Leibniz Institute for Financial Research SAFE

SAFE Finance Blog

11 JUL 2023

Regulatory lessons from bank failures – beyond the obvious

Elke König: The collapse of Silicon Valley Bank prompts regulators to reassess capital and liquidity requirements, but reforms should go beyond bank regulation

The failure of Silicon Valley Bank and two other mid-sized banks in the U.S., as well as the global banking group Credit Suisse, has sparked a debate about further strengthening banking regulation and supervision. The insights into the U.S. situation provided by Michael Barr, Vice Chair of the Federal Reserve for Supervision, and Martin Gruenberg, Chairman of the Federal Deposit Insurance Corporation (FDIC), offer solid food for thought. The Swiss National Bank's reflections on the failure of Credit Suisse in its Financial Stability Report 2023, which will be followed by a detailed report commissioned by the Swiss government, adds to this dialogue – although domestic considerations will of course play an important here as well.

The case of Silicon Valley Bank has demonstrated that the failure of a regional bank has serious repercussions for financial stability and the broader economy, prompting a reassessment of capital and liquidity requirements. Perhaps even more pressing is the need to rethink the timeliness and intrusiveness of supervision. This seems to be a lesson to be learned from both, Silicon Valley Bank and Credit Suisse.

At the same time, it is surprising that there is not more focus on drawing lessons for resolution regimes and strategies. The resolution regime put in place after the global financial crisis has been a major step forward, but it also needs to be thoroughly prepared in order to be implemented vigorously and in a timely manner, i.e. before resources are fully exhausted. Of course, the focus should extend beyond globally systemic banks to all potentially systemic banks. As we have seen in the US cases, small(er) players can also be systemic and this needs to be reflected in regulation.

Reconsidering the protection of transaction accounts

The bank runs that occurred in the U.S. and Switzerland in March 2023 have triggered a discussion about the risk of bank deposits running off and how this risk can be reduced or at least contained. The focus here is on extending the depositor guarantee in general or on developing solutions to protect transaction accounts. The insights provided in SAFE Policy Letter No. 98 and Martin Gruenberg's statement "On Options for Deposit Insurance Reform" will hopefully enrich the discussion and guide the reflection on "Crisis Management and Deposit Insurance" within the EU. In particular, the protection of transaction accounts needs to be reconsidered, where a bank failure could result in small and medium-sized enterprises being unable to pay their creditors and threaten financial stability.

It seems that we have learned some of the lessons for bank regulation, supervision and resolution, and deposit insurance from these recent bank failures. Is that enough; should that be the sole focus going forward?

The sharp rise in interest rates since mid-2022, and especially the events of March 2023, caused depositors to shift funds from their banks to banks perceived as "safer" and to the short-term funding market, primarily money market funds (MMFs). These funds, rightly or wrongly, are considered cash equivalents.

The largely ignored risk posed by money market funds and non-bank financial institutions

Apart from comments made by U.S. Treasury Secretary Janet Yellen at the NABE Economic Policy Conference on March 30, the potential risk to financial stability posed by MMFs or, more broadly, non-bank financial institutions (NBFIs), particularly in light of the recent growth of MMFs, has been largely ignored. The Financial Stability Board's (FSB) 2021 "Policy Proposals to Enhance Money Market Fund Resilience" clearly spells out the risks that MMFs can pose. This should be taken as a stark warning. The risk of MMF runs materialized in both 2008 and 2020 and led to central bank intervention to stabilize these funds.

In essence, in response to the recent bank failures investors are shifting funds from one unstable, runnable instrument, bank (demand) deposits, to another, (government) MMFs. The FSB paper focuses heavily on non-public debt MMFs, which pose significant (liquidity) risk due to their inherent credit and market risk. However, given the rise in interest rates since mid-2022 and market volatility, the market risk of government securities cannot be overlooked. Treasuries, especially U.S. Treasuries, may be, and probably are, the safest and most liquid instrument investors can think of, but they are only redeemable at par on maturity.

In particular, stable NAV MMFs promise daily redemption at par despite the inherent maturity transformation and credit/market risk. A promise that can falter under stress, triggering the familiar vicious cycle of runs and fire sales. "Withdraw first, ask questions later" is perfectly rational given the first mover advantage inherent in the design of these funds. This is a serious concern for financial stability.

Bank failures underscore the need for reform in the non-bank financial sector

The FSB intends to review its recommendations this year and plans to assess the national implementation in 2026. It has been a long journey since the 2008 GFC and the 2020 "reminder". This year's bank failures make this review and a timely implementation of any relevant recommendations even more critical.

While the FSB raised the right questions and provided a menu of options in its 2021 paper, recent events may require a reassessment. The focus needs to be on all MMFs, not just on non-public debt MMFs. Any instrument that promises daily redemption at par (stable NAV funds) needs to have, at a minimum, robust liquidity buffers to withstand adverse market conditions. Alternatively, and perhaps preferable, the "stable NAV feature" may need to be eliminated. The design of these funds may need to be revised to limit volatility, such as by limiting eligible assets and their duration. Regular stress tests based on the market value of the funds under management need to be conducted.

In conclusion, the bank failures earlier this year provide valuable insight and underscore the urgency of addressing the risks posed by NBFIs and, in particular, MMFs. They are a significant and growing part of the financial ecosystem and are still largely outside the scope of regulation. The upcoming FSB and International Organization of Securities Commissions launch event for the Open-Ended Funds Consultations on July 12 will hopefully tackle this topic.

Elke König is a SAFE Senior Fellow and was Chair of the Single Resolution Board from 2015 to 2022 and President of the German Federal Financial Supervisory Authority BaFin from 2012 to 2014. She was also a member of the Supervisory Board of the Single Supervisory Mechanism.

Elke König

SAFE Senior Fellow

BACK

NEWS & LATEST

All News

SAFE Finance Blog

Events

In this Section:

FOLLOW US

CONTACT

Leibniz Institute for
Financial Research SAFE

Theodor-W.-Adorno-Platz 3
60323 Frankfurt am Main

Phone: +49 69 798 30080
Fax: +49 69 798 30077
Email: info@safe-frankfurt.de