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WEBINAR

SHOULD THE CEILING ON DEPOSIT INSURANCE BE LIFTED? A DEBATE.

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Wessel [00:00:14] Good morning. I'm David Wessel, director of the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution. On behalf of the Hutchins Center and our friends at the Wharton Initiative on Financial Policy and Regulation, welcome to our debate on the question: should the 25 $250,000 ceiling on deposit insurance be lifted? We've assembled a terrific cast today. Prasad Krishnamurthy from Berkeley Law School will argue "yes". Peter Conti-Brown from Wharton will argue, "well, yes, but". And Thomas Philippon from NYU Stern School and Patricia McCoy from Boston College Law School will argue against lifting the ceiling. I'm very pleased that my longtime friend and colleague, Kelly Evans of CNBC will moderate the debate. If you have questions, you can email them to events at Brookings.edu or use the website sli.do, S L I dot D O, hashtag deposit insurance and we'll try and get your questions addressed. You can also do that on Twitter so with that, Kelly Evans, take it over.

Evans [00:01:19] David, thank you. Hi, everybody. It's great to be back here. And we did this in December on the crypto topic that I think remained highly relevant and helpful for all of us from the media and everything else in terms of framing the the regulatory debate over the past couple of months. So with that said, obviously this has now shifted into a higher gear. We were sort of asking a theoretical question last time about crypto's regulation and now all of a sudden we have to ask the very practical question of what to do with our financial system. And one of the core premises of that, which is deposit insurance, and judging by the questions that have come in today, we have representation in this audience of everybody from small and regional banks to major banks, Federal Reserve, media, so I won't reveal too much. But I do think that this is the topic that everybody wants to hear about.

So we'll hear a quick remark from each of our panelists about their position, we'll go back around once more after that and then we'll kind of open it up and I'll, I'll try to feed some of the questions from you into this at the same time. So with that, we'll start with Prasad. You know, I don't want to overstate this, Prasad, but you seem to have the most sort of unqualified yes, that the cap should be raised, and why do you think that is? And could you explain?

Krishnamurthy [00:02:37] Thanks, Kelly. I want to start off by taking the position that you should significantly consider extending the cap far beyond what it currently is now. And first, we have to acknowledge that so-called uninsured deposits are actually insured. All of the deposits in Silicon Valley Bank and Signature Bank were insured after the fact. Neither of these banks was on the Federal Reserve's radar as a systemically risky or important institution. The decision to insure all the deposits was done through joint action by the Federal Reserve and the FDIC and Secretary of Treasury.

And consider Secretary Yellen's remarks in the aftermath of that decision. On March 16, she stated to the Senate that uninsured depositors would be protected for failure to do so, quote, would create systemic risk and significant economic and financial consequences, unquote. So this covers all depositors and all the major or systemically important financial institutions. That's a lot of deposits. On March 23rd, she told the American Bankers Association similar actions could be warranted as smaller institutions suffer deposit runs that pose a risk of contagion. So blanket deposit insurance also extends, in many instances to smaller institutions as well.

So whether we like it or not, deposit insurance for the uninsured, the quote unquote uninsured, it does exist, in fact, and it exists because policymakers have this commitment problem. Secretary Yellen or Chairman Powell or really anyone in their situation is always going to err on the side of insuring deposits when there is stress on the banking system because they're afraid that depositors will just exit the banking system in mass and go and buy a government bonds for safety. So given this fact and undeniable implicit insurance, it makes sense to potentially consider a more orderly and rational system of deposit insurance.

And so I'll just put out one example. We could expand the existing system and cover many more deposits, let's just say for this simplicity, say all deposits that are in the banking system, the FDIC, which is the main deposit regulator, could assess a fee to all banks on the basis of their total deposits and any other factors that go into bank insolvency. I can talk in the discussion about how to do this in such a way so that smaller depositors would not be hurt and the brunt of the costs would fall on large depositors. With explicit insurance, bank depositors would not be able to threaten the stability of the banking system in a crisis. Instead, actually, the crisis funds would flow into the banking system because of the insurance, and the Fed would be able to conduct monetary policy without worrying about interest rate moves that would trigger a banking panic.

Now, the most important criticism of this expanding deposit insurance trade is going to be made by my colleagues is that the banking system would actually become less safe because depositors would now ignore risk and banks would take advantage of the cheap funding that they would get and banks would become riskier. This phenomenon is known as moral hazard, and it's the phenomenon of when you will ignore risk whenever you're insured against it. And this is a real concern, but I think there are a number of steps that could be taken that could mitigate this briefly. First, banks would need enough capital and they would need enough subordinated debt to make sure that those those instruments would have absorbed the first losses in the wake of a bank crisis, and so the depositors would be substantially subordinated in the bank's financial structure. Second, regulators would need to assign insurance premiums that were based both on regulatory measures of risk and on market-based measures of risk, because both of them capture independent things. Regulators would need to act promptly in order to fail resolving banks and to resolve banks so that the deposit insurance fund could be protected from loss. And then finally, it's worth considering a cap on deposit interest rates. A cap on rates would prevent depositors from running out to the bank that would give them the highest yield and the Federal Reserve, just as it sets a overnight rate for bank funds, could set short term rates for deposits, and this would also give the Fed an additional tool of monetary policy.

And in fact, all of the reforms that I've suggested should be considered, even if we don't expand deposit insurance explicitly, because as an implicit matter that deposit insurance exists and there's already moral hazard in our system because of it. So to sum up expanded deposit insurance, it's an idea worth considering.

Evans [00:07:06] That's interesting, especially what you said about capping deposit rates. Prasad, thank you so much. Peter Conti-Brown, we turn to you.

Conti-Brown [00:07:14] Thanks so much, Kelly. Delighted to be with you all and to take up this debate. I'm styled in the debate as "yes, but" and you could also think of me as "no, but", I'm kind of in a squishy middle. Let me start by where I agree with Prasad. There's simply no doubt that we have learned some unsettling things, some old truths made truer and some new surprises, too, from the collapse of Silicon Valley Bank. And it's worth spelling out a bit what it is that we have learned so far, even as we recognize that the lessons from the banking crisis of 2023, the banking kerfuffle, the banking embarrassment, we'll, we'll figure that out soon. But those lessons will continue to work their way through the system.

Here's what we know so far. We learned that some bankers are very bad at the basic business of banking. We learned that some bank supervisors, even when they identify these basic risk mismanagements in the system for reasons that we don't know, can be extremely slow to implement and the reforms needed before it turns to catastrophe. And we learned that uninsured depositors are extremely flighty, and that might be faster than ever before because of how easy it is on a smartphone to make those withdrawals. But we learned that their very flighty-ness makes regulators flighty, too, or at least trigger-happy with declarations of banking crises, including the provision of government benefits to those who are not legally entitled to receive them.

I think with that, Prasad would mostly agree so far, the question then is what we do about this. And I think that there is one class of uninsured depositors whose flighty-ness is both systemically important and equitably important that would require us to rethink the way that we do deposit insurance. That class of people and institutions are not multi-millionaires who, for reasons all their own, have decided to park seven, eight, nine figure deposits in a single bank. They're also not large corporations that have so mismanaged their cash position that they've exposed themselves to colossal risk of bank failure by locating billions of dollars in a single account. It's the group of individuals, very small businesses with just a few dozen employees that are trying to find their way in the world and are using a cash management system that seems pretty, pretty straightforward. They've just extrapolated from their own cash management as individuals, but put it in a corporate account. Right now, the law treats them identically to the very wealthy and we should change that. If you are a small business that needs to meet a monthly or biweekly or even weekly payroll, then the $250,000 limit is probably extremely difficult to honor. And so we should recognize this.

There are various proposals that have come through, and the one that I prefer is just keep the deposit insurance limits in lock step with each other between these two classes of individuals and organizations. So I would advocate actually lowering the individual deposit insurance rate to 200,000 from 250,000. And I would say that we should keep it in lock step going forward to an order of magnitude higher for small businesses, which will be tricky to define, but I would say that have at least five employees and no more than 100. The reason I think we should lower it is we need to send a signal that just because there is, as Prasad says, an implicit guarantee of all uninsured depositors, that does not mean that we need to make that guarantee explicit. We need to get better regulators who are willing to let market discipline do what it does so well, and to let people who have made choices to manage their risk as best meets their needs to bear both the upsides of their risk, which they enjoy freely, but also the downsides from which the government has spared them. If we can do this, then we can send a signal that we've never sent before, and that is that government guarantees for depositors don't simply move in a one way ratchet as they have done historically. We can push that down a bit while also recognizing that individuals and small businesses are not identically or even similarly situated. Deposit insurance makes more sense at higher levels for the latter category, it does not make any sense for the former.

Evans [00:11:51] Peter thanks. So those are two vigorous arguments in favor of raising the cap and Peter's case more raising the cap for small businesses and in fact, lowering them for the wealthy to 200,000. Prasad's case of raising the cap, but then also doing a few regulatory things he argues maybe need to be done in either case. So with that said, we'll turn it over to Patricia McCoy to demolish these arguments. Now, Pat, over to you.

McCoy [00:12:20] Thank you so much. That's a tall order, so it's good to be with you. Ultimately, this debate comes down to which hurts more? Potential losses to uninsured depositors in the near future, or more risk-taking by banks leading to more and worse financial crises in the future. Which is worse – I put it to you – some pain today or more pain tomorrow?

Here, it's important to stress that almost no country offers unlimited deposit insurance and those that did rolled it back. That's because scrapping the cap is a very bad idea for at least four reasons. The first, as Prasad mentioned, is moral hazard. Moral hazard is the concern that the mere presence of insurance will cause banks to gamble on reckless risks, and they bet that deposit insurance will cover the losses if the bank fails. Economists have repeatedly found that countries with higher deposit insurance coverage have a significantly greater likelihood and severity of financial crises. They've also concluded that the destabilizing future effect of this moral hazard outweighs the stabilizing effect of higher deposit insurance right now. Currently, we have an approach that creates uncertainty among banks, whether they, too would get the same full coverage as SVB or signature bank. And that's a good thing, this uncertainty is a good thing.

The second reason is that due to this moral hazard, unlimited deposit insurance would require even stricter and fully consistent financial regulation. We have to get real. History has proven that our political system is incapable of that. We have periods of strict deregulation and then we have rollbacks as we have seen in the past few years. This lack of political will has grown worse with the growing political might of banks, and banks are already pushing back against tighter regulation.

Third, calls for unlimited deposit insurance are premature. There are other ways to protect uninsured depositors if more banks fail now. Normally, during bank failures, uninsured depositors are protected through something known as purchase and assumption agreements. These are mergers where a healthy bank honors all of the deposits of the failed bank. Now, why didn't we have these agreements for Signature Bank and Silicon Valley Bank? The big reason was because they had such a high level of uninsured deposits ranging between 88 and 90%. So instead of lifting the cap, we should limit the ratio of uninsured deposits to assets and increase regulation of banks similar in size to those two banks.

We should also focus on private solutions to cash management for larger depositors. Uninsured depositors have not taken avail avail of these market solutions as fully as they should have, but they're out there. One example consists of deposit sweep programs that allows companies to park their deposits at multiple banks, while only dealing with one bank. Businesses can also use treasury management services and lines of credit at other banks. Finally, and this is a big concern, can the U.S. actually afford total coverage and who will pay for it? Right now, banks pay for deposit insurance through premiums. If we got rid of the deposit insurance cap first, would banks be able to pay sufficient premiums to cover all the deposits? And second, would they be willing to pay those higher premiums? Already, banks are resisting having to pay the special assessment to cover the 100% coverage at SVB and Signature Bank. Imagine their reaction if they had to pay for 100% coverage at every bank. Also note deposit insurance premiums are chronically underpriced and don't capture the increased systemic risk from 100% coverage. So even if banks are willing to pay higher premiums, they still would not be paying enough. If banks don't step up to finance this increase, then let's be clear it will be borne by taxpayers, including ordinary working families. And if banks do step up, we will be paying higher bank fees anyhow. I rest my case.

Evans [00:17:31] I'm going to break with convention, Patricia, and just ask you one follow up, because this is really provocative and interesting. In the collapse of Silicon Valley Bank, in which there would have been many companies struggling to make payroll the following day, and we saw, for instance, some board members step up some different solutions on that Friday, what would you have done if I'm just curious, what sort of fit fit that situation into everything that you've just described? If you don't mind real quick.

McCoy [00:18:02] Absolutely. As I've as I've spoken to to a few chief risk officers, what they told me was the first thing they did was to set up an account or more than one account at other banks, if they did not already have that and have those accounts ready, so if they could transfer funds from Silicon Valley Bank or

Signature Bank, they were in a position to do that. They also tapped their lines of credit and they finally made arrangements with their payroll providers to be using these new lines of credit and or bank accounts at other banks.

Evans [00:18:46] So you think basically that, if the uninsured depositors were not protected, let's say, you know, it sounds like those who could have gotten their money out would have gotten their money out, But those who remained trapped would hopefully either have had those deposits transferred under an M&A agreement to a new bank and protected, or, I mean, do you think in any situation like you're describing, they would have faced the possibility of a loss and in literally an inability to make, for instance, payroll or other business needs in the very short term?

McCoy [00:19:18] That that was that was a potential issue. I will say that in all likelihood, the FDIC would have paid them a certain amount of their deposit by Monday morning. And my understanding is, in the case of SVB and Signature Bank, that would have been about half the deposit. So that that is not the same as 100% of the deposit, but it's not as if they would have gotten zero and the money would have been totally frozen indefinitely.

Evans [00:19:52] Okay. Appreciate it. Thomas, over to you.

Philippon [00:19:59] Sorry, I have to end it. Thank you very much. Good morning, everybody. I pretty much agree with everything Patricia said. Just to go back to what the Prasad said at the beginning and to be consistent. I actually advocated against the bailout of the large depositors. And I thought that the answer to your question, Kelly, was that the FDIC, too, could prepare a fraction, I think 50% would be too low, you could be a bit aggressive because it's a situation of stress. You could say an initial debitor, I'd give you a check right now on Monday morning for, say, 75, 80% of whatever you had, and that's more than enough for your payrolls. And then the remaining 20% would be assessed upon the recovery values of the assets later on. That's the standard procedure. I think that that's what they should have done.

Evans [00:20:47] Thomas, apologies, where would the FDIC be getting this money? Let's say that, you know, about I mean, they.

Philippon [00:20:52] [inaudible], 100% something. They should not have gone for the same exact way they got the money for 100%. They should have done only 80%.

Evans [00:20:59] My understanding is they're currently they face $20 billion of losses, some of which they're looking to recoup from the equity and the new in the deal. But in the situation you're describing, I mean, you know.

Philippon [00:21:12] It's like a what I would have argued is that they because of the stress, I mean, the normal thing to do that you're not insured. [inaudible] I think given the stress, that would have been too tough. So you could have a middle ground where you say, well, because of the stress of the situation, I will take a risk as the FDIC and give you some of your money up front. Maybe I will not recover all of it, which I will end up with a loss, the loss will be much smaller than what they have now because they went to 100%.

Evans [00:21:43] All right. But just again, I want to clarify. So the $20 billion loss that the FDIC is taking here, I think it's still one of the largest they've they've taken it's actually a pretty big hit. If they had to pay 50 to 75% of what you're describing of the uninsured deposits, that would be, you know, quickly from upwards of 100 and 50, 150 billion dollars.

Philippon [00:22:02] No no, the loss that they have now is because they provide 100%. They should have provided only 80% upfront and the rest pending based on the value of the assets. So their losses would have been a lot smaller, but they could still have been. My point is that a loss is in that's you could argue that the loss was justified in that sense because in a stress situation, the FDIC could. It's a bit like they have to take a guess on the value of the assets that are getting. And then I'm saying in that case, it could be a bit aggressive and then you book the value of the asset a bit high so they can provide higher recovery to the to the SMEs. But that's for the past, by the way. So, you know, the answer to that is we should not have been there in the first place given that we were in that mess, and I want to be consistent, I would have argued for not giving them 100%.

Now, so what to do next? So, so the first thing is, I agree with what Patricia said, I think it's even simpler than that, by the way, if you think if you start thinking about what it means to have universal and complete unlimited insurance, once you finish ticking all the boxes, you might as well nationalize the banking system because it's not just cap on interest rate, you have cap on quantity, because if you make it a limit, then for sure banks are going to issue more of it. So how would you limit it? You're going to have to limit it. I mean, if you go down that track of narrow banking, which was always not very realistic, becomes more realistic. So I think the likelihood we go that way is zero, in my opinion, because it's equivalent to completely nationalizing the banking system and no other country has done it.

Now, also, just because some moronic bankers in a medium size bank completely failed at the basic risk management, the idea that because of that one data point, you're going to change the entire system for most of the industries who did not make these mistakes strikes me as a little bit of a stretch. Banks also already have a large funding advantage, as Patricia has said, that the deposit insurance is underpriced, which means that structurally banks have this funding advantage. So extending that, I think is a bad idea. So that's my take on it.

Now, but doesn't mean nothing should be changed. And in fact, you know, a few things could be changed, but they are not rocket science. It's pretty simple. The first is that you have to distinguish between transaction accounts and savings accounts. Transaction accounts are what people use to make payments every day, and this should be insured. And then the question is, how big should the insurance cap be? I agree that for households, just like Peter was arguing. For household 250 is just way more than enough. I mean, the vast majority in the 90th percentile of deposit distribution in the US is like $60,000. Okay, so that's it for households. So they we don't need to have 250,000. But, you know, whatever, you can keep it that way. That's a big deal, the issue is with the SMEs. But that's also it's not a new problem. It's something that many other countries have had to deal with. In fact, in Europe, when I was in government ten years ago during the banking crisis, we had exactly that same issue with the banks in Cyprus failing, and they had large money from in part from rich households in bulk from rich Russian oligarchs, they were all above the €100,000 limit. And, you know, clearly we didn't want to insure these guys, so we put the hackers on the deposits. The issue, of course, was that if you do it with one size fits all, you're also going to get some SMEs caught in that process who have structurally higher deposit transaction accounts because they need all the perils. So then the solution is to treat these guys differently from large or small depositors. And it's again, that's not rocket science. That's pretty much what the EU has done after that, and it is not that complicated. So going forward, I think and I think that's consistent with what people were saying. I think you need to distinguish on the one hand transaction versus savings and on the other hand SMB versus household. And yes, it does make sense to have different role for SMEs because it is too dangerous to put large [inaudble] on SME accounts that are used to make payrolls.

Evans [00:26:14] Is there any foreign country, Thomas, that currently has figured out how to do this to distinguish transaction accounts from savings accounts?

Philippon [00:26:22] I mean, so what happens really is that the the, you can to some extent, yes. I think at the end of the day, the limit, the size cap is usually enough because for households, if you put it at 200, 250, you you cover all of the they are need for their transaction accounts and you also cover some in fact, for most forms for many people, many of their savings as well, which you don't need to. So I agree with Peter, you could actually lower that and and still being able to cover all the transaction accounts of households. I don't think that's a very critical issue, to be honest. So I'm not sure. I mean, we could do it. I'm not against the lowering to 200K, I don't think it's first order, I think the first order is to deal with the SME accounts. And that just requires so that that's not based so much on the size moved on the nature, and so you need to identify something which is a corporate treasury account and then this would be treated separately. Once you do that, though, you have the issue of, you know, how how do you make them pay for it? So you could have a two-tier system where you know this the SMEs can [inaudible], extra insurance for any amount above the 250 cap limit and then you can price it. That's one option. I mean, there are all the options we can discuss later, but I think this is the way to go.

And the last thing is in terms of banking supervision, we've learned, and I agree with that, that's what Prasad had said at the beginning, that we've learned that some deposits are less stable than we thought. Well, that also is not rocket science. When you do a liquidity ratio test, you have something called a deposit beta, which is essentially the extent to which deposits get repriced, either you have to raise the rate for them to stay or they have the risk of running away. So we just update these estimates and then that means the political [inaudible] ratio are going to be a bit tighter for some banks and they're going to have to hold more liquidity in front of that. And again, that is just not rocket science.

Evans [00:28:26] All right, Prasad, over to you now for a full five-minute rebuttal.

Krishnamurthy [00:28:40] So I think there's actually a fair amount of agreement here in the sense that we all agree that there there exists a lot of implicit deposit coverage that extends far beyond the 250,000 in each account. And there's an argument to be made, and Pat and Thomas both make it, you and Peter, to that extent that that that the uncertainty around that is a good thing because it means that at least there's some incentive on the part of depositors to to take care. And then there's also a reaction on the part of banks so that banks know that if they do anything risky, then their deposits will get repriced, as Thomas was just alluding to. And that risk is something that they have to take into account in their in their loan settings. But I think where what we disagree on is what what would be necessary in order, as a regulatory system, to respond to that reality, that many, many more deposits are insured then and then we currently state under the law. Thomas says he would have imposed some losses on the Silicon Valley bank deposit uninsured depositors. But but the FDIC did it, and they did it with what must have been a lot of conversations with the Fed and with Treasury over what to do. And Secretary Yellen and Chairman Powell understand all of the incentive arguments that we're raising here. They understood that as well. And they still decided to insure all the depositors. They did it through an explicit exemption to the usual rules.

And the question is, well, why did they do that? Well, maybe it was a maybe it was a wrong decision, but it was justified in the sense that they probably thought that if they were going to impose the losses on these depositors, it wasn't an issue of whether it was right or wrong to help these very wealthy folks. It's that if you impose losses on them, what are going to be the spillover effects to the system? And what I worry about is that what we see, what we saw in Silicon Valley Bank is a little bit like what happened in the late 1990s with the hedge fund called Long Term Capital, and that was a hedge fund that failed. That failure imposed some losses on a large set of banks and it took the New York Fed a large set of conferences and a type of private bail in from other institutions in order to resolve this issue. And in retrospect, in the 2000s, we understood, oh, long term capital probably told us that our banking system was a lot less stable than we thought. And the 2006 to 8 crisis showed that to be the case. And I worry in SVB is a kind of canary in the coal mine that, yes, it's too much. It's just a small regional bank, and what they did was was just pure mismanagement. But look at the size of that bag and look at what is what was threatening to the banking system as a result of some small level of losses that might have been placed on depositors. Secretary Yellen was announcing to the economy that essentially all systemically risky deposits are insured.

So if we have such an outsized reaction to even a small failure, what's going to be the reaction when there's a failure? And there will be a failure – I mean, 4000 banks, or 4000 or so banks in the United States, maybe five of them, haven't managed the increase in interest rates that the Fed has put through very well, and 3995 have managed it fine. Five didn't. But the five that did it are still seeming to impose a pretty large externality on the system. It's useful, I think, to think prospectively about what to do in a situation where there's a failure that's much larger than Silicon Valley Bank because there will be, I mean, we have a lot of financial institutions. Some of them are going to fail. Institutions will fail, regulators will fail. We need a robust system that deals with that failure. And if we have insurance, we need regulatory mechanisms to counteract the negative effects of insurance.

Evans [00:32:43] Prasad, if I could ask you one follow up question that is sort of off track, but then I'll try to get us back on track. But in this current case, where, as you've said, there's a lot of confusion about whether there is actually a full government backstop of deposits in this country, period, I'm reminded a little bit of 2008 when authorities, you know, worked to bail out Bear Stearns, let's say, had to deal with Fannie and Freddie and then wanted to demonstrate, hey, we don't just backstop everybody, and so we let Lehman fail. We made that choice because bailouts were becoming political, politically toxic, and that's probably the decision everybody, in retrospect, most regrets because of the ensuing damage to the economy. So as we stand right here with, again, this kind of uncertainty around the government's willingness to back all deposits, probably that willingness and resolve will be tested again, if it's actually their intention to not have people conclude that there is a blanket deposit guarantee, do you think they would choose to let another institution fail in order to demonstrate that backstop is not there, ala Lehman?

Krishnamurthy [00:33:49] I think for the logic that you laid out, they would have to, and this is consistent with what Thomas I think was indicating as well, is that if you want to send a signal to the markets that some costs are going to be imposed on uninsured depositors and they should take care, you have to make that threat credible at some point. But then the longer you wait to do that, the more serious the situation in which you have to impose those, maybe they should, for example, going back to 2008, maybe they should have allowed Bear to fail because there was a smaller investment bank, it was earlier in the cycle, and maybe by doing so, the discipline on the markets would have corrected a lot of the risk that built up in in early 2008 and late 2008. But instead, they let Bear go and they dropped the hammer on Lehman. And Lehman was maybe too big and it was too late. And so that's consistent perhaps with the idea that you should impose losses and impose losses early on in the process to send a signal to the markets.

Evans [00:34:54] So why, if that's the case, wouldn't that be an argument for imposing losses right now instead of raising the cap?

Krishnamurthy [00:35:01] It's an argument, but what we see are our major decision makers don't think it's a convincing enough argument to do. They're worried about the fallout, even even in a situation like SVB. And so if we can anticipate that our politicians and decision makers are always going to ensure in the face of uncertainty, maybe we should have the institutions upfront that deal with them.

Evans [00:35:28] One thing also that Pat said and maybe [inaudible] can chime in as I move along to you, Peter, I wonder if we would all if you would all agree on the following. She said, and this is, without being in favor of raising the cap, nevertheless, we should limit the ratio of uninsured deposits to assets or somehow correlate that with regulatory oversight. And that's something that seems to come up quite a lot, is kind of an obvious best practice that would maybe be quite simple from a regulatory point of view and be kind of fair across the board. So I'll circle back to it, Peter, but if you want to address it at all, I obviously I want to give you a chance just to rebut the the case and make again the case for raising the cap.

Conti-Brown [00:36:08] Yeah. So I think that there's so much on on the table here, but let me do my duty as a yes button side and not not gang up on it. I know that Thomas and Pat will have a lot to say and highlight something that I think that Prasad is getting right, that those who are skeptical of the uninsured depositor bailout, myself included, are just we have to grapple with, and that is crisis fighting regulatory incentives, which are different from supervisory and regulatory incentives in peace times. My my thought I to amplify Prasad, we have crisis-tested regulators in the Biden administration who came to these conclusions. I'm skeptical that they gave due attention, as Prasad says, to all of these downside risks in that single weekend. I think in the fog of war, it's very difficult to do. But to Prasad's point, that's always going to be the case when we've got a large bank teetering on the edge of an abyss, that the fog of war is going to make, the asymmetry of overreacting versus under reacting be front and center.

But this is why my proposal to only focus on small and medium sized enterprises is is so much better than the the rather club-footed, heavy-handed idea of of a universal deposit insurance. And that is because if we had a system where small businesses that were insured up to 2 million, then we would have a we would not have had the same sort of situation in the same sort of criteria. They're concerned so far as we understand them is with the regulators who decided to declare a banking crisis were exactly on these questions, can small businesses make payroll? And for that matter, they were concerned about businesses making payroll in general. But the idea that this would be a bailout to provide free insurance to uninsured depositors always leaves a bad taste and is only considered cost beneficial in order to spread that contagion in the flightiest of those contagion spreaders will be will be those those small businesses whose failure to make payroll will ripple throughout the system. So I think that problem is not completely solved, our bailout commitments are only as good as those who accept them. But this would would solve the problem without introducing all of the extra problems that Thomas and Pat have have identified of of skewing our system over anchored as it is on a single failure.

Let me conclude then, just by saying Kelly, about my thoughts. I think Pat's idea is incredibly good. Citi Group, for example, is is has an uninsured insured leverage of about 3 to 1, meaning 75% of their depositors are uninsured. JP Morgan Chase is about 1 to 1. Bank of America about 2 to 1. Silicon Valley Bank was 22 to 1. My fear, I think that a regulatory correction here would be so much more important because this had been the domain of supervisors. They were not surprised by this. We haven't read the details of the of the reports they filed in 2022, but I would bet my boots that they are. They include raising red flags that this ratio is off. And the reason I feel sure of this is because bank supervisors have focused on that ratio for a very long time.

Evans [00:39:54] So this will kind of morph into the free-for-all phase, and in which case please, to the panelists as well, feel free to jump in and chime in as needed.

Pat, I wanted to ask you a question about the elephant in the room right now, which are money market funds. And so, again, to your point that that cash always has an alternative and it goes to where it's treated best. And the more we assess on deposits, the less cash people are going to hold there, which presents its own risk to the banking system and economic growth, but also now we see cash flooding into money market funds, and that will really pick up from here on out. And in 2008, ironically, money market funds were the problem. They broke the buck. They were overexposed to some risky assets, and that created a flight probably back into the the bank deposit world. In this case, it does look like most of the money market funds, because of reforms and whatnot, are basically just holding treasuries or government money market funds. Do you view this deposit flight as a good thing or a bad thing? And do you view a banking system that is not going to have any kind of increased deposit insurance as one that is going to permanently leave more funds in the money market system instead? And is that a good thing?

McCoy [00:41:06] The interesting thing about the flight to money market funds is that those funds are uninsured. So so the reason for the flight is not lack of deposit insurance. It's that they offer a higher rate of return that the banks do. And and so we have two dynamics that are going on right now. Some some flight of funds are to safety. That doesn't explain the flight to money market funds. Other flights of funds are for yield. And and so we need to disentangle both of them. I, i, I do worry about disintermediation. In other words, flight of deposits out of the system into money market funds for a couple of reasons. First of all, it destabilizes banks. And secondly, money market funds are less regulated than than banks when when it comes to to the safety of the funds that the money market funds. And so so I consider money market funds funds part of the shadow banking system that we worry about not being sufficiently regulated yet creating systemic risk. I am concerned about capping deposit interest rates at banks because it encourages this flight to yield into money market funds.

Evans [00:42:42] Thank you. Because that's the other question I was going to ask. One more follow up, because I want to kind of focus on this idea, which I wonder if is the most doable, pragmatic thing that can come out of this. If you limit the ratio of uninsured deposits to assets or somehow require banks to have capital needs that vary with that package, you just sketch out a little bit about what that would look like and what it would cost?

McCoy [00:43:04] Right, so, so you could have a a very simple ratio of uninsured deposits to assets, for instance, and and have a numeric cap. I don't know right now exactly where that numeric cap should be set. And economists could do sensitivity testing as to flight risk. But it seems right now the median level of uninsured deposits to assets within the banking system currently is in the mid 40%, and so something tells me that that that cap would be of somewhere in that region. As to the cost, that remains to be determined, I think that's a really important question. One advantage that this would have is that it would probably force some deposits out of the four big banks and back into community banks, and that would be, I think, a good thing in many respects.

Evans [00:44:13] And one more follow up question. If you're concerned about money market funds disintermediating the banks, then isn't the only way to reverse that, get money back into the banks to perhaps raise the deposit or offer some incentive, either higher deposit rates or, you know, raise the deposit cap, what's going to be the incentive for people to move their money out of money market funds back into banks? Obviously, liquidity is probably the top reason why they'd want to do that, but what would be the further incentive if we're not going to raise the cap and therefore kind of leave many corporate treasurers feeling like, you know, they can't do good diligence and leave any amount over, you know, 250 and any institution like this?

McCoy [00:44:53] Right, right, so I don't think raising the cap is the answer simply because this flight into money market funds was due to yield. They don't get any insurance protection in the money market fund, so the fact that they would get that protection with a raising of the cap doesn't seem to be an inducement to me. I think unfortunately, what we're going to find is that banks are going to have to offer higher yields. That creates other interest rate risk issues. So the the answers are not straightforward, and I don't want to pretend that they are, but I don't think a blanket raising of the cap is going to solve the money market fund problem.

Evans [00:45:48] And one more question, then we'll move on to Tom. One option you said was to limit the ratio of uninsured deposits to total assets, maybe somewhere in the 50% zone. That might be functionally very difficult for banks. What if there was a model instead where they were just certain costs were imposed on them for uninsured deposits over, let's say, the 50% mark. And so instead of capping their ability to take those deposits at all, they simply, for instance, have to hold more capital or can take less risks when they're above the threshold, something like that?

McCoy [00:46:18] I think that is an important alternative approach to be considered, in fact, something that I think has been obscured in the whole discussion about the failure of Silicon Valley Bank that's been portrayed as purely a liquidity issue, but in fact, it imposed a very large loss on the deposit insurance fund of about $18 billion, and what that tells us is that Silicon Valley Bank actually was undercapitalized, that that will come out in a future inspector general report, I'm fairly sure. And so so we have to be concerned that bank capital levels are actually too low and we need to raise minimum capital adequacy requirements.

Evans [00:47:10] So, Thomas, I'll turn to you and and and ask about the practicability, which we spoke to a moment ago about distinguishing between small business and household bank accounts. You know, if we're not going to be able to meaningfully do that in the U.S., then what other option is there other than deposit insurance to kind of force appropriate risk taking behavior at banks? And to put it a little bit differently, one of the arguments I hear for raising the deposit cap is to say that this wasn't a bailout because equity was wiped out, that obviously, you know, a [inaudible] and so on and so forth. So, in other words, if you're running a bank and you run into trouble in this situation, your equity is still going to zero. You know, you're out of business, you're a pariah and so forth. So I guess the question would be, you know, is this really a bailout or are we just protecting depositors? And aren't banks still punished for their bad behavior even if we raise the deposit cap?

Philippon [00:48:11] Okay, so in sequence. So first it is a bailout. Anybody arguing the other way does not understand economics. So it is a bailout because you bring in outside money to bail out people who had their money in the bank. Now, whether you recoup that money by raising taxes, okay, that's a taxpayer bailout or by raising the fees on every other deposit down every other bank. Since most taxpayers also deposit is exactly the same. So it is a bailout, no question.

Second, the fact that you wipe out equity and debt does not mean you solve any problem because the guys have an incentive. That means in bad times they lose that money. Yes, but in good times they make a lot more money than they would without the more hassle. That's the whole point. They have a funding base that ask for 0% return on something extremely small like deposit. That means that in good times the upside for the equity and the junior debt in all of these guys is extremely high. But they make all the money in good times. That's always going to be there. The fact that you wipe them out in the one case where from time to time they fail does not solve them. So that argument and the fact is arguing that, oh, because we wiped out [inaudible] that we sold the more has other is actually also completely wrong.

Now with respect to the two things, the money market fund, the railways with this, that shows you the the tension as I agree with Prasad, if you want to go to if you want to expand the broad insurance, you're going to have to put tons of rules and have to have quantity limits on the you gonna have to essentially have quotas to limit the size of the gap between have limits on interest rates and the veins cannot outcompete each other on this thing. You're going to have to increase tons of new layers of challenger to capital in the system. But then if you put cap on deposits, then they can't compete with any market fund. So then you will back, this is literally going back to the eighties. This is like the “Back to the Future,” that movie. That's that's what we are doing. This is also we've discussed like 30 years ago, this is not new. So I don't think that's going to work.

The other thing that is true is that we've learned that some depositors are more flighty than we thought. So okay, that is there is something called the liquidity test or liquidity coverage ratios. And so what you do is you take a bank, assume that say for what it's going to cost for one month. They can't get wholesale funding in their market. They get some bad news, so their haircuts are increased and then you make assumptions. So they have a liquidity problem. And then you ask, as a regulator, do you have enough money to survive this liquidity problem? One of the key elements when you do that assessment is assumptions, behavior or assumptions about how depositors behave. And the typical assumption is insured deposits stick around, so that means that you assume that $1 of bank of insured deposits will stay within that stress period. And then you have other assumptions for uninsured large depositors, which is an extent to which they are supposed to go away in a crisis. Yes, these numbers are too low, because we saw that in the SVB case, these guys can run faster than we thought. That means that going forward, all we have to do is tighten up the assumptions, to be of your assumption about large depositors in a liquidity crisis. This will automatically do what Patricia would say, because that means that mechanically, you know, if you have a lot of unusual deposits, that number, that liquid you drain is going to be high. And so automatically the liquidity coverage ratio regulation is going to say that banks must have more liquidity on the asset side in front of that, the public, but that's the way to do it. It's the way to do it is not to put a cap because a cap would not occur in a different business model. You have banks who have extremely, even today, you have banks in which you have very large amount of financial deposits and they have no problem like Bank of New York. Why? Well, because they run the Tripathi repo markets. Okay. And it's all electronic transaction from from large corporates. But of course, they have an unlimited pile of cash in front of it and nobody is worried about anything. So banks can have different business models whereas the where the ratio of uninsured to insured deposit can vary a lot.

One way to think about SVB is and that's kind of a rule for banking, one mistake doesn't kill you in banking, two mistakes at the same time do. So you can have a lot of uninsured deposits, but then you need tons of cash on the asset side. Not long-term debt, not Treasuries, cash. And that's fine. You can perfectly run that business model and many banks to be successful. Or you can have a very stable deposit franchise, very diversified, in which case you can have some assets and you can afford having some, you know, unrealized losses on these long term assets that are not mark to market because your contract is stable and therefore you're going to run through the thing that's called the value of the deposit franchise of the banks, and it's actually most of the value of the banks. So that's fine as well. But what you cannot do is both at the same time, you cannot have very long-term exposure on your banking book and a very diversified deposit franchise. When you make these two mistakes at the same time, then you get SVB. My point is, just like there are very few banks who make both mistakes at the same time. And so I don't think we need to overhaul the whole system just for that.

Evans [00:53:34] Well if we don't change the system, will the big just get bigger, you know, because people will say so for the problem with this. But this is also the problem.

Philippon [00:53:43] Yes yes the too big to fail is and that's what I agree. That's to me as the biggest.

Evans [00:53:47] Because it it's not like we can all go, oh, you know what? It's the year of 2014. We're mid-cycle. Let's take a moment to examine SVB, like these things always happen with the business cycle. So right now the problem is so people might be sitting there going, okay, let's say I'm worried about commercial real estate. Even the sell side analysts, you know, the entire investment community is trying to figure out the answer to this question. They didn't spot SVB coming. They're probably not going to get it exactly right on on commercial, you know, office exposure, for instance, and who's going to suffer most from that. So how are any depositors supposed to figure out which institution is going to be safe from from any future losses? Because we are watching the business cycle roll over. And so why wouldn't people just say, I'm going to go stick with, you know, one of the big four, big five, and kind of like a personal observation as well on that front. When my husband was starting a business and wanted to open a business account, I mean, big five were like when, you know, we don't just open business, what are you talking about? Like there there is a real sort of utility that these small banks and SVB in the startup community played in the sense of supporting the creation of new businesses. And if all the deposits go to the big four, big five or whatever, it's probably going to undermine new business formation.

Philippon [00:54:58] Correct, no, no, so, I think that's one place we I believe we all agree, which is that you need that you need a way of treating the deposits by small and medium sized enterprises, by small businesses. You need to find a way to treat their deposits in a bank differently. So it could be so one, what Peter was saying was, let's have for these guys the higher level of the deposit shops, so say 2 million or something. I think that's what you were thinking. Or two and a half, I forgot what you wrote in The New York Times today. So then you would have, like say, you would have a 200K for your, for your average family and 2 million for your typical SME. And that's one option. In Europe, we didn't do that. What we did is that we said that in case of resolution or recovery, SME deposits have priority over other deposits. And so for take the case of SVB. The problem is you had to bail out everybody and lose $18 billion, as Patricia said, in order to protect just the SME accounts. Yeah, well, but there's a simple solution. Don't make them all very basic. Don't treat them all the same. You say that what we're going to do is that first that the insured guys are paid out, of course, 100%. And then next our SME deposits. They have priority over wealthy household deposits. If you do the math for this case, this guy would have got 100% of the deposit back. But of course, the flip side means that the wealthy household would probably have a slightly higher haircut. Yeah. So that's another way of doing sort of the same thing. I'm not sure which one is best at that point, to be honest. I think this proposal makes sense. I think in Europe we seem to be walking fine with the priority structure. You can, we had both at the same time, but these are practical solution to the specific issue of SME deposits because these guys do need a large transaction account. I think that's just absolutely clear.

Evans [00:56:55] Oh, for sure. And a priority, using priority might be an easier way than trying to differentiate between accounts on real time or instead [inaudible].

Philippon [00:57:06] So there's also a little thing that the other elephant in the room beyond the money market funds is the US. Okay, so the only reason we're having this debate is because we are talking about the US. No other country in the world as enough money to even contemplate a full deposit insurance on deposits. This is like the dollar privilege that we're talking about. Like this is something we would never discuss in any of our countries because nobody has the fiscal capacity of saying, oh, I'm going to guarantee all deposits. So therefore, they have to find rules that are a bit less taxing for the balance sheet of the governments and therefore we go for the priority rather than the present chance. But it doesn't mean that would be the right solution for the US.

Evans [00:57:45] Prasad let's come to you and kind of circle back to this issue of competing for cash disintermediated the banks. And if this, as we see, there's tons of capital flowing into money markets right now. You're on mute.

Krishnamurthy [00:58:01] There is some convergence kind of taking place here in that I think there's a lot of agreement among the panelists on what are the kinds of regulations that we need going forward, because I think there's some agreement that capital levels need to be adjusted in light of the new reality that many more deposits are insured than we thought, that we we should treat banks that have deposits of any type as posing liquidity risk, and those deposits should be deep in the banks capital structure. There shouldn't be a lot of junior debt and equity on top of it when we were disagreeing is saying like, whereas I'm saying that should be accompanied by some legislation or regulation that says we're doing this because the deposits are actually insured. My, my discussants on the other side are saying, well, we should maybe keep that ambiguous because maybe there's some value in that in that ambiguity.

But on this issue of money going out of the financial system, and this goes to a point Thomas was raising, that saying that is what I'm proposing, essentially a nationalization of the banks. I think that's going that's putting it a little too far. There is there is some sense in in potentially capping deposit rates. And that sense might exist even if we don't have explicit insurance because we have implicit insurance. So there is a case for a kind of price control there, but it's similar to the way in which the Fed sets overnight rates with banks. That's also a rate that's set by the government. And there is already quality controls, in that regulators already try to cap the deposits, the insured deposits that banks have, and they should try to cap the uninsured deposits, too, because we know those are actually potentially insured. It goes far beyond small business transaction accounts. Secretary Yellen has said systemically risky deposits are are potentially protected. That's that's far broader than small business transaction accounts. So if you were to have these kinds of regulations in place and maybe a price cap on deposits in place, yes, money would go out to the money market funds. And this as Tom was saying, it's like back to the seventies, which is maybe like a bad movie in some way, but I'm not sure that's such a bad thing because what one package said going to the money market funds must be about yield, but it's also about risk because what do money market funds hold, either they hold treasuries or they hold a diversified portfolio of financial institution debt. This was made very clear, actually, it's the data that came out in the aftermath of the last financial crisis. So if you hold that money market fund, that's a private money market fund, you have a diversified portfolio of bank debt, essentially, and just one small bank failing is not really going to affect the value of your portfolio. So you're getting you're getting insurance through diversification, and maybe we should have more money that's in money market funds. An idiosyncratic bank risk won't threaten depositor action if everybody just holds a portfolio of financial institution debt. We'll still have systemic issues that exist in the money market fund. But we're always going to have systemic risk issues and at least will only have problems when there are large scale bank failures as opposed to the contagion problems that we seem to be trying.

Evans [01:01:15] It's very interesting, and I would I would love to know if there's been work on kind of the ideal percentage of, you know, of funds in money market versus banks, and I'm sure the answer, like many things, is that it depends. Even now, money markets are very different beast than they were, you know, in '08. They're they're largely government, you know. So I think that's why Treasuries feel more secure about them. Peter, let me turn to you, though, and ask about what we were just discussing in terms of, you know, how do you kind of identify and segregate small business versus household accounts could be very difficult to do, you don't want to, you know, create all sorts of weird incentives that extra regulatory you know, I'll put it this way, I worry it's a little impractical, but you certainly can identify the accounts like we're talking about with Thomas, maybe deal with that in resolution. What do you think about that idea?

Conti-Brown [01:02:05] Think that both ideas the European model of dealing with it in resolution, with providing higher priority, which is a version of what we do in the United States, as Pat mentioned. We have mechanisms on the Monday-after failure to provide businesses with payroll advances on uninsured deposits. I like that proposal a lot. I like the transactional proposal proposal a lot. I don't like them all the way. And here's why. The the basic fundamental, fundamental principle of deposit insurance is the clarity and the signal. It's not new to debates about deposit insurance limits that go back to the late 19th century in the United States, that wealthy individuals and businesses are not identically situated. They felt that we would that we couldn't solve the problem because people would be confused about who they were relative to, to these issues. And I think that's something we have to take seriously that's in favor of either the status quo or in making deposit insurance unlimited.

But the the problem, though, that we see in other parts of our of our lawmaking and policymaking is that we distinguish between individuals and companies all the time. The tax code is filled with these kinds of instances and places where we really worry about tax evasion and arbitrage are for the wealthy don't really apply. People aren't going to bend over backwards to try and take advantage of very low interest bearing investments. And the truly financially sophisticated wealthy people have already solved this problem for themselves. But if you are a small business owner and you are told, don't worry, you'll see your insurance, you'll see your recovery be given a higher priority in bankruptcy, that business owner is going to say, "wait what recovery, what's priority and wait who's bankrupt?" There's just no clarity. You don't get the FDIC stamp saying, in a legible way that you have a high priority in bankruptcy, and so that's going to increase the flightiness of people that we want to stay put. The same applies to a transaction account. I really like this proposal, I think it's far better than the status quo. I would if I were a politician, I would vote in favor of it. I like the proposal I offer more because it is relatively simple. I think it is easy to implement, although not trivial to implement. But if you tell your aunt or uncle at Thanksgiving that we are going, the new policy is to provide either very high insurance or unlimited insurance to transaction accounts, their very first question is, wait, what's a transaction account? And you can start to explain, oh, it's like your checking account, but that's not actually true, your transaction account could be your savings account through which you do ACH payments in and out. And then that leaves people saying, so wait, which of my accounts is a transaction account? And even with our sophistication at that Thanksgiving table, you can't say, "I know the answer to that, let me show you". And so I don't like the transaction account proposal for that reason. That said, all of these ideas of trying to create more opportunities for SMEs to make their recovery through either transaction accounts priority or a numerical limit are all better than the status quo, and don't introduce all of the issues that I think Thomas and Pat have have us nailed to our rights. Dead to rights, I should say, on why the unlimited insurance proposal is not a good one.

Evans [01:05:39] One more question and then I want to kind of go back around the horn to anticipate the path that we might be going down this year, sort of based on on which regulatory choice we make or don't make. But, Pat, my one question to you would be, would you support, for instance, a move that said, okay, we're going to raise the cap to 350 K, that's more or less inflation adjusted from 2008. People are now fully aware of the risk that you have if you leave uninsured deposits in the system, they've probably moved money already, they will probably continue to do so to evaluate other needs, etc. In other words, behaving in the kind of risk seeking way that you might want them to behave in while at the same time providing a little bit extra cushion of 350 as a way of still implying, you know, we don't want people really obsessing, especially households too much about, you know, is my bank going to go under and and so forth. So would something, would something as simple as just raising the cap to 350, Pat, be something that you think would be the right move here or would that even introduce problems that you've discussed?

McCoy [01:06:44] I have a couple of concerns about doing that. I do think it would increase moral hazard, but I think more importantly, it would proceed by half measures, it would not solve, if we are really concerned about the flight risk of uninsured depositors, it does not solve that problem. And so so I wouldn't go down that path. I am intrigued that we now have this breathing spell in which we do see smaller businesses making plans, contingency plans for the next time. And so if you do a simple Google search, you'll find all sorts of law firms with newsletters giving advice to companies about various Treasury management techniques and in talking with companies, I'm on the board of of a nonprofit, and tomorrow we're having this discussion about Treasury management at the nonprofit. These discussions are going on in boardrooms all over the United States right now. And so, again, I think the call for lifting the cap is premature. This resort to private market protections is a very important shift. And I'll close by saying one last thing, which is that we managed to get through the 1980s crisis. We managed to get through 2008. We managed to get through the 2020 COVID financial crisis, which which was short in duration, without these overwhelming concerns about payroll protection. And my concern is that we can solve these problems without going to what is a really drastic move for moves removing all caps altogether. Peter's proposal is intriguing to me, but I do worry about its administrability. It will create confusion among members of the public about exactly what the caps are, because there would be two caps, and I'm concerned that there might be some fraud in creating accounts that qualify for the higher cap that truly are not small and medium-sized enterprises.

Evans [01:09:31] In this country? No, never.

McCoy [01:09:34] Never. Not after PPP.

Evans [01:09:37] I can't imagine that that would ever happen. So let's let's just kick, there's there's so much more, obviously, you guys, there's so much more we could get into. I think this is has been helpful but there's still sort of big question, I mean, there's a layer, I think, which maybe everybody would agree that kind of goes back to what I was saying. You know, taking the ratio of uninsured deposits itself as a key input and perhaps requiring, you know, some kind of big response to that maybe on the capital front or something else. So I just want to offer that is an observation that you can rebut or agree with, and then ask each one of you to just weigh in on what you think is going to happen for the rest of this year, on if effectively nothing changes right now. So, you know, not to make too much out of the 2008 comparison, but, you know, if SVB was Bear Stearns, is there a Lehman event that we're heading into the way that we're going to see losses in other parts of the economy, like I mentioned, commercial real estate and others, or or not? Are we making too much of all of this? So if you don't mind just spinning this forward a little bit to kind of help us understand the risks or opportunities here? Prasad, I'll ask you to go first.

Krishnamurthy [01:10:52] Sure, so, you know, I would say on on what's the right number to set as far as an increase in the limit? It's really it's a macroprudential financial regulation question. So it can't be analyzed at the level of thinking about 250,000 for a household or as 300,000 for a small business. It's we need to think about what is the amount of aggregate uninsured deposits, where does it sit and what is its run risk in the event of bank failures of various sorts? Because bank failures will will happen in the future, that banks will never be perfectly managed, there are too many of them, regulators will never perfectly get it right.

So I think we need to think about that question of the right limit in in that way. And then I agree. You had mentioned what are some things that we can do right now if we don't make any changes, we can act from the regulatory perspective as if our deposits are insured. And so have regulators treat uninsured deposits like insured deposits in the sense of asking banks to hold more capital or to hold subordinated debt, or to make sure that there are limits on their total deposits as opposed to just limits now on the insured deposits, which are what the FDIC is more concerned about because it historically thought that was the deposits they were insuring.

So I think there are intermediate steps that we can take now. Do I think that they'll be taken? Probably not. Peter may disagree with this, he's got it, a, he has a very influential paper in this area. But I still think that financial regulation happens after a crisis, so something bad will happen, there will be some bank failure, we may see that there's more run risk than we thought, and then after the fact, we'll try to craft a solution to that problem. That seems to be our historic pattern may be interrupted in certain ways and with some some twists to it, but that would be my view.

Evans [01:12:40] Peter.

Conti-Brown [01:12:43] So thanks for that shout out, Prasad. I do think that the likelihood of legislative change following this in the current government is relatively low, and I'm troubled by this. We need to have some sort of mechanism that gives a a that changes the risk profile for regulators. The declaration of a banking crisis on on March the weekend of March 13th is a an absolute misgovernment. Either because they got it wrong, which I'm mostly persuaded by at this point, or because they got it right, and that tells us that there is so much rot in our banking system 15 years after the last crisis, that the rest of the apparatus got it wrong ahead of time. And so I think most of the changes that we're seeing there, because I think the likelihood of legislative change in response to this crisis is low to moderate, perhaps after the 2024 election if there's a realignment.

But even then, I think most of the changes that we want to see are at the regulatory and supervisory level. And for that, I think there's a really important, if somewhat squishy case for us to make, which is the way that we as the public, as academics, as commentators, as journalists remember, March 2023 should be as a black mark, not only on the bankers who got this wrong, I think Prasad's point earlier, that the overwhelming majority of bankers got this right is correct. We need to have this be a black mark on central bankers and the government regulators who either got this call totally wrong and did not allow the system to work. They didn't allow uninsured haircuts to work. They didn't allow Dodd-Frank to work, or they got it wrong in the many years leading up to this. But this can't be seen or celebrated in the minds of future regulators as a as a case of a really effective crisis fighting or bank supervision or a bank regulation. And if we can distinguish that, then I think we've increased the cost of of sprinting toward overcorrection and overreaction in the face of this kind of crisis. And also, we increased the costs of massive desupervision and deregulation. The costs of both of those governmental decisions should be increased far beyond what they were in February 2023.

Conti-Brown [01:15:16] Thomas.

Philippon [01:15:20] First of all, I completely agree with what Peter just said. This would be remembered as a black mark. In fact, to be honest, from a European perspective, this is the US did exactly what the US was making fun of Europeans for doing ten years ago, which is no no depositor left behind. Even those even those who don't, they were not actually insured. So there is no question that this would be remembered as a black mark.

You were asking what's like asking a tough question, which is you're asking economists to make predictions. What's going to happen this year? Well, so I'm going to make one and then be able to be proven wrong. So I think that it's clear the government bought some time by these actions. I think that what we will see is, you know, we move from runs to profit margins. And it's not that complicated to understand. So, you know, the rally is the thing we worry about now, I think the government action us, but enough time that we are not going to see too many runs, but we will have repricing of funding for the bank and it can happen in two ways, the money market is one example. So imagine somebody who has money in the bank and they take it out because there's a higher yield in the money markets. Yeah, where is the money market going to park the money where they could put they could put that in Treasury bonds bills, sure, but they would also provide wholesale funding to the banks. In fact, money market funds are one of the main source of wholesale funding for the banks. Now, what's the difference, though? The money is coming back to the bank, well, the difference is not at the same price. So because the depositors used to receive very little on the accounts, and if they put it back in the mutual a money market fund, which then provides the money back as wholesale funding to the bank, that would be at market prices. So what that means is that this run risk is going to turn into a standard profit margin bank market, bank market value of equity risk. So what we would see is more differentiation among banks based on their deposit franchise. Those with a truly stable deposit franchise will keep their profit margins relatively stable, and therefore you're going to see the equity value being sort of okay.

That's what we saw, by the way, over the past months. I mean, if you look at the market prices of bank equity in the US and in Europe for all the way managed bank are back to where they were before is B. But of course banks who don't have a high quality deposit franchise, which when we say that, by the way, it sounds abstract, but it really means you provide services to your depositors beyond deposits, so all the transaction act on principle, a variety of other services linked to that account, and that's the reason people are willing to keep their money in the bank even though the interest is low. So this is what we do is what we mean by deposit franchise. So the banks will have that will be able to maintain their profit margins better and the value of equity is going to stay. So that means that the run risk is going to turn into a repricing risk and therefore profit margin risk. That's something which is much more manageable. And also we'd have more time to see at the end of the year or the banks that are losing value. Maybe that's going to trigger also mergers or consolidation in some cases, but otherwise I don't think it's going to have crisis consequences.

Evans [01:18:28] One observation, Thomas, is that it was SVB's loss on its securities that kind of prompted the run in the first place.

Philippon [01:18:37] Yeah.

Evans [01:18:37] So what happens in a in a regime where things are so uncertain as to take everybody's comment, it looks like we're going to be kind of status quo, whatever the status quo is for some time. So let's say my my bank comes out with bad earnings and, you know, I see the share price go down 6% on that. I mean, am I panicking? Have I already panicked? Is there no need to panic? You know, I guess the point is, as this turns into a profitability issue, which is exactly what's going to happen, does the does falling profitability itself risk triggering further bank runs? Because people are now unclear about whether their bank is going to become the next SVB or whatever.

Philippon [01:19:17] Well, so, I think are there's three, three, three key points. The first is the one that Patricia made earlier which is which is again specific not to households, I think because, you know, the vast majority of households in the US, like 95% don't care about any of that. They have less than 450 K anyway. None of that matters for them. The rich ones, they have other ways to deal with it. So the ones that are kind of stuck in the hard place are the SMEs. They don't have like the full-time treasury of very large corporations to get out and risk management essentially run their own bank if you want. So these guys, but as Patricia was saying, these guys, they are not waiting for discussion. They've been talking about that for the past months at every board meeting. And so they are looking at solutions and they see there are many solutions already in the current system. We see accounts that can't make that. So that's the first thing. And the second one is on the asset side of the banks. There are two, two difference. I think two key issues. One is the market-to-market of long-term asset treasuries, agency debt and stuff like that, and too much bank securities. The thing there is this is really transparent. In the math, you can do the math in five lines. It's really simple. Now, the mark to market losses are horribly large. Okay. But of course, they are in for 90% of the bank, they are exactly offset by the change in the franchise value of deposits so that the impact on net margins is going to be nothing. I think that's going to be true for the vast majority of banks. And the other key feature to remember and the big difference between today and 2008 is that these losses are fully transparent. I mean, literally, I can compute them on an Excel spreadsheet in 5 minutes for all the banks. It's that simple. So I think that's going to, I don't think that's going to create any new surprises. And if anything, by the way, the crisis itself, as the Fed to delay a little bit the hike in interest rates, 25 lives instead of 50. So that's going to push a bit in that direction.

Evans [01:21:14] Just to interject. The loan books are more what I'm talking about as those start to sour on consumer and commercial.

Philippon [01:21:21] But consumer, I'm not worried. Commercial real estate is slightly different. So commercial reale state is tricky, because it's also in commercial rates and that includes two mortgages for a household just classified as multifamily. So commercial real estate is a bit tricky because that's also that's where we could see a credit crunch. Because the banks that were more affected by the repricing of deposit risk are also the ones who are more heavily involved in commercial real estate. And so that means that there is a bit of a risk of a credit crunch in the commercial real estate market. Going to an end point too, the losses are going to be harder to evaluate because these are not securities that are mark to market all the time. So this is the one place, if you want to think, where you could have something that might look a bit more like what we had ten years ago, we would be in that market.

Evans [01:22:09] And Pat.

McCoy [01:22:12] Yes, I wanted to circle back to some of Peter's comments and talk about what may be going on behind the scenes. If we think about needed reforms at bank in terms of stricter regulation, those reforms are not going to happen through Congress. I think we all agree on that, on this, on this call, however, the regulators themselves have substantial discretion, and they have discretion along three different dimensions. One is supervision, which which is is a fuller name for bank examinations. You can bet that bank examiners right now are all over the banks and and that the banks are under very close scrutiny to clean up their balance sheets as as far as they can do to try to stabilize their position. And that that undeniably is going on right now. That is a highly confidential process. And so we will not have sight lines into it.

But the regulators are under incredible pressure to ramp up their supervision. They can also ramp up enforcement. One of the questions about Silicon Valley Bank, for instance, is the enforcement history there. That sometimes, again, is a confidential process and in other cases is a public transparent process. And so we may see the beginning of more enforcement actions that would require banks with binding enforcement actions to take certain precautions. The last thing that regulators can do is propose regulations. For example, going back to Thomas' point, Silicon Valley Bank and Signature Bank were not subject to the liquidity coverage ratio because of their size. However, the Federal Reserve has the discretion under statutes to extend that ratio down to banks between $100 billion and $250 billion in size, which would cover both of those banks. If it were extended, I will stress that the regulation process is a slow one. The regulators have to formulate a proposed regulation, they have to publish it, put it out for public comment. The comment period takes a couple of months. Then the regulators have to read the comments and then maybe they write a proposed rule, and so a rocket docket for regulation is a year. Often rulemaking is take longer than that. So I anticipate rule makings, but they will not be overnight.

Evans [01:25:31] So finally, I just want to know if anyone's mind has changed Prasad or Peter, either of you maybe thinking that perhaps we don't need to raise the cap because of the actions that symbols are taking to protect themselves now?

Conti-Brown [01:25:45] I have. Thomas and Pat have made some incredibly effective arguments. It's not fair ,because I started out already inclined to believe them a little. So I'll say that I think the SME problem is very serious. I agree that it's solution is not obvious. I fear that if we don't solve the SME problem, then then Prasad's strongest argument, that I think has has persuaded all of us, that regulators are going to guarantee whatever the law says if that remains our unchallenged reality. You know what regulators saw on March 2023 is what they will always see in the face of any kind of of major bank failure.

Evans [01:26:35] Or do you think, Peter, that the SMEs are going to take care of this problem themselves because they have boards or they they see they're not going to shoot themselves in the head unnecessarily, and therefore, is the sort of are these private market solutions going to step up here in the interim without us needing to change the rules?

Conti-Brown [01:26:53] I don't know if they have enough incentive to do so. I think they're going to draw the lesson from Silicon Valley Bank that they don't need to.

Evans [01:27:00] Even if that's a bit of a gamble?

Conti-Brown [01:27:02] Yeah, they like to gamble with public money. That's the asymmetry of it, that's what's frustrating about it.

Evans [01:27:07] And Prasad, our last comment.

Krishnamurthy [01:27:09] Cheers, I've been convinced that we can get a lot of the benefits of a regulation without necessarily officially stating we have insurance of uninsured deposits, even though in fact we do. And I think I'm not persuaded that this is an issue that we should think about with the SME focus. It's a I think it's a it's a financial stability, systemic risk issue. And as far as hidden risks, you know, I went back to long term capital. I mean, that was those were losses that were in the Russian bond market. But the lesson of long term capital wasn't that we should worry about the losses in the Russian bond market, it was about losses to systemically important financial institutions. So going forward, we don't know what the next credit crisis will be. If we did we would all be wealthier than we are. But but we know that it'll be in some some area that we couldn't anticipate. And then the question will be, is uninsured or uninsured deposits posing a run risk to the system in that environment? I'm not persuaded that we we have a good answer to that question.

Evans [01:28:13] Just a quick--

Krishnamurthy [01:28:13] Sorry, so the last point that I haven't had the chance to make, there's been some concern about how depositors might absorb the costs of this, right, at the deposit insurance bond and is paying for uninsured deposits as well, $20 billion for SVB, but who pays for that? We can think about ways to do that in a more progressive way. For example, the FDIC could say to banks, "we will not assess you on your first 24, on the first $20,000 in the account", and there's no assessment fee for that. All the assessment will be for the marginal additional dollar of deposit above 21,000. Now you're assessing a fee on banks that they're not going to pass on to low deposit customers because there's no cost associated with that. All the fee will be associated with the large accounts. So there are ways to structure those fees that are more progressive, so to the extent that there are these progressive concerns about for deposit insurance, I think those can be met.

Evans [01:29:05] Yeah, it just interesting. I know we have to leave it here, but if we already have the benefits of this unofficial backing side, that means we also have the drawbacks of them that Pat and Tom, Thomas are warning about, which means that we're already basically incentivizing moral hazard because some people think we already have introduced a system of unlimited backing. So that's why I do worry about if authorities decide that's not the message they want to send, that they will choose to send that message in an impactful way, shall we say. But I know we're we've reached our limit, and thank you all so very, very much for being so generous with your time. And these are just so, so such wonderful thoughts for sharing with us today. David.

Wessel [01:29:45] Thank you, Kelly, and on behalf of the Hutchins Center and the Wharton Initiative, I want to thank everybody for participating. Thomas, Prasad, Peter and Patricia. I think that in my mind this is a model of what discussions about public policy should be. We style that as a debate, but it wasn't people who it wasn't a conversation where people stuck to their corners and felt that they couldn't acknowledge other people's points. This was a thousand times better than the congressional hearing that will be held on this topic. And for that, I thank you all, and I particularly thank the online audience for joining us. And this video will be archived and you can watch it over and over and over again. So thank you all and have a good day.