Run on the Banks!
What Happens Next - 03.19.2023

Larry Bernstein:
Welcome to What Happens Next. My name is Larry Bernstein. What Happens Next is a podcast which covers economics, finance, politics, and science.

Today's special episode is entitled Run on the Banks!

Our guest today is Nicolas Véron who is a senior fellow at Bruegel Institute in Brussels and at the Peterson Institute in Washington, DC. His research focuses on the financial system and international banking regulatory matters. Today Nicolas will discuss the radical change in US policy for uninsured bank deposits.

There is much to cover so buckle up.

I make this podcast to learn, and I offer it free of charge. If you enjoy today's podcast, please subscribe from our website for weekly emails so that you can continue to enjoy this content. Let's begin with Nicolas's six-minute opening remarks.

Nicolas Véron:
I can set the scene with what happened and why, and what we should expect. So what happened is Silicon Valley Bank was closed on Friday March 10th and taken over by the FDIC. And the expectation was that the Federal Deposit Insurance Corporation would do it by the book. They would sell assets, they would reimburse insured depositors as early as Monday morning.

And then the rest of the uninsured deposits, probably a small haircut. And during the weekends, they said, oh, by the way, we're providing a lot of liquidity to the banking sector on very generous terms that bank term funding facility, but even more significant, we are actually going to guarantee deposits of Silicon Valley Bank and also of Signature Bank for that matter without any limit.

Silicon Valley Bank is a bank where there were very, very large depositors. I still haven't completely figured out if some of them were above a billion dollars. That's a lot of money. So that was the action. I'm leaving aside the term facility, but I'm focusing on the unlimited guarantee of deposits. So why did they do that? That's a difficult question to answer. There was a big article of the Financial Times early in the week, and to me it's difficult to understand the decision purely from a standpoint of financial stability and avoiding contagion. So I think a big driver of the decision was actually to rescue Silicon Valley.

You can call it a bailout if you want, but it's not a bailout of the bank or for that matter of the banking sector. It's really a bailout of Silicon Valley. So, when President Biden says, shareholders weren't bailed out, that's actually not true. It is true that shareholders of Silicon Valley Bank were not bailed out. That's absolutely true. But shareholders of a number of Silicon Valley startups and a lot of limited partners of a lot of Silicon Valley venture capital funds were bailed out. They would have lost their money. They didn't lose their money because of this extraordinary intervention of the federal authorities. And what they did is they invoked the systemic risk exemption, which was really to say, if we don't do that support action, the whole economy and financial system are going down the tubes.

I think the short answer to why they did it to rescue Silicon Valley. That may be a legitimate objective. But from a strict financial stability perspective, they didn't have to do that. Now, the implications, of course, are vast and unknown. It's in my view, a regime change in US banking, because I don't see how you can put the proverbial toothpaste back in the tube once you've said this is a bank that's not so big. Signature Bank is even smaller. The financial conditions before Friday, March the 10th were orderly. No particular turmoil. So, you have a medium size bank that fails in orderly conditions, you say, oh, systemic risk.

So that means you will do it all the time. I really cannot see how that decision can be reversed. And therefore, my contention is that there has been for 90 years this regime of limited deposit insurance, and I think it's over. So it's a massive change for the United States. Important to know this is specific to the United States because in other jurisdictions deposits are guaranteed without limit. I mean, that's not the letter of the law. It varies across jurisdictions, but there are very few cases in Denmark where you have the kind of market discipline that had existed in the US until now, where deposits were not essentially fully guaranteed by the government. We saw Cyprus, but the government was broke. There have been other examples like that in emerging markets, but in economies where the government is not broke, normally, the guarantee of full deposits was basically as good as the government credit itself.

The US was an exception. It has a lot to do with the fact that the US is much less of a bank-based economy, much more of a capital-markets-based economy, than other parts of the world. And I think one of the biggest questions is, will that be reversed? That decision, will the US become more bank based, less capital markets based? So my view is there are very profound implications. We're at the beginning of a learning curve. That's a big deal.

Larry Bernstein:
Do you think adults could disagree about the state of the financial system, namely that you think the system is robust and could handle financial runs while others might think that it is unstable and could not? And how was the FED unaware that Silicon Valley Bank had huge losses on its investment portfolio?

Nicolas Véron:
We'll know more as the Fed has commissioned the forensic analysis of its Silicon Valley Bank supervisory failure. We can discuss the exact drivers; it's not all down to the relaxation of rules under the Trump Administration, because even under lax rules, this was a bank that was supervised by the Fed and the Fed had to make sure it had a viable business model. I'm all for blaming the Trump administration for exempting Silicon Valley Bank, and the likes from a number of ratios and enhanced reporting, prudential regulation or whatever it's called, but that doesn't exonerate the Fed from its supervisory failure.

Larry Bernstein:
Silicon Valley Bank had two unique attributes to its balance sheet. On the asset side it had an enormous position in long-dated Agency and Treasury bonds that it did not hedge the interest rate risk and lost substantial sums when interest rates went up, and second on the liability side it had mammoth deposits from very few accounts, and this was fast money that could leave the bank on a moment's notice. So, funding risky long-dated assets with overnight deposits seems like lunacy. And I am not sure you can blame the Trump Administration because the losses on the portfolio only happened recently in the past year during the Biden Administration when the Fed started raising interest rates.

Nicolas Véron:
The Fed looks bad. Let's make it clear this is a supervisor failure. The Fed didn't do what it was supposed to do. No way to sugarcoat it.

Larry Bernstein:
Next topic is why did the Fed/Treasury/FDIC decide to protect all the uninsured creditors of Silicon Valley Bank. As you said, the risk of system wide contagion did not seem catastrophic. You can always guarantee deposits of the other banks after the first bank failure that had losses on deposits to prevent future moral hazard. Why do you think Silicon Valley is considered so vulnerable and required financial support in this way, and do you think that this may be related to Silicon Valley's political contributions to the Democrats?

Nicolas Véron:
I didn't say Silicon Valley used its power. I think that's a plausible assumption, but that's not what I said.

There are people who think that Silicon Valley is super important for the nation and cannot be allowed to fail because it's a national treasure. The national security community, a lot of Silicon Valley startups do business with the Pentagon, with the intelligence community. You could imagine political motivations to rescue Silicon Valleys that don't boil down to political power, lobbying, political influence, donations.

Larry Bernstein:
The Silicon Valley greater community had in aggregate $200 billion of deposits with Silicon Valley Bank. The chatter was that these uninsured deposits would get back at least 80 cents on the dollar.

The FED could have said we're going to give you 50 cents of cash right now, and more depending on the proceeds after we liquidate the bank. The total losses we're talking about here are $20 to $40 billion, which is peanuts. This is the change in the equity market value of Amazon stock every hour. Why did we feel the need to protect the wealthiest Americans from any losses after they made an error in financial judgment?

Nicolas Véron:
And also non-Americans, which is a political point of contention. I don't disagree with any of this. I just don't want to jump to conclusions. Now, the counter argument to that you said adults can disagree. The counter argument to that is the corporate deposit run was much faster than anybody expected. $46 billion or whatever it was in less than 24 hours. We discovered something new that we didn't know, which is that this is more powerful, faster, larger, scarier than any of us believed. It's a new era. You can move money with a click on your smartphone, new technology. None of that had been anticipated. It's not your grandmother's bank run. And therefore, the old playbook didn't apply.

Larry Bernstein:
In 2009, a relatively junior finance minister in the Irish government announced that Ireland would fully guarantee all the deposits of the Irish banking system. Within minutes all the deposits started leaving the other major European banks and headed to Ireland. So we have seen that before. And as part of Dodd-Frank, we had this dual class banking system, the largest systemically important banks have all of their deposits fully insured, but for the mid-sized banks, think Silicon Valley Bank, their big deposits are not. So, there is no reason why you should hold your deposit at Silicon Valley Bank when you can hold them at JP Morgan and be risk-free. Maybe you earn less interest and get inferior services. But my God, you can't lose your money and access to cash, for what?

Nicolas Véron:
That's exactly the argument that can and has been made to justify the invocation of the systemic risk exemption, which is the system was less stable than we thought it was. If we hadn't involved that exemption, we would have had a massive run from all the regionals and maybe also community banks. And that would have been unmanageable; we would have had shotgun

marriages and things like that. The Fed would have had to provide generous liquidity the way it did anyway no matter what. The playbook during the weekend should have included the announcement of something like the bank term funding program, maybe a bit less generous.

We can debate that. I'm unconvinced it had to include unlimited deposit guarantee. I think it's the fact that we would have seen more deposits moving and running. We would have seen probably a number of regional banks more than just First Republic being the target of shotgun acquisitions. So it would have been more bumpy. It would have been less orderly than what we observed in the last few days. I think that's a fact. My contention is it would have been manageable. The US banking system would have been transformed by the episode. But not as fundamentally as it has been transformed by the abandonment of limited deposit guarantees. That would be my way of looking at it.

Larry Bernstein:
Walter Bagheot said in the mid-19th Century that it is the role of the Central Bank to provide liquidity in a banking crisis by providing loans against good collateral at a discount to market value with a penalty interest rate. And here the Fed is offering to lend money against collateral not at a discount but at original cost and at a low interest rate for term with no mark-to-market provision. This runs against all the Bagheot rules of central banking.

Nicolas Véron:
Yes and no. I mean, there have been other examples of poorly collateralized emergency liquidity assistance. Cyprus was a notorious example. There have been examples of favorable lending operations of the ECB. My impression is that the bank term funding facility announced on March 12th was particularly generous, maybe too generous. There is a reasonable debate to be had, but I view it as less fundamental change as the unlimited deposit guarantee.

Larry Bernstein:
I know the Fed did not say we are guaranteeing all uninsured deposits forever but who would not think that?

Nicolas Véron:
I think it'll be basically impossible to reverse in practice. So I think that's why I've called it a regime change.

Larry Bernstein:
Who made the decision to abandon the playbook and insure all the deposits? Was this like that junior treasury official in Ireland in 2009 who nearly bankrupted the country?

Nicolas Véron:
It's really clear that the decision involved the political level and probably all the way to the White House. At this point, we don't know exactly how that decision was made, and what arguments were weighed and who advocated what position. I would imagine the FDIC didn't advocate the plan that was adopted based on their historical stance.

Larry Bernstein:
Let's go back to your metaphor about putting the toothpaste back in the tube. Congress may not want to guarantee all the deposits going forward, will they choose to prevent Treasury from guaranteeing deposits even in a systemic crisis to convince the market to go back to the previous uninsured deposit regime?

Nicolas Véron:
I suspect you're right. I'm not sure how explicit it has to be. If you want to reverse it, probably you need a number of people to fall on their swords, because that means you're saying the decisions that was made was a wrong call. And that has consequences. I don't know whether it's possible to do that. I don't think you can say oops, we made the wrong call. But everything goes on as before. What I hear in Congress is not really we need to defend market discipline. It's more like some banks have been told it has its guarantee and others haven't, and that's unfair, which is not exactly the same message.

The likely direction of policy will be effectively everybody's guaranteed. But how that will be formulated, I don't know. And if you think the situation is stable, you could leave it at that. The interesting thing is, what happened when another bank fails and it depends which bank it is. Right? So can you invoke the systemic risk exception if it's a very tiny, small town bank in the middle of nowhere? You tell me. I mean, I think this perception that the limited deposit insurance now is a complete fiction is now a very reasonable way to look at things. I think it'll become entrenched, but I'm not sure you need the legislation for that.

Larry Bernstein:
I suspect that congress will demand that if all deposits are insured that they will demand increasing regulation and that banks reduce the risk of their balance sheets. We are not going to allow banks to take risk and earn a big return for their shareholders if the US Treasury takes the downside and equity holders get the upside. I also do not think that banks will be allowed to take interest rate risk; they can only take some credit risk within strict limits.

Nicolas Véron:
I'm not sure how could you can say the banks don't hold interest rate risk, right? You want them to hold high quality liquid assets. That's part of the framework, actually.

Larry Bernstein:
They would be required to hedge their interest rate risk using derivatives.

Nicolas Véron:
Yeah. Is it really possible to hedge an entire bank's balance sheet? I mean, in theory, yes. But in practice, I don't know.

Larry Bernstein:
As a professional fixed income specialist, I could have managed Silicon Valley Bank's interest rate exposure and it would not have meaningfully infringed on my podcast work.

Going back to your opening remarks and your comment that Europe is a banking led system and the US is a capital markets funded system. And you suggested that America will be moving in the direction of funding more with banks and less with the capital markets. I want to push back on this idea. I think banks will face new onerous capital and regulatory requirements that will make it even more difficult for banks to invest in long-term risky assets. The capital markets will be more competitive to purchase assets. This means that there with ever greater securitization of loans that are sold to non-bank institutions.

Nicolas Véron:
Maybe, we'll see. My model for the decision is this was a rescue of Silicon Valley as too important to fail. You mentioned political donations, I mentioned national security, maybe it's something different. But the point was we don't want a gigantic cycle in Silicon Valley. We're becoming a bit Chinese, right? I mean, that's exactly what the Chinese government did in 2015 about its equity markets. We haven't done that for equity markets. But basically, when President Biden commented on the decision by saying, this is how capitalism works, <laugh>, my reaction was, no, actually it isn't. Capitalism is people taking risks, and that includes venture capitalists and very wealthy individuals and startups. And if this grew up by leaving too much money in a single bank account, which is not insured, they learn from their mistakes. So, I think there is a profound question, to which I don't have the answer, which is, what does this action reveal about where the US is right now, and what also fundamentals of the US system, and certainly looked at from outside of the US? This is a question that jumps out of the situation we're observing.

Larry Bernstein:
I am not sure Biden's views reflect his administration, the congress, or the country. I think it might be a simple message to remain calm and not much else.

Nicolas Véron:
Yeah, he had to say that this is normal. Of course we know it's not a full story because losses will be borne by the banking system through special assessments of the FDIC, and that cost, one way

or another will be passed onto the economy. So, strictly speaking, there is no taxpayers' money at stake unless the government has to rescue the FDIC. But we are not there at this point. His words were broadly correct, but that's not the economic reality of what has been decided. And I suspect nobody misses that point.

Larry Bernstein:
The largest banks in the United States announced on Thursday March 17th that they were making $30 billion of deposits in First Republic Bank.

When the stock was halted, my expectation was those one or more banks would put in equity in First Republic. Instead, the banking group invested in four-month senior debt claims which was not exactly resounding support to improve the quality of the capital structure of the bank. Who thought this would be a meaningful solution to the bank run or that would improve the capital structure?

Nicolas Véron:
I have no idea. I'm at the loss. I don't get it.

Larry Bernstein:
Did the banks meet with Treasury and did the government ask them to put in equity and did they counter with debt that would be guaranteed effectively by the US Government?

Nicolas Véron:
I've never worked in the US government. I've worked for two and a half years in the French government a very, very long time ago. But that's my government experience. What I learned is from the inside governing looks much messier and more chaotic than from the outside. And that's much more the case when you're in a situation of crisis or turmoil or volatility or uncertainty or whatever you call it, than on a day-to-day basis. When you're in government, it feels like crisis every day. <laugh> at a senior enough level of government at least. So I could easily imagine that inner workings of this decision making process both during the weekend leading to the full deposit guarantee, and during the week leading to this transaction, assuming as you do and as I do tools, that there was some government input into the transaction. Probably there was a lot of chaotic back and forth. Maybe one day we'll learn the details, maybe not.

Larry Bernstein:
We abandoned our 90-year history that FDR initiated of insuring deposits up to a limit. That regime is over. What does the new, new deal look like and is it meaningfully different?

Nicolas Véron:
So my gut tells me it's important. I cannot imagine it with being without consequence. The US has had this limited deposit guarantee not far from a century. And basically nobody else has had that. There are jurisdictions, which have introduced limited deposit guarantee in the statute book, but they have never really implemented in practice. And so the Eurozone is a good example of that. Japan is a good example of that. The US was a place where the limited deposit guarantee existed on paper, but actually was implemented that way with variations. And we know that in 2008, there was a suspension of most of it.

But you look at the practice of the FDIC over the decade, and there has been a drumbeat of small banks being resolved with uninsured depositors losing some money. Generally, not a lot, but some of the money. And that meant it was not just a method, it was a reality. So, let's assume that's over. What does that mean? It'll mean the US becoming a bit more like the other jurisdictions, more bank based, less capital market based. But maybe I'm wrong about this. It's a giant experiment. We don't know. I think it's probably going to be transformational. It means less market disciplines. That's a fact. I think it's undeniable.

Larry Bernstein:
Let's examine the European experience. Ireland guaranteed its country's bank deposits and it almost bankrupted the sovereign.

Nicolas Véron:
That's right. It took two years for people to realize it, but to its credit, the IMF understood it very early.

Larry Bernstein:
Iceland recognized immediately that it could not guarantee its bank deposits because it could not afford it. Switzerland's banks are too big relative to its size as well.

Nicolas Véron:
In most countries there is no such thing as uninsured deposits. The Eurozone has gone through a gigantic crisis. Greece has defaulted. Cyprus was basically broke. A number of countries have had to go to the IMF. We had capital controls, we had a number of bank failures. Has a single depositor lost money outside of Cyprus? I'm not aware of that. So yes, they did in Cyprus, but that was basically a sovereign event.

Larry Bernstein:
What are you optimistic about as it relates to the US banking system?

Nicolas Véron:
I hope that we will see a sense of accountability into supervisory framework. I think the Fed has convinced us that yes, it's screwed up, but it's able to learn from the lessons.

I think we're going to see a number of good US institutions in action. There's a lot of posturing in Congress, but congressional hearings can also be very useful. I hope we'll see genuine policy debate, hopefully resulting in better policies.

Larry Bernstein:
As a final follow-up question. The systemic banks must capitalize their losses on the held to maturity investments and the mid-size banks do not. I assume that will change. I suspect that capital requirements in banks will increase, and that mark-to-market accounting will be required even for hard to value assets.

Nicolas Véron:
In a way it's an impossible equation, right? I mean, you want to mark bank balance sheets to market, but you don't want to mark their regulatory requirements to market because that would be insanely procyclical. So, there's no really comprehensive solution to that challenge, and you have to find the least bad compromise. Some of it has to be supervision. We need discretion in the hands of the supervisor, because I don't think you can encapsulate a perfect formula, a perfect sense of mechanical incentives that will keep banks sound. So the banking sector is neither public nor private. It'll remain that way. It's as old as finance, and finance is several thousand years old. I don't expect these contradictions to be fully resolved because I don't think that's possible. But maybe we can avoid the same mistakes being made in the same way again.

Larry Bernstein:
Thanks to Nicolas Véron for joining us today.

If you missed this week's show Parent's Paying for the Party! Check it out. Our guest was Laura Hamilton who is a sociologist at UC Merced and the author of multiple books including Broke, Who is Paying for the Party, and Parenting by Degree. Laura is interested in how socio-economic status influences who goes to college, how students perform, their job prospects, and their marriage market.

Last week's show was on the Opioid Crisis.

Our speaker was Gerald Posner who wrote the book Pharma: Greed, Lies and the Poisoning of America. Gerald spoke about the conflict that pharmaceutical firms face with their desire for advancing public health and maximizing profits. We will also discuss the advancement of pain management care, fears of addiction, and the success and failures of OxyContin.

I would now like to make a plug for next week's podcast with Dan Willingham who is a professor of cognitive psychology at the University of Virginia. He is the author of the new book entitled Outsmart Your Brain: Why Learning is Hard and How You Can Make It Easy.
You can find our previous episodes and transcripts on our website whathappensnextin6minutes.com.

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I would like to thank our audience for your continued engagement with these important issues, good-bye.