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Bank Runs and Regulation

By Stephen Norris

Introduction

Silicon Valley Bank was the first US bank to fail in 2023.
Vanity Fair

The United States faced three major bank failures in 2023: those of First Republic Bank, Signature Bank, and Silicon Valley Bank. Internationally, long-standing institutions like Credit Suisse, the second-largest Swiss bank, have also failed. While banks like these have long been the bedrock of the global financial system, recent developments have shown just how delicate they are.

Former Congressman Stewart McKinney (R-CT) once declared that large financial institutions in the United States were "too big to fail." This phrase was echoed by many policymakers during the 2008 financial crisis. Because these banks housed such a large amount of assets and were interconnected with other institutions around the globe, their failure would have catastrophic ramifications. The influence of banks like JP Morgan, Morgan Stanley, and Goldman Sachs is undoubtable, but recent high-profile failures suggests that even these banks may be at risk of disruption. With the rise of digital technology, even midsized regional banks have become important and connected parts of the global financial ecosystem. The failure of Silicon Valley Bank and the resulting turmoil point to this fact.

Banks were originally created to provide customers with a secure place to store their cash. While banks continue to provide this service today, it is only a fraction of what they offer. Now, banks primarily act as intermediaries between depositors and borrowers, ensuring that **capital** is used efficiently. This process allows for the transformation of short-term deposits into long-term debt, which is essential to fund many of the world's projects. Although vital, this transformation also opens up banks to significant risk.

Capital - wealth, in the form of money, property, or other assets owned or employed in business by an individual or firm.

EXPLANATION OF THE ISSUE

Historical Development

The first evidence of banks originates from around 2000 BCE in present-day India. These banks accepted deposits and lent out grain to merchants who transported it from place to place (History of Banking, n.d.). From that point on, the influence of banks kept expanding. For example, archeologists have found evidence of temple-based lenders across the Roman Empire (History of Banking, n.d.). Later, banks and other financial institutions grew particularly important in Western Europe because they funded many trade expeditions.

The Bank of New York Mellon continues to operate today as one of largest US banks.

The modern banking system has prominent ties to 17th century London and Amsterdam. During this time, banks were accepting deposits, lending, and issuing bank debt, all of which are staple services of our current system. Alexander Hamilton and Aaron Burr used these institutions as a blueprint during their creation of The Bank of New York, which now operates as the Bank of New York Mellon (Johnson, 2022). As the influence of banks expanded, so did the need for regulation. Today, we can easily see how past developments have shaped the current regulatory landscape for banks.

The Great Depression

Perhaps the largest failure of the banking industry occurred during the Great Depression. Due to the impending recession and risky lending practices, depositors lost faith in banking institutions and rushed to withdraw their money. Having lent out a large proportion of these deposits, banks could not afford to pay depositors and were forced out of business. Between 1930 and 1933, more than 1000 banks failed each year (Mitchener and Richardson, 2013). Since then, failure of this scale has not occurred again—largely because policymakers enacted many regulations following the Great Depression. For example, the Glass-Steagall Act of 1933 separated investment and consumer banks, allowing regulators to focus on consumer protection (Mitchener and Richardson, 2013). This crisis ushered in many of the regulations we still see today.

***Mortgage-backed security** – a type of investment vehicle composed of a large basket of mortgages.*

***Insolvent** – pertaining to bankrupt persons or bankruptcy, occurring when liabilities exceed assets.*

The 2008 Financial Crisis

In 2008, the world saw the largest financial meltdown since the Great Depression. Banks had overextended themselves by purchasing massive amounts of **mortgage-backed securities**. Investors wrongly assumed that these assets were diversified and when housing prices across the US simultaneously dropped, the investment bank Bear Stearns became **insolvent.** Many other institutions followed suit, plunging the world into recession.

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Scope of the Problem

Bank run *– When the customers of a bank or other financial institution withdraw their deposits at the same time over fears about the institution's solvency.*

This section outlines some of the dilemmas that financial policymakers grapple with on a daily basis. These are just some of the problems you will be forced to address throughout the conference.

Bank Runs

With the advent of the modern banking system came **bank runs**. A bank's main function involves taking in deposits and lending out this money to earn depositors a return. Many of today's advanced economies were built upon this system. While this system has fostered significant economic growth, it also creates risk for a bank. Because banks lend out deposits, much of a bank's assets are not stored as cash or cash equivalents that can be withdrawn by depositors at any time. As a result, if many depositors rush to extract their money from a bank at once, a bank may not have the liquid funds to pay their depositors.

Before digital technology, customers would physically run to their bank in the event of a crisis and attempt to withdraw their deposits. Nowadays, it is a simple as picking up your smartphone. Regardless of the withdrawal method, bank runs induce a significant strain on financial institutions. Accordingly, one of the largest challenges for regulators and for Congress is preventing these runs before they begin.

A bank run during the Great Depression at American Union Bank, where consumers physically rushed to withdraw their funds.

Wikipedia

Market Consequences

Financial regulation is extremely important because of the interconnected nature of the banking industry. Digital technology has allowed even small banks to become pivotal members within the global financial ecosystem. Silicon Valley Bank is an example of this. Although its portfolio was relatively small, the bank's failure had ramifications across the banking industry.

Given the impact that even small banks can have on the industry, we must reconsider how they are regulated and how to prevent their failure.

Risk Management

Interest rate risk *– the risk a financial institution faces from changing interest rates (rising interest rates result in currently held bonds to decrease in price).*

Banks are constantly required to weigh risk and return. A bank could potentially earn more profit by investing in riskier ventures, but this would increase the chance of failure if things went wrong. Banks are constantly balancing risks derived from market conditions, government policies, and interest rates with their returns. For the largest banks, regulations force them to take on only a limited amount of risk, but smaller banks can more readily take on greater risks.

The recent bank failures in 2023 resulted from a lack of awareness of **interest rate risk** from midsized regional banks.

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When interest rates increase, the value of previously issued bonds decreases. So, when the Federal Reserve—the central bank of the US—raised interest rates to combat inflation, banks with large bond portfolios suffered massive losses and became insolvent.

Then-President Obama signing the Dodd-Frank Act into law in 2010.
The White House

Consumer Confidence

Perhaps the largest determinant of a bank's health is consumer confidence. If consumers believe that a bank is strong, they will leave their deposits with it, allowing the bank to continue operating. The opposite can also apply, where low confidence results in the withdrawal of deposits. Consumer confidence can therefore be a powerful predictor for the health of the bank. Thinking a bank is unstable may actually cause it to become unstable. As a result, many of the policies that Congress and the Federal Reserve implement are geared towards bolstering consumer confidence.

Regulation

Perhaps the largest determinant of a bank's health is consumer confidence.

The extent to which the government should regulate banks is an important point of debate. Many argue that regulation only stifles a bank's ability to operate, as banks must allocate significant resources for compliance. These critics of regulation argue that without stricter regulations, banks can provide better rates for borrowers and depositors, creating even more value for the economy.

Proponents of stronger regulation would argue that a lack of regulation in 2008 and 2023 caused bank failures and harmed the average consumer. Regulation can have a major impact on ensuring that banks don't take on high risks and protect consumers.

Congressional Action

One of the most important pieces of legislation on bank regulation passed by Congress is the Dodd-Frank Wall Street Reform and the Consumer Protection Act. This act was passed in the wake of the 2008 financial crisis and targeted the types of institutions credited with causing the crisis, including mortgage lenders, insurance companies, investment banks, and credit rating agencies (Hayes, 2023). In particular, this act established multiple regulatory agencies specifically tasked with the oversight of these institutions, such as the Consumer Financial Protection Bureau. Additionally, investment banks were prohibited from associating with private equity firms or hedge funds that were seen as too risky. Furthermore, investment banks could no longer practice **speculative trading** (Hayes A., 2023). These restrictions were known as the Volcker Rule.

Speculative trading – *The act of conducting a financial transaction that has substantial risk of losing value but also holds the expectation of a significant gain or other major value.*

This act remained intact until 2018, when then President Trump signed the Economic Growth, Regulatory Relief, and Consumer

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***Margin** – The difference between the price at which a product is sold and the costs associated with making or selling the product.*

Protection Act into law. This act rolled back many of the regulations established in the Dodd-Frank Act. For example, the asset threshold for stress tests and other risk mitigating policies was raised, allowing small regional banks to operate without these checks (Hayes A., 2023). Additionally, the law excluded "lenders with assets of less than $10 billion from requirements of the Volcker Rule" and instead put those smaller lenders under "less stringent reporting and capital norms" (Hayes A., 2023). Many analysts believe that if the Dodd-Frank act had remained intact, the failures of Silicon Valley Bank, Signature Bank, and First Republic Bank may never have happened.

Other Policy Action

There is also an element of self-governance within the banking industry. It is in the best interest of all banks that the industry operates successfully. As we have recently witnessed, the failure of one bank can trigger crises in others, meaning collective security is a top priority. This common goal has materialized in the establishment of an insurance fund created by the banks to support institutions in times of distress. Each member bank that pays into this fund receives the security that the insurance provides, while also profiting from the increased consumer confidence in their institution. Self-governance works well when all parties' goals are aligned as they are in this case, but regulators should be careful about this as a long-term solution as these agreements can often break down as compliance loosens.

IDEOLOGICAL VIEWPOINTS

Conservative View

Conservatives tend to take the free-market approach when it comes to banking regulation. They believe that any significant regulation put forth will limit the economic impact that banks can have, thus harming the economy. For example, they might believe that if a bank is required to devote significant time and resources towards compliance, their fees will be higher, and their economic impact will decrease. Under this framework, the thought is that while some banks may fail, this will leave only the toughest banks remaining, strengthening the banking system as a whole.

Conservatives would also be concerned with any policy that would require the use of taxpayer funds. A key aspect of the conservative agenda is reducing government spending, so any initiative not in this framework would likely be opposed.

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Liberal View

Moral Hazard *– lack of incentive to guard against risk where one is protected from its consequences, e.g. by insurance.*

On the other hand, liberals prefer a more hands-on approach. They believe that stricter bank regulation will more adequately protect consumers. They acknowledge that these regulations will decrease the **margins** of financial institutions. Yet liberals argue that without strict oversight, banks engage in risky and dangerous tactics. This perspective means that liberals would be in favor of increasing deposit insurance and regulating reserve ratios. This viewpoint aligns with the broader liberal view that government has a greater role to play within society.

AREAS OF DEBATE

Unlimited Deposit Insurance

Currently, accounts at FDIC insured institutions are insured up to $250,000.

Perhaps the most prominent solution discussed following the most recent banking crisis is unlimited deposit insurance. Currently, accounts at FDIC-insured institutions are protected up to $250,000 (Knorr-Evans, 2023). This means that if one of these organizations fails or goes bankrupt, the government will compensate each depositor up to $250,000. The goal here is to reduce the frequency of bank runs or, ideally, avoid them all together.

Defaulting *– Being unable to repay debts.*

Deposit insurance can fund this amount because doing so bolsters confidence. As discussed previously, bank runs occur when consumers lose confidence in a financial institution and attempt to remove their deposits as they fear they will lose their money if the bank **defaults**. If their deposits are insured, however, they will receive up to $250,000 in compensation if their banks are unable to pay out their account balance. While $250,000 has been the threshold for over a decade, it cannot prevent all bank runs. For example, because 93.8% of Silicon Valley Bank's deposits were uninsured as many accounts exceeded $250,000, deposit insurance was not effective at preventing a bank run (Hayes D., 2023).

However, some theorize that if the FDIC guaranteed all deposits, a bank run could have been avoided altogether. In this scenario, consumers would have confidence that no matter the situation or how much money they had, their money would be safe.

While unlimited deposit insurance could help prevent future bank runs, critics argue that it could actually result in riskier behavior from banks. This phenomenon is referred to as **moral hazard**. If depositors are guaranteed their money, the consequences for a bank's risky behavior are significantly diminished. This moral hazard results in more reckless behavior from banks, leading to increased financial turmoil.

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Political Perspectives on this Solution

Most liberals argue in favor of this policy because they purport that it protect consumers. Conservatives are skeptical of this approach because it essentially writes banks a “blank check” and incentivizes risky behavior.

Economists are also split on this solution. Most acknowledge the benefits of bolstering consumer confidence, as well as the risk from moral hazard. Interestingly, many argue that the US has already implicitly adopted an unlimited deposit insurance policy given its recent pledge to protect the full deposits of Silicon Valley Bank customers.

Oversight and Capital Requirements for Midsized Banks

Required reserve ratio - *the portion of reservable liabilities that commercial banks must hold onto, rather than lend out or invest*.

While the largest banks operating within the United States are subject to many regulations, stress tests, and a large **required reserve ratio**, midsized banks face far fewer rules (Krawcheck). While this has allowed for smaller banks to experience massive growth, this growth has often come at the expense of oversight. For example, Silicon Valley Bank had large amounts of interest rate risk go unnoticed in early 2023. If subject to the same regulations as a large bank, such as JP Morgan Chase, this risk would have been identified before a crisis. Additionally, large banks are required to keep a higher amount of cash on hand in reserves to cover withdrawals. This rule reduces the chance that a bank becomes insolvent. Expanding this regulation to smaller institutions would have the same impact.

Political Perspectives on this Solution

Republicans tend to be opposed to increasing the regulation of midsized banks and argue that doing so could stifle growth. Businesses would be required to devote resources to compliance, which may entail re-allocating internal budgets and possibly taking away from everyday operations. On the other hand, Democrats would largely be in support of expanding this sort of oversight. Prioritizing the security of private consumers over corporate profit aligns with their general economic positions.

Dividend - *a sum of money paid regularly (typically quarterly) by a company to its shareholders out of its profits (or reserves).*

Enhanced Dividend Sensitivity

Many banks pay out **dividends** to their investors. These dividends represent the investor’s share of the year’s profits. Although the dividend payout is typically based on the performance of a company, it can be slow to react to worsening business conditions. In many cases, an institution may be unwilling to decrease dividends below the prior year’s level, as this may come off to investors as the start of a decline. Simply put, reducing dividends

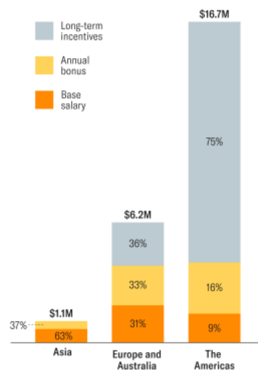
can indicate poor performance, causing investors to sell their shares.

That said, paying out large dividends when the performance of a business is declining could exacerbate the chance for disaster. In times of struggle, some believe that a company would be better off using their capital for business operations (Krawcheck).

Political Perspectives on this Solution

Members of both parties would be split on this issue. Those opposing could primarily cite that this change would likely have to originate internally for businesses in the financial sector. In their minds, dividend payout policy is at the discretion of individual businesses.

Supporters would highlight that if this policy could help to prevent future financial chaos, then it may still be worth considering despite its novelty.



Breakdown of executive compensation by region and method of delivery.

Harvard Business Review

Rethink Executive Compensation

As it stands, executives in all industries are compensated based on their ability to produce a profit (Krawcheck). While this has proven to be a strong motivator for executives to adopt performance-enhancing policies, it often incentivizes risky behavior. Compensation should not only be based on a bank's profit, but also its strength and longevity. In this case, executives would be incentivized to make a profit and act responsibly, thus benefitting the consumers as well as themselves.

This solution would undoubtedly be challenging to implement through regulation. The current evaluation system has been in place for centuries and quantifying the strength of a financial institution is more difficult than evaluating profit. That said, adopting such a policy will ensure that the goals of consumers and executives are aligned at all times.

Political Perspectives on this Solution

Support for a policy like this would likely receive pushback from members of both parties. In the past, issues like executive compensation have been left up to each individual firm. Any intervention in this realm might be seen as government overreach and would likely be challenged in the courts. That said, despite its likely opposition, the value of such a policy should not be discounted.

Fire sale *– A sale of goods or assets at a very low price, typically when the seller is facing bankruptcy.*

Government Purchases of Assets

When a bank is strapped for cash because of a bank run, they often engage in a **fire sale**. Banks are forced to sell assets at a discount to cover deposits, which often further imperils their stability. Instead of leaving banks to sell their assets on the open

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market, the government can step in and purchase assets from the bank at a fair market value.

The government already implemented a similar policy during the recent banking crisis. Banks had and still have billions worth of **unrealized losses** on government bonds due to the increasing of interest rates. While banks would typically be forced to sell these bonds at **market value** to cover the deposit requests during a bank run, the government offered to purchase them at their **book value** instead, providing a lifeline to what would be otherwise failing banks.

***Unrealized loss** – A "paper" loss that results from holding an asset that has decreased in price, but not yet selling it and realizing the loss.*

***Market value** – Value of an asset if it was to be sold on the open market.*

These types of policies allow for the government to minimize the impact of a bank run on a bank's **balance sheet** while also recovering their initial expenditure in the future.

Political Perspectives on this Solution

Republicans tend to be wary about these types of policies, as they would likely cost the taxpayer in the short run. However, if it was made clear that the government would likely recover much of the funds in the future when the assets are sold or the bonds mature, Republicans might be willing to adopt such a policy.

***Book value** – The value of a security or asset as entered in a company's books.*

Democrats on the other hand are more likely to be in favor of a policy like this as it closely aligns with their platform advocating for further regulation. Democrats generally support stronger consumer protections.

***Balance sheet** – A statement of all assets, liabilities, and capital of a business.*

BUDGETARY CONSIDERATIONS

The major source of funds when it comes to bank regulation is the FDIC Deposit Insurance Fund. This fund was created to insure deposits at insured banks and to resolve bank failures (FDIC, 2023). This account is funded by **insurance premiums** paid by banks. The government then invests these funds and earns interest (FDIC, 2023). Banks are willing to pay into this fund because having FDIC backing reduces the risk of a bank run and creates institutional confidence in the banking industry.

***Insurance premiums** – The amount paid each period for insurance.*

Funding could also come from Congress, although this would be a much more contentious route. In the past, using taxpayer dollars for programs to support large financial institutions has been unpopular. For example, in 2008, Congress passed the Troubled Asset Relief Program (TARP) to bailout banks following the banking crisis. This program gave the Federal Reserve approximately $700 billion to stabilize the banking and auto industries, restart the credit market, and help struggling families (US Dept. of the Treasury, 2023). Although this program recuperated much of the funding it lent to large financial

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institutions in subsequent years, a similar program would likely still receive scrutiny by members of the public and Congress.

CONCLUSION

The recent failures of Silicon Valley Bank, First Republic, and Signature Bank highlight just how delicate the banking industry is. The failure of a small institution can set off a chain of events that sends the economy into turmoil. As representatives, it is your duty to protect the average consumer, prevent bank runs before they occur, bolster confidence in the banking industry, and maintain the benefits of a free market. This is undoubtedly a difficult task, but I have faith that through compromise and creativity, you will be able to succeed.

As you theorize solutions, you are encouraged to incorporate the solutions presented, explore your own ideas, and synthesize multiple solutions. The importance of this topic cannot be understated. The global economy depends on your response to this issue.

GUIDE TO FURTHER RESEARCH

As representatives it is your responsibility to find solutions that not only protect consumers, but also promote a free market.

To better understand this topic while writing this briefing, I found that reading articles from the New York Times and Wall Street Journal was most useful. Both of these publications published numerous articles about the recent bank failures, which do a great job of contextualizing the current landscape within history. If you are unsure about why banks have been failing and what regulators have done to prevent this, these articles are a great asset.

Additionally, I highly suggest listening to a few episodes of *The Economist Podcast*. They do a great job explaining the intricacies of the banking industry and its regulations in a very unbiased manner. In addition, their guests include many prominent economists, who introduce various unique solutions.

With your further research, I suggest focusing your time and energy on understanding current regulations and identifying additional solutions. While there are many solutions included in this briefing, they are only a drop in the bucket, so you are encouraged to research further and even find your own solutions.

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GLOSSARY

Capital - wealth, in the form of money, property, or other assets owned or employed in business by an individual or firm.

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Margin – The difference between the price at which a product is sold and the costs associated with making or selling the product.

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Unrealized Loss – A "paper" loss that results from holding an asset that has decreased in price, but not yet selling it and realizing the loss.

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Book Value – The value of a security or asset as entered in a company's books.

Balance Sheet – A statement of all assets, liabilities, and capital of a business.

Insurance Premiums – The amount paid each period for insurance.

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