Bill Dudley

Lessons from the banking crisis

On Thursday, March 30, Bill Dudley will join Markus' Academy for a lecture on Lessons From the Banking Crisis. Dudley is a Senior Research Scholar at Princeton University's Griswold Center for Economics Policy Studies and former President of the Federal Reserve Bank of New York.

A few highlights from the discussion:

- **A summary in four bullets:**
    - The Federal home loan bank system is a lot more important than people think.Its lending is more popular than the discount window, as it does not have the stigma
    - The decision on whether or not to protect uninsured depositors is not black and white. We can conceive of a system where a bank opts to have all their deposits insured, but at the cost seeing restrictions in its activities.
    - We talked about bank compensation during the financial crisis, but we quickly forgot about it. Paying executives with subordinated debt (that is bailed-in if the bank fails) would encourage prudent behavior.
    - The economy is fundamentally in good shape, and the debt ceiling is the most concerning issue. We will be much better off if we can avoid eleventh hour deals to increase it.

- [3:56] **What went wrong at SVB?**
    - SVB stretched for yield in the low rate environment. A lot of deposit growth which was dumped into long-dated treasuries and mortgage backed securities. When rates rose, they suffered large mark-to-market losses.
    - The deposit base was largely uninsured and highly concentrated, leading to an extremely fast bank run. SVB's plan was to face the losses with a capital raise, but they did not have time to complete it
    - Panic spread across the market to similar banks
- [9:52] **The FDIC and the Fed's lending facilities**
    - Systemic risk exception evoked, allowing the FDIC to protect all depositors
    - S&L Crisis is similar in that the root problem was an interest rate mismatch, yet most S&Ls had limited uninsured deposits (and so no bank runs). Without these the S&L's were able to continue operating while being insolvent, which increased their risk taking

- The Federal home loan bank system is a lot more important than people think. Its lending is more popular than the discount window, as it does not have the stigma and can give term loans
    - It is possible the Fed liquidity facility would not have been able to compete with the home loan banks without the collateral-at-par lending
    - The Fed still has plenty of tools if the situation worsens: it has the funds of the exchange stabilization fund, it can lower the discount window or set up new term auction facilities
- [36:50] **Implications for monetary policy**
    - The Fed is in the same place they were before: the economy is too strong, the labor market is too tight. However due to the banking crisis the situation is worse because of the uncertainty in the trajectory of growth
    - Lagarde is largely correct that you can separate financial stability issues from monetary tightening, but there is no doubt that higher rates put more stress on the banking system
    - If the Fed had tightened sooner there would have been less stress. This has been one of the fastest tightenings in the Fed's history
    - The market is pricing in more monetary policy tightening as sentiments about the banks improve
- [47:30] **Implications for regulation and supervision**
    - Regulators don't want the big banks to get bigger, and large banks are not as eager about acquisitions as before
    - In 2018 the threshold for considering a bank systemic was raised from $50bn to $250bn, but the Fed was given discretion to lower that threshold to $100bn for any individual bank. It is likely the Fed will start using this discretion
    - It is clear that regulators need to move faster and more aggressively when identifying problems
    - The decision on whether or not to protect uninsured depositors is not black and white. We can conceive of a system where a bank opts to have all their deposits insured, but at the cost seeing restrictions in its activities
    - We talked about bank compensation during the financial crisis, but we quickly forgot about it. Paying executives with subordinated debt (that is bailed-in if the bank fails) would encourage prudent behavior
- [1:04:55] **What to watch going forward**
    - From first quarter earnings we should carefully look at four things: (1) How much banks are borrowing from the federal home loan banks and from the Fed's discount window, (2) whether their interest margins shrink due to deposit outflows, (3) the size of the mark-to-market losses, (4) whether bank lending stalls, indicating a broader impact on the real economy
    - Commercial real estate is less of a problem, since not many loans are due this year and so rollover risk is low
    - The debt ceiling is the most concerning issue, and we will be much better off if we can avoid eleventh hour deals to increase the debt ceiling.

    - Economy is fundamentally in pretty good shape, and it seems like there will be a mild recession and then a recovery. Inflation will come down slowly, the Fed is on the right track, though a hard landing is more likely than not

Timestamps:

[3:56] What went wrong at SVB?
[9:52] The FDIC and the Fed's lending facilities
[36:50] Implications for monetary policy
[47:30] Implications for regulation and supervision
[1:04:55] What to watch going forward