Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: May 30, 2023

Was the social media run Silicon Valley Bank's kiss of death? Its former CEO says so. Regulators agree because the more the failure came from the great beyond, the less material their manifold supervisory mistakes. But, while it's true that managerial malfeasance and supervisory forbearance played a huge role in recent failures, social-media herds can still trample a bank flatter than a morning croissant. FedFin outlined solutions shortly after the mid-March failures, but we didn't then know what we also know now about investor runs. This memo reviews the runs, updates the regulatory responses, and shows why new liquidity buffers – surely the least controversial of any pending proposal – are urgently needed before the next round of regional bank stress.

Why do I say regional banks aren't out of the woods? Maybe they are and here's hoping, but market volatility combined with three new studies suggest we may well be in a calm before the next storm.

Recent data on deposit outflows, Fed-window use, and Home Loan Bank advances remain so worrisome that federal officials are still promising that all deposits are protected all the time even though federal law says they aren't. Still, this moral-hazard safety net did not save First Republic and it's been insufficient to secure other large regional banks from the threat of near-term failure. The reason for this is to be found in social media, and not just the kind that powered Silicon Valley's run-- the real threat now isn't coming from depositors, but from opportunistic investors, many of whom take their cue from social media and the financial press therein.

How do we know this? The first study essential to informed action finds that bank deposits flow out faster and in larger amounts when rates rise at banks with digital platforms – that is, pretty much all of them. It's not epiphanic to see that digital platforms speed decisions, but, when depositors flee, the study also shows that a bank's franchise value is likely to fall by at least forty percent because investors also race for the exit.

As two additional studies make clear, news derived from whatever online source not only speeds deposit flight, but also market response, taking what might be a bad day in the market and turning it into disaster. We analyzed the first of these studies in more detail last week. It comes from the Fed and creates a new "twitter sentiment index" (TSI). Tracking this index versus equity-market prices and bond spreads shows that the TSI is not only a leading price indicator, but also a price-setter.

The third study is brand new from the Fed. It's less enthusiastic about twitter sentiment as a driving market force. However, it nonetheless makes clear that investors are acting quickly on "news," paying more heed to it than even to Fed pronouncements. As recent events have demonstrated all too clearly, that which is on twitter isn't necessarily news, but news that is on twitter and of

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course across the array of social-media sources from which most of us now derive our news is still an externality that creates market realities all its own.

As a result, deposit outflows and investor sentiment now interact in a powerful negative feedback loop with catastrophic consequences when meme-traders and short-sellers are able to arbitrage their positions for still greater gain at even bigger loss to target banks. The only way to stop a negative feedback loop is to cut it and here's where liquidity buffers must come in to prevent a liquidity shock from turning into a market-capitalization rout that spawns a solvency disaster.

In equity markets, negative feedback loops are cut by kill switches and these should be carefully considered for banks. With a kill switch, severe deposit outflow would result in an immediate ban on further withdrawals. This is the modern-day equivalent of the "bank holiday" Roosevelt used to prevent a complete collapse of the banking system in 1933. It didn't stop the Great Depression, but many other factors – an equity rout, lack of FDIC coverage, central-bank mistakes, and so forth are also to blame. The bank holiday made the banking crisis less bad and that was all to the good.

A kill switch undoubtedly affords considerable advantage to first movers, but only if the bank then fails which is far less likely if runs are throttled. Federal Reserve Bank of New York staff have suggested a minimum-balance-at-risk alternative to reduce first-mover advantage, but this is simply not applicable for entities with deposit insurance nor is it advisable since depositors with the least money would take the greatest loss.

Other options we identified in our report that could be adopted on their own or in conjunction with a kill switch include a mandatory early warning so that depositors nearing the $250,000 ceiling get an alert from their bank advising them that funds are at risk. I like this a lot because it ensures that depositors know that they are newly at risk and thus can reasonably be expected to protect themselves, minimizing moral hazard and the rush to the exit when a bank is the target of social-media ignominy.

Other options that are not mutually exclusive along with a kill switch and early warning include technical changes to the liquidity rules, better stress testing, or a new Fed facility that provides emergency liquidity to banks still suffering deposit outflows once the kill switch is turned off. To avoid moral hazard and ensure effectiveness, this facility should not be cheap and even then it should be backed by pre-positioned collateral that all banks are required to post as part of their contingent-funding plans (which of course need to be a darn sight better than they've proved to date).

As hearings last week again made clear, Congress is wrapped in a negative feedback loop of its own. In it, Republicans try to implicate the Biden Administration by castigating the Fed and FDIC and Democrats demand statutory changes tied inexorably to former President Trump. There's right and wrong in each point of view, but neither gets us anywhere because none ensures rapid reform and then transparency and accountability under current law. Worse, regulators are so whip-sawed by these demands that each spends more time defending itself than advancing substantive change on which they can all agree.

Cutting this loop would take a near-term proposal that mollifies both sides of the aisle and that's a new approach to liquidity-risk management founded on clear-eyed understanding of how deposit and investor runs interact and accelerate. I've the ideas outlined above and there are others of equal or greater merit. All are doable under current law and more than a few should be quickly embodied in tough, transparent rules.