

How Congress Can Reform Banking Regulations to Reduce the Cost of Bank Runs—or Prevent Them Altogether

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KEY TAKEAWAYS

Bank runs happen in any system that lets banks lend money while simultaneously promising to keep it available for depositors.

Current policy to reduce the cost of financial crises is expensive and ineffective: Deposit insurance pays for a crisis in advance and raises the odds of new crises.

New competition and new business models in the banking industry can lower the cost of payment services and financing while reducing the prospect of bank runs.

On March 8, Silicon Valley Bank (SVB) announced that it had sold \$21 billion in securities at a \$1.8 billion loss while seeking to raise new capital.¹ Intended to calm depositors, the announcement put them on edge, instead.

Coverage through the Federal Deposit Insurance Corporation (FDIC) applies to account balances up to \$250,000, but 96 percent of the deposits at SVB were uninsured because SVB's clients were mostly firms in the tech industry with large deposit accounts. With their funds at risk, depositors rushed the next day to pull their money from the bank before the vaults were drained. A total of \$42 billion left SVB in a matter of hours, leading to the bank's failure.

SVB's failure left its customers and others fearing the ramification of missed payroll checks and a dash for cash spreading across the financial system. In

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response, the FDIC, Federal Reserve, and Treasury announced a plan to guarantee all deposits with SVB, even those with account balances above the \$250,000 limit.

Mid-sized banks have asked the FDIC to extend the coverage to all deposits,² and some lawmakers have indicated support for the idea.³ Such a move would double down on policies that have not worked. While the U.S. has used deposit insurance and regulatory oversight since the Great Depression as tools to stabilize the financial system, the United States has had more banking crises than other developed nations.

This *Issue Brief* reviews the causes of the run on SVB and of bank runs generally, discusses limitations of the current measures to prevent runs, and proposes a solution to reduce the cost and frequency of bank runs—potentially preventing them altogether. Our recommendation is to introduce fully backed accounts at existing banks or new, specialized payment banks that obviate the need for expensive and ineffective government oversight.

Bank Runs Are a Fundamental Feature of the Fractional Reserve Business Model

Simply put, banks take deposits from people with funds to save and lend them to businesses that need funds to invest. Banks hold long-term assets (loans) while funding those assets with short-term liabilities (deposits), which creates a maturity mismatch.

The maturity mismatch leaves banks susceptible to runs. Businesses borrow funds for long-term investments, but depositors can request their funds back from banks at any time. In essence, banks promise that a dollar can be in two places at once, in both the depositor's and borrower's accounts. Depositors get to earn a return on their savings while having it available for withdrawal whenever they want.

The system works—until it does not. Depositors may increase withdrawals whenever a bank suffers losses on its assets or simply because depositors believe that the bank is not managed prudently. If depositors believe that a bank could become insolvent, they rush to withdraw their funds from the bank before they are all gone.⁴

A bank run is an equilibrium phenomenon, making it difficult to avoid. Depositors running on banks act in their own interest—even though it puts the bank and financial system at greater risk. Bank runs can be triggered by actual mismanagement or just the perception of mismanagement.

Even if the trigger for a run occurs only in the minds of depositors, financial crises have real costs. Bank runs are economically damaging because

banks may need to call in loans from businesses that are not ready to repay them. As loans are called in, the panic can spread the financial stress to other firms. The possibility of well-managed banks getting swept up in a panic related to the mismanagement of a single bank has motivated most arguments for government intervention in financial markets.

Current Government Policy for Financial Stability Is Expensive and Ineffective

Federal policy since the Great Depression has used the government to limit the riskiness of the banking system. Current policy uses four main tools:

1. **Deposit insurance** attempts to address this problem by removing the need to run on the bank. However, insurance creates moral hazard, increasing the potential for and cost of bank failures. Because insured depositors are protected from loss, they do not act as a check on bank management taking undue risk.
2. Recent decades have seen legal measures to **socialize the losses** in hopes of preventing contagion. Deposit insurance recovers some of the cost of crisis in advance, but ultimately the FDIC is backed by the full faith and credit of the United States.⁵
3. **Regulators** were supposed to catch the risk of a run before it started. They clearly failed in this instance. While regulation is often touted as a way of ensuring that banks limit potential losses, it opens up an avenue through regulatory capture to ensure that incumbent banks stay profitable through limiting competition.⁶
4. Certain banks were designated as **too big to fail** after the 2008 financial crisis. Regulatory protections have forced the concentration of banking into an industry dominated by “too-big-to-fail” firms with government backing. The concentration has increased systemic risk, creating a vicious cycle necessitating further too-big-to-fail backing from the government.

The existing regulatory framework focuses on preventing losses during a recession. Stress tests did not consider the prospect of high inflation and rising interest rates depressing the price of government bonds with little

default risk. Extending the threshold for a bank to be considered too big to fail down to \$50 billion in deposits would not have prevented the collapse of SVB. The risk of contagion remains because of inconsistent messaging and shifting rules from the government about which deposits are insured.

These tools do not so much reduce the risk of crises as rearrange it. A more effective solution would get around the problems of moral hazard and provide incentives for bank managers to lend prudently and avoid the need for a bailout from the government.

Depositors Have No Safe Place to Move Their Funds

Before the general framework of federal policy to limit bank runs was established after the Great Depression, the cost of bank failures was typically borne by depositors. Due diligence by depositors and the prospect of them moving money away from mismanaged banks typically kept bank management in check.

However, current options for depositors to impose meaningful discipline on bank management are limited. For example, if SVB's depositors felt uncomfortable with the riskiness of the bank's balance sheet, other options for them to protect liquid funds come with drawbacks:

- **Another bank.** While some banks are more prudent in managing their assets than others, every bank funds its operations through the same fractional reserve arrangement. Deposit insurance and the expectation of bailouts have limited the need for banks to compete for deposits on soundness.
- **Private deposit insurance.** The FDIC provides insurance on accounts up to \$250,000. Only one firm in America provides private deposit insurance for balances above that amount, and then only for credit unions.⁷ Private insurance could reduce the cost of financial crises on the public, but only if there is no public backstop and losses fall on the private insurers.
- **Money market funds.** These are traditionally thought of as safe and liquid, but still fluctuate in value with the funds' assets. Notably, money market funds ran into distress in the past two financial crises.⁸ To limit panicked withdrawals, funds have liquidity fees and redemption gates, meaning that firms cannot guarantee access to their money without loss of value.⁹

Simply put, in today's system there is no single institution where clients of SVB could have kept millions of dollars for payroll without being exposed to the risk of losses in a bank's balance sheet.¹⁰

The relative frequency of bank panics in the United States suggests that these measures are insufficient for stabilizing banks. The United States has had 15 banking crises over the past 190 years. Over the same time frame, Canada has had only two.¹¹ Current policy is focused on how to protect the financial system after a crisis occurs. Instead, the financial system needs an option that would *prevent* runs and crises, eliminating the need for bailouts.

Eliminate Runs by Separating Payment Services from Financial Services

If banks change their operating models to always keep cash on hand for demand deposits, the logic that leads to bank runs would be cut off before they ever start. The previous exposition points to a few changes to how banks operate that would bring greater stability to the financial system.

At the most basic level, banks provide two types of services:

1. **Custodial services.** Banks store deposits for safekeeping and they process payments involving those deposits, and
2. **Financial intermediation.** Banks use deposits as a source of funding for loans to businesses.

Banks' current business model bundles storage and payment services with lending services. Storage and payment are provided without fees but paid for through the interest rate spread between a bank's earnings and its deposit rate. Alternative models could involve banks charging fees for storage and payment processing while paying higher rates on other deposits. Consumers would have the option of using one or both services.

Separate payment services could be provided by existing banks or by new, specialized banks.¹² One model is a payment bank, which does not make loans, and only processes payments. Another model is a fully backed deposit bank, which only lends out owners' equity and time deposits, which are not subject to bank runs. Payment banks and fully backed deposit banks could provide payment services at a lower cost by avoiding FDIC insurance. Both types of banks would never need insurance because demand deposits always remain with the bank until depositors come to withdraw them.

Securities and Exchange Commission rules require brokers to keep segregated accounts for their own trading and for trading on behalf of customers. The consumer-protection rule is intended to limit brokers' use of customer assets for their own benefit and to protect customers' assets in the event of a broker's insolvency. This policy extends the same principle to bank assets funded by deposits. Deposits for safekeeping and deposits for investing would be kept in separate accounts or separate financial institutions.

Most important, a completely safe option for storing funds removes the pretext for public backing of deposit insurance. Customers would have the choice of keeping their money safe or putting it at risk to earn interest. But with that choice comes the responsibility of planning for the possibility of loss. The existence of a fully safe option makes it easier for regulators and lawmakers to say no to requests for private bailouts at public expense.

Congress Can Allow More Competition from Safer Business Models

Additional competition reduces the need for a public backstop to prevent contagion. Newer, smaller entrants would reduce the susceptibility of the financial system to the failure of a single institution. Banks should be small enough to ensure that when a bank fails due to mismanagement, it can close without holding the American public hostage.

However, firms that want to operate a payment bank or offer fully backed deposit accounts face regulatory and legal challenges to entering the industry. To create a viable path for firms that want to provide stable payment services, Congress can:

- **Amend** the Dodd–Frank Act to adjust how the FDIC calculates assessments. Since 2011, banks pay FDIC insurance based on their total liabilities, not only on insured deposits.¹³ Therefore, a bank's insurance cost is the same regardless of whether it keeps cash in reserve or loans it out. The FDIC's pricing model prevents banks from profitably offering the kinds of accounts proposed in this *Issue Brief*.
- **Allow** the Office of the Comptroller of the Currency (OCC) to issue special-purpose charters to payment banks or fully backed deposit banks. Special-purpose bank charters are available to banks with limited operations.¹⁴ The OCC grants special-purpose charters for certain activities, such as credit card operations or fiduciary activities, but has discretion to approve or deny proposals.

New competition in the banking industry can lower costs for consumers and taxpayers while reducing the risk to the financial system. If banks offer payment accounts and back demand deposits with cash, that would reduce the banking system's fragility. With widespread adoption, it could end systemwide bank panics once and for all.

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