IlLUminate Blog Transcript: Kathleen Hanley Explains Bank Failures

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ANNOUNCER: 00:02	[music] This podcast is brought to you by ilLUminate, the Lehigh Business blog. To learn more, please visit us at business.lehigh.edu/news.
JACK CROFT: 00:14	Welcome. I'm Jack Croft, host of the ilLUminate podcast for Lehigh University's College of Business. Today is March 20th, 2023, and we're talking with Kathleen Hanley about the recent Silicon Valley and Signature Bank failures that touched off so much turmoil in the markets both in the United States and globally. Dr. Hanley holds the Bolton-Perella Endowed Chair in Finance and the College of Business's Perella Department of Finance. She's also the director of the Center for Financial Services and the co-director of the FinTech Minor. From 2011 to 2013, Kathleen was the deputy chief economist at the Securities and Exchange Commission and the deputy director in the Division of Economic and Risk Analysis. In those positions, she oversaw the integration of economic analysis into policy and rule-making across a broad range of topics and financial economics. Among those were the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the JumpStart Our Business Startups Act. In addition, she managed the division's research activities, data analytics, and risk assessment initiatives. Prior to that time, Kathleen was a senior economist at the board of governors of the Federal Reserve System in the risk analysis section and a senior financial economist at the SEC. Welcome back to the ilLUminate podcast, Kathleen.
KATHLEEN HANLEY: 01:42	Thank you for having me.
CROFT: 01:44	As I just mentioned in the intro, your background at both the SEC and the Federal Reserve System included specifically risk analysis, which seems to be a key part of the story behind the recent bank failures at Silicon Valley Bank and Signature Bank. So let's start there. How large a role did risk management play in what happened at those banks?
HANLEY: 02:08	So this is a very interesting question. I think that much of this is still developing even as we speak, but the circumstances surrounding Silicon Valley Bank, in particular, was that deposits began to be withdrawn. Some have said it was for liquidity reasons because of recent hikes in interest rates, and that necessitates the bank to sell assets to meet that demand. Generally speaking, a bank will get rid of assets in order of their liquidity and the ability to get par for those assets. So for example, obviously, cash would come first, and then treasury securities would be next. Now, generally speaking, we think of treasury securities as being risk-free, which they are free from default, but what they are not free from is the risk of interest rate movements. And as we know, interest rates have been climbing in the past four to six months. And some of the treasury securities the bank held were then worth less than the amount that they paid for them because as your readers-- I mean, your listeners probably know, when interest rates rise, bond prices fall. So when they had to meet demand, they began to sell assets, in which they realized a loss. And that meant that they were unable to meet the demand with assets in the bank that were highly liquid and at their full value. So from my understanding of this, it then meant that they had to try

to raise some capital to try to do that. It was unsuccessful, and the regulators began to step in in order to shore up the deposits of that bank in order to eliminate a bank run.

HANLEY: 04:19 So the risk management failure, one of them, as I understand it, is that the bank did not hedge their interest rate risk fully. In other words, they were betting on interest rates. From the numbers that I can find, they had a portfolio of $125 billion of investments, of which only half a billion were hedged. When the run began and deposits were being withdrawn, they sought to sell $21 billion of assets for a loss of almost $2 billion. So one risk management failure is the willingness of the management of the bank to not pay for those hedges in order to potentially be more profitable.

CROFT: 05:19 Now, clearly, it seems interest rates also were a big part of this story, and we had had very low interest rates for what seemed a very long time. And did people just kind of get used to this idea that it was going to go on this way indefinitely?

HANLEY: 05:39 Well, I think, certainly, consumers thought it would go on indefinitely. I don't know that everybody thought it would go on indefinitely. But because the assets of the bank, the treasury securities that had the interest rate exposure were held on the books of the bank at par value or at purchase value rather than at mark-to-market value, it was unclear what the losses, (A), were in this bank, and (B), the bank did not have to realize any of those losses on their balance sheet. And so interest rates here, in this case, may have caught them off guard. But again, there are sophisticated hedging activities that a bank can take, or any other entity for that matter, to reduce the exposure to interest rate risk. Now, of course, that reduces their profits as well because you have to pay for those hedges.

CROFT: 06:37 Now, the 2008 global financial crisis, in some terms, wasn't that long ago. It's still fresh in a lot of people's minds. And immediately, as the news broke about Silicon Valley and Signature, a lot of people started saying, "Oh, no, we're heading for another." So what are some of the key differences between the causes of the 2008 global financial crisis and the recent failures at those two regional banks?

HANLEY: 07:09 Well, I think the causes are quite different. The Silicon Valley Bank is a classic bank run in which the assets of the bank are insufficient to cover deposits. During the crisis, many banks held assets, mainly mortgage-backed securities, that were highly correlated with other banks. And so therefore, when one bank got in trouble and tried to sell those assets, all the other banks were affected because now the assets that they held would then be worth less. In this case, this is a more isolated incidence. It doesn't seem to me that, neither of these banks were having problems because of a correlated risk with other banks. In other words, there may be other banks that hold treasuries, so that may not be fully the idea. But this Silicon Valley Bank had a lot of depositors that were not insured. They had very large deposits on this bank, and so withdrawing them is very problematic for that bank. I don't see this as being a systemic event per se. It has systemic implications, but in itself, it's a mismanagement of the bank's assets that partially generated this problem. In the financial crisis, even good banks were affected by this because of the collapse of the mortgage market. We're not seeing a collapse of the mortgage market. We're not seeing huge losses in the banking sector in their investment portfolios on other assets. So it is quite different than the financial crisis.

CROFT: 09:01 You had mentioned systemic implications. Are there any similarities that give you any pause for concern?

HANLEY: 09:12 Well, I think behavioral aspects are always at play here. I mean, if you remember, during the pandemic, toilet paper became scarce. So everybody ran out and got toilet paper, [laughter] right? So a similar psychology can happen in a bank run. In fact, it's not even irrational to do that. So if we don't know-- if you don't know how stable your bank is, you might want to take your money out just in case there's a problem at your bank. And so, in this case, I think this bank was large; we can talk about whether or not Congress thought it was large. But in this case, this fairly significant bank had trouble. And if you don't know-- if your bank is in trouble, you might want to take your money out. So it is not irrational to want to go do that, right? You went to the grocery store to get toilet paper because if you didn't go, you would never get it. So it wasn't an irrational thing, but you can see how it created a shortage when there didn't need to be a shortage, and the same thing happens here for uninsured deposits. Now, insured deposits, there should be no run behavior, though some people not understanding the banking system will certainly try to withdraw their money. But if you are above the $250,000 limit, you might decide to withdraw your money just in case. And if that is the psychology of those depositors, then a very stable bank, who can't prove to these depositors that they are stable may themselves be subject to a run for no fundamental reason other than concern about the overall banking sector.

CROFT: 10:59 Right. And initially, there was a lot of concern expressed that the failure of Silicon Valley and Signature could lead to problems with other regional banks that, exactly what you were just talking about, people would just kind of figure on their own that, "Well, my bank must be in trouble too," whether there was any evidence of that or not. And last week and over the weekend, where we had First Republic Bank teetering on the verge of failure and a dozen banks, including several of the nation's largest, agreed to inject $30 billion in deposits in a rescue deal brokered by the U.S. government. Meanwhile, in Switzerland authorities arranged a takeover of the troubled Credit Suisse by its larger rival, UBS. Obviously, these were attempts by the governments in both places and the financial community to reassure investors and depositors and head off any other problems. At least initially, those moves appear to have had little effect on reassuring the markets. So how concerning is that?

HANLEY: 12:10 I think it's a general sense of panic. I think there were lots of problems in Credit Suisse that have been identified over a substantial period of time that bank has been in the news with respect to its performance. Certainly, these smaller regional banks are again more prone to run behavior by depositors who are concerned that these smaller banks are not as safe as perhaps larger banks are. The banking sector stepped in because they would be affected by a widespread failure of regional banks in the sense that if those banks have to sell assets, then the assets of those large banks could become impaired. So it's worth their while to try to stop a failure of a regional bank that may create spillover effects to other regional banks. I think that the government's decision to ensure all deposits of SVB - we can debate on whether it's the right thing or not - was certainly designed to send a signal that this was an idiosyncratic event and that the government would try to fix it. So it's unclear how far this will spread and, because of low interest rates, how much risk some of these regional banks were taking on when they could not generate enough profit on mortgages and other interest-bearing instruments, how much risk they took to make up for that. And so I think that that is what is coming to light now is that perhaps they were taking more risks than they should have to make money when they couldn't make it on their loans.

CROFT: 14:00

Now, there's already been considerable debate about whether regulatory changes are needed in light of the failures of Silicon Valley and Signature Bank. And while you were at the SEC during the early years of the past decade, one of your responsibilities was overseeing implementation of the Dodd-Frank Reform Act, which was enacted after the financial crisis of 2008 that sparked the Great Recession. So looking at it, are there regulatory changes you think make sense in response to what's happening now?

HANLEY: 14:37

Well, I think one possible contributor to this entire episode is the fact that Congress increased the threshold for a bank to be considered a systemically important financial institution. So under Dodd-Frank, that value was $50 billion, and Congress raised it to $250 billion. So SVB was clearly above the $50 billion range and would have been required to comply with enhanced regulatory standards, including more liquidity. But the repeal of part of Dodd-Frank and the implementation of a higher threshold may have contributed to this by not having these banks be more overseen and being designated as being more important. And I think this episode demonstrates that a bank of $50 billion or more has the ability to send systemic shockwaves through the financial system. So I anticipate that this threshold will then be changed once again to encompass banks of First Republic or Silicon Valley Bank size.

CROFT: 16:04

And what are some of the other main lessons then that we need to learn from the collapse of Silicon Valley and Signature banks?

HANLEY: 16:12

Well, I think one of the lessons that we've learned is that deposit insurance, which is meant to stop some of this behavior, can't stop it all. And it is unclear why so many entities had large deposits at banks that would have been exposed to any mismanagement within the bank or problems within the bank. I think, more importantly, the government has to think very carefully about the way they bail out or don't bail out these banks in order to send either a signal to other banks or to give the impression that everybody's money is safe in every single bank. I don't think that the U.S. government can ensure all deposits, though I think Senator Warren is calling for that, but I don't think that that's going to be a feasible solution to this particular problem. If that's the case, banks then sort of become public goods rather than private entities. So there is a real concern here that the government will send the wrong message with respect to its intention to bail out banks in a specific way.

CROFT: 17:32

Now, is there anything we haven't discussed that our listeners should know about the turmoil caused by the recent bank failures? And I think specifically the question I think most people have top of mind is, "Is my money safe? Is there anything I should be doing?"

HANLEY: 17:49

Well, I think it's very important for depositors, particularly not large depositors but sort of the regular mom-and-pop or public, if you're lucky enough, to have deposits of no more than $250,000 in any one institution. You are insured; your money will come back to you if you have that. You don't have to worry about what happens within the bank. And I think cash management is a big part of what corporations engage in. So I think that some corporations are going to have to rethink how they manage their cash and where they're going to put it so that they are not exposed to this kind of risk.

But for the regular member of the public who has some savings in a bank and are not ultra-wealthy, if you have it below $250,000, you are probably fine. And if you go to withdraw your money, you're just going to exacerbate the problem with those banks if they should be in any kind of trouble. So it is worth thinking about just sitting tight until some of this has played out.

CROFT: 19:04 Kathleen, thanks again for joining us and shedding some light on the recent bank failures that have caused so much uncertainty in global markets.

HANLEY: 19:14 Well, thank you for having me.

CROFT: 19:15 Dr. Hanley's research focuses on capital formation and market pricing and has been published in leading finance journals such as The Journal of Finance, Journal of Financial Economics, The Review of Financial Studies, Journal of Accounting and Economics, and The Journal of Accounting Research. This podcast is brought to you by ilLUminate, the Lehigh Business blog. To hear more podcasts featuring Lehigh Business thought leaders, please visit us at business.lehigh.edu/news. And don't forget to follow us on Twitter @LehighBusiness. [music] I'm Jack Croft, host of the ilLUminate podcast. Thanks for listening.