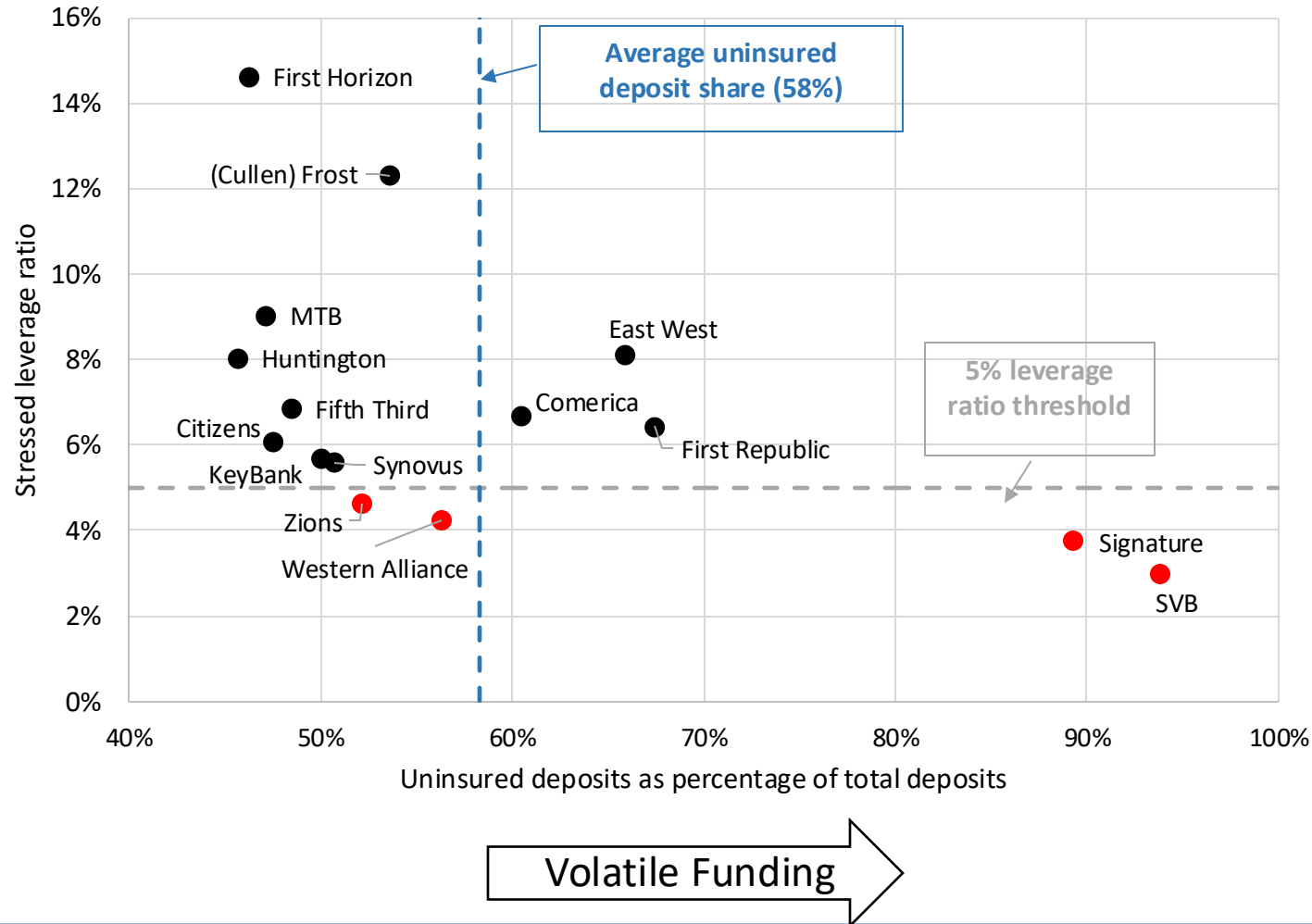


LESSONS FROM THE MARCH 2023 TURMOIL

Stephen G. Cecchetti

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Fatal asset-liability mix



Banks can survive either

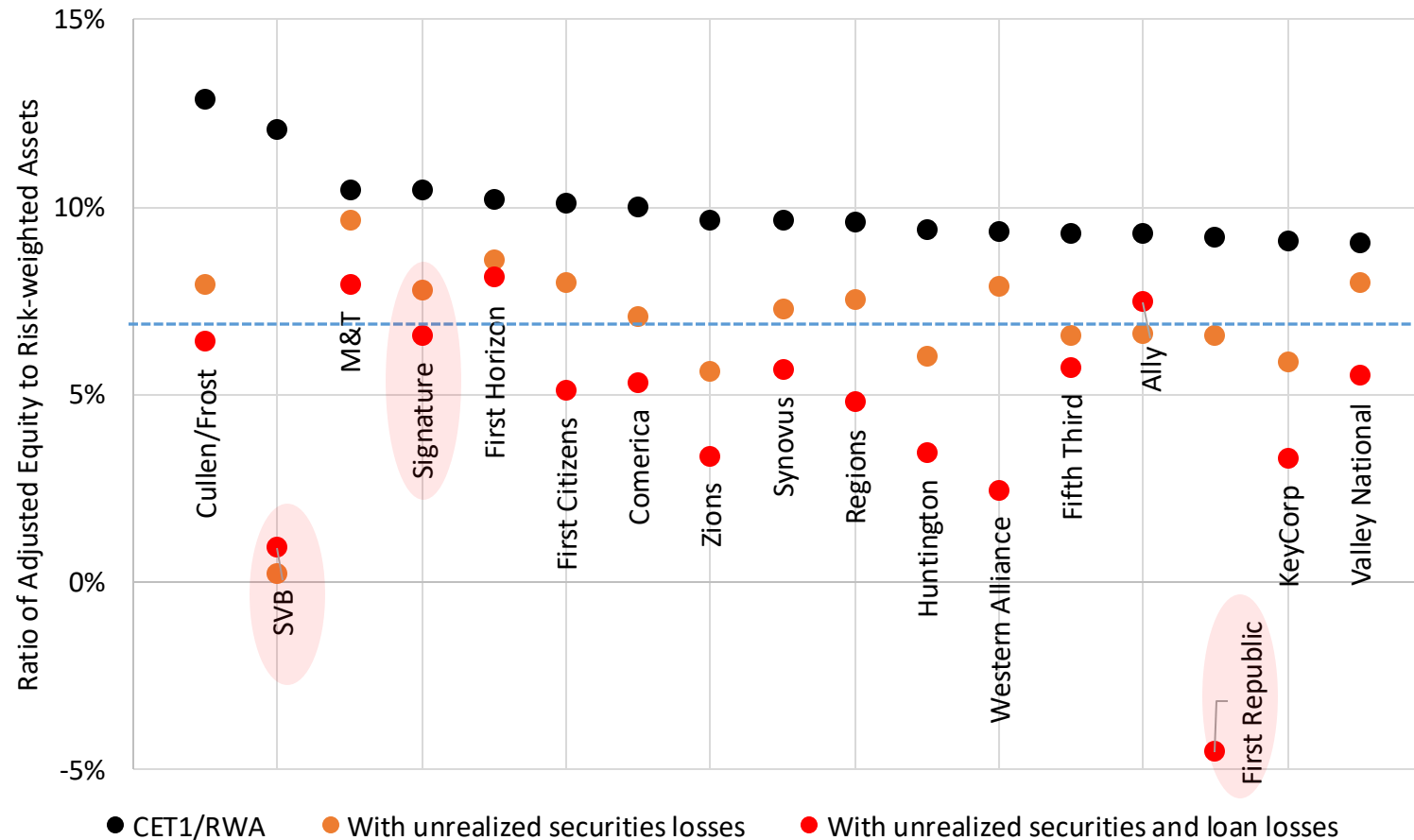
1. volatile funding

or

2. risky assets

but not both

Impact of unrealized losses on mid-sized banks' capital ratios (percent of risk-weighted assets), Q4 2022



Unrealized losses pushed most banks below the regulatory minimum.

Source: JPMorgan Chase Asset Management, courtesy of Michael Cembalest.

SVB, Signature, First Republic, and beyond

- Banks cannot have both volatile assets and runnable liabilities
- Banks provide critical services, e.g. to payroll service providers
- Post-crisis capital and liquidity reforms are insufficient

Important considerations

- Social cost of capital << Private cost of capital

Well capitalized banks: lend more, to healthier borrowers, less procyclically
(Remember, capital is a *source* of funding, not a use of funds. It is not idle!)

- People who create externalities never voluntarily bear the costs

Polluters don't like pollution taxes, but the social good is clean air and water

Financial polluters don't like capital regs, but the social good is financial stability

Big lessons from March 2023

- 1) You will always bail them out
- 2) Supervision is essential but never sufficient
- 3) Current accounting rules are inadequate

You will always bail them out

- There is an insurmountable time consistency problem
- Commitment to not bail out lacks credibility
- No one wants to be the parent of the next crisis

Supervision is essential, but never sufficient

- Private incentives favor concealment of risk
- Detecting risky behavior will always be difficult
- Even if detected, officials face a high bar for imposing remedies
- Changing attitudes of officials weaken credibility to sustain rigor

Current accounting rules are inadequate

Shift toward mark-to-market (fair value) accounting

- Improves transparency
- Focuses attention on frailest institutions
- Encourages better risk management
- Allows resolution authorities to act promptly

Reform proposals

1. Strengthen existing capital funding and liquidity standards
2. Adjust or replace deposit insurance

Strengthen existing capital funding and liquidity standards

- A. Raise capital requirements
- B. Strengthen and simplify liquidity requirements
(Make liquidity rules sensitive to mark-to-market capital)
- C. Modify financial accounting
(Shift to mark-to-market and stick with it)

Adjust or replace deposit insurance

A. Options for refining the current system

- Improve risk-adjusted pricing
- Targeted increase in caps for SMEs

B. A more radical option: Pawnbroker for All Seasons (PFAS)

- All short-term liabilities backed by central bank (prepositioned collateral)
- Covers banks and nonbanks offering liquid liabilities
- Haircuts on bank assets determine (risk-based) capital requirement

Priorities for reforming regulation and supervision

- Higher capital requirements
- Recalibrate liquidity requirements
(make them mark-to-market capital sensitive)
- Modify accounting standards

Readings

- Cecchetti and Schoenholtz “[Making Banking Safe](#),”
CEPR Discussion Paper No. 18302
- Acharya, Richardson, Schoenholtz, and Tuckman, eds.
[SVB and Beyond: The Banking Stress of 2023](#)

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Crypto group Circle admits \$3.3bn exposure to failed Silicon Valley Bank

Stablecoin's value drops as crypto market reels from US bank failures



US exchange Coinbase said it was temporarily pausing conversions between USDC and the US dollar © Bloomberg

Even large uninsured depositors
do not monitor banks

The Washington Post
Democracy Dies in Darkness

ECONOMIC POLICY

The company that needed \$545 million for paychecks when SVB collapsed

The Silicon Valley Bank crisis could have mushroomed well beyond tech when Rippling, which distributes other companies' payroll money, had its funds frozen



By Jeanne Whalen

April 2, 2023 at 9:40 a.m. EDT

RIPLING

Providers of vital services
have large uninsured deposits