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

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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 \textit{and} runnable liabilities
- Post-crisis capital and liquidity reforms are insufficient
- Do we need to alter
  - Deposit insurance
  - Lender of last resort
  - Resolution
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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March 2023:

- 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)