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How to involve other banks in bank rescue operations?

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How to involve other banks in rescue operations?

Abstract

In four recent international bank resolution cases other banks stepped in and took over (part of) the failing banks. This position paper argues that public authorities' aim to quickly find a buyer may have made them accept prices that were "too low", thereby imposing losses on the state and on deposit guarantee schemes. Keeping failed banks longer in receivership, writing off their truly bad parts, and thereafter selling them in an auction may be welfare enhancing and more cost-effective in the end.

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LIST OF ABBREVIATIONS

BRRD	Bank Recovery and Resolution Directive
CDFPI	California Department of Financial Protection and Innovation
CS	Credit Suisse
EBU	European Banking Union
DIF	Deposit Insurance Fund
FDIC	Federal Deposit Insurance Company
FINMA	(Swiss) Financial Market Supervisory Authority
FRB	First Republic Bank
GAO	Government Accountability Office
LPA	Loss Protection Agreement
NRAs	National Resolution Authorities
NYCB	New York Community Bancorp
NYSDFS	New York State Department of Financial Services
PSI	Private sector involvement
ROE	Return on Equity
SBNY	Signature Bank of New York
SNB	Swiss National Bank
SRB	Single Resolution Board
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
SVB	Silicon Valley Bank
USD	US dollar

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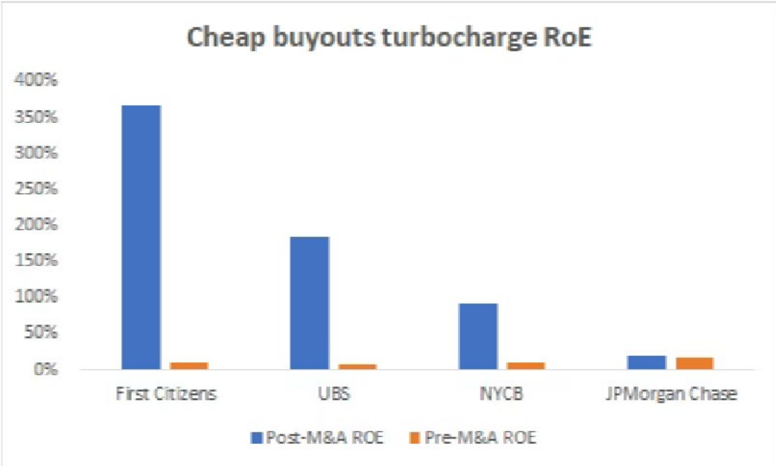
1. INTRODUCTION

In four recent international bank resolution cases (Silicon Valley Bank (March 2023), Signature Bank (March 2023), First Republic Bank (May 2023), and Credit Suisse (June 2023)) other banks took over (part of) the failing banks. According to recent press reports, the acquiring banks made large profits (estimated to be USD 44 billion).[1] This has been argued to elevate their return on equity (see Figure 1). According to the press reports, the buyers took over the target banks for an effective purchase price far less than the target's book net asset value (the fair value of their assets less the fair value of their liabilities).

Figure 1: Return on equity before and after the take-over (%)



Source: Financial Times, September 5, 2023.

The first question addressed in this position paper is whether the circumstances at the time forced the public authorities to accept prices that were "too low", thereby imposing losses on the state and on deposit guarantee schemes and whether an alternative approach could have been more cost-effective.

The four cases referred to above involved three regional US banks and one Swiss bank. The second question this position paper will address is whether the EU may face similar issues in case a European bank fails.

To answer these questions, the paper takes a detailed look at these four cases. It is concluded that it is not surprising that the banks that took over the failed banks were able to strike a profitable deal. While profit numbers mentioned in press reports are hard to verify, the incentive structure created by the public authorities was such that these banks were able to make a profit in the short run, although in the longer run they may face new risks and uncertainties due to the takeovers as well. Keeping failed banks longer in receivership, writing off their truly bad parts, and thereafter selling them in an auction may be welfare enhancing and more cost-effective in the end.

As to the second question, it is important to point to the Bank Recovery and Resolution Directive (BRRD; 2014/59/EU) which provides a crisis management framework for banks in Europe. It offers authorities instruments to deal with failing banks at the national level, as well as cooperation arrangements to

[1] See Financial Times, $44 bn bank bail out bonanza, 5 September, 2023 and Financial Times, Deal of the century, August 23, 2023.

tackle cross-border banking failures. As a corollary to centralised supervision by the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) was established as a framework for the management of insolvencies of significant banks within the euro area. The Single Resolution Board (SRB) is the central resolution authority within the European Banking Union (EBU) and, together with the National Resolution Authorities (NRAs) of participating Member States, forms the SRM.

Bail-in, i.e., conversion into equity or cancellation of (part of) bank debt owed to creditors and depositors, plays a key role in EU bank resolution and is supposed to forego bail-out, i.e., the rescue of banks by the government, using taxpayers' money. At the same time, another aim of resolution is safeguarding failing banks' critical functions (Enria, 2017). This can be done by letting other banks take over (parts of the) failing bank. The paper concludes that how and when such takeovers are implemented will determine the likelihood that acquiring banks make large (potential) profits.

2. RESCUE OPERATIONS IN THE US AND SWITZERLAND

2.1. Silicon Valley Bank

On March 10, 2023, the California Department of Financial Protection and Innovation (CDFPI) closed Silicon Valley Bank (SVB). The Federal Deposit Insurance Corporation (FDIC) was appointed as receiver. Before that, SVB's investments greatly decreased in value when interest rates rose. As this was happening, customers began to withdraw funds from their (often uninsured) accounts. In the US, deposits are insured up to a limit of $250,000. According to the Government Accountability Office (GAO), in 2018–2022, SVB's uninsured deposits to total assets ranged from 70 to 80 percent, while during the same time period, the median uninsured deposits to total assets for a group of peer banks ranged from 31 to 41 percent (GAO, 2023). To accommodate these large withdrawals, SVB sold approximately $21 billion in securities on March 8, 2023, which resulted in a loss of $1.8 billion (GAO, 2023).[2] Deposit outflows were over $40 billion on March 9, and management expected $100 billion more the next day. This unprecedented outflow led the CDFPI to close the bank on March 10. At the time of closure, SVB was the sixteenth largest U.S. bank, with 17 branches in California and Massachusetts, around $209 billion in assets and $175 billion in deposits as of year-end 2022 (Congressional Research Service, 2023a). The bank was particularly well-known for serving start-ups and venture capital-backed firms.

According to a report by the Federal Reserve (2023: 1), SVB "*failed because of a textbook case of mismanagement by the bank. Its senior leadership failed to manage basic interest rate and liquidity risk. Its board of directors failed to oversee senior leadership and hold them accountable. And Federal Reserve supervisors failed to take forceful enough action…*". Furthermore, the report states that: "*Regulatory standards for SVB were too low, the supervision of SVB did not work with sufficient force and urgency, and contagion from the firm's failure posed systemic consequences not contemplated by the Federal Reserve's tailoring framework.*" SVB had grown quickly, almost tripling its assets to $211 billion in the two years between 2019 and 2021. The vulnerabilities of the bank included "*widespread managerial weaknesses, a highly concentrated business model, and a reliance on uninsured deposits.*" SVB's business strategy focused on serving the growing technology and venture capital sector. These depositors held large cash balances for payroll and operating expenses. The reliance on uninsured

[2] In accordance with U.S. Generally Accepted Accounting Principles, publicly traded banks and bank holding companies are not required to report loans intended to be held for investment at fair value on their financial statements.

deposits and its concentrated client base left the bank exposed in an environment of rising rates and a slowdown in the tech sector. SVB had invested in longer-term securities to generate yield against its deposits. As interest rates rose, SVB's interest rate risk increased and the bank accumulated unrealized losses on its lower-yielding securities. Such losses can become actual losses if a bank needs to sell the securities to meet liquidity needs, which can occur with deposit outflows. Fed officials found problems with SVB's interest rate risk management strategies in November 2022 and planned to downgrade the firm's rating related to interest rate risk, but the firm failed before that downgrade was finalized. SVB was allowed to fail (the same holds for other banks discussed below): shareholders lost their investment, creditors (except for secured depositors) took losses, and the boards and the most senior executives were removed (Gruenberg, 2023a).

FDIC initially transferred all insured deposits to the newly created Deposit Insurance National Bank of Santa Clara and later transferred insured and uninsured deposits and a significant balance of the assets to a bridge bank, Silicon Valley Bridge Bank N.A. The Bridge Bank had about $167 billion in assets and about $119 billion in deposits according to the FDIC. The transfer of all the deposits was completed under the systemic risk exception approved by the Secretary of the Treasury, Janet Yellen (see section 3 for more details) on March 12.[3] This decision (that also applied to Signature Bank) was taken to limit 'contagion' to other banks with uninsured deposits.[4] The decision also implied that the bidding on SVB had to be reopened. At the time, bids for SVB were being evaluated by the FDIC, but the initial bids received were based on an insured deposits-only basis. According to Grunberg (2023a), the FDIC received bids from only two institutions, only one of which provided a valid offer on the insured deposits and some of the assets of SVB. Therefore, the decision was made to conduct an expanded marketing effort of the institution on a whole-bank basis, which was anticipated to engender more and better offers.

On March 20, the FDIC announced it would extend the bidding process for SV Bridge Bank. The FDIC also announced it would allow parties to submit separate bids for SV Bridge Bank and its subsidiary Silicon Valley Private Bank. Bidding closed on March 24. The FDIC received 27 bids from 18 bidders, including bids under the whole-bank, private bank, and asset portfolio options (Gruenberg, 2023a).[5]

The FDIC entered into a purchase and assumption agreement for all (insured and uninsured) deposits and loans of Silicon Valley Bridge Bank by First–Citizens Bank & Trust Company, Raleigh, North Carolina. The 17 former branches of the bank opened as First–Citizens Bank & Trust Company on March 27, 2023. The transaction included the purchase of about $72 billion of the Bridge Bank's assets at a discount of $16.5 billion. Approximately $87 billion in securities and other assets that had dropped in value and initially sparked the drop in SVB's shares were kept by the FDIC.[6] The FDIC received equity appreciation rights in First Citizens BancShares, Inc. common stock, which were exercised on March 28, 2023, and sold on April 4, 2023, at a total return of $500 million (Gruenberg, 2023b).

3 https://www.fdic.gov/news/press-releases/2023/pr23017.html.

4 As pointed out by Gruenberg (2013a), a number of institutions with large amounts of uninsured deposits reported that depositors had begun to withdraw their funds. Some of these banks drew against borrowing lines collateralized by loans and securities to meet demands and bolster liquidity positions. The FDIC estimated the industry's unrealized losses on securities were $620 billion as of December 31, 2022, and fire sales driven by deposit outflows could have further depressed prices and impaired equity.

5 For details, see: https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/svb-bid-summary.html.

6 On April 5, 2023, the FDIC announced that it had retained BlackRock Financial Market Advisory, pursuant to a competitive bidding process, to conduct portfolio sales. The sales are ongoing at the moment of writing.

The FDIC and First–Citizens Bank & Trust Company also entered into a loss–share transaction on the commercial loans that the latter purchased from the Bridge Bank. Both will share in the losses and potential recoveries on these loans. According to the FDIC, the loss–share transaction is expected to maximize recoveries on the assets by keeping them in the private sector and to minimize disruptions for loan customers. In addition, First–Citizens Bank & Trust Company will assume all loan–related Qualified Financial Contracts.

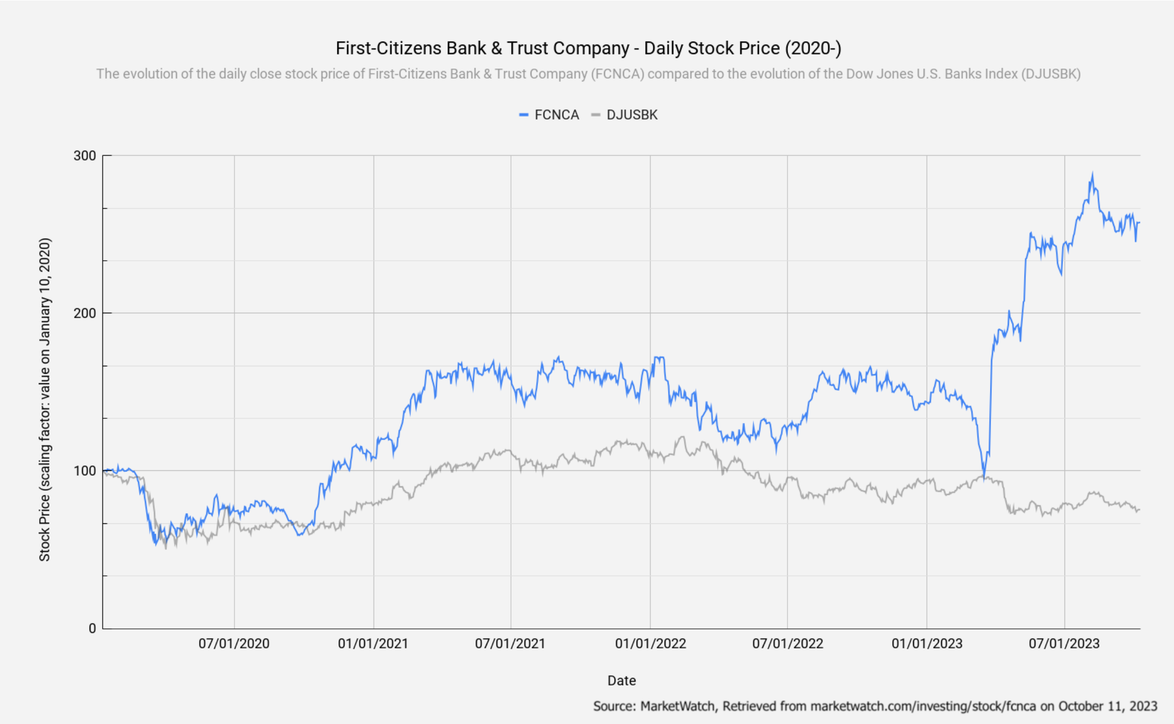
The FDIC estimates the cost of the failure of Silicon Valley Bank to its Deposit Insurance Fund (DIF) to be approximately $16.1 billion (Gruenberg, 20223b).

According to news reports, First Citizens Bank reported a more than 30-fold increase in profits for the first three months of 2023, benefiting from its purchase of SVB. Net income amounted to $9.5 billion ($653.64 a share) in the first quarter, up from $264 million ($16.70 a share) in the same period last year, because of a $9.8 billion gain from its deal for SVB. The windfall made First Citizens the second-most profitable bank in the US during the quarter. In a call with analysts, chief executive Frank Holding described the SVB acquisition as a "home run financially".[7]

Figure 2 shows the stock price of First Citizens in comparison with the Dow Jones US Banks index, both rescaled (level at 1 January 2022=100). After the acquisition of SVB, First Citizen's outperformance of the index improved substantially. Of course, this approach is indicative only. To come up with a proper number of the profit that First Citizens made with the deal, one needs to estimate how First Citizens would have performed without the takeover of SVB and then calculate the difference between this estimate and actual profit. Still, the figure shows that stock market participants expected the deal to boost future profits of First Citizens.

[7] https://www.ft.com/content/2df4cea1-1c0c-48b3-8969-95198d497ea4.

Figure 2: Stock price of First-Citizens Bank & Trust Company and Dow Jones US Banks Index (January 2022=100).



2.2. Signature Bank

After SVB had failed, the equity prices of some banks, including Signature Bank of New York (SBNY), declined sharply. Furthermore, SBNY saw sizable outflows from uninsured depositors. Depositors panicked after SVB had failed because Signature had high amounts of uninsured deposits; its uninsured deposits to total assets ratio ranged from 63 to 82 percent, compared to 31 to 41 percent for a group of peer banks (GAO, 2023).

On March 12, 2023, the New York State Department of Financial Services (NYSDFS) closed SBNY and appointed the FDIC as receiver of the bank. The FDIC in turn transferred all the deposits and nearly all of the assets to Signature Bridge Bank, N.A., created by the FDIC on March 12, 2023. The Signature Bridge Bank was a full-service bank operated by the FDIC, while it looked for potential bidders to take over the operations of Signature Bank.

Signature Bank functioned as an FDIC-insured, New York state-chartered commercial bank, primarily working with privately owned businesses with offices in the states of New York, Connecticut, California, Nevada, and North Carolina. SBNY's main lines of business were commercial real estate and commercial and industrial lending, which were principally funded through uninsured deposits gathered from mid-sized commercial companies. SBNY experienced tremendous deposit growth during 2020 and 2021, resulting in the bank's size more than doubling. In 2022, as interest rates began to rise and deposits began to contract due to volatility in the digital assets market, the bank experienced significant deposit outflows. As of December 31, 2022, SBNY had total deposits of \$88.6 billion and total assets of \$110.4 billion. SBNY was the 29th largest bank in the country, and its failure constituted the third largest bank failure in United States history (FDIC, 2023a).

According to the FDIC (2023a: 7), the "*primary cause of SBNY's failure was illiquidity precipitated by contagion effects in the wake of the announced self-liquidation of Silvergate Bank, La Jolla, California (Silvergate), on March 8, 2023*[8]*, and the failure of Silicon Valley Bank, Santa Clara, California (SVB), on March 10, 2023, after both experienced deposit runs. However, the root cause of SBNY's failure was poor management. SBNY's board of directors and management pursued rapid, unrestrained growth without developing and maintaining adequate risk management practices and controls appropriate for the size, complexity and risk profile of the institution. SBNY management did not prioritize good corporate governance practices, did not always heed FDIC examiner concerns, and was not always responsive or timely in addressing FDIC supervisory recommendations (SRs). SBNY funded its rapid growth through an overreliance on uninsured deposits without implementing fundamental liquidity risk management practices and controls. Additionally, SBNY failed to understand the risk of its association with and reliance on crypto industry deposits or its vulnerability to contagion from crypto industry turmoil that occurred in late 2022 and into 2023*."

Bidding for Signature Bridge Bank closed on Saturday, March 18. The FDIC received five bids from four bidders (Gruenberg, 2023a). On March 19, 2023, the FDIC announced that it had entered into a purchase and assumption agreement for substantially all deposits and certain loan portfolios of Signature Bridge Bank by Flagstar Bank, National Association, Hicksville, New York, a wholly owned subsidiary of New York Community Bancorp (NYCB), Inc., Westbury, New York.[9] According to press reports, the FDIC had sought to sell Signature in one piece, but this did not materialise.[10] The transaction included the purchase of about $38.4 billion of Signature Bridge Bank's assets, including loans of $12.9 billion purchased at a discount of $2.7 billion. The 40 former branches of Signature Bank started operating under New York Community Bancorp's Flagstar Bank, N.A., starting Monday, March 20, 2023. Around $60 billion in loans remained in the FDIC receivership.[11] The deal with Flagstar also excluded Signature's crypto unit Signet, which facilitates the buying and selling of digital currencies. The assets in that division, which had been one of the fastest-growing in the bank, had sunk to just $4 billion, from nearly $30 billion a year ago.[12] In addition, the FDIC received equity appreciation rights in New York Community Bancorp, Inc., common stock with a potential value of up to $300 million.[13] The FDIC estimates the cost of the failure of Signature Bank to its Deposit Insurance Fund to be $2.4 billion (Gruenberg, 2023b).

The shares of NYCB jumped 30 per cent on Monday morning after Flagstar had agreed to buy most of Signature Bank, suggesting that investors considered the deal attractive. Figure 3 shows the stock price of NYCB in comparison with the Dow Jones US Banks index, both rescaled (level at 1 January 2022=100). After the acquisition of Signature, NYCB outperformed the index.

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8 Silvergate Bank had a business model focused almost exclusively on providing services to digital asset firms. Following the collapse of the digital asset exchange FTX in November 2022, the bank experienced an outflow of deposits from digital asset customers that, combined with the FTX deposits, resulted in a 68 percent loss in deposits – from $11.9 billion in deposits to $3.8 billion. The outflow of deposits caused the bank to sell debt securities, resulting in a loss of $1 billion. On March 8, 2023, Silvergate announced that it would self-liquidate (Gruenberg, 2023a).

9 NYCB bought Flagstar in December 2022.

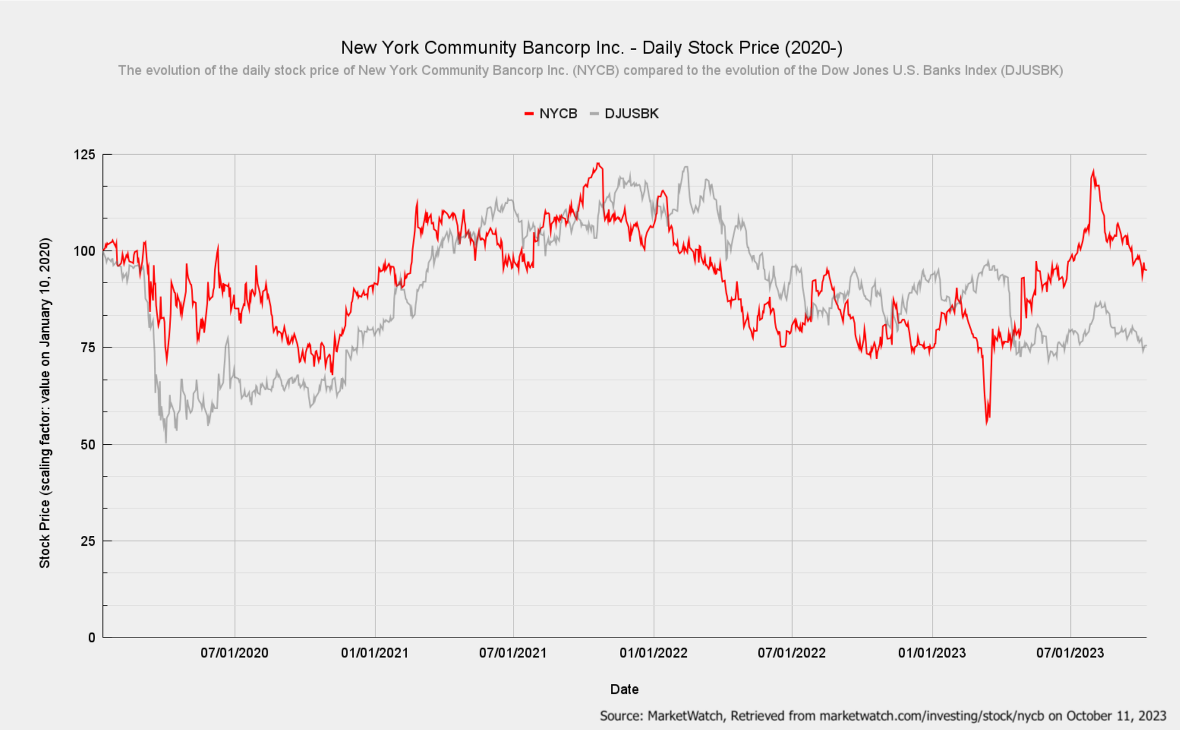
10 https://www.ft.com/content/d39a22dd-30ab-4eb5-9acf-928c9ae118ce.

11 On April 3, 2023, the FDIC announced the framework of a marketing process for the approximately $60 billion loan portfolio retained in receivership following the failure of Signature Bank.

12 https://www.ft.com/content/d39a22dd-30ab-4eb5-9acf-928c9ae118ce.

13 FDIC Press release March 19, 2023. https://www.fdic.gov/news/press-releases/2023/pr23021.html.

Figure 3: Stock price of New York Community Bancorp Inc. and Dow Jones US Banks Index (January 2022=100).



2.3. First Republic Bank

First Republic Bank (FRB) was closed on May 1, 2023 by the CDFPI, which appointed the FDIC as receiver. FRB was a San Francisco-based regional bank focusing on high-net-worth clients, including residential real estate lending, private banking, business banking, wealth management, trust, and brokerage services. Single-family residential loans were the primary loan product and included non-conforming jumbo mortgages with interest-only repayment terms (FDIC, 2023b). Nearly two-thirds of the bank's deposits were uninsured, according to S&P Global Market Intelligence.[14] The bank's failure followed a run on deposits after the collapses of SVB and SBNY. Due to the collapses of these banks, along with credit ratings downgrades, clients were increasingly concerned about keeping uninsured deposits with a regional bank. Furthermore, rising interest rates reduced the value of many of FRB's assets, further reducing depositors' confidence. A liquidity injection of $ 30 billion by some of the largest US banks on March, 16, 2023 did not stop the run, nor did the bank's borrowing of $105.4 billion from the Federal Reserve and the Federal Home Loan Bank Board. The FDIC reports that as of April 13, 2023, First Republic Bank had approximately $229.1 billion in total assets and $103.9 billion in total deposits.

As with the other recent bank failures in the US, supervision could have been better. A report by the FDIC (2023b: 5), found fault in how regulators in the FDIC's San Francisco Office dealt with the bank in the years leading up to its collapse in May 2023. According to the report, regulators could have been more forward-looking in assessing the risks that rising interest rates would pose to the bank, could have done more to challenge and encourage bank management to manage those risks, and were too generous in evaluating whether the bank had enough liquid assets on hand. However, the report

[14] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/svb-signature-racked-up-some-high-rates-of-uninsured-deposits-74747639.

concludes that "*We cannot say whether taking earlier supervisory action such as criticizing interest rate risk or liquidity risk management would have prevented First Republic from failing given the significance and speed of deposit withdrawals. However, meaningful action to mitigate interest rate risk and address funding concentrations would have made the bank more resilient and less vulnerable to the March 2023 contagion event*."

The FDIC entered a purchase and assumption agreement with JPMorgan Chase Bank, National Association, Columbus, Ohio, to assume all of the deposits and a substantial part of the assets of FRB. According to JPMorgan Chase, it acquired "*the substantial majority of First Republic Bank's assets, including approximately $173 billion of loans and approximately $30 billion of securities*" and "*approximately $92 billion of deposits, including $30 billion of large bank deposits, which will be repaid post-close or eliminated in consolidation*." [15] JPMorgan Chase did not assume FRB's corporate debt and preferred stock. The New York Stock Exchange delisted FRB's common stock on May 2, 2023. As part of the transaction, FRB's 84 offices in eight states reopened on May, 1 as branches of JPMorgan Chase.

The FDIC and JPMorgan Chase also entered into a loss-share transaction on single family, residential and commercial loans it purchased from FRB. The FDIC and JPMorgan Chase Bank shared in the losses and potential recoveries on the loans covered by the loss–share agreement. According to the FDIC, the transaction is expected to maximize recoveries on the assets by keeping them in the private sector and to minimize disruptions for loan customers.

According to the FDIC, the resolution of FRB was different than that of SCB and SBNY, as it "*involved a highly competitive bidding process and resulted in a transaction consistent with the least-cost requirements of the Federal Deposit Insurance Act*."[16] The FDIC invited 21 banks and 21 nonbanks to participate in the bidding process, and received 12 bids from four bidders. As a result of the competitive first round of bidding, the FDIC requested best and final offers from the four bidders by 7:00 P.M. on April 30, 2023 (Gruenberg, 2023b).

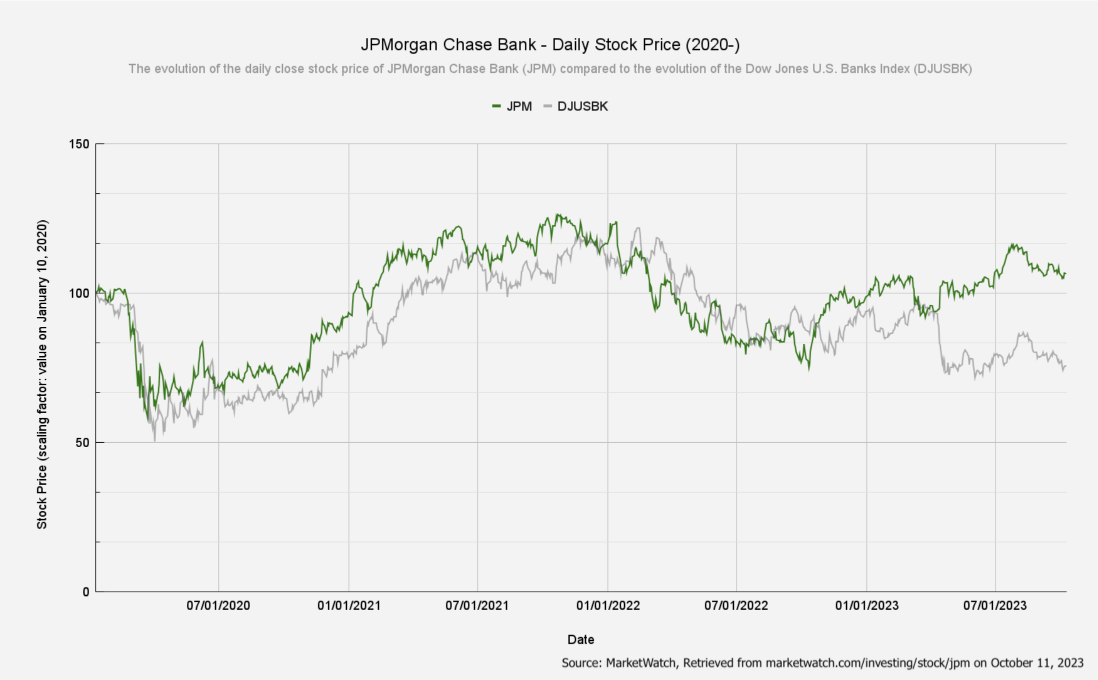
JPMorgan Chase paid $10.6 billion to the FDIC for the acquisition of FRB. The FDIC provided $50 billion in five-year, fixed-rate financing for balance sheet restructuring as well as some loss coverage for mortgages and commercial loans. The FDIC's portion comes from the Deposit Insurance Fund (DIF). The FDIC estimates the cost to the DIF to be about $13 billion (Gruenberg, 2013b).

Figure 4 shows the stock price of JPMorgan Chase in comparison with the Dow Jones US Banks index, both rescaled (level at 1 January 2022=100). After the acquisition of FRB, JPMorgan Chase outperformed the index. Although this takeover was arranged via an auction, the stock market considered that it increased the earning capability of the acquiring bank.

15 https://www.jpmorganchase.com/ir/news/2023/jpmc-acquires-substantial-majority-of-assets-and-assumes-certain-liabilities-of-first-republic-bank.

16 https://www.fdic.gov/news/press-releases/2023/pr23034.html.

Figure 4: Stock price of JPMorgan Chase Bank and Dow Jones US Banks Index (January 2022=100).



2.4. Credit Suisse

Years of scandals, flawed strategies, the collapse of two investment funds in which the bank was heavily involved, poor profitability, and many changes of management at Credit Suisse (CS) Group AG had led to low investor confidence in the second-largest bank in Switzerland. In addition, the March 14, 2023, release of the financial statements revealed material weaknesses and the announcement by the largest shareholder that it would not provide additional capital. The crisis of regional banks in the United States in the first months of 2023 accelerated the loss of confidence in CS. On March 15, 2023, the Swiss Financial Market Supervisory Authority (FINMA) and the Swiss National Bank (SNB) issued a press release asserting that "the problems of certain banks in the USA do not pose a direct risk of contagion for the Swiss financial markets. The strict capital and liquidity requirements applicable to Swiss financial institutions ensure their stability. Credit Suisse meets the capital and liquidity requirements imposed on systemically important banks. If necessary, the SNB will provide CS with liquidity."[17] However, an emergency credit line of CHF 50 billion provided by the Swiss National Bank (SNB) failed to arrest a steep decline in the bank's share price. CS ultimately suffered a bank run and was no longer able to recover without assistance.

Following the intervention of the Swiss Federal Department of Finance, the SNB, and the Swiss Financial Market Supervisory Authority (FINMA), CS and UBS Group AG entered into a merger agreement on March 18, 2023. FINMA decided that CS's Additional Tier 1 Capital (contingent convertible bonds) of approximately CHF 16 billion would be written off to zero. UBS was willing to pay about CHF 0.50 a share in its own stock, worth CHF 3 billion, up from an earlier bid of CHF 0.25 that was rejected by the CS board.[18] The closing price of CS was CHF 1.86. The Swiss regulatory authorities allowed the takeover without the shareholders' approval of either entity.

[17] https://www.finma.ch/en/news/2023/03/20230315-mm-statement/.

[18] https://www.ft.com/content/ec4be743-052a-4381-a923-c2fbd7ea9cfd.

On June 12, the merger was legally consummated. According to FINMa, "*The legal consummation of the merger between UBS Group and Credit Suisse Group marks the end of a phase of great uncertainty. This creates clarity and stability. Under the umbrella of UBS, the practical integration of the two large banks is now beginning under the new management structure and governance and with risk management processes clarified and defined for the enlarged bank. One of the most pressing goals for the merged bank is to quickly reduce the risks of the former Credit Suisse investment bank. FINMA welcomes this strategic focus. Following the completion of the transaction, the merged bank has the necessary capital and liquidity resources to carry out these risk reduction activities quickly and decisively and to successfully complete the integration.*"[19]

It is too early to assess the distribution of the costs of the merger. For one thing, there is the risk that the write down of the AT1 bonds will be legally challenged, since CS's equity holders made a recovery (albeit not a full one). Indeed, regulatory authorities in the EU and other countries made clear that this would not have happened under their regimes.[20] FINMA poses that the AT1 instruments issued by CS contractually provide that they will be completely written down in a "Viability Event", in particular if extraordinary government support is granted. As CS was granted extraordinary liquidity assistance loans secured by a federal default guarantee on 19 March 2023, these contractual conditions were met for the AT1 instruments issued by the bank. Therefore, FINMA instructed CS to write down the AT1 bonds.[21] However, holders of AT1 bonds are likely to challenge this decision.[22]

Another risk for UBS is that it may face fines for CS's behaviour in the past. The Federal Reserve Board imposed a fine on UBS of $268 million for "misconduct" by Credit Suisse in July 2023. The misconduct charge was levied against CS for "unsafe and unsound counterparty credit risk management." Additional fines were imposed by the Swiss FMSA and the Bank of England's Prudential Regulation Authority, the total cost to UBS were reported to be around $387 million.[23]

UBS and Credit Suisse will operate separately until their planned legal merger in 2024, while the Credit Suisse brand and logo will not be retired until 2025, when the migration of the bank's clients to UBS's database is expected to be complete.

In August 2018, UBS announced that it voluntarily ended a CHF 9 billion Loss Protection Agreement (LPA) with the government which helped to secure the takeover of Credit Suisse. The LPA was meant to cover losses of up to CHF 9 billion (only to be drawn after UBS had taken on the first CHF 5 billion of losses). The LPA would have covered a designated portfolio of CS non-core assets. At the time, this was deemed necessary to protect UBS against potential tail risks as there had been very limited time to review respective assets over the rescue weekend. UBS also terminated SNB emergency liquidity support of around CHF 100 billion.[24] This support was set up on 19 March 2023 by the Swiss government and allowed the SNB to provide sufficient liquidity support to Credit Suisse, backed by a federal default guarantee. UBS also announced that all emergency measures and loans, including an

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19 https://www.finma.ch/en/news/2023/06/20230612-mm-vollzug-zusammenschluss-ubs-cs/.

20 https://www.ft.com/content/0443875a-fcac-476b-82ac-3ee37d0ccaf7.

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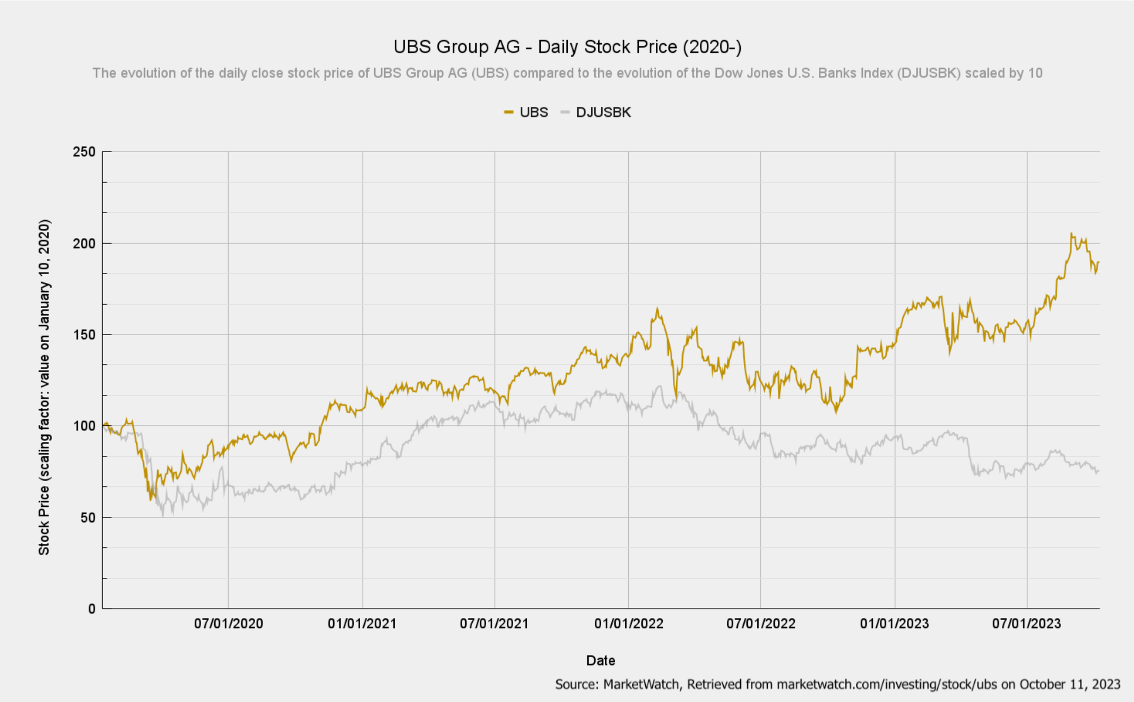
Emergency Liquidity Assistance Plus loan of CHF 50 billion for Credit Suisse had been repaid. The decision to end government and central bank support suggests that the assets attained by UBS may not be as toxic as earlier feared.

Figure 5 shows the stock price of UBS in comparison with the Dow Jones US Banks index, both rescaled (level at 1 January 2022=100). After the acquisition of CS, UBS outperformed the index even more than before.

Figure 5: Stock price of UBS and Dow Jones US Banks Index (January 2022=100).



3. AN ASSESSMENT

3.1. Large profits for acquiring banks are not inevitable

What made the recent US failures different from previous failures was the speed of the bank runs. According to the Federal Reserve (2023: 2), "*the combination of social media, a highly networked and concentrated depositor base, and technology may have fundamentally changed the speed of bank runs. Social media enabled depositors to instantly spread concerns about a bank run, and technology enabled immediate withdrawals of funding*." In addition, even though the banks that failed were not very large, there were serious concerns that "*a firm's distress may have systemic consequences through contagion—where concerns about one firm spread to other firms—even if the firm is not extremely large, highly connected to other financial counterparties, or involved in critical financial services*." As pointed out in section 2, some of the US banks that failed heavily relied on uninsured deposits, which according to the authorities, created a huge risk of 'contagion' to other banks with uninsured deposits.[25] In fact, the authorities felt compelled to provide insurance to all deposits

Banks frequently fail in the US and often the FDIC is then appointed as the receiver. This means that the FDIC takes control of the bank and resolves it through an administrative process. Costs to the FDIC associated with a resolution are funded by drawing on the FDIC's Deposit Insurance Fund (DIF), which is funded through assessments on banks and backed by the U.S. Treasury. Typically, uninsured depositors, creditors, and shareholders are not protected against losses. However, the Federal Deposit Insurance Corporation Improvement Act of 1991 allows one exception to the requirement that the FDIC should seek solutions with minimum costs for the DIF. If complying with that requirement would "have serious adverse effects on economic conditions or financial stability and if FDIC assistance or other actions would avoid or mitigate those effects," a systemic risk exception could be granted. The law requires that the decision to grant such an exception can be made by the Secretary of the Treasury in consultation with the President, but only after a written recommendation by a two-thirds majority of both the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve System. As discussed in section 2, the Secretary of the Treasury decided to apply this exception based on unanimous advice from the FDIC and the Fed.

The FDIC normally uses two main resolution methods: (1) purchase and assumption transactions and (2) deposit payoffs. The FDIC seeks bids from qualified bidders for the failed bank's assets and the assumption of deposits and accepts the bid that is judged least costly to the DIF. Frequently, the FDIC finds another private bank that acquires (parts of) the failing bank.[26] If no viable acquiring institution can be found, then the FDIC typically deploys a deposit payoff in which the FDIC ensures that the customers of the failed institution receive the full amount of their insured deposits. The FDIC retains the assets of the failed institution in its capacity as receiver. The assets are eventually sold to maximize the recoveries to the DIF, uninsured depositors, creditors, and owners (Congressional Research Services, 2023a).

[25] One may question whether the term 'contagion' should be used here. Failure of one bank may cast doubts on the solvency of banks with similar asset/liability structures even if there is no new information about these banks. But this is perhaps better labelled as a 'wake-up call': a crisis initially restricted to one bank may provide new information prompting investors and depositors to reassess the vulnerability of other banks.

[26] For an overview, see: https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/

In the case of some of the resolutions discussed in the previous section, the FDIC used a so-called bridge bank. The FDIC may establish a bridge bank to resolve a large or complex failing bank in which more time is needed to find a buyer. The bridge bank can maintain normal operations until the sale of the failed bank to another bank. By law, a bridge bank is initially chartered for two years, with optional one-year extensions for three more years (Congressional Research Services, 2023b). This implies that the authorities may wait before selling a bank in resolution. Waiting would also have the advantage that potential buyers have more time to assess the riskiness of a take-over. Furthermore, the FDIC would have time to consider whether it could receive more and better bids for a failed bank at higher prices by writing off its truly bad parts so prospective buyers will bid for the good ones. As Berner et al. (2023) argue: "*In theory, the FDIC had better information about the riskiness of these banks' portfolios than potential buyers can quickly obtain over a weekend. Segregating those risks can reduce the need for loss-sharing arrangements and help expand the potential pool of bidders and raise their bids by reducing uncertainty.*"

At the same time, this does not imply that there will be no costs for the authorities and the banking system which funds the DIF. But in my view, this will limit the likelihood that the acquiring bank will make large short-term profits as they did in the US as shown in Table 1.

Table 1: Performance of acquiring banks compared to Dow Jones Bank Index before and after takeover

Average Difference in Stock Price and Dow Jones U.S. Banks Index, Equal number of days before and after Takeover		
	Before Takeover	**After Takeover**
FNCNA	57.65	159.32
NYCB	-10.48	14.87
JPM	10.44	28.28
UBS	56.81	87.20

Source: the author's calculation based on Market Watch data.

UBS also made a large profit after it had taken over CS. However, the case of the failure of CS is very different from the US bank failures because the Swiss authorities decided that only a Swiss solution would be appropriate. According to the Expert Group on Banking Stability (2023: 12), "the state-supported takeover by UBS had the advantage that it was relatively simple, it restored confidence quickly and avoided the risk of a bail-in." However, by choosing the Swiss-bank-only option, the authorities gave UBS a very strong bargaining position. The lesson to be drawn here, also for possible future resolutions in the EBU, is that going for national interests may not be the most cost-effective way to involve other banks in rescuing failed banks.

Table 2 shows how the stock price improvement is related to some characteristics of the takeovers. JPMorgan Chase had the smallest increase in relative stock price performance. This takeover took place via a proper auction, but also involved a much larger acquiring bank than in the other 3 US cases.

Table 2: Difference in performance of acquiring banks before and after takeover and deal characteristics

Deal:	Difference:	Total assets failed bank:	Total assets acquiring bank:	Auction:
SVB	101.67	$ 212 billion	$ 109 billion	No
SBNY	25.35	$ 118 billion	$ 64 billion	No
FRB	17.84	$ 213 billion	$ 3,666 billion	Yes
CS	30.39	$ 558 billion	$ 1,104 billion	No

Source: the author's calculation based on Market Watch. Size data from annual reports; data refer to end of 2022 (except for SBNY which refers to 2021; for SVB and NYCB consolidated data).

3.2 Proposed amendments to European resolution

Under the BRRD, the SRB is responsible for the recovery and resolution of the largest European banks, while national authorities are responsible for the recovery and resolution of smaller banks. As a consequence, small and large banks may not be treated in the same way. There are at least two reasons for this. First, if the SRM is responsible for the resolution of a significant bank in the EBU, it is more likely that the bail-in framework will be properly applied than when the resolution is done by national authorities, which are more exposed to domestic political pressure (de Haan, 2022). Whether or not the SRM gets involved is determined by its Board's Public Interest Assessment (PIA). In essence, the PIA compares resolution against insolvency, in particular assessing how each scenario impacts (i) financial stability; (ii) the bank's critical functions; and (iii) the use of extraordinary public financial support. Under the current framework, resolution can only be chosen where insolvency would not allow achieving the resolution objectives to the same extent (EC, 2023b). As shown in de Haan (2022), in several instances the SRB decided that public interest was not sufficient and that therefore the SRM would not get involved. Second, it is more difficult to liquidate large banks in view of the contagion and financial stability risks. However, as the US experience discussed above has shown, winding down even relatively small banks may be highly problematic. Furthermore, banks that are small from a European perspective "*may be 'too big to liquidate' under national insolvency regimes*" (European Commission 2023a: 3). Indeed, during the last two decades, many failing small or medium-sized banks in EU countries have been dealt with under national regimes often involving the use of taxpayer money (bail-outs) instead of the industry-funded safety nets, such as the SRF that so far has been unused in resolution (EC, 2023b). Still, the Danish experience shows that small banks can be liquidated in an orderly fashion while maintaining financial stability and limiting bail-outs (Dyrberg Rommer and Kleiner, 2021).

In April 2023, the European Commission has published a proposal to adjust and further strengthen the EU's existing bank crisis management and deposit insurance (CMDI) framework, with a focus on medium-sized and smaller banks (EC, 2023a; EC2023b). According to the Commission, "*the very recent U.S. and Swiss banking crises … underline the importance of ensuring that EU arrangements for managing bank failures are as robust and effective as possible.*" (EC 2023a: 2).

An important element in the Commission proposals is the proposed "*clarification of the public interest assessment in managing bank crises to ensure that a full range of crisis management tools, such as transfer tools, can also be applied to failing smaller and medium-sized banks, if this can more effectively achieve the objectives of safeguarding financial stability, depositor confidence and protecting* *taxpayers' money. Transfer tools include the sale of the failing bank or parts of it to a viable buyer, the transfer to a bridge bank or the use of the asset management vehicle.*" (EC, 2023a: 3).[27]

The recent experiences with failing US and Swiss banks as discussed is this document is especially relevant for this element of the proposal. The EC (2023a: 2) stresses that "*the framework must ensure that any losses related to a bank failure can be met while minimising the risk of recourse to public funding*." However, as pointed out in the previous section, if a failing bank cannot be liquidated and if there is pressure to find a solution in the very short run, this principle may imply that an acquiring bank may make a windfall profit (even though it remains to be seen whether expected higher profits materialize in the longer run). A more balanced approach in which the authorities' horizon goes beyond the very short term may imply that temporary government involvement (in the US case: keeping the bank in FDIC receivership) may be welfare enhancing and more cost-effective in the end. This may involve public money, but quickly selling the bank with an explicit or implicit subsidy to the acquiring bank may also involve public money and for sure will imply a loss for the deposit insurance fund.

4. CONCLUSION

Acharya et al. (2023: 1) describe the banking crisis is the US as follows: "*The banks that ran into trouble were those with both a large capital shortfall (presumably due to losses on their fixed-income security holdings and fixed-rate loans induced by higher interest rates) and a large share of uninsured deposits. The erosion of capital at these banks led to potentially large losses for uninsured depositors and threatened a systemwide run. In response to calls for depositor bailouts, the central bank, the deposit insurance agency and the Treasury quickly stitched together a patchwork of over-the-weekend resolution strategies*."

According to Enria (2023), there "*is no direct read-across of the US events to euro area significant banks. First and foremost, this is because the banks we supervise do not exhibit the outlier features of extreme interest rate risk and predominant reliance on a concentrated, uninsured deposit base – what might be termed the "SVB business model". Our banks generally operate with a more diversified customer base. Although uninsured deposits are an important source of funding in the euro area as well, they tend to be more relevant for business models which are well diversified on both the asset side and the liability side, including their depositor base. Importantly, all our banks are subject to LCR and NSFR requirements. Liquidity coverage ratios have only decreased marginally since the monetary policy normalisation process began, and they averaged in excess of 160% towards the end of last year. More than half of the existing buffers of highly liquid assets are made up of cash and central bank reserves, which sensibly mitigates the risk of mark-to-market losses when liquidity needs arise. In fact, recent data indicate that those banks that have experienced some deposit outflows appear to have succeeded in maintaining their levels of excess liquidity. They have done so mostly by issuing debt securities and reducing interbank lending, and only to a minimal extent by liquidating securities.*"

[27] The proposed changes are rather marginal: (i) in the definition of 'critical functions' reference is added to the 'national or regional level' of the impact of the disturbance of their discontinuation to the real economy or to financial stability; (ii) an amendment indicating that funding provided by the industry-funded safety nets should be considered preferable to funding supported by taxpayers' money; and (iii) an amendment to clarify that national insolvency proceedings should be selected as the preferred strategy only when they achieve the framework's objectives better than resolution (and not to the same extent).

It seems thus not very likely that bank failures similar to those in the US will happen in the EBU. However, banks may fail for other reasons. If small- or medium-sized banks fail and other banks takeover (parts of) the failed banks, the latter may receive windfall profits if the sale is done under huge time pressure and if there are few biddings due to uncertainty about the riskiness of the assets to be taken over (Berner et al., 2023) or if foreign banks are precluded to take over the failing bank. Keeping failed banks longer in receivership, writing off their truly bad parts, and thereafter selling them in an auction that is open to foreign banks may be welfare enhancing and more cost-effective in the end.

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In four recent international bank resolution cases other banks stepped in and took over (part of) the failing banks. This position paper argues that public authorities' aim to quickly find a buyer may have made them accept prices that were "too low", thereby imposing losses on the state and on deposit guarantee schemes. Keeping failed banks longer in receivership, writing off their truly bad parts, and thereafter selling them in an auction may be welfare enhancing and more cost-effective in the end.

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