Bank runs and resolutions

The collapse of Silicon Valley Bank and the swift intervention by the US authorities hold lessons for India – to complete the unfinished policy agenda on handling failed financial firms

ILLUSTRATION: BINAY SINHA

The collapse of the Silicon Valley Bank (SVB) and a few other banks has once again drawn attention to the need for better methods and institutions in financial economic policy. Banks have suffered from runs right from the earliest times. Our thorough understanding of bank runs comes from Douglas W Diamond and Philip H Dybvig, who in 1983 obtained deep insights into the fundamental paradox of banking and won the 2022 Nobel prize for this work. Banks are repositories for consumers’ cash. The cash in turn is put to use by banks. However, banks make investments with that cash and generate income, and this tends to tie up money, which cannot be immediately liquidated. In normal times, this is a good way to create wealth, but it can lead to a crisis if everyone panics and tries to withdraw all their funds at the same time. To quote Professor Diamond “[The system] is very vulnerable to the fear of failure”. Banks are intrinsically illiquid, and vulnerable to bank runs, and that itself creates the trigger for bank runs.

Bank runs are very disruptive for ordinary depositors — farmers, pensioners, gig economy workers getting paid through their phones — who cannot be expected to understand the fragility of a bank. Governments have a three-pillar path to solving this problem: (1) Prudential regulation tries to cap the risk of bank failure (2) The central bank runs a “lender of the last resort” borrowing window for banks, aiming to lend freely against good collateral and (3) There is a special bankruptcy mechanism for banks that works fast and pays deposit insurance to ordinary depositors.

While many parts of US financial economic policy have deficiencies, most experts hold their system of resolution of bank failure as the gold standard.

What stands out in the recent difficulties of some banks in the US is the swift resolution for depositors by the Federal Deposit Insurance Corporation (FDIC).

Readers would recall that in the first week of March 2023, when SVB announced plans to raise capital, there was a run on its deposits. Over the intervening weekend, the FDIC created a new bank into which all of SVB’s deposits were transferred and announced that all insured depositors will have full access to their insured deposits on Monday morning. All of SVB’s physical bank branches reopened on Monday to carry out these announcements.

And we are discussing a bank with $0.2 trillion, or 4 trillion, of assets, the second largest bank failure in US history. And, what’s more, the FDIC solved not one but two bank failures at the same time, the other being Signature Bank, which was the third largest bank failure in US history. This is the sort of state capability that makes an advanced economy work, that we must aspire for in India’s journey to prosperity and greatness.

No losses were borne by the US taxpayer. Shareholders, managers, and some professional lenders suffered losses. The senior management of failed banks were removed.

There are concerns about the fact that the US FDIC went beyond its mandate — a promise to protect deposits up to $250,000, which is about 3.5 times the US per capita gross domestic product — to protect all deposits of SVB. This has created the danger that all bank depositors believe they are protected. US policymakers are now carefully working to draw the line, asserting that all deposits are not protected, that people with over $250,000 in a single bank need to exercise their own monitoring of the soundness of this bank.

We in India have a lot of work to do on this score. In India when a bank gets into trouble, depositors can and have been stuck for long periods of time. For instance, for two weeks in early March 2020, there was a 95% withdrawal limit on all deposits of Yes Bank until a merger scheme was announced.

At a strategic level, there are two kinds of firm failure. One where there is a financial firm with unsophisticated household customers, while the other category includes everything else.

The Insolvency and Bankruptcy Code (IBC), which is a comprehensive reform of the legislative framework for insolvency and bankruptcy, was enacted in 2016 to cover the “everything else”.

While the IBC-style insolvency process can work well for some financial firms, such as non-banking financial companies, which do not have household deposits (e.g. Dewan Housing), a special arrangement is required when faced with such unsophisticated depositors. For a variety of reasons, financial firms, including banks, will fail even when prudential regulation and the lender of last resort works correctly. What is important is ensuring that the failure is orderly, and that consumers are protected while preserving systemic stability and resilience without relying on taxpayer-funded bail-outs.

The standard IBC processes are usually not suitable for financial firms that have unsophisticated household customers. Typically, such processes take time. This delay will in turn exacerbate the threats to consumer funds as well as to systemic stability. The fear of a financial firm going into a long-winded process can itself trigger runs on these firms even when they are solvent. Hence, it is important to have a credible resolution regime run by a competent expert body to ensure efficient, orderly and fair resolution of financial firms.

A specialisation resolution corporation was first recommended by the Financial Sector Legislative Reforms Commission nearly a decade ago, which also developed a draft law. The High Level Working Group on Resolution Regime for Financial Institutions was formed by the government, which broadly endorsed this idea. Synthesising all this, a Ministry of Finance committee drafted the Financial Resolution and Deposit Insurance (FRDI) Bill. The government introduced the FRDI Bill in Parliament in August 2017. After a reference to a Joint Parliamentary Committee, the government withdrew the Bill for re-examination.

This is an important missing piece in the Indian financial regulator architecture. More than ever, we need a government organisation which will swiftly solve problems of a failed financial firm with unsophisticated lenders.

The writer is an honorary professor at IIM, member of a few for profit, and not for profit boards, and a former civil servant.