Deposit insurance – Demon or rescuer: How to deal with the risk of bank runs?

Part 1: The rescuer-view

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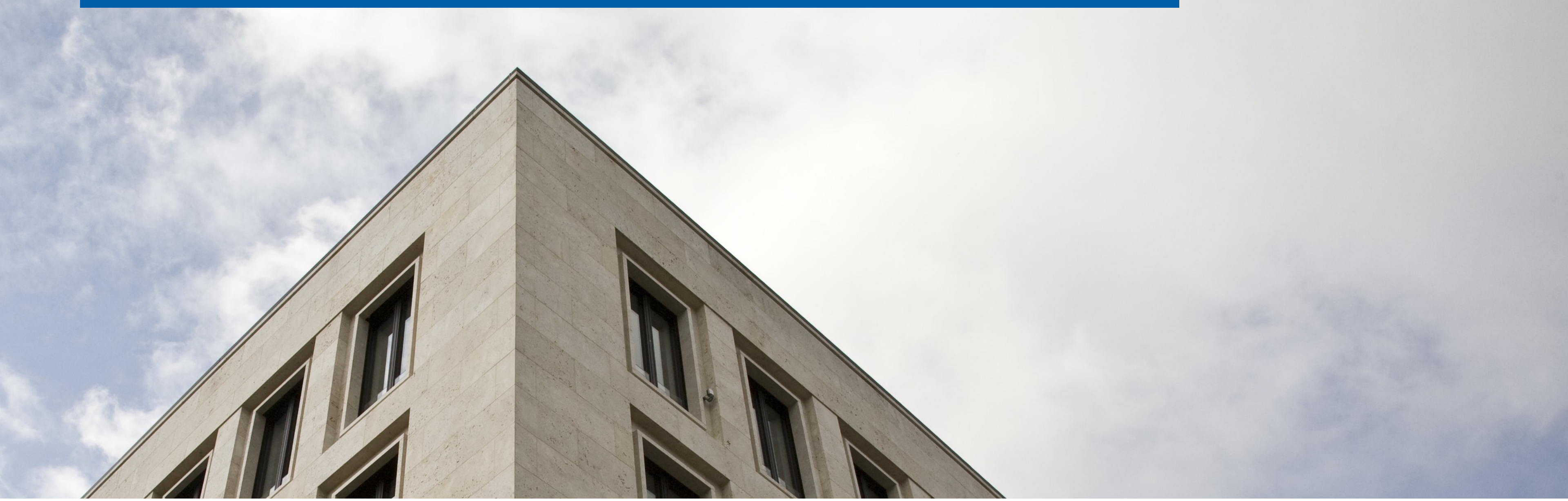

Two opposing views about market discipline in banking

- „US view“
  - Moral hazard in banking is kept under control by the threat of bank runs. Bank fragility (→leverage, liquidity provision) is key for market discipline to be effectiv;e Diamond/Rajan, JPE 2001.

- „EU view“
  - Moral hazard in banking is kept under control by the threat of bailing-in designated bank creditors, in an orchestrated resolution process (→ bank exit via SRM)

- Views differ
  - how to value bank runs (Necessary tool for market discipline, vs. Barrier to orderly resolution)
  - How to value deposit insurance (Necessary evil vs. Necessary prerequisite)

Two opposing views about market discipline in banking

- Why two views?
  - My speculation: because of centralized (US) versus decentralized (EU) government structure.
  - Ability to act if there were contagion, in case of a single bank run, is trusted more in US, than in EU.
  - Therefore, the „bank run is value destroying“-view is consistent with the market discipline-philosophy of the BRRD.

- Consequences („costs“) of a bank run
  - Foremost: SRM is side-lined, decisions are taken by treasury and central bank, not resolution agency.
  - Living will not applied,
  - Bail-in not used for early recap, but for loss allocation only.
  - Last not least: ex-post insurance of all (sight) deposits.

SVB and CS: Why so much turbulence and fear around a comparably manageable problem: the exit of a poorly managed firm?

- Our diagnosis
  - There were acute bank runs in both cases, SVB and CS
  - The runs were perceived as posing the risk of a spillover to other financial institutions
  - Aka, risk of a systemic event

- Our recommendation for the EU
  - All demandable (sight) deposits of banks are insured – retail and corporate, small and large → no run.
  - Insurance is priced as usual (fair premium plus margin call) → no free lunch.
  - Minimum loss absorbing capital (equity plus bail-in debt) is proportional to volume of sight deposits → containing moral hazard

European model of market discipline…

- Bail-in is for real, see CS case,
- Living and orderly resolutioin not functional under systemic risk threat.

- Therefore, we suggest to complete BRRD model (capstone regulation)
  - Banning runs
  - Enabling bail-in and SRM to work according to plan.

To conclude

- European model is the only model we know that allows to have market discipline when there are large banks in small countries, with no common fiscal backstop.

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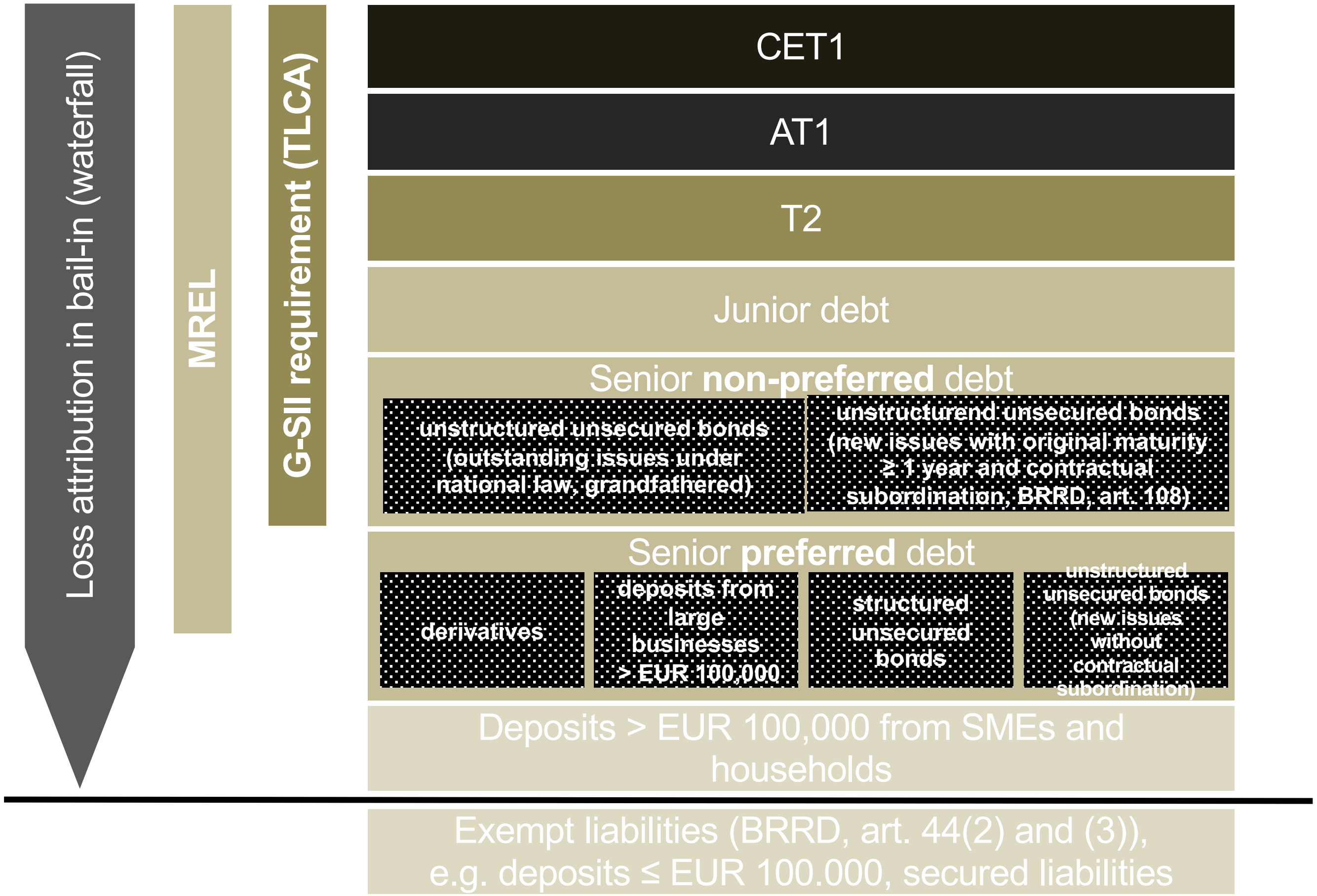
Thank you for listening – now to the other side in the debate…

Additional slide 1
Minimum and maximum requirements for bail-in



Additional slide 2
Summary recommendations: Three “no”s

1.	(No run)	Extending DI coverage to all sight deposits
2.	(No subsidy)	Pricing DI to reflect real cost of liquidity
3.	(No moral hazard)	Conditioning loss absorbing capital on bank risk-taking behavior (aka RWA)

Additional slide 3
2022/23: Discussion about HMT vs. AFS & unrealized losses

March 6	FDIC: ”Unrealized losses … reduced …banks’ equity capital”.
SVB	+ 2d: $1.8 bn realized loss from securities sales
	+ 6d: **FDIC, Treasury** and FED guarantee all deposits
	+ 6d: **FED** provides Bank Term Funding (“ELA”) for up to 1 yr.
	+ 6d: FDIC takes SVB in resolution
CS	+ 9d: “No fresh equity capital for CS” (Saudi)
	+ 10d: Liquidity assistance to CS 50 bn by SNB
	+ 12d: Liquidity assistance LOC of 100 bn, federally backed
SNB	
	+ 12d: **BoC, BoE, BoJ, ECB, FED and SNB** → US$ swap line
	+ 12d: UBS takes over CS, backed by govt. guarantee