TOWARDS A NEW BANKING PARADIGM IN US?

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The failure of three banks in the US, between March 10th and May 1st 2023, revealed weaknesses in the banking regulation and supervision scheme in charge of the Federal Reserve (FED) and raised questions about the deposit insurance scheme in charge of the Federal Deposit Insurance Agency (FDIC). This, possibly, marks a turning point in the US financial architecture; and is an opportunity to lay the foundations for a better banking system.

The cases

On Friday, March 10th 2023, the FDIC intervened and closed Silicon Valley Bank (SVB). As of December 31st 2022, the SVB had total deposits of approximately US$ 161.5 billion and total assets of approximately US$ 209 billion (being the #20 bank in the ranking of banks by deposits). Simplifying, the fall of this bank was due to two fundamental factors. On the one hand, the liabilities showed a very high concentration in large short-term deposits of companies that, due to their amount, were not covered by the deposit insurance guarantee; this type of liabilities are highly volatile and should never constitute the major part of bank's deposits. On the other hand, the assets consisted mainly of 10-year Treasury bonds, acquired with those deposits at times when the interest rate was close to zero. When the Fed started raising rates, the value of bonds fell -as textbooks indicate-. Depositors, noticing this situation, decided to withdraw their funds, forcing the SVB to sell their bonds and realize the loss. This situation exacerbated the run and, given the high concentration of deposits, the world record for a bank run was set: US$ 42 billion in one day. The last day of the SVB.

Until then, the FED had not considered the SVB as a systemic bank and, therefore, it was not subject to the same rules as the big banks. But that weekend the Fed and Treasury declared the systemic risk exception, thus ordering the FDIC to take care of not only insured deposits but uninsured deposits as well. In other words, the authorities considered that if depositors with more than US$ 250,000 were not “saved”, the stability of the financial system would be affected. Thus, deposits of hundreds of millions of dollars were treated as "insured" and were bailed out by the FDIC. To do this a bridge bank was created, which was later sold to First Citizen Bank, a bank of the same size as the SVB. The estimated loss to the FDIC from this transaction is USD$ 20 billion.

At the same time, on March 12th 2023, Signature Bank of New York (SBNY) was closed by the New York State Department of Financial Services (NYSDFS) and intervened by the FDIC. The SBNY was a commercial bank founded in 2001. As of December 31st 2022, it had total deposits of US$ 88.6 billion and total assets of US$ 110.4 billion (bank #32 in the ranking of banks by deposits). The FDIC estimated that the cost of the SBNY bankruptcy to the deposit insurance fund would be approximately US$ 2.5 billion.

The SVB and SBNY bankruptcies were, respectively, the second and third largest bank failures in FDIC history; and were mainly due to sudden and unexpected liquidity needs as a result of large uninsured deposit withdrawals. Of the total estimated cost for the deposit insurance fund of US$ 22.5 billion (US$ 20 billion from the SVB and US$ 2.5 billion from the SBNY), the FDIC estimated that approximately US$ 19.2 billion (85%) is attributable to the cost of covering uninsured deposits.

After these bankruptcies, the authorities highlighted that these two banks were particular cases and that the system in general was in good liquidity and solvency conditions; that it was resilient.

A few months later, on May 1st 2023, First Republic Bank collapsed and had to be intervened by the FDIC. As of December 31st 2022, this bank had total deposits of US$ 176.4 billion and total assets of approximately US$ 212.64 billion (bank #16 in the ranking of banks by deposits). In this case, it was not necessary to declare the situation of extraordinary risk (as in the two previous cases), since a buyer for all the deposits was found, in exchange for all the bank's assets and a contribution from the FDIC. However, the Fed had to give another exception so that the largest bank in the country could buy a bank in resolution. The loss in this case to the FDIC is estimated to be US$ 13 billion.

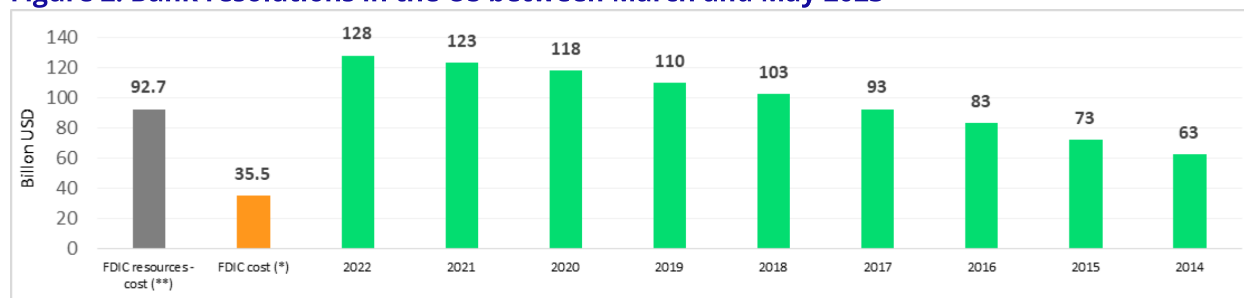
Figure 1 summarizes the main features of the closure of the three US banks between March 10th and May 1st 2023.

Figure 1. Bank resolutions in the US between March and May 2023

	Announcement date of FDIC transfer to another entity	Statement of systemic risk	Resolution method	Estimated cost to FDIC (in billions)
Signature Bank of New York (SBNY)	19/03/2023	YES	Bridge bank and subsequent sale	2.5
Silicon Valley Bank (SVB)	26/03/2023	YES	Bridge bank and subsequent sale	20
First Republic Bank	1/5/2023	NO	Transfer of assets and liabilities	13
			Total	**35.5**

Figure 2 shows the evolution of the FDIC's resources in recent years; the cost to the FDIC of the resolution of SBNY, SVB and First Republic banks between March and May 2023; and the amount of funds that results from subtracting the resources available as of December 2022 and the amount of the loss due to these bank resolutions.

Figure 2. Bank resolutions in the US between March and May 2023



(*) Cost to FDIC for the resolution during 2023 of SBNY, SVB y First Republic banks.
(**) Value of FDIC resources as of December 2022, net of the cost of the resolution of banks in 2023.

The resolution of the SBNY, SVB and First Republic banks between March and May 2023 cost the FDIC USD 35.5 billion, which represents 28% of the total funds available in December 2022.

The Fed and FDIC reports - The missing issues

Given these facts, the FED published a report analyzing the SVB case, and the FDIC published a document where analyzes reform alternatives to the US deposit insurance system.

In its report, the FED acknowledges weaknesses in both banking regulation and supervision and commits to improve both aspects.

For its part, the FDIC, as an initiative to improve the current deposit insurance system, presents and analyzes three options for the deposit insurance scheme:

• Guarantee a fixed sum for all deposits (current scheme).
• Provide unlimited guarantee of all deposits.
• Substantially increase the guarantee only for commercial payment accounts.

Both reports acknowledge weaknesses in the US financial system and open the door to changes in the regulatory framework, supervision policy and deposit insurance in the US financial system. It is evident that the current bank regulation and protection scheme has shown weaknesses that are incompatible with a stable and robust growth of the economy and the banking system.

However, there are two additional aspects that were not addressed in the FED and FDIC reports and should be taken into consideration:

- The scheme for intermediation of large deposits.
- The way in which the FDIC performs bank resolution processes.

Intermediation of large deposits

The SVB had clients with deposits of tens of millions of dollars; in some cases they were deposits of more than US$ 100 million and there were even cases where deposits exceeded US$ 1,000 million. Given this situation, those responsible for the design and regulation of the financial system should ask themselves an elementary question: is it socially and economically convenient for a bank to take multimillion-dollar deposits from individual clients paying a fixed rate and then invest them in the capital market? A priori, it does not seem to be any benefit for the economy or society if these large sums of money are channeled into the capital market, being incorporated into the banks' balance sheets. The same legal, regulatory and protection treatment is given to a deposit from a family that trusts its savings in the financial system as to a corporation that deposits hundreds of millions of dollars.

In this sense, it would be opportune to analyze the convenience of considering mechanisms through which these types of deposits are channeled to the capital market without putting the liquidity and solvency of the banking system at risk and without "placing them under the umbrella" of the FDIC. One way to do it could be to go towards a scheme known as “functional banking” system, where there are different types of institutions for different types of operations; in this scheme, deposits and loans up to a certain amount are treated under a traditional banking scheme, while large investments are channeled through investment banks into capital market instruments.

Bank resolution
Recent bank resolution cases handled by the FDIC show some issues that deserve to be analyzed in detail. Between March and May 2023, the FDIC has taken over the resolution of three banks (SVB, SBNY and First Republic Bank), which together represented 2% of the system's deposits; and whose estimated cost of resolution is US$ 35 billion, which constitutes 28% of the resources available to the FDIC as of December 31st 2022. On the other hand, in the case of the SVB, the bank that took over the assets and liabilities doubled its size in one day with this operation; that is to say, that in one day it grew as much as it had done in the 125 years since its foundation; assuming a new operation in new places and with new clients. This undoubtedly generates significant risks for the acquiring entity.

These facts allow us to think that there is an opportunity to improve the bank resolution processes of the FDIC; in particular regarding the treatment given to depositors who have tens of millions of dollars, under insure schemes provided for small depositors. Also, in terms of enabling banks considered systemic to continue growing from acquisitions in bank resolution processes.

Conclusions and next steps

Conditions are in place and it is necessary for the authorities and members of the US financial community to evaluate the necessary changes to promote a stable development of the banking system and the US economy in general. The changes must be carried out with a comprehensive look at the rules and institutions that define the way in which banks operate. The changes may be important enough to call for a new paradigm in US banking operations. This will have an impact not only on the future stability of the US economy, but also on the world economy.

Recent banking events suggest the need to review and improve various components of the financial safety net; mainly, financial regulation, the bank resolution scheme and the deposit insurance system. It is also necessary to evaluate how to efficiently channel savings and excess funds of families and companies towards investment options, without constituting a threat to the financial stability. A functional banking system may be an option.

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