action without taking responsibility for these areas instead of the bank.

We have achieved a lot in recent years. Based on the lessons of the financial crises of recent decades, where bank-like credit intermediation almost always played a part, we have to continue to develop regulation and supervision to become best-in-class – for everyone’s benefit. We should never forget that a resilient financial sector is the foundation for a healthy economy.