FedFin Client Report

Monday, March 20, 2023

FedFin Analysis: Possible Cures for a Viral Run

Client Report: LIQUIDITY33

Executive Summary

Among the most vexing issues in the wake of SVB's failure is the extent to which social media may have led to the first "viral run," a run akin to the meme-stock volatility that lead the SEC and others to fear a new form of "flash-crash" risk. In this report, we assess current policy options related to deposit runs resulting from social media, an issue cited frequently by HFSC Chairman McHenry (R-NC) as a top priority as he begins work on post-SVB financial standards. We note some remedies – e.g., a ban on deposit-related communication were they permissible under various constitutional and statutory free-speech edicts. In this report, we thus assess tools more readily at hand that federal regulators might deploy now that social media's destabilizing impact has been recognized, noting the challenges of forestalling runs without at the same time providing opinions on individual banking organizations or issuing preemptive systemic protections that would have the effect of eliminating deposit-insurance limits. This report will thus also assess other options, including standards prohibiting deposit-related "exclusivity" requirements, dedicated Fed liquidity facilities, and revisions to the liquidity rules. Options to revise FDIC coverage to address this risk through structural changes to coverage thresholds will be detailed in a forthcoming Petrou op-ed.

Analysis

Media coverage of the "viral run" has suggested that something improper was done when venture-capital (VC) firms Thursday morning warned the companies in which they invested to withdraw funds, with Sen. Warner (D-VA) calling for them to be held accountable. However, it should be noted that, even if VCs or the firms they alerted in which they also held direct investments may well have sparked a run, many firms had life-or-death exposures to SVB not necessarily due to ignorance of the need to reduce uninsured-deposit exposures, but because SVB conditioned its lifeline funding on covenants mandating that funds received from SVB be redeposited at the bank unless or until disbursed. We expect these to be banned as regulatory reforms advance.

Additional actions may include:

- a mandatory early-warning system banks would need to trigger as deposits near the $250,000 mark;

- revisions to the liquidity rules requiring additional buffers for banking organizations holding significant volumes of HQLAs in HTM accounts;
- less favorable liquidity treatment for core deposits (deemed very sticky in current standards);
- significant changes to stress testing to incorporate run risk in seriously adverse scenarios; and/or
- a prefabricated Fed facility designed expressly to handle liquidity runs via disposition of pre-positioned collateral required of banks with high-risk models or that come under stress.

Alternatively, Congress by law or FHFA by rule or even tacit agreement could accept the role Federal Home Loan Banks have played in the current crisis, expecting them to respond to advance demand without regard to the borrower's housing mission or heightened FDIC resolution cost. Either of these outcomes is less likely than the regulatory revisions noted above, but continuing stress could lead to structural realignment.

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com