Industry in Focus

Recent market events: Implications for the UK banking sector

March 2023

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An initial point of view

On March 8th, a bank and its primary regulator, the California Department of Financial Protection and Innovation (DFPI), publicly announced the bank's voluntary liquidation. Two days later, the DFPI publicly announced it had closed the bank citing inadequate liquidity and insolvency, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver.

There are a number of drivers of the current stresses, but specific issues were a loss of consumer confidence, balance sheet mismatches and risk management challenges that collectively led to a depletion of the bank's liquidity and capital position. Contributing factors included:

01
A significant proportion of excess liquidity invested in long-term bonds.

02
The subsequent rises in interest rates leading to a fall in the value of these bonds.

03
Customers reducing their deposits post-pandemic as fundraising has become more challenging.

04
Capital-eroding losses being crystallised when investment portfolios are sold down to fund those withdrawals.

05
Digitally networked and enabled customer bases that then lose confidence and start withdrawing their money at pace.

The UK banking sector is more financially and operationally resilient than it was in the lead up to the 2008 Global Financial Crisis, underpinned by a more robust regulatory framework. The events of the last week are understood to have been idiosyncratic and bank specific. They are nonetheless a reminder of the inherent risks all banks face, regardless of the jurisdiction and the key structural and regulatory differences between those jurisdictions, including in this case between the US and UK / European banking markets. Risks are further exacerbated by increasingly complex customer dynamics and changing world events - including the war in Ukraine, macro economic uncertainty, market volatility, inflation, interest rate rises as well as the rise of social media.

Against this backdrop, recent events illustrate the importance of effective governance and risk management to drive prudent balance sheet, liquidity and interest rate risk management that become even more critical during challenging and uncertain economic times. This is equally relevant for corporates and the approach they adopt for their own treasury risk management. Inevitably, the market, customers and regulators will yet again refocus on the resilience of the banking sector and banks will need to respond.

So what questions should bank Boards and Executive teams be asking themselves?

- Has the approach to governance and risk management evolved to be sufficiently sophisticated and provide the necessary resilience required to navigate today's increasingly uncertain times?
- How resilient is the business model and growth strategy given the current changing geopolitical and macroeconomic dynamics?
- How is the potential impact (both in terms of quantum and speed) of public and market scrutiny managed, given perceptions and the risk of contagion spreading in a digital world?
- What risks are inherent in the bank's critical third party ecosystem?
- Is the bank prepared for the increased scrutiny?

In this document we provide some initial views on the likely key regulatory responses and steps that banks' Boards should be considering to manage their resilience in the current challenging market conditions.

How recent events may increase regulatory focus?

Area	Impact
Governance	Questions will clearly be raised over the effectiveness of governance arrangements at the institutions that have failed, in particular whether there was enough scrutiny from the Board over those banks' risk management, asset / liability strategies, deposit strategies, group risks, etc. Regulators will seek assurances that banks have robust governance arrangements in place to ensure these risks are mitigated in other firms.
Risk Management	Recent events highlight the problems that can arise when risk management is not prioritised by banks in their core operating models. Risk management capability is already a key focus for regulators and these events will reinforce the importance of banks continuing to develop, evolve and enhance their risk management capabilities and culture in a rapidly changing and increasingly uncertain world.
Stress testing capabilities	Similarly, the importance of stress testing as a core risk management tool, as well as planning for severe but plausible risk events. Banks should also consider (increasingly common) "Black Swan" type events in their institutions' stress testing scenarios. Regulators may also further increase the scrutiny of smaller and specialist banks and the risks associated with concentrations in their business models and balance sheets.
Recovery and resolution	Recent cases highlight the risks posed to the real economy from bank failures, even from those not considered systemically important. Regulators will consider the events of the last week as part of their continual development of recovery planning and resolution requirements, including expectations regarding solvent wind-down planning.
Regulatory regime	The UK regulator is currently developing a new prudential regime for non-systemically important banks. Recent events are likely to influence the regulators' thinking when developing the regime, as recent events have reinforced the need for banks of all sizes to have an appropriately robust prudential framework.
Accounting and hedging	While there remain a number of differences between US and UK / European accounting standards, there will be focus on the implications of banks' chosen accounting policies and in particular their hedging strategies, as the current market volatility is putting some of those hedging relationships under stress leading to potential hedge ineffectiveness.

Area	Impact
Interest rate environment	The current interest rate environment, that contributed to recent failures, will naturally result in more scrutiny from bank supervisory teams. This will include the management of interest rate risk in the banking book (IRRBB) and exposures to certain asset classes and exposure types, particularly those impacted by the higher interest rate environment.
Liquidity risk management	The deposit outflows in the US reinforce the importance of comprehensive funding and liquidity risk management. UK banks are subject to the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Regulators will continue to focus on banks' performance against these core regulatory metrics, as well as the robustness of firms' overall liquidity adequacy ratio (OLAR) and the associated ILAAP processes, which determine the overall level of a bank's liquidity requirements.
Asset Liability Management	Regulators will be seeking assurances that Asset and Liability Committees (ALCOs) are closely scrutinising asset and liability / deposit strategies and risk management policies. The focus will be to ensure liquidity, funding and interest rate risks, along with the associated balance sheet and maturity mismatches, are appropriately managed and remain within risk appetite, including during the current stressed market.
Group risks	The regulator already expects to receive information on group wide risks, which could impact UK-based subsidiaries of overseas headquartered banks. Recent incidents highlight the spillover effects that can result from some of those group risks and this will reinforce the regulatory focus and likely challenge in this area.

Questions banks should be considering to manage their resilience in light of the challenging market conditions

Area	Impact
Governance	Does the Board have the requisite skills in relation to, and are they sufficiently engaged in the oversight of the bank's risk management of, asset / liability strategies, deposit strategies, group risks, etc.?
Strategy and business model	Has the Board reconsidered the robustness and viability of its strategy and business model in light of recent bank failures and the current market pressures as well as the geopolitical and macroeconomic outlook?
Risk Management and Stress Testing	Has management and the Board considered what enhancements are required to the bank's stress testing capabilities, including how to incorporate 'Black Swan' type events into those stress tests (and their associated impact on cash / deposit outflows) as well as the interrelationship and interdependencies between liquidity (ILAAP) and capital (ICAAP) stress tests? Has the bank revisited its contingent funding plans for liquidity stresses in light of recent market events?
Recovery and resolution	When were the bank's recovery plan, solvent wind down plan and resolution pack last updated and do they remain robust and appropriate given recent market developments and current market and economic conditions? Has the bank run a Fire Drill exercise with the Board to test those plans?
Deposit strategies	Recent events show the importance of deposit strategies that provide robust and stable deposit funding; has the bank revisited its deposit strategies (type, profile, customer base, etc.) in light of recent market events, including potential outreach to existing clients, pricing strategies and steps to attract new customers / deposits?
Accounting and hedging	Does the Board fully understand the implications of the bank's chosen accounting policies, in particular around investment portfolios and hedging strategies, and therefore where accounting and economic measurement and valuations diverge?
Interest rate environment	Recent market events have created a degree of uncertainty on the trajectory of future interest rates in the US and globally. Has the bank considered those different scenarios and the implications for the bank's risk exposures, clients and counterparties? Has this been built appropriately into existing stress tests?
Interest rate risk appetite	Has the bank re-evaluated its interest rate risk appetite and risk management strategies, including its approach to hedging and enhancing interest rate risk modelling, to include scenario tests that evaluate different balance sheet trajectories?

Area	Impact
Liquidity risk management and ALM	Has the bank reviewed its approach to liquidity risk and its ALM strategy in light of recent market events, including its risk appetite and assumptions around liquidity outflows on its deposit books and its approach to balance sheet and maturity mismatches?
Group risks	Have management and the Board fully considered any group risks and how those could and should be managed and mitigated?
Capital raising	Have management and the Board considered the implications for any capital raising activities that may be planned or required either as part of current BAU / growth plans or in relation to any mitigating actions for stress scenarios?
Communication strategy and plans	Has the bank re-evaluated its investor and depositor communication plans in the event of market disruption? Do the scenarios considered adequately cover recent market events, including the impact of social media?

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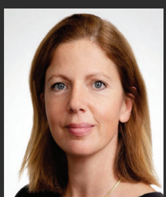

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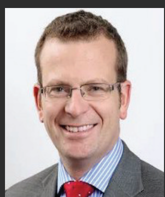

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