

Financial Advisory Roundtable Minutes of the October 6, 2023

Attendance (Physical and Virtual):

FAR Members: Viral Acharya, Hayley Boesky, Keishi Hotsuki, Yie-Hsin Hung, Maureen O'Hara, Thomas Philippon, Srinivas Ramaswamy, Joanna Welsh, Toni Whited

New York Fed Staff: Chair: John Williams, Nina Boyarchenko, Ozge Akinci, Linda Goldberg, Jonathan McCarthy, Jim Mahoney, Nicola Cetorelli, Jordan Pollinger, Argia Sbordone, Giorgio Topa, Caren Cox, John Clark, Lee Seltzer, Kinda Hachem, Hyeyoon Jung, Peter Van Tassel, Tomas Jankauskas, Rita Csetjey, Jeff Dawson, Silvia Miranda-Agrippino, Rick Ostrander, Michelle Neal, Katherine Tilghman, Paolo Pesenti, Gara Afonso, Maco Del Negro, Emily Yang, Michael Fleming, Matthew Plosser, Or Shachar, Eric Lewin

Summary: The Financial Advisory Roundtable (FAR) meeting discussed the potential long-term implications of the March 2023 bank distress. Specifically, FAR members provided their views on the following questions:

1. Reflecting on the bank stress experienced in March of 2023, what are the key lessons for policymakers?
2. Have market participants, banks, and depositors modified their behavior? If so, how? What are the implications for financial stability and monetary policy?
3. What are the costs and benefits of policy responses (or inaction)? How might these policies trade-off financial stability versus bank concentration and/or perceived "too big to fail" safety? Policy adjustments include (but are not limited to): Deposit insurance, Lender of last resort programs, Capital and liquidity regulation, and supervisory tools.

The meeting began with introductory remarks by Thomas Philippon and Keishi Hotsuki. First, Thomas Philippon provided a summary of the recent banking stress, and discussed policy proposals related to changes to deposit insurance and bank resolution planning. Then, Keishi Hotsuki provided a practitioner's perspective of the unique challenges for banks' risk management highlighted by the March 2023 runs on Silicon Valley Bank and its regulatory implications.

Potential Regulatory Implications

FAR members began with a discussion of potential changes to deposit insurance, such as, targeted coverage where not all depositors are equally insured in case of bankruptcy. One possible implementation of targeted coverage that was discussed in depth is expanded deposit insurance for transaction accounts of small and medium enterprises (SME). Several FAR members noted that given the government support that was provided, SMEs may anticipate that they will receive insurance in the case of a bank run in the future. Therefore, to resolve uncertainty about eligibility and size of such insurance, FAR members suggested to explicitly define targeted coverage ex-ante. FAR members highlighted the importance of being explicit about the eligibility and the size of insurance, and who bears the cost. That

said, FAR members noted that due to administrative burdens, and the practical difficulty in identifying eligible group of targeted coverage, implementation is not straightforward.

FAR members also discussed resolution planning for banks as another potential policy adjustment, weighing both its benefits and costs. Some members noted that the Credit Suisse run episode may have demonstrated that resolution planning is not useful. Nevertheless, FAR members noted that the process of resolution planning has at least two benefits. First, it incentivizes banks to simplify their organizational structure, and activities. Second, it might facilitate a faster purchase by potential buyers in case of a failure because due diligence information is readily available.

FAR members also pointed out that it is important to make sure banks can borrow from the lender of last resort when needed, without any stigma attached. Several FAR members pointed out that there is still a stigma associated with borrowing from the discount window. To make sure that banks borrow from the discount window when needed, FAR members emphasized a need to reduce such stigma.

FAR members discussed other policy adjustments, such as regulations designed to reduce the duration of bank assets or to improve the liquidity of bank assets. FAR members suggested that placing regulatory caps on the share of held-to-maturity securities banks can hold would induce banks to lower the duration of their assets and reserve sufficient capital. This suggestion is based on the view that the problem was fundamentally driven by a lack of sufficient bank capital. There was also a view that liquidity was an important driver of the problem. FAR members suggested that more timely stress testing covering more diverse groups of banks could mitigate the problem. In particular, FAR members pointed out that allowing for greater simplicity in stress testing could allow banks to consider a range of creative scenarios and quickly provide results of their stress tests. This would provide regulators with more up-to-date information on bank balance sheets. Some argued that the current emphasis on the accuracy of the stress tests comes at the cost of timeliness which reduces their usefulness.

In the follow-up discussion on the supervision of bank asset holdings, FAR members noted that liquidity risk is often monitored differently than market credit risk. As a result, it can be challenging for banks to adequately consider liquidity risks in their stress tests. While there was a view that a higher capital requirement can somewhat address the liquidity problem, FAR members agreed that the two risks are interrelated and that additional work needs to be done.

Potential Impact on Market Participants' Behavior

In the discussion of key drivers behind the recent bank distress, FAR members agreed that technological advancements, which allow depositors to withdraw cash without being physically present at the bank, allowed for a “quicker” run relative to historical episodes. FAR members pointed out that deposit betas, i.e., the sensitivity of deposits to changes in rates, are moving higher, but are consistent with pre-Global Financial Crisis tightening cycles, suggesting that there has not been a fundamental change in the behavior of deposit rates.

FAR members also noted the growth of non-bank investment vehicles like money market assets that compete with bank deposits. Several FAR members noted that this is largely an artifact of the decade-long period of low interest rates that recently ended. At the same time, investment in these assets tends

to be very sensitive to interest rates, so FAR members indicated that such sensitivity can potentially lead to a liquidity problem when investors exit their positions at the same time.

Other Comments

FAR members made a few remarks in relation to the recent fluctuations in the bond market. FAR members pointed out that the term premium is an important driver of these movements. Specifically, FAR members discussed several demand-side factors, such as changes in the economic policies of several foreign central banks. FAR members also discussed risks in the US yield curve related to the geopolitical condition in the country.