Tim Phillips [00:00:00]:

Today on VoxTalks Economics, we will be making banking safe. Welcome to VoxTalks Economics from the Centre for Economic Policy Research. My name's Tim Phillips. Every week we bring you the best new research in economics. So remember, subscribe. Follow us on Instagram as well. You'll find us at VoxTalks Economics. Our financial system is supposed to be more resilient than before the global financial crisis. But that didn't save Silicon Valley Bank or Signature Bank or First Republic.

Tim Phillips [00:00:40]:

What went wrong with those three banks and can we fix it? Steve Cecchetti of Brandeis is here with me today. And we've also got Kim Schoenholtz down the line from NYU Stern School. And today we're going to be talking about their new discussion paper called Making Banking Safe. Ambitious. Steve, welcome.

Stephen Cecchetti [00:01:02]:

Thank you very much for having me, Tim.

Tim Phillips [00:01:04]:

And Kim, welcome as well.

Kermit Schoenholtz [00:01:06]:

Thank you so much Tim. Pleasure to be here.

[Voiceover] [00:01:10]:

The collapse of Silicon Valley Bank is causing shockwaves across the entire business world. Silicon Valley Bank's collapse set off a panic… Out to a developing story after the collapse of Silicon Valley Bank on Friday, another bank just shut down. Signature bank marks the third largest bank failure in U.S. history. We're back with some breaking news this morning. First Republic Bank has been taken over by federal regulators and sold to JP Morgan Chase. This comes after regulators spent the weekend trying to find a buyer for the bank.

Tim Phillips [00:01:41]:

Steve, explain to me exactly what happened. Silicon Valley Bank, first of all, failed on the 10th of March 2023. It was considered to be a pretty successful bank, wasn't it? So what was the hidden weakness that did for it?

Stephen Cecchetti [00:01:56]:

Well there were numerous failures Tim, and once you actually look into what happened, what you find first of all is failures of risk management by the bank itself. Once we look and see, we can see that it had been in trouble for quite some time. There was a failure of monitoring by the equity and the debt markets because there was a lot of public information available that people should have been able to sense and actually see what was going wrong. The supervisors are supposed to be enforcing a set of regulations. They saw a number of deficiencies in the bank but then they didn't actually demand any remediation on the part of the bank. And finally the resolution authorities have the ability to shut banks down before they're insolvent and they obviously failed to do that. So I would say there were really four failures and there's quite a lot of blame to go around.

Tim Phillips [00:02:45]:

This was quickly followed by runs on Signature and First Republic. Did they have the same problems?

Stephen Cecchetti [00:02:51]:

Not exactly, but some of the problems were very similar and one of the big ones was that they were also very weakly capitalized. They also had unrealized losses on their balance sheets and they also had very concentrated customer bases. It was different from the SVB customers, who were all of these startups and venture capitalists. But in all three cases, the customers, the liability holders, were quite concentrated. And so when one of them goes, they all go at the same time.

Tim Phillips [00:03:21]:

Kim we're always hearing that since the global financial crisis, the regulators have massively strengthened stress testing. So why didn't the stress tests capture these pretty obvious, with hindsight, vulnerabilities in these three banks?

Kermit Schoenholtz [00:03:38]:

Obviously stress testing needs improvement. There are two basic reasons why stress testing failed here. One is that in some cases, they didn't impose stress tests at all. These banks were growing rapidly, and during that period of rapid growth, for example, SVB did not face a stress test. That's a big problem. The second is no less important, and that is the nature of the stress tests themselves. They did not take account of interest rate risk in a rising interest rate setting. And that, frankly, is almost amazing, given that most people would agree that was the biggest vulnerability facing the U.S. banking system in 2021 2022.

[Voiceover] [00:04:20]:

Back in 2019, Patrick Honohan spoke to us about his experience as Governor of the Central Bank of Ireland in 2009, with the Irish economy in meltdown. Listen to the episode; Lessons from the Irish Banking Crisis.

Tim Phillips [00:04:42]:

So these runs were so dramatic, we hear, on the U.S. banks because they had some very large and a large number of uninsured depositors. Kim, why were there so many uninsured deposits in these banks?

Kermit Schoenholtz [00:04:56]:

Well, I think there are probably two reasons, again, Tim. First, even the large depositors, the ones who are uninsured, were not monitoring. They weren't taking account of the welfare or the condition of their banks. This includes big payroll services providers and firms operating with large operating balances. What's also worrisome is the supervisors did not focus on this problem until the runs began, and they suddenly became worried that these payroll services providers, for example, could cause systemic risk elsewhere in the economy. The second reason is the behavior of our deposit insurer, the FDIC, since 2008, since Lehman, more or less, they've almost always used a method of resolution that protects all deposits, not just the insured ones. And so, de facto, that has meant that a lot of uninsured depositors might have thought they were actually protected. They would not have been wrong. And that's exactly what we saw with SVB, Signature and First Republic.

Tim Phillips [00:05:58]:

For some people who might be scratching their heads, deposits, you would imagine they're exactly what banks want if they want to be successful. So can we explain why all this money flooding into the banks suddenly made them incredibly vulnerable?

Kermit Schoenholtz [00:06:11]:

I think it's all about how they use the funds. There's an old adage about banks that they can either have risky assets or runnable liabilities, but not both. These banks did both. They took the runnable liabilities and put them into risky assets, and that meant that they were vulnerable. And when the shocks hit that caused them, for example, to lose value on their assets, their capital depleted, and people ran.

Tim Phillips [00:06:37]:

With hindsight, were there obvious clues to what was going to happen if the supervisors or if the investors or if the depositors had looked closely for them?

Stephen Cecchetti [00:06:47]:

Tim I think the answer to that is yes, that there were glaring clues. And remember that these banks had quarterly disclosures. These disclosures are long, they're not easy to read, but you can find things in them. I can find things in them, and I don't spend my life reading those disclosures. And one of the things that you can find in them is you can find the unrealized losses on the securities portfolios that the banks have. So remember and Kim mentioned this a minute ago, this was a rising interest rate environment. Of course, when interest rates rise, the value of bonds falls. And that means that the value of the bonds were below the value where the banks had purchased them. Now, the actual amount that they had of these unrealized losses was included in their disclosures. So, for instance, for SVB, you can go and you can find that if you were to do what I think is a more accurate accounting, that they were just barely solvent in the middle of 2022. Now, remember, they didn't fail until March of 2023. So there's another eight months after that when they were probably still on their way down. Now, the second thing is that the supervisors clearly had knowledge of the vulnerabilities. We know this in hindsight from the bar report, and they knew, but they didn't actually force the banks to address them. So, yes, I think there were clues. There were clues both for the markets and there were clues for the authorities, and nobody did anything.

Tim Phillips [00:08:16]:

So I guess an accounting question here. If they had been forced to disclose these unrealized losses in some different way on their balance sheets, in a quarterly disclosures, would that have led to a change in the bank's behavior or the depositor's behavior that might have saved them?

Stephen Cecchetti [00:08:36]:

I think the answer to that is yes. I think if you change the regulation to require the disclosure, that you do change the behavior of the bank. In fact, that's one of the reasons why you would change the regulation. It's interesting also to look at the case of SVB, because remember that during the week that SVB failed, they had started an attempt to raise capital several days earlier, which they then canceled. And one of the reasons that they canceled this attempt to raise capital is that they were concerned that it was going to shine light on these unrealized losses. And if they hadn't been unrealized losses, then that concern wouldn't have been there. People would have known a long time ago. And so if they are actually in the accounting, then either there's a strong incentive for recapitalization earlier, or, as I mentioned, the Resolution Authority then has an incentive to shut them down before they actually become insolvent. So I think there's a strong argument for improving and changing the accounting rules.

Tim Phillips [00:09:39]:

Steve, there's one group of people who really should not have been surprised by the state of these banks, and that is the risk managers within their banks. Surely we should blame them?

Stephen Cecchetti [00:09:50]:

Yes, we should blame them. But I think it's also important to keep in mind that the risk managers are not the bosses. They are not the chief executives or the board chairs of the bank. The risk managers can only do so much, and in some places, the culture of the place is such that the risk managers have very little say in what ultimately happens. There's evidence that people were trying internally to warn SVB of what was going on and that the executives just weren't interested in hearing it. To the point where they didn't even have a chief risk officer for quite a long time during 2022.

Tim Phillips [00:10:41]:

Okay, so our theme today is making banking safe, and we've talked a bit about why the banks failed. So let's talk a little bit about how we might be able to fix it. So, Kim, I know in this paper you come out heavily in support of rules based regulation, but surely all crises, all situations, contexts are different. Isn't some discretion for the supervisors absolutely essential?

Kermit Schoenholtz [00:11:08]:

Tim, we're not going to get rid of discretion. The question is really how much you rely on it. And the problem we have is that we're relying too heavily on it. And we've seen obvious supervisory failures of the kind that we just discussed. So we want to create a set of rules that reduce the reliance on discretion, that make it easier for discretion to work in the circumstances where it needs to work. In fact, what we're saying essentially is relying so much on supervision to promote risk management discipline within the banks has failed. We need a better way to do it, and we should start with more rigorous rules.

Tim Phillips [00:11:46]:

Also, you're recommending bigger capital and liquidity buffers. We have been going down this road for quite some time. Isn't there a problem with this, though, that this just encourages risk taking in other areas of bank's activities?

Kermit Schoenholtz [00:12:02]:

I think not. In our view, the higher capital and liquidity requirements mean that owners and managers have more skin in the game. That ought to reduce their willingness to take risk. So put simply, more capital should lead to less risk taking. And if risk taking is reduced, it will lower the required return on the liabilities of these banks. Another way to say that is, a bank that relies more on equity finance should find that its debt costs are lower and the premium that they have to pay on their debt is lower because they have a greater distance to default.

Tim Phillips [00:12:35]:

Also, you're heavily in support of mark to market accounting. The case for this seems pretty clear considering how you described what caused the banks to fail. But also there is the objection that mark to market accounting introduces volatility to banks. It makes them more pro cyclical. Is that not something you're worried about?

Stephen Cecchetti [00:12:55]:

I think that we would reverse the argument, actually. Without mark to market accounting, you're hiding volatility, and this makes disruptions worse when they come. I think our point is that we're far better off if we know the true health of the bank and it's out in the open. And this means accounting rules that force an accurate reflection of the level of capital, not one that's hidden, not one that's in the footnotes of their disclosure, not one that only certain very high quality banking analysts can figure out.

Tim Phillips [00:13:28]:

Certainly stress testing didn't do its job here. So are you looking for more rigorous stress testing in future?

Stephen Cecchetti [00:13:33]:

At some level the answer to that also has to be yes, because stress tests should be stressing all the risks that could be on a bank's balance sheet. And in the current circumstance, and with respect to the issues surrounding the March turmoil and problems that led up to it, it's interest rate risk that was a real problem because that's what was missing from the stress tests. So the point here is that effective stress tests do need to be stressful, and they need to be flexible, changing with the way the environment adjusts. And I'm afraid that we're not necessarily very good at that at the moment, and we have to improve.

Tim Phillips [00:14:09]:

Kim, are all these suggestions that you're making here, are they a change in the objectives, the culture of regulation, or are you just saying we need better supervisory tools?

Kermit Schoenholtz [00:14:23]:

We're not trying to change the objectives of regulation. All the regulators I know would like to see a well functioning banking system that people can bank on. But we doubt that supervisors can achieve their goals relying on discretion if they don't have a foundation of strict rules that they can also count on. And that makes their job easier. It reduces our dependence on them getting it right all the time. If they miss problems or if they don't react quickly enough to problems, those rules, those buffers for capital and liquidity, provide us protection and make the banking system safer.

Tim Phillips [00:14:59]:

So my final question, Kim, is you made a big promise here because you're talking about making banking safe. Well, banking has never been safe. There have always been bank failures and crises. Are we talking then about making banking safe or just a bit safer?

Kermit Schoenholtz [00:15:13]:

I think more than a bit. Definitely, you're absolutely right. There can always be extreme developments that threaten financial instability that require government intervention. The obvious example would be a war. The U.S. experienced this actually in 1914. It wasn't even involved in the war and needed intervention to protect its financial markets. But the whole purpose of making the financial system robust or resilient is to reduce the need for such extreme intervention or to make it highly unlikely. And the danger we see is that the repeated bailouts that have been occurring fuel the incentives to take risks, and over time, that makes the system even more fragile.

Tim Phillips [00:15:52]:

Well, let's hope the regulators are listening. Kim, thank you very much.

Kermit Schoenholtz [00:15:55]:

Thank you, Tim.

Tim Phillips [00:15:56]:

And Steve, thank you as well.

Stephen Cecchetti [00:15:57]:

Thank you very much, Tim.

Tim Phillips [00:16:07]:

The paper's called Making Banking Safe. And the authors, of course, are Steve Cecchetti and Kim Schoenholtz. It is discussion paper 18302.

[Voiceover] [00:16:26]:

This has been a VoxTalk from the Center for Economic Policy Research. If you enjoyed this episode, remember to subscribe. You can find us wherever you get your podcasts. Next week on VoxTalks Economics, how successful has gerrymandering been in the U.S.?