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Global Regulators React to Banking Sector Turbulence

Following this spring's shocks to the banking system, US, UK, and European regulators are considering whether existing regulatory and crisis management measures require reform and enhancement.

June 2023

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Introduction

The spring of 2023 saw more dislocation in the global financial sector than any time since the 2008-09 financial crisis. In the US, banking institutions with over $500 billion in total assets failed, and other banks that were publicly traded saw their share prices come under significant pressure, leading to intervention by the authorities. In Europe, Swiss regulators undertook similar measures. The rapidity of these failures came as a surprise to both regulators and the general public. With instability not fully subsiding, US, UK, and European regulators have begun to consider how to calibrate their supervisory regimes in response.

US

By now, the broad outlines of the US response to the spring's bank failures have become clear — amid partisan wrangling in Congress, the federal banking agencies will use their existing authority to increase regulation of banks in the $100 billion to $700 billion asset range (Large Banking Organizations). In addition, they will tighten day-to-day supervision. The precise level of regulation will come only after required notice, comment, and potential transition periods and therefore will not address the remaining causes of instability in the short term. However, stakeholders should expect heightened requirements for capital, liquidity, and resolution preparedness.

Raising the Level of Capital Generally

Before the spring 2023 banking failures, Federal Reserve Board Vice Chair Michael Barr had indicated that the Federal Reserve Board was conducting a "holistic review" of capital requirements, as part of its preparations to implement the remaining aspects of the new Basel Capital Accord — the so-called "Basel III Endgame." In December 2022, Vice Chair Barr stated that although US bank capital was generally strong, "large, unexpected shocks can occur with little notice. Our inability to predict such events would argue for a higher overall capital level than one based solely on historical experience." His view was echoed in the May 18, 2023, congressional testimony of Acting Comptroller of the Currency Michael Hsu on the spring 2023 failures: "[i]n an environment of uncertainty, bank capital remains foundational. As we have seen, strong capital requirements have proven repeatedly to be a critical element of the bank regulatory framework . . . The OCC [Office of the Comptroller of the Currency] remains committed to implementing the enhanced regulatory capital requirements that align with the final set of Basel III standards, and it is important that we move forward as soon as possible."

Tailoring Capital Requirements and Addressing Unrealized Losses in Securities Portfolios

A common theme of congressional Democrats in hearings on the spring 2023 failures was that, under the Trump Administration, the federal banking regulators had loosened too many regulations for Large Banking Organizations. This deregulation had occurred as part of the implementation of the bipartisan Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which passed Congress in 2018 with substantial majorities in support. The current heads of the federal banking agencies appear to agree with the proposition that this deregulation went too far. It would not be surprising, therefore, that as part of Vice Chair Barr's "holistic review" of capital requirements, the differences in treatment between Large Banking Organizations and the nation's globally significant banks become less stark.

A particular area of focus relates to the capital treatment of unrealized losses and gains on available-for-sale securities portfolios. Under the Obama Administration's implementation of the initial Basel III reforms in 2013, banks with less than $250 billion in assets and less than $10 billion in foreign country exposure were permitted to make a one-time decision to opt out of a rule, applicable to the US's largest banks, that required unrealized gains and losses on available-for-sale securities portfolios to be recognized when computing bank capital. One of the banks involved in the spring 2023 failures had made such an opt-out decision, and the first step in its demise occurred when the bank liquidated its entire available-for-sale securities portfolio to shore up its liquidity.

Vice Chair Barr indicated an interest in revisiting the banking agencies' 2013 decision in his May 18, 2023, congressional testimony on the spring 2023 failures, stating that "[w]ith respect to capital, we need to evaluate whether our capital requirements appropriately measure the ability of banks to absorb losses. Had [the failed bank] been required to reflect declines in the face value of available-for-sale securities in its capital, it may have held more capital to cover these losses."

Increased Resolution and Long-Term Debt Requirements

As with bank capital, bank resolution had been an area of banking agency focus before the spring 2023 failures. In the fall of 2022, the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) issued an advanced notice of proposed rulemaking (ANPR) seeking input on whether to impose a form of the "total loss absorbing capacity" (TLAC) requirement under which Large Banking Organizations would be required to issue increased long-term debt in an effort to improve their resolvability. With some foresight, the ANPR noted that "some large banking organizations have increased their reliance on large uninsured deposits to fund their operations over the past decade. These deposits may be less stable relative to insured deposits under conditions of firm-specific stress and resolution." A new TLAC requirement was endorsed by Acting Comptroller Hsu and FDIC Chair Martin Gruenberg in their testimony on the spring 2023 failures. In addition, the federal banking agency heads have indicated an openness to requiring Large Banking Organizations to submit more detailed and/or more frequent resolution plans.

Heightened Liquidity Requirements

At bottom, the spring 2023 failures were failures of liquidity — bank runs of unanticipated speed driven by cell phones and social media platforms. As with the issue of capital deregulation, congressional Democrats seized on the loosening of liquidity requirements by the Trump Administration as a potential cause of the failures, despite the fact that the runs would have overwhelmed the banks even under the heightened requirements applicable to the nation's largest banks. Still, given the rapidity of uninsured depositor flight in the spring 2023 failures, the calibration of liquidity requirements for uninsured deposits will likely be adjusted for all banks, and Large Banking Organizations will likely be required to hold more liquidity as a general matter.

Deposit Insurance Reform?

Part of the response to the spring 2023 failures was the full coverage, as opposed to the haircutting or "bail in," of deposits of more than $250,000, which do not benefit from FDIC insurance. Two of the spring 2023 failures resulted in a "systemic risk" determination from the Federal Reserve Board and the FDIC, which permitted the FDIC to cover uninsured deposits fully, with resulting losses to the US Deposit Insurance Fund to be replenished by means of a special assessment on the banking industry. The FDIC has proposed such an assessment, to be funded based on a bank's amount of uninsured deposits. The FDIC has noted that no US bank with assets of $5 billion or less is likely to be required to contribute to the assessment.

More broadly, the FDIC issued a report on deposit insurance reform that discussed certain alternative approaches to the current deposit insurance regime, such as the FDIC's insuring all deposits or fully insuring deposit accounts that are used for payroll purposes — since one of the most destabilizing aspects of one of the spring 2023 failures was the number of payroll accounts that the failed institution had carried. Failing to invoke "systemic risk" and insure such accounts fully could have resulted in widespread failures of many companies to "make payroll." Any changes to the current deposit insurance scheme could not be made by the FDIC itself, but would require new legislation.

More Responsive Supervision

Both the Federal Reserve Board and the FDIC, the primary federal regulators of the banks that failed in spring 2023, acknowledged that their supervision of the institutions had come up significantly short. The reports that these regulators issued in the aftermath of the failures (here and here) indicated substantial delays in taking necessary action when supervisory staff noticed deficiencies. Both Federal Reserve Board Vice Chair Barr and FDIC Chair Gruenberg testified that they will be seeking to speed up their supervisory processes in reaction to the failures.

Europe

In Europe, a crisis management framework including improved systems for recovery and resolution was implemented following the 2008-09 financial crisis. The European Commission sees these reforms as a success and believes, as Executive Vice President Valdis Dombrovskis commented in a recent speech, that "[a]ll these years of work and reforms have certainly paid off, as we saw during turbulent times starting with the COVID-19 pandemic."

At the same time, Europe is striving to complete its Banking Union. In this context, in a statement on 16 June 2022, the Eurogroup agreed to focus on strengthening the crisis management and deposit insurance framework, an effort supported by the European Parliament in its annual report on the Banking Union in 2022.

It was thus coincidental that shortly following the recent crisis the Commission published, on 18 April 2023, a legislative proposal to reform the bank crisis management and deposit insurance (CMDI) framework. The Commission did, in Mr. Dombrovskis' words, see the recent failures as "a reminder of why we need a strong, functioning system to deal with all banks — whatever the size — when they get into trouble: also when it comes to smaller and medium-sized banks."

The new proposal, which would primarily amend the Bank Recovery and Resolution Directive (Directive 2014/59/EU), the Single Resolution Mechanism Regulation (Regulation 806/2014), and the Deposit Guarantee Schemes Directive (Directive 2014/49/EU), seeks to address these gaps, focusing on the following three objectives with respect to failure of smaller and medium-sized banks.

Preserving Financial Stability and Protecting Taxpayers' Money

The proposal aims to facilitate the use of safety nets funded by the industry by way of deposit guarantee schemes to aid in resolution under the argument that this would shield depositors from bearing losses. The use of the funds from deposit guarantee schemes would only be possible after a bank's internal loss absorption capacity (8% of the failed bank's total liabilities and own funds) had been exhausted and only with respect to banks that were "earmarked" for resolution, as opposed to liquidation. Further, such funds would only be used: (i) if the resolution authorities concluded that bailing in depositors (rather than tapping into deposit guarantee scheme funds) would lead to financial instability; (ii) when the resolution strategy led the failing bank to exit the market; and (iii) with a capped amount so as not to deplete deposit guarantee schemes.

The main argument is that by tapping into the deposit guarantee scheme's funds and enabling an orderly resolution, the depositors would be better shielded in case of bank failures, and access to deposits in excess of the deposit protection secured €100,000 could be more likely than in an insolvent liquidation.

To achieve this objective, the existing "super-preference" of (mandatory) deposit protection schemes in an insolvent liquidation of an institution would be abolished (as otherwise the no-creditor-worse-off principle would likely hinder the application of the deposit protection scheme's fund in a resolution), with all deposits (whether covered or not) ranking *pari passu* in an insolvent liquidation.

Shielding the Real Economy From the Impact of Bank Failure

Under the proposal, there would be a higher incentive to resolve smaller and medium-sized banks rather than have them enter insolvent liquidation. The proposal also allows for broader use of the resolution tools to better protect financial stability, public funds (taxpayers' money), and depositors. As with the original proposal of the resolution regimes, resolutions are seen as benefitting: (i) depositors, in better protecting their access to deposits (a relevant concern in the US banking failures) by way of, for example, transferring accounts to a bridge bank or another bank; and (ii) the general economy and local community, by preserving the critical functions of the bank with the goal of preventing a spill-over of the crisis.

Better Protection for Depositors

The proposed rules reverse the current flexibility granted to national legislators as to whether certain deposits are covered by mandatory deposit protection or not. As such, the proposal would extend the protection to public entities as well as to client money deposited with certain types of intermediated institutions, such as investment companies and payment and e-money institutions.

The latter in particular is seen as an improvement compared to the status quo, where gaps in protection may exist. The proposal also extends protection to temporary high balances (i.e., exceeding €100,000) on bank accounts in certain specific events such as inheritance or insurance payouts. Notably, the proposed package does not seek to change the €100,000 protection that all eligible depositors receive in case of an insolvent liquidation of a bank.

The proposed package has drawn criticism, particularly in Germany, from both the private sector in respect of the abolition of the insolvency preference for deposit protection systems, as well as in a more general way from the sectors working under an institutional protection scheme for interfering with well-functioning national systems of deposit protection.

The package will now be discussed in the European Parliament and Council. The Commission has called for an agreement to be reached prior to the European Parliament elections in June 2024.

UK

In the UK, there is a strong focus on the post-Brexit agenda, which involves rewriting the European legislation that the UK adopted post-Brexit to better suit UK markets and reviewing domestic measures to consider their impact on the UK's competitiveness. Despite a focus on ensuring the strength and stability of the UK financial sector, there is also a deregulatory agenda that seeks to enhance the UK's attractiveness as a place to do business. The UK's financial regulators are being given a new statutory objective relating to international growth and competitiveness, and they have already started to undertake their work through this lens.

Recent events do not appear to have made the regulators more conservative. Andrew Bailey, Governor of the Bank of England, remarked in a recent speech: "The post crisis reforms to bank regulation have worked. Today I do not believe we face a systemic banking crisis. When I look at the UK banks, they are well capitalised, liquid and able to serve their customers and support the economy." Therefore, the sentiment seems to be that the UK does not need to make changes to its crisis management measures at present beyond potentially improving deposit protection measures. Plans are already underway to relax the bank ring-fencing regime, and this does not look set to change following the recent crisis.

Ring-Fencing

The UK government is looking to reform the so-called ring-fencing regime, which was introduced following the 2008-09 financial crisis to help insulate retail arms of larger banks from any contagion risk from their investment banking operations. Broadly, banks with retail deposits of £25 billion or more are required to hold extra capital to bolster their retail operations, and their retail arms are restricted from carrying on certain activities such as proprietary trading.

In March 2022, an independent review of the regime published a final report, which suggested some improvements. The UK government has committed to undertaking various reforms that the report recommended and plans to consult on these in mid-2023. These reforms include:

- Increasing the deposit threshold for the regime from £25 billion to £35 billion
- Taking banking groups without major investment banking operations out of the regime
- Reviewing and updating the list of activities that ring-fenced banks are restricted from carrying out
- Removing blanket geographical restrictions on ring-fenced banks operating subsidiaries or servicing clients outside the European Economic Area

Subject to the consultation process, the government intends to lay legislation to make these changes later in 2023. Separately, the government published a Call for Evidence in March 2023 that considers whether the ring-fencing regime is required in the longer term. The above-mentioned review found that the ring-fencing regime would be less beneficial over time as the resolution regime (which helps banks in crisis wind down in an orderly manner) may offer a more comprehensive solution once it is fully embedded. Consequently, the Call for Evidence asks for thoughts on how the ring-fencing and resolution regimes could better align and on whether there should be a new power to remove banks from the ring-fencing regime if they are deemed to be resolvable.

Deposit Protection

There are suggestions that the UK might raise its deposit protection limit. The current level of protection is £85,000. In his speech referred to above, Bank of England Governor Bailey stated: "The US authorities have announced a review of their deposit insurance system. In the UK, the Bank is also considering improvements to our approach to depositor pay-outs for smaller banks which do not have Eligible Liabilities [subordinated liabilities that can bear losses by being converted into equity in the event of a resolution]. Our work has thus far focused on the speed of pay-outs. Going further and considering increasing deposit protection limits could have cost implications for the banking sector as a whole. As with all things relating to bank resolution, there is no free lunch."

As the Governor mentioned, the Bank of England has already been considering changes to deposit protection in the UK. In March 2023, the scope of deposit protection was expanded to cover eligible customers of payment and e-money institutions, thereby closing a gap in protection. Eligible customers will therefore be protected should the bank holding the payment or e-money institution's safeguarded funds fail.

The other area of focus has been minimizing disruption to deposit holders in a situation in which deposits are protected but the holder relies on the account for day-to-day banking and access to money. The UK authorities are proposing to:

- Introduce an online portal that would facilitate electronic transfers of protected deposits in the event of a bank failure
- Improve the continuity of banking services by enabling the transfer of payment information such as direct debits and standing orders
- Improve operational support in circumstances in which deposit holders need to open a new bank account following a bank failure

The Bank of England notes that this work predates the 2023 instability in the banking sector, but will incorporate lessons learned from recent experience and is seen as a priority area.

Global Outlook

The remainder of 2023 will be active in the US, UK, and Europe as national supervisors address their regulatory priorities. They will be doing so amid continued uncertainty in the global economy and as new issues (such as the state of the commercial real estate industry in the US) arise that may affect bank balance sheets for the worse. As they consider their policy responses, supervisors will be required to balance their concerns for avoiding systemic risk and maintaining financial stability against the risks of credit contraction and the migration of activity to the unregulated financial sector.

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