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FINANCIAL RESILIENCE AFTER SVB:
REFORMING DEPOSIT INSURANCE AND THE LENDER OF LAST RESORT

Stephen G. Cecchetti

www.moneyandbanking.com

SVB Failure

- Bank systems failed to manage risk

  SVB had no Chief Risk Officer
- Markets failed to discipline the bank

  Public disclosures revealed insolvency in mid-2022
- Supervisors failed to detect risk-taking and apply remedies
- Authorities failed to impose timely resolution

  Mark-to-market value implied prompt corrective action by mid-2022

Big lessons from March 2023

1) You will always bail them out
   - Credible commitment to *not* bail out is impossible (lacks time consistency)
   - No one wants to be the parent of the next financial crisis

2) Supervision is essential, but never sufficient
   - Private incentives favor evasion of rules and concealment of risk
   - Detecting risky behavior and applying remedies will always be difficult
   - Officials' changing preferences weaken credibility to maintain rigor

SVB, Signature, First Republic, and beyond

- Banks cannot have both volatile assets *and* runnable liabilities
- Post-crisis capital and liquidity reforms are insufficient
- Do we need to alter
  - Deposit insurance
  - Lender of last resort
  - Resolution

Crypto group Circle admits $3.3bn exposure to failed Silicon Valley Bank

Stablecoin's value drops as crypto market reels from US bank failures

US exchange Coinbase said it was temporarily pausing conversions between USDC and the US dollar © Bloomberg

The Washington Post
Democracy Dies in Darkness

ECONOMIC POLICY

The company that needed $545 million for paychecks when SVB collapsed

The Silicon Valley Bank crisis could have mushroomed well beyond tech when Rippling, which distributes other companies' payroll money, had its funds frozen

By Jeanne Whalen

April 2, 2023 at 9:40 a.m. EDT

RIPPLING

Even large uninsured depositors
do not monitor banks

Providers of vital services
have uninsured deposits

Options for reforming deposit insurance

1) Maintain limited coverage
   (per person, not per bank)
2) Targeted increase in caps for SMEs
   (allow firms to meet payroll and other essential expenses)
3) 100% deposit insurance
   (increases burden on regulators and supervisors, as well as cost to public)
4) Pawnbroker for all Seasons

Pawnbroker for All Seasons (PFAS)

- All short-term liabilities backed by central bank (prepositioned collateral)
- Covers banks and nonbanks offering liquid liabilities
- Haircuts on assets function as (risk-based) capital requirement
- Substitutes for deposit insurance
- Untested: 160 countries have deposit insurance, none has PFAS

Note: Narrow banking is a limiting case where the haircuts are 100%

When depositors run, where do they go?

- Liabilities
  - Deposited in another bank
  - Leave the banking system
- Assets
  - Go with the deposits
  - Stay where they are
- If assets stay, government entity recycles liabilities
  - Federal Reserve
  - Federal Home Loan Banks (FHLBs)

FHLBs: Lender of *second*-to-last resort

- Lends against collateral to illiquid intermediaries
- Super-senior: precedes *all others* (including government entities)
- Reduces incentive of banks to manage risk
- Government-backed liabilities facilitate regulatory arbitrage

Principles for the Lender of Last Resort

- We need one, and *only* one
- Never lend to an insolvent intermediary
- Require good collateral with a haircut
- Charge a penalty rate to induce timely repayment

Reforming the FHLB system

- Eliminate super-seniority
- To ensure solvency, require supervisors to approve borrowing
- Require immediate disclosure

Reforming Resolution

- Measure capital accurately even in crisis
- Shift to mark-to-market accounting
- Timely resolution
  - Promotes risk management
  - Reduces public costs

Priorities for Reform

- Increase capital funding
- Strengthen liquidity requirements (make them capital sensitive)
- Eliminate the lender of second-to-last resort
- Impose timely resolution based on an accurate measure of capital

(Reforming deposit insurance is lower priority)

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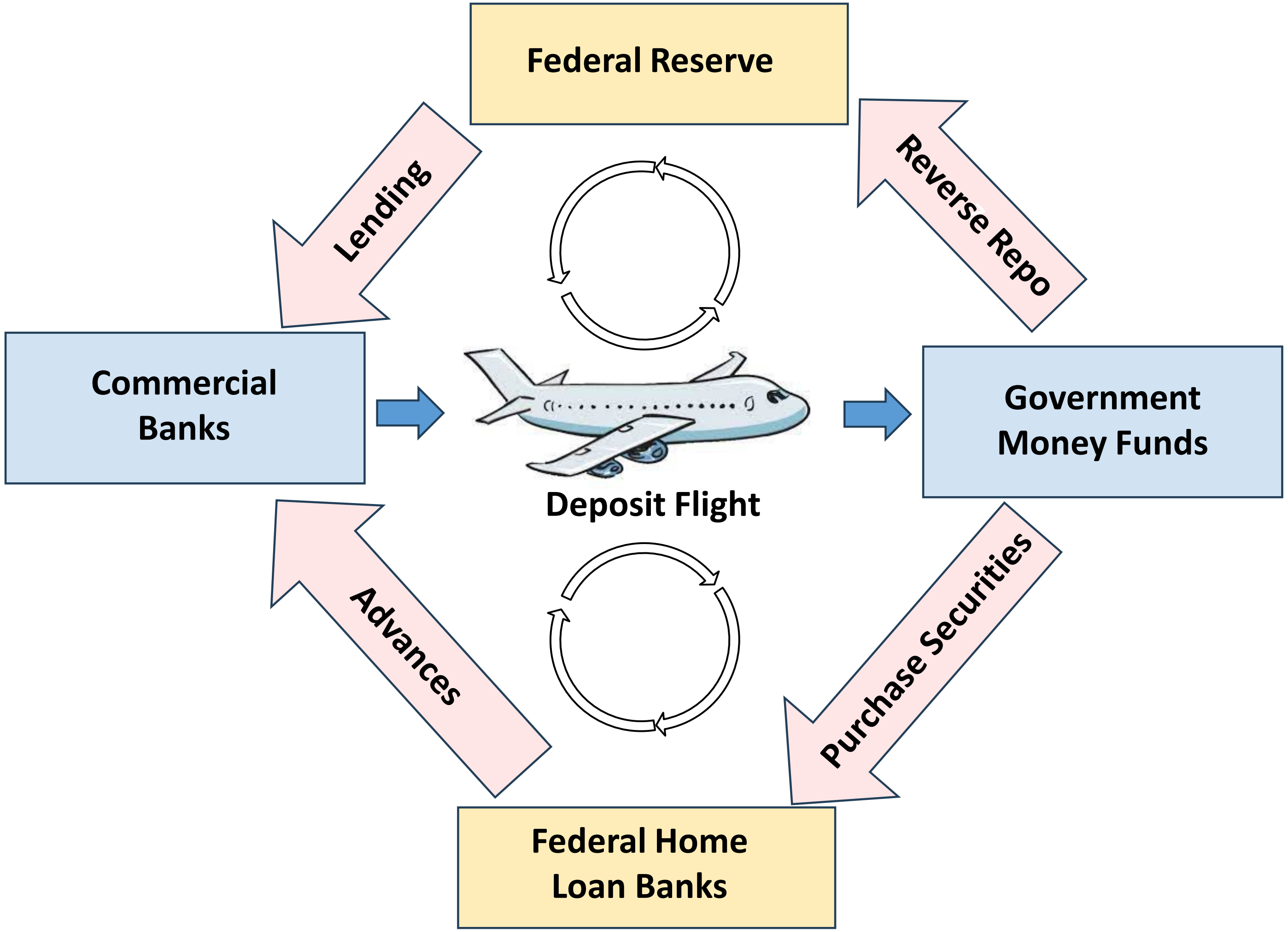
Fund recycling in the US banking system



<u>March 2023:</u>

- **Banking system assets +$203bn!**

- Deposits Flight → MMFs $307bn
- FHLB Advances → Banks $225bn
- Fed Lending → Banks $328bn
- MMF Purchases → FHLB securities $312bn
- MMF → Fed Reverse Repo $53bn

(Numbers are not exactly contemporaneous)