February 14, 2024

Written testimony of Simon Johnson, Ronald A. Kurtz (1954) Professor of Entrepreneurship, MIT Sloan School of Management, and Co-Chair CFA Institute Systemic Risk Council.[1]

Before the Subcommittee on Financial Institutions and Monetary Policy of the Financial Services Committee, United States House of Representatives. Hearing on "Lender of Last Resort: Issues with the Fed Discount Window and Emergency Lending," Thursday, February 15, 2024.

A. What Have We Learned?

1) In a traditional bank run, depositors lose confidence in one or more banks and seek to convert their deposits into cash. As some bank assets are not liquid, the role of the central bank is to "lend freely against good collateral," allowing banks to convert valuable assets into cash that can be paid out.
2) In the modern US economy, bank runs have taken on a different nature, with depositors engaging in a "flight to quality", whereby they seek to transfer funds out of troubled assets and also away from assets that are considered adjacent to trouble (which could be, for example, specific bank deposits, or money market funds, or hedge funds) into whatever instruments are considered by the market as "least likely to fail."
3) Modern herding runs can be self-fulfilling, as seen in the example of Silicon Valley Bank (SVB) in spring 2023.
    a. On Thursday, March 9, 2023, depositors attempted to transfer a large amount of funds from their SVB uninsured deposits to uninsured deposits at large money center banks, with J.P. Morgan Chase (JPM) being widely regarded as too big to fail.
    b. By the weekend, there was widespread discussion among chief financial officers and others around the country of the need to transfer operating funds from all small and medium-sized banks to the largest banks (and particularly JPM). In private sector and official circles, there was a well-founded fear that some form of contagion could cause a series of bank failures, with negative consequences for access to uninsured deposits as well as downward pressure on other asset prices, resulting in much tighter credit conditions and a potential contraction in the real (non-financial) economy.
    c. This run took place despite the fact that SVB was a member of the Federal Reserve system and as such had full access to existing Fed facilities, including the discount window. Signature Bank also faced a similar bank run on March 10 (and likely to intensify the next week), for related reasons.
    d. In response, "the Treasury Secretary, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve (Fed) announced on [Sunday] March 12, 2023, that the FDIC would guarantee uninsured deposits at those banks [Silicon Valley Bank

[1] All views expressed here are personal.

and Signature Bank] under the statutory systemic risk exception to least-cost resolution."[2]

e. This reassured depositors that they would not suffer losses on SVB and Signature deposits, and also sent a signal that other affected banks would also be covered by a similar guarantee if necessary.
f. In addition, invoking Section 13(3) of the Federal Reserve Act, the Federal Reserve created the Bank Term Lending Program (BTLP), as "an additional source of liquidity against high-quality securities, eliminating an institution's need to quickly sell those securities in times of stress."[3] Key elements include:
    i. Eligible collateral, such as US Treasury securities, is valued at par with "no haircut". "Advances made under the Program may have a term of up to one year."[4]
    ii. "Any U.S. federally insured depository institution (including a bank, savings association, or credit union) or U.S. branch or agency of a foreign bank that is eligible for primary credit under the Federal Reserve discount window is eligible to borrow under the Program."
    iii. This program was operational on March 12.

4) This experience raises three questions:
    a. Should or could the Federal Reserve have intervened with "lender of last resort" facilities, in support of SVB or other financial institutions?
    b. Is there some other deficiency in our financial sector (depository institutions) emergency support mechanisms, including how decisions are made and by whom?
    c. More broadly, is the US well-prepared for future financial crises, in whatever form these may take.
5) Regarding the Federal Reserve: The creation of the Bank Term Lending Program was entirely consistent with the Fed's mandate, including the spirit of the Dodd-Frank reforms. This program (BTLP) was available to all depository institutions subject to existing eligibility requirements (i.e., being eligible for primary credit from the Fed).[5] This program was not intended to help just one or a few banks, and it did not reach beyond member banks.

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[2] https://crsreports.congress.gov/product/pdf/IF/IF12378. "Generally, the FDIC is prohibited from protecting "depositors for more than the insured portion of deposits" that would have the effect of increasing losses to the Deposit Insurance Fund. However, the Federal Deposit Insurance Act (FDI Act) includes a "systemic risk exemption" that enables the FDIC to take any other action "as necessary to avoid or mitigate" "serious adverse effects on economic conditions or financial stability." Pursuant to this authority, the FDIC will insure all deposits of the failed banks, which were transferred to the two bridge banks chartered by the Office of the Comptroller of the Currency." These quotes are from a leading private sector interpretation of events, written at the time: https://www.lexology.com/library/detail.aspx?g=58f2fc31-9eb2-4934-b7e1-023b390e9bfe.

[3] https://www.federalreserve.gov/financial-stability/files/bank-term-funding-program-faqs.pdf

[4] In contrast, "Advances under primary credit [the main discount window lending program for depository institutions] may be made for a term of up to 90 days."

[5] Primary credit is Fed lending through the discount window, for up to 90 days to well-capitalized depository institutions. There is sometimes a perceived stigma attached to discount window borrowing, i.e., because it may be perceived to indicate weakness on the part of borrowers.

However, the authorities were likely correct in their assessment that the BTLP by itself was not enough to stabilize the situation and prevent a widespread run on other small and medium-sized banks – hence the need to invoke the systemic exception (i.e., a permitted action by the FDIC, with the Treasury Secretary and Fed Board of Governors as the other two "key holders").[6]

6) Regarding other deficiencies: It is disturbing that the authorities had to invoke the systemic risk exception, particularly given that the prior expectation and assertion was that banks at the size of SVB (roughly $250 billion assets and without complex derivatives) could be resolved through the standard FDIC procedures. A major contributing factor was that Dodd-Frank changed the terms under which the Transaction Account Guarantee (TAG) program can be implemented by the FDIC.[7] This now requires congressional approval, with a fast-track procedure in the Senate (although not in the House). This process was likely seen by officials as too slow and cumbersome for the SVB moment.[8]
7) Regarding crisis preparedness in general. When a crisis hits, the key question is whether offsetting actions are needed (a) within weeks, or (b) within hours (or a few days). When a response within a few weeks is needed, Congress has shown that it can take decisive action (e.g., in the case of the CARES Act, to address COVID).[9] However, when a crisis is more intense and faster-moving, as is frequently the case with financial markets, the executive branch needs to have sufficient delegated authority. The main gap is the lack of authority for the FDIC to create a TAG program.

B. Overall Recommendations

1) An important goal is for the U.S. authorities to once again be able to put any bank into FDIC resolution, including with potential losses for uninsured depositors. Spillover effects can be intense and may manifest very fast. Hence there is a need for executive branch authority to apply the TAG (or a functionally equivalent program), with the goal of not protecting uninsured depositors in the failing bank, but rather preventing contagion effects on other banks.

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[6] The systemic risk exception to least-cost resolution requires support from a supermajority (two-thirds) of the FDIC board and the Fed Board of Governors, as well as the Treasury Secretary: https://crsreports.congress.gov/product/pdf/IF/IF12378.

[7] Sheila Bair has explained the motivation for TAG this way, "When I chaired the FDIC during the financial crisis, we instituted such a programme for uninsured transaction accounts used by institutions for payroll and other operating expenses. We did this to protect community banks who were losing uninsured business customers to banking giants such as JPMorgan Chase and Wells Fargo." https://www.ft.com/content/b860ebb6-f202-4ec6-a80c-8b1527c949f4

[8] Former FDIC Chair Sheila Bair spoke clearly on the importance of the TAG program and why it would have been helpful in March 2023. See, for example, https://www.washingtonpost.com/washington-post-live/2023/03/22/transcript-path-forward-banking-with-sheila-bair/.

[9] The TAG program was reauthorized by Congress as part of the CARES Act in 2020, as part of a package of measures intended to protect the financial sector as COVID swept around the world. However, while the COVID crisis was intense and unexpected, modern financial crises often move much faster – measured in hours, not weeks.

As discussed above, the TAG system should be restored to its pre-Dodd-Frank status, under the control of the FDIC board (requiring a super-majority of the FDIC board, with the agreement of the Treasury Secretary, in consultation with the President of the United States). Including the Treasury Secretary and the Federal Reserve Chair (or Fed Board under simple majority or super-majority rules) as required decision-makers would be reasonable and in line with current practice (and Dodd-Frank requirements). Having these three key holders is not burdensome and will not prevent decisions from being made fast enough to make a difference.

If this is not possible, it is essential to create a fast-track for TAG approval in the House, to parallel what exists in the Senate. (There is no obvious or well-documented reason why Dodd-Frank did not create parallel structures for rapid approval in both chambers.)

2) It is of paramount importance to continue improving bank supervision and the enforcement of sensible regulations. On these dimensions, the Fed seems to be heading in the right direction, although it is too early to assess all the changes that have been promised or put in place.[10]

However, we still need further governance reform of regional Feds. The fact that the head of SVB sat on the board of the San Francisco Fed is a huge embarrassment to the Fed System. Member banks should not sit on these boards. The fact that they continue to do so is a bizarre hold over from the 1913 Federal Reserve Act and amounts to a massive anomaly in modern American governance.

In addition, all records at the regional Feds should be subject to the same disclosure requirements as at the Board of Governors (and government records more generally). Sensitive documents can, of course, be published with an appropriate time lag. But too many regional Fed documents currently remain secret forever. This issue came up in the context of the 2007-08 Global Financial Crisis but has never been resolved in a satisfactory manner.

3) It is important for the US to complete the process of implementing Basel III. (Please see the recent CFA Institute Systemic Risk Council letter on this issue, including our emphasis on the ways in which "bank capital" is misunderstood or even, in some instances, potentially misrepresented.)[11]

Officials should continue to emphasize and communicate the need for strong capital and liquidity requirements, as well as market transparency and full disclosure, as appropriate for all banks. Systemically Important Financial Institutions (SIFIs) pose additional dangers to the US and global financial system, and it is appropriate that they should face additional requirements and scrutiny (as agreed under Basel III).

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[10] The Federal Reserve should be commended for the speed with which it produced a report on what happened: https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf. This report is remarkably clear and honest on at least some dimensions of the supervisory failures.

[11] Available here: https://www.systemicriskcouncil.org/2024/01/cfa-institute-systemic-risk-council-writes-in-support-of-agencies-efforts-to-implement-the-basel-iii-international-standards-for-large-banks/. The SRC has also written recently in favor of the proposed long-term debt rules: https://www.systemicriskcouncil.org/2023/12/cfa-institute-systemic-risk-council-writes-in-support-of-proposed-rules-on-long-term-debt-requirements/.

International official cooperation with regard to the regulation of SIFIs (and other banks) is important, to prevent or at least limit regulatory arbitrage. The UK, EU, and US are on the same page in terms of agreement, but the US needs to follow through on full and timely implementation.

Graduated requirements are fine (and entirely consistent with Basel III), but there should be no exemption for heightened scrutiny over mid-size banks (a threshold of no more than $50 billion continues to make sense, in line with my 2015 testimony to the Senate Banking Committee).[12] The CEO of SVB submitted a letter to the 2015 Senate Banking Committee hearing on raising the thresholds; all of his arguments have been demonstrated (by the failure of his bank in March 2023) not to hold.[13]

It would be unwise to allow cryptocurrency "stable coins" to acquire official status or any implicit government backing, including by becoming too important to fail.[14] While the failure of Signature Bank no doubt had myriad causes, its exposure to entities active in cryptocurrency space proved to be one destabilizing factor.

4) It makes sense to better prepare all depository banks to access Fed emergency lending under unexpected circumstances. This could be done by making sure that private sector information technology systems are set up so as to interface effectively and immediately with official systems. Tabletop exercises will likely reveal where friction currently exists.

C. Other Observations

As the work of this subcommittee includes monetary policy (and the interaction of financial institutions and the effectiveness of monetary policy), I would like to emphasize three other relevant points.

1) Concern about tighter credit conditions resulting from higher capital requirements is massively exaggerated. This is explained in the Systemic Risk Council comment letter on

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[12] See, for example, Section B, "The Critical Threshold Issue," p.69, in my written testimony, https://www.govinfo.gov/content/pkg/CHRG-114shrg94375/pdf/CHRG-114shrg94375.pdf, which attempted to remind us of the dangers posed by financial institutions with around $100 billion in total assets. SVB had $166 billion in total deposits and a balance sheet of around $200 billion when it failed, https://oig.federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.pdf. Signature Bank had total assets of just over $100 billion, https://www.reuters.com/markets/us/signature-bank-failure-due-poor-management-us-fdic-report-says-2023-04-28/#:~:text=The%20FDIC%20estimated%20the%20deal,state's%20Department%20of%20Financial%20Services.

[13] The written statement submitted by Greg Becker to the Senate Banking Committee in March 2015 is available here: https://www.govinfo.gov/content/pkg/CHRG-114shrg94375/pdf/CHRG-114shrg94375.pdf. Mr. Becker was CEO of SVB at that time, and he was also CEO when the bank failed (or came close to failing) in March 2023.

[14] Please the separate SRC letter on this issue: https://www.systemicriskcouncil.org/2022/02/cfa-institute-systemic-risk-council-urges-fsoc-to-address-the-risks-to-u-s-financial-stability-posed-by-unregulated-and-underregulated-stablecoins/.

Basel III, referenced above. Over the business/credit cycle, well-capitalized banks are better able to sustain lending than banks with relatively little capital (i.e., which fund themselves with more debt relative to equity).[15] Periodic and rolling testing of the Fed's discount window may also be called for, to improve operational practices on both sides.

2) The Federal Reserve retains strong control over the average and marginal pricing of credit (interest rates), as demonstrated repeatedly over the past two years. Interest rates have a material impact on the US economy. In no sense has monetary policy become ineffective. The problems encountered by SVB and Signature Bank were ultimately due to excessive risk-taking by management, not due to any problem with the functioning of monetary policy. Interest rates will always rise and fall in unpredictable fashion, sometimes due to policy and sometimes due to market reactions to non-monetary events.

[15] The economics of bank capital are explained clearly by Anat Admati and Martin Hellwig, https://press.princeton.edu/books/paperback/9780691251707/the-bankers-new-clothes.