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MAKING BANKS SAFE

SAMUEL JOHNSON ACADEMIC CENTER

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www.moneyandbanking.com

Silicon Valley Bank shut down by US banking regulators

Tech-focused lender failed in eleventh-hour attempt to raise new capital after facing \$42bn in deposit outflows



With about \$209bn in assets, SVB has become the second-largest bank failure in US history © David Paul Morris/Bloomberg

FT Reporters MARCH 10 2023



Systemic in death but not in life

Credit Suisse Group AG [+ Add to myFT](#)

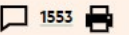
UBS agrees to buy Credit Suisse for more than \$2bn

Swiss authorities engineer a deal that will combine the country's two largest banks



The all-share deal between Switzerland's two biggest banks will be priced at a fraction of Credit Suisse's closing price on Friday © AFP via Getty Images

Arash Massoudi, Stephen Morris, James Fontanella-Khan, Laura Noonan and Owen Walker in London MARCH 19 2023



Resolution plan ignored

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

Even large uninsured depositors
do not monitor banks

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



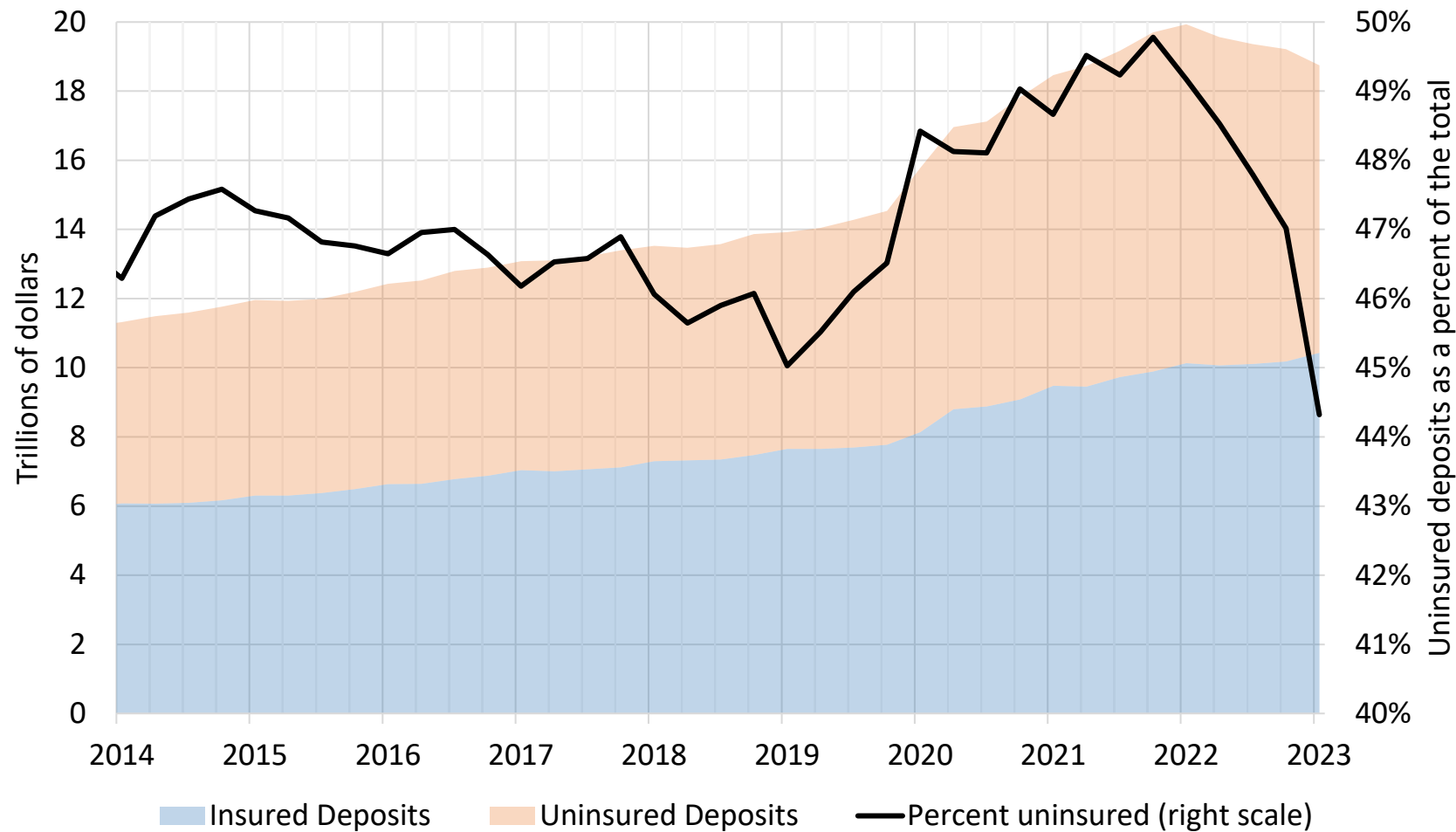
By [Jeanne Whalen](#)

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

}}}} RIPPLING

Providers of vital services
have uninsured deposits

Growth in uninsured deposits

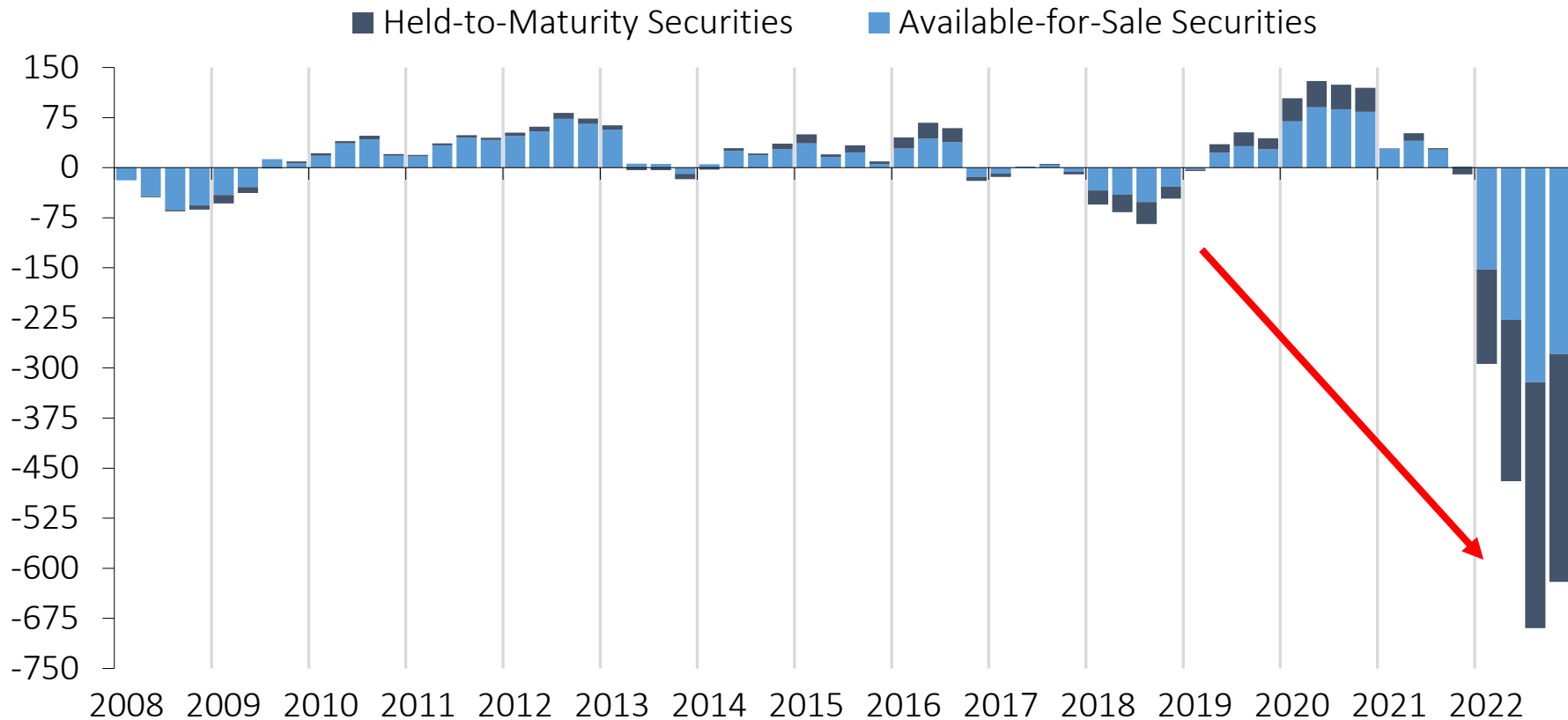


Grew in pandemic
 Declines starting 2022
 Plunges in Q1 2023

Source: FDIC Quarterly Banking Profile

Unrealized Gains on Investment Securities

Unrealized Gains (Losses) on Investment Securities



Example:

Fixed-rate 5-year bond

Interest rate:

0.75% → 4.5%

Fall in value is 17%!

Source: FDIC.

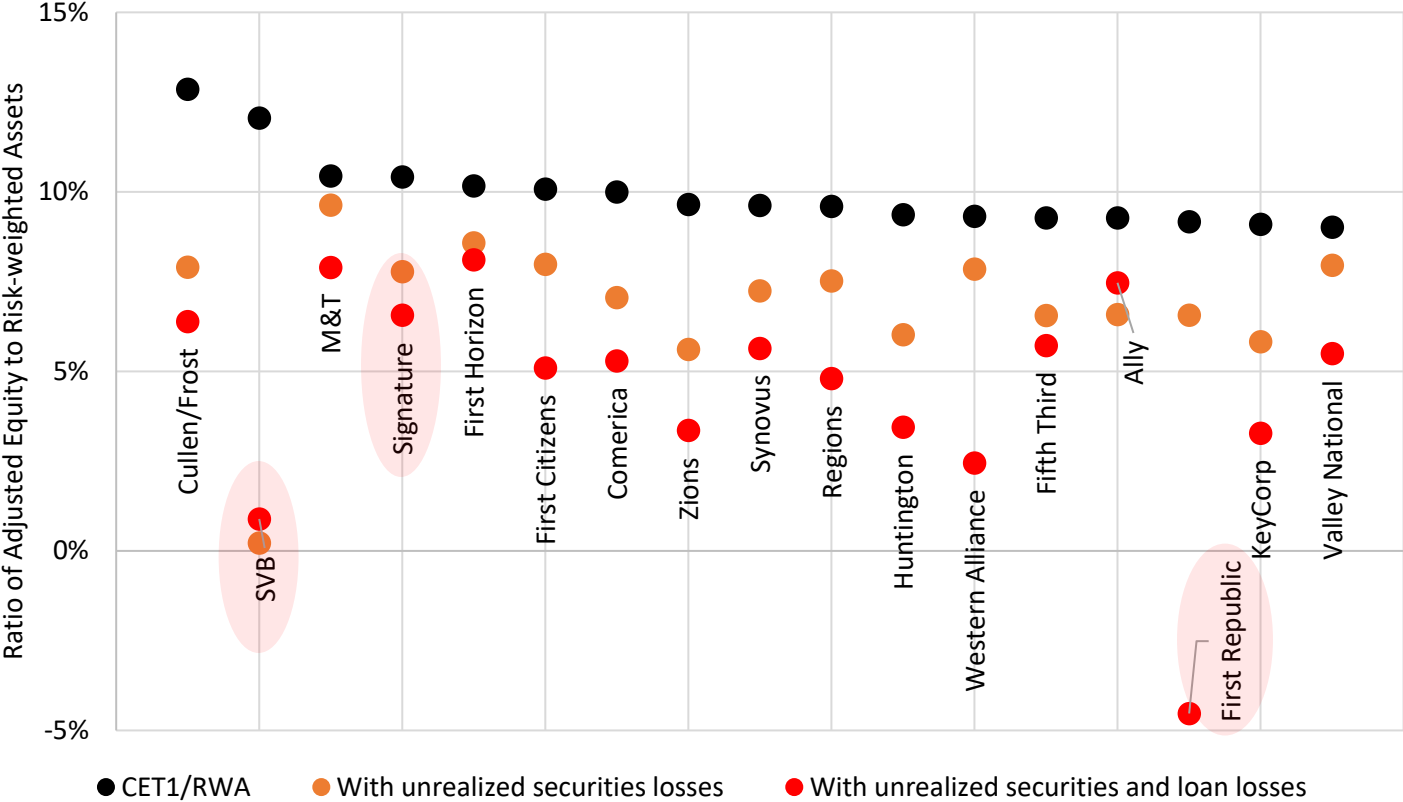
Unrealized capital losses

14 Feb 2023 quarterly briefing to the Federal Reserve Board

- As of Q3 2022 unrealized losses exceeded 50% of capital for 722 banks
- As of Q3 2022 31 banks had negative tangible equity

Supervisors knew the system was fragile

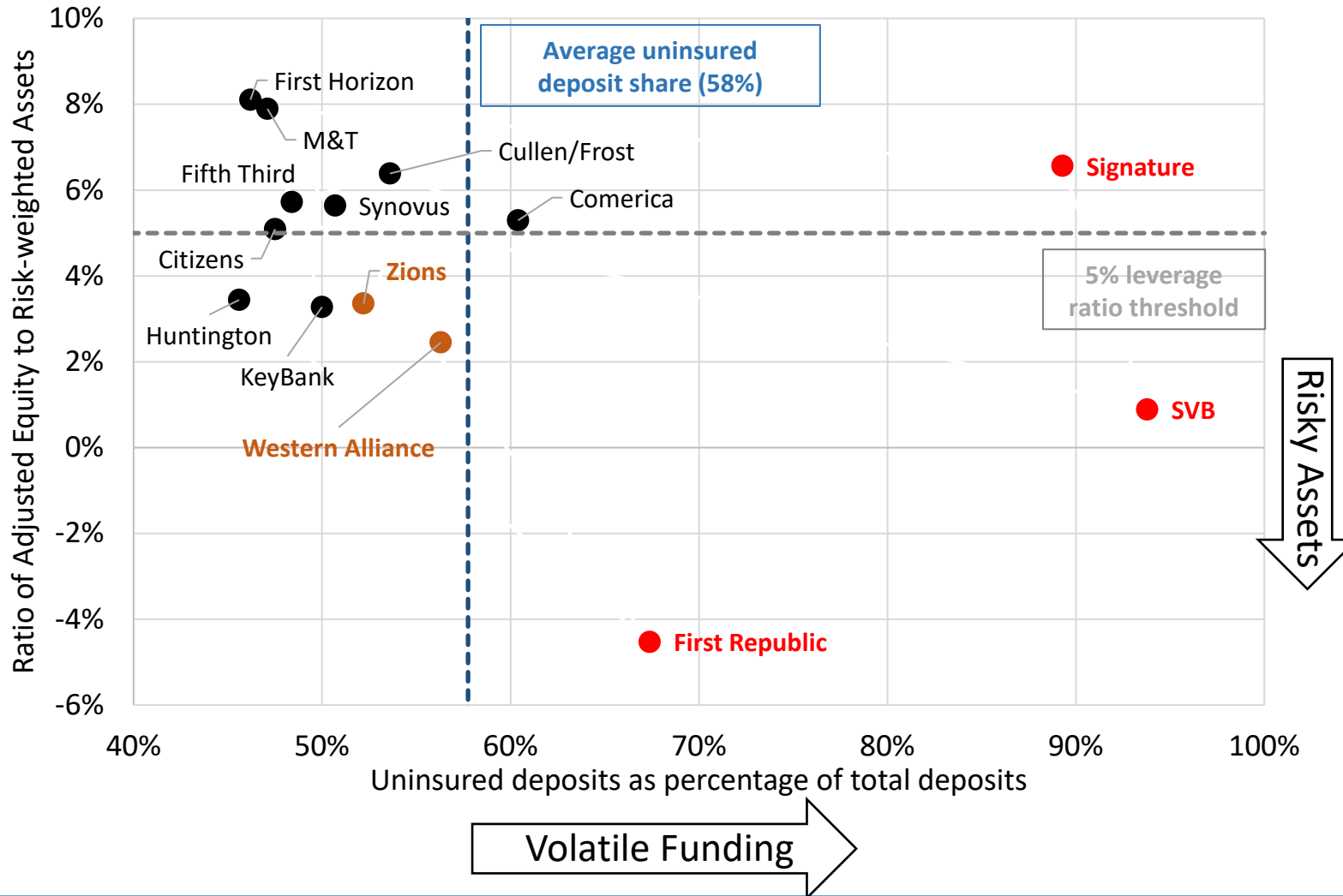
Impact of unrealized losses on mid-sized banks' capital ratios (percent of risk-weighted assets), Q4 2022



Unrealized losses pushed banks well-below the regulatory minimum.

Source: JPMorgan Chase Asset Management, courtesy of Michael Cembalest.

Fatal asset-liability mix



Banks can survive either

1. volatile funding, or
2. risky assets

but not both

Implications

- Risk management at institutions failed spectacularly
- Supervisors failed to detect obvious frailties at weakest banks
- Supervisors failed to sanction frailties they did identify
- Market discipline failed to punish fragile banks
- Accounting rules vastly inflated regulatory capital
- Deposits were not a hedge against large securities losses (wrong-way risk)
- Authorities treat banks as systemic in death but not in life

Outline of what remains

- Turmoil revealed systemic fragilities
- Regulatory and supervisory objectives and tools
- Deficiencies of the current system
- Principles of a robust regulatory framework
- Regulatory reform proposals
- Evaluating the proposals

Turmoil revealed systemic fragilities

- Discretionary supervisors have difficulty
 - Identifying interest rate & liquidity risk in a timely fashion
 - Enforcing standard remedies when risk is identified
 - Implementing timely, flexible and severe stress tests
 - Anticipating systemic implications of failures
- Authorities cannot credibly commit to
 - Enforce sanctions on identified frailties
 - Limit extent of deposit insurance
 - Limit scope of emergency lending
 - Implement resolution plans

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**Need a system that recognizes:
Weaknesses of supervision
Authorities' inability to commit**

What to do about regulation and supervision?

- Leave objectives unchanged
 - Robust payments system
 - Uninterrupted credit supply to healthy borrowers
 - Refine the tools
 - Balance sheet structure
 - Capital requirements
 - Liquidity requirements
 - Safety net
 - Lender of last resort
 - Deposit insurance
- } Both need to have a static and a dynamic/forward-looking component

Deficiencies of the current system

- Uninsured deposits are run prone
- Complexity thwarts enforcement and promotes gaming
- Changing preferences of regulators reduce credibility
- Measurement of capital is difficult and backward looking
- Accounting conventions reduce accuracy of asset valuations
- Inadequate regulation of nonbanks favors risk shifting
- Managerial compensation schemes encourage risk taking

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THESE ARE NOT NEW!

Principles of a robust regulatory framework

1. Rule-based

- Less likely to be subject to changing preferences
- More credible (if you can stick to them)
- Easier to identify violations and enforce remedies
- May be possible to apply to nonbanks (same activity, same risk, same regulation)

2. Simple and transparent

- Checklists for examiners (unavoidable)
- Promotes market discipline
- Anticipates gaming

Principles of a robust regulatory framework

1. Rule-based
2. Simple and transparent
3. Stringent preventative standards
 - Reduces risk of bailouts
 - Substitutes for weaknesses in supervision
 - Guards against uncertainties in valuations
4. Streamlined use of resources

Banks can fail without putting the system at risk!

Regulatory reform proposals

1. Strengthen existing capital and liquidity standards
2. Adjust or replace deposit insurance

1. Strengthen existing capital and liquidity standards

A. Raise capital requirements

(Increase steady-state buffers)

B. Require subordinated debt for all potentially systemic banks

(Enhance TLAC/MREL, create laddered debt w/ covenants that substitute for supervision)

C. Strengthen and simplify liquidity requirements

(Enhance the LCR as a substitute for the NSFR and create committed liquidity facility)

D. Modify financial accounting

(Shift to mark-to-market and stick with it)

E. Improve stress tests

(Multiple scenarios, stress what is most profitable, include nonbanks, link to managerial comp)

2. Adjust or replace deposit insurance

A. Eliminate brokered deposits (pure regulatory arbitrage)

Vanguard

Stephen, you could get FDIC coverage up to \$1.25 million for your individual account or \$2.5 million for your joint account.*



From my email on 23 May 2023

2. Adjust or replace deposit insurance

A. Eliminate brokered deposits

(pure regulatory arbitrage)

B. Refinements to the current system

- Targeted increase in caps for SMEs
- 100% deposit insurance for everyone

C. Replace with Pawnbroker for All Seasons (PFAS)

2. C. Pawnbroker for All Seasons (PFAS)

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

2. Adjust or replace deposit insurance

- A. Eliminate brokered deposits
(pure regulatory arbitrage)
- B. Refinements to the current system
 - Targeted increase in caps for SMEs
 - 100% deposit insurance for everyone
- C. Replace with Pawnbroker for All Seasons (PFAS)
- D. Narrow banks

2. D. Narrow banks

- Require 100% reserve backing for demandable liabilities
- Shifts credit supply out of the banking system
- Won't stop runs on nonbanks doing liquidity and credit transformation

Evaluating the proposals

- Do they meet the characteristics of a robust framework?
- Do they address the deficiencies?

	Strengthen existing standards					Adjust or replace deposit insurance				
	Higher Capital Req.	Require Sub Debt	Strengthen Liquidity Req.	Modify Accounting Standards	Improve Stress Tests	Eliminate brokered deposits	Targeted cap for SMEs	100% insurance for all	Pawnbroker for All Seasons (PFAS)	Narrow banks
Meets principles of a robust regulatory framework										
a. Rules based										
b. Simple/Transparent										
c. Tough standards										
d. Efficient										
Addresses deficiencies of the current system										
i. Uninsured deposits are prone to runs										
ii. Complexity thwarts effectiveness										
iii. Changing preferences reduce credibility										
iv. Measurement of capital is difficult										
v. Accounting rules reduce usefulness										
vi. Nonbank regulation favors risk shifting										


Note: **Green shading** implies the reform is consistent with the principle or addresses the deficiency.

Orange shading means that the proposed reform violates the principle or exacerbates the deficiency.

Priorities for reforming regulation and supervision

- Combination of

- Higher capital requirements
- Recalibrated liquidity requirements
(increasing run-off rates & extend window beyond 30 days)
- Improved stress tests
(include cross-model assessments)
- Modified accounting standards



Possible within
current
framework

- Consider Pawnbroker for All Seasons (PFAS)

Conclusion

- Turmoil revealed fragilities in the current system
- Essential that we agree and implement reforms
- Acknowledge weaknesses of supervision
- Recognize authorities' inability to commit
- Priorities for refinements to the existing system:
 - Higher capital (15% leverage ratio equivalent)
 - Higher liquidity (higher runoff rates with longer window)
 - Mark-to-market accounting (make regulatory capital realistic)
 - Transparent, flexible and severe stress tests (worse than historical experience)

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