



BAYES
BUSINESS SCHOOL
CITY UNIVERSITY OF LONDON

(formerly Cass)

Financial Resilience After SVB: Reforming Deposit Insurance & the Lender of Last Resort

Discussion

Vasso Ioannidou
(Bayes Business School & CEPR)

[[bayes.city.ac.uk](https://www.bayes.city.ac.uk)]

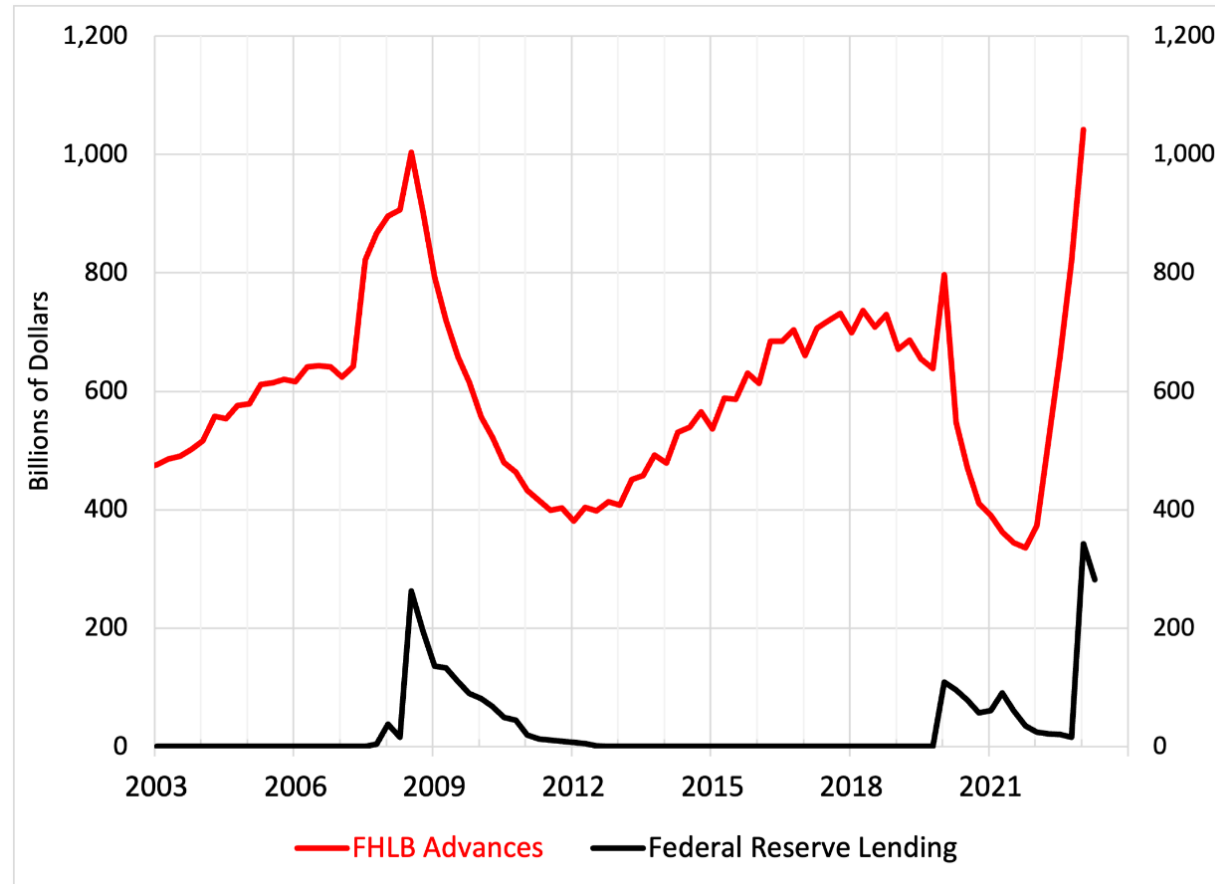


FHLB's: lender of *second-to-last* resort

- The distortions created by the Federal Home Loan Bank's (FHLB's) subsidized lending to failing institutions are **not to be underestimated**
- FHLB's lending to its members in recent years **crucially undermines**:
 - Federal reserve system in its **lender of last resort** function
 - Discount window is not supposed to be a permanent support for unsound banks (e.g., loans to troubled banks limited to ≤ 60 days in any 120 day period, unless authorized by FDIC & institution's primary regulator)
 - Bank **supervision** & **deposit insurance** (e.g., deposit insurance limits, risk-based deposit insurance premia)
- Fully agree with Steve's **guiding principles** for lender of last resort function and **proposed reforms** for FHLB (which take the political economy into account)
- This is very important! (stylized facts in next 2 slides)

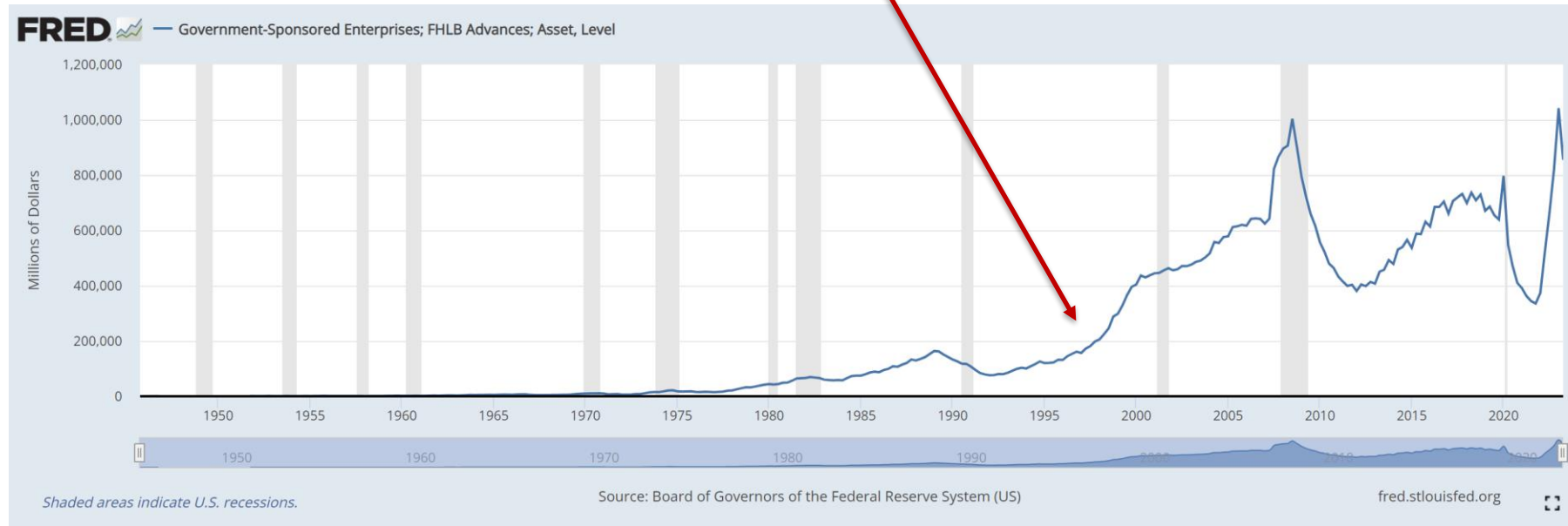


FHLB Advances to FHLB Members dwarf Federal Reserve Lending to Banks



This was not always the case!

- FHLB lending increased markedly since the mid-1990s as a result of membership mobilization and the demise of thrift institutions (Frame, 2016; White & Frame, 2023)



- [Frame \(2016\)](#): “Today, despite its name, size, and principal activities, the FHLB System **actually provides little targeted support to the housing sector**. Instead, recent research highlights the role of the FHLB System as a provider of subsidized general liquidity to its members, including the very largest commercial banking organizations.”

Options for reforming deposit Insurance

- **A. Maintain limited coverage well below 100%**
(per person, not per bank; FDIC deposit registry)
- **B. Targeted increase of coverage for SMEs**
(allow firms to meet payroll and other essential expenses)
- **C. 100% deposit coverage**
(increases burden on regulators and supervisors, as well as cost to public)
- **D. Pawnbroker of all seasons (PFAS)**
(substitutes for deposit insurance by broadening LOLR practices)

Options for reforming deposit Insurance

- **A. Maintain limited coverage well below 100%**
(per person, not per bank; FDIC deposit registry)
- **B. Targeted increase of coverage for SMEs**
(allow firms to meet payroll and other essential expenses)
- **C. 100% deposit coverage**
(increases burden on regulators and supervisors, as well as cost to public)
- **D. Pawnbroker of all seasons (PFAS)**
(substitutes for deposit insurance by broadening LOLR practices)

Yes, registry a clear plus (overdue in the era of big data & AI)

Maybe, under certain conditions

No! (& I would add moral hazard to Steve's mix)

Probably (best) not



Option B: targeted increase of coverage for SMEs

- **Sympathetic to** the principle of having a financial architecture that provides a safe space for SMEs to perform payroll activities and day-to-day operations (transaction accounts)
 - **Not** sympathetic to creating a space for SMEs to “park” large cash balances without any consideration to the fundamentals of the banks they go to. It will not end well.
- Yes, under **strict conditions**:
 - FDIC registry, closing possibilities for gaming the system with brokering
 - Strict eligibility criteria for SMEs, calibrate coverage threshold based on firm-specific data. **Need better data!**
 - Increase DIF size
 - Increase risk-sensitivity of DI premia (idiosyncratic & systematic)
- Still, if history is any predictor of the future, the risk of gaming and increased moral hazard is real and should not be underestimated. So, I **remain skeptical** with Option B.



Option D: Pawnbroker of all seasons (PFAS)

- Substitutes for deposit insurance by broadening role LOLR practices, where LOLR guarantees the liquidity of short-term liabilities at all times
- Probably **not** a good idea!
 - Likely to only exacerbate external (political) pressures on central banks
 - These pressures are real:
 - Financial (in)dependence ([Goncharov, Ioannidou, Schmalz, 2023](#))
 - Personal (in)dependence ([Ioannidou, Kokas, Lambert, Michaelides, 2023](#); Summary on [Vox](#))
 - Tension between financial stability & monetary stability is real
 - Lines between illiquid vs. insolvent institutions **often blur** in practice
 - **Time-inconsistency** maybe a bigger problem when you are the one to be blamed
 - Applies both for monetary policy & financial stability mandates
 - No “Chinese walls” between the two mandates ([Ioannidou, 2005, Table 4](#); [Peek, Rosengren, Tootell, 1999](#))

In an era of growing (global) populism these dangers are real

- See an FT article from this morning (Nov 17, 2023) with clear warnings

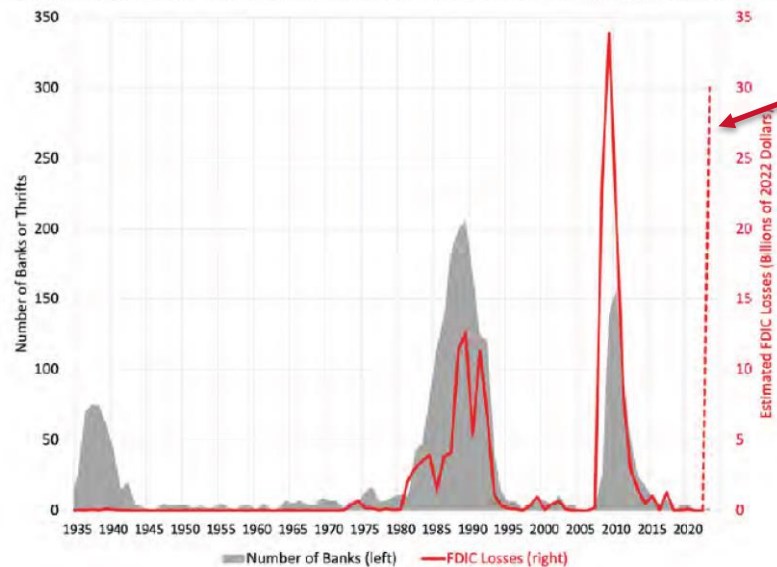


A scary alternative scenario is that Donald Trump is elected, that he puts a lackey at the Fed, who monetises some of the debt, and we get high inflation. We know that high unexpected inflation does great things for the debt ratio.

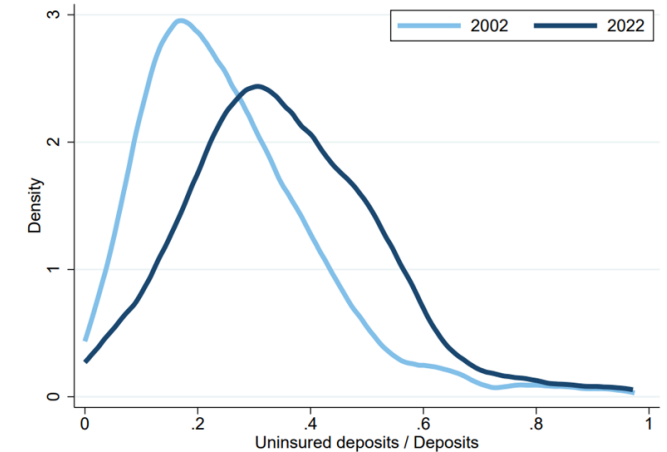
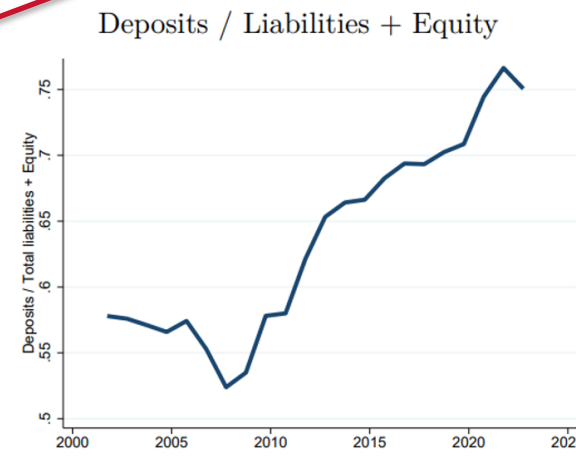
What was different in March 2023?

- The March 2023 turmoil and the failure of a handful of mid-size banks have wiped out DIF
- Why? Unusually, high volumes of uninsured deposits & rapid growth (i.e., out of steady-state)

Figure 1: Bank Failures and DIF Losses (Billions of 2022 U.S. Dollars), Annually, 1934-2023E



Source: Cecchetti et al. (2023)



Source: [Vuillemeys \(2023\)](#)

- This is not due to a sudden increase in SMEs' payroll and operational expenses. Regardless of whether it is due to QE or structural changes in the economy, the answer is **not**: "lets insure it all" to stop runs

What have we learned from March 2023?

- Investors “see through” accounting and respond to real-time changes in market values → **regulatory capital & liquidity** metrics should reflect this (better)
- While there may not be much of an appetite to revise capital requirements, it is important not to underestimate how capital may **endogenously increase** if we reduce exogenous “distortions”
 - E.g., tax advantage of debt ([Schepens, 2016](#)), FHLB, implicit guarantees
 - Similar for liquidity (see, e.g., [Carletti, De Marco, Ioannidou, and Sette, 2022](#))
- Still, there is clear role for regulation (private ≠ social)
- Need better data on deposits (i.e., deposit registry)
 - Both for proper policy evaluations & bank risk-management purposes



Thank you!



Table 4
The effect of monetary policy on the probability of getting a Formal Action

| Category | Regressors | (1) | (2) | (3) | (4) | (5) |
|---------------------|------------------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|
| Capital adequacy | <i>Tier1/AvA</i> | -0.0727*** (0.011) | -0.0824*** (0.0099) | -0.0820*** (0.0099) | -0.0776*** (0.0103) | -0.1011*** (0.0084) |
| | $\Delta(Tier1/AvA)_{t,t-4}$ | -0.0124*** (0.005) | -0.0119*** (0.0051) | -0.0119*** (0.0051) | -0.0122*** (0.0049) | -0.0113*** (0.0021) |
| | <i>Tier1/RWA</i> | 0.0001 (0.0034) | -0.0031 (0.0023) | 0.0031 (0.0023) | 0.0020 (0.0028) | 0.0035 (0.0022) |
| | <i>REL/L</i> | 0.0081*** (0.0020) | 0.0095*** (0.0020) | 0.0096*** (0.0020) | 0.0094*** (0.0020) | 0.0086*** (0.0019) |
| Asset quality | <i>C&I/L</i> | 0.0037*** (0.0012) | 0.0042*** (0.0012) | 0.0042*** (0.0012) | 0.0039*** (0.0012) | 0.0046*** (0.0010) |
| | <i>OREO/L</i> | 0.0273*** (0.0034) | 0.0280*** (0.0034) | 0.0279*** (0.0034) | 0.0268*** (0.0034) | 0.0145*** (0.0038) |
| | <i>NPL/L</i> | 0.0662*** (0.0054) | 0.0669*** (0.0054) | 0.0669*** (0.0054) | 0.0663*** (0.0054) | 0.0599*** (0.0048) |
| | <i>LLR/A</i> | 0.0085 (0.0230) | 0.0076 (0.0233) | 0.0070 (0.232) | 0.0079 (0.0231) | 0.0235 (0.0204) |
| | <i>GAP1/A</i> | 0.0008 (0.0014) | 0.0005 (0.0014) | 0.0006 (0.0014) | 0.0007 (0.0014) | |
| | <i>GAP2/A</i> | -0.0010 (0.0017) | -0.0016 (0.0017) | -0.0016 (0.0017) | -0.0015 (0.0017) | |
| | <i>R/AvA</i> | -0.0287*** (0.0102) | -0.0276** (0.011) | -0.0278** (0.0109) | -0.0288*** (0.0105) | -0.0224** (0.0094) |
| | <i>LLP/AvA</i> | 0.0562*** (0.0146) | 0.0560*** (0.0155) | 0.0559*** (0.0155) | 0.0547*** (0.0151) | 0.0564*** (0.0126) |
| Liquidity | <i>LA/A</i> | -0.0086*** (0.0014) | -0.0089*** (0.0014) | -0.0089*** (0.0014) | -0.0089*** (0.0014) | -0.0089*** (0.0012) |
| | <i>BKD/A</i> | 0.0030 (0.0051) | 0.0038 (0.0049) | 0.0038 (0.0049) | 0.0039 (0.0050) | 0.0081*** (0.0030) |
| Off-balance sheet | <i>Derivatives/A</i> | 0.0010*** (0.0004) | 0.0010*** (0.0003) | 0.0009** (0.0003) | 0.0009*** (0.0003) | 0.0008*** (0.0003) |
| | <i>NII/TH</i> | 0.0026* (0.0014) | 0.0016 (0.0017) | 0.0015 (0.0015) | 0.0021 (0.0015) | 0.0001*** (0.00002) |
| Bank size | <i>LogAssets</i> | -0.113*** (0.0132) | -0.1164*** (0.0133) | -0.1163*** (0.0133) | -0.1155*** (0.0133) | -0.1216*** (0.0117) |
| Supervisor specific | <i>OCC</i> | 0.2337*** (0.0557) | 0.2417*** (0.0556) | -0.1302 (0.1542) | -0.1406 (0.1545) | -0.1647 (0.1539) |
| | <i>FDIC</i> | -0.1822*** (0.0572) | -0.1734*** (0.0571) | -0.5495*** (0.1582) | -0.5511*** (0.1588) | -0.5638*** (0.1563) |
| Monetary policy | <i>FFunds_{t-1}</i> | | -0.0098 (0.0092) | | | |
| | <i>FED × FFunds_{t-1}</i> | | | -0.0728*** (0.0252) | -0.0709*** (0.0251) | -0.0757*** (0.0253) |
| | <i>FDIC × FFunds_{t-1}</i> | | | -0.0040 (0.0134) | -0.0026 (0.0134) | -0.0064 (0.0130) |
| | <i>OCC × FFunds_{t-1}</i> | | | -0.0048 (0.0119) | -0.0023 (0.0120) | -0.0059 (0.0119) |

(Continued on the next page)

(back)

E. Carletti, F. De Marco, V. Ioannidou et al.

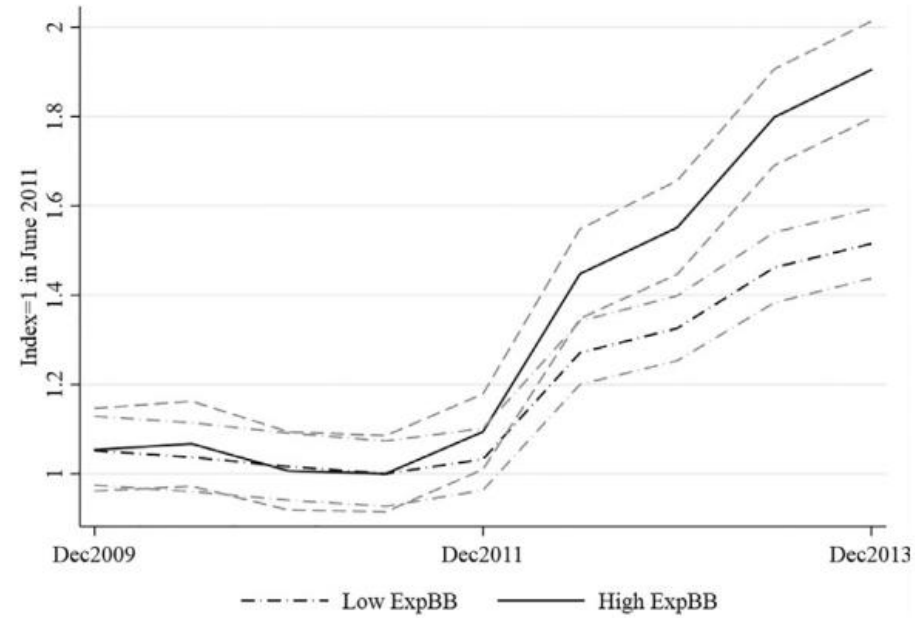


Fig. 7. Liquidity ratio by bank exposure.

This figure shows the liquidity ratio (cash and other short-term securities over total assets) for banks with above the median (solid line) and below the median (dash-dot line) exposure to the reform (Exp_BB_b) with the associated standard errors. The series has been normalized to have a value of one before the reform approval date (i.e., index value =1 in June 2011, given that balance sheet information is only available semi-annually).

[\(back\)](#)