Bank Runs: How do we Regulate them?

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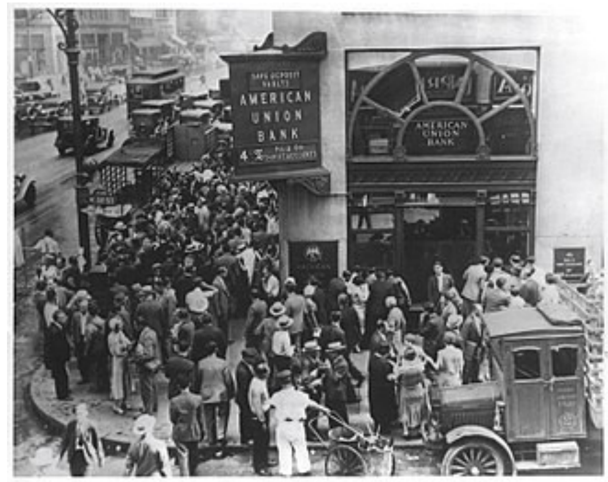
The Great Depression began as a normal recession in the summer of 1929, but the market crash destroyed confidence in banks. Without government regulation, banks began collapsing as customers withdrew more and more funds. Banks didn't have enough funds reserved to cover these withdrawals, and as more banks defaulted, more individuals withdrew funds, creating a snowball effect that led to what we now call the Great Depression. By that time, several thousand banks had collapsed across the US between 1929 and 1933. The situation became so dire that President Franklin Roosevelt declared an unprecedented four-day national banking holiday, to give Congress time to pass the Emergency Banking Act.



American Union Bank, NYC. April 26, 1932.

Thanks to the introduction of the Emergency Banking Act, when banks reopened on March 13, 1933, individuals stood in line not to withdraw, but to deposit the funds they had withdrawn in panic. Thereafter, the Federal Reserve regulated banks by introducing reserve requirements. These requirements require banks to reserve a certain portion of deposits, in the case of many withdrawals. We call this fractional-reserve banking. Banks accept deposits and lend them out, while holding in reserve a fractional amount of the bank's deposit liabilities. Over the decades, these reserve requirements introduced by the Emergency Banking Act have changed to better suit current economic conditions. More often than not, such changes are the result of bank runs.

What we saw in the Great Depression are called bank runs. To cover an abnormally large amount of withdrawals banks are forced to liquidate loans and sell their assets – at rockbottom prices – to pay out. To clarify, bank runs are generally caused by panic, a perceived solvency crisis, not a true issue with the bank's solvency. However, a bank run *can* cause a subsequent solvency crisis because the institution is forced to sell off assets at below-market rates.

Even before the Great Depression, we saw the damage bank runs could cause in the lesser-known Bank Panic of 1907. Charles Morse and F. Augustus Heinze's failed attempt to buy shares of a copper mining firm resulted in a run on the banks associated with them. These were only two minor brokerage firms, and they were declared solvent by the New York Clearing House just days later. But by then, it was too late, confidence in the economy had plummeted. The panic began in New York City, but made its way to other economic hubs across the US. Only $30 million of federal government aid was able to quell the fears, with prominent financiers J.P. Morgan and John D. Rockefeller pursuing deals to bring back confidence.

The modern Federal Reserve System originated from the Bank Panic of 1907, to act as a central bank. With the goals of increasing employment and stabilizing inflation, it increases stability by providing liquid assets for banks and other financial institutions to access.

Although the Bank Panic of 1907 was caused by runs on only two minor firms, even the most established of banks aren't immune to these risks. Consider Bear Stearns. You no doubt know of the once highly respected Wall Street investment bank, and that it no longer exists. Despite surviving the 1929 Stock Market Crash, in 2008 the institution went bankrupt and its assets were sold off to JP Morgan for pennies on the dollar. But how?

Bear Stearns was progressive; the risks they took, such as being one of the first to adopt Lewis Ranieri's securitization of debt, allowed them to grow to a global scale. Their wide range of services included hedge funds that had collateralized debt obligations (CDOs) to profit by using enhanced leverage. Of course, these CDOs posed some risk, but Bear Stearns had a

market cap of $20 billion and a diverse portfolio of offerings. What could go wrong?

In April 2007, the housing market collapsed and Bear Stearns, along with the rest of Wall Street realized that the risk of these CDOs was far more than they had anticipated. Bear Stearns decided the solution was to further increase leverage. Only after this did they realize discover the downside risk – normally limited – was unlimited in the case of an extreme market collapse.

Bear Stearns was able to manage those multibillion-dollar losses thanks to their $20 billion market cap. But for the first time in 80 years, Bear Stearns saw a quarterly loss. Rating firms downgraded Bear Stearns' mortgage-backed securities time after time, until they were stuck with only illiquid assets in a bear market. In March 2008, now out of funds, Bear Stearns went to the Federal Reserve for a credit guarantee. They applied through the Term Securities Lending Facility (TSLF) which allowed them to borrow from the US treasury by pledging eligible collateral. What was eligible collateral? Those supposedly safe, illiquid mortgage backed securities. The TSLF helped Bear Stearns and others increase their liquidity. But the catch was that they could only borrow US Treasury securities for 28-days.

Luckily, this 28-day time limit wasn't an issue for Bear Stearns, their securities were hit with another downgrade and a bank run started. Shares dropped by 47 percent, and by March 13, Bear Stearns was broke. With the support of the Federal Reserve, JPMorgan stepped in to keep the firm afloat. Bear Stearns was the first domino to fall in 2008, and certainly not the last. Parallels can be seen with the Bank Panic of 1907 and the 2008 Recession. The latter was centered around investment banks without access to the Federal Reserve System, while the former spread from trust companies without access to any central bank. Although both started outside of traditional banking services, they caused public confidence in the banking system to plummet.

We can all feel the aftereffects of the Great Recession. People who suffered due to the Great Recession, whether that be financial, housing-related, or job-related, these individuals – thirteen years later – are still more likely to show symptoms of depression, anxiety, and drug addiction. Given the way the Recession has affected the psyche of the US, you might be wondering what the current Federal Reserve requirements are. As of March 2020, there are no longer *any* reserve requirements for banks across the US. In March 2020, the Federal Reserve eliminated them; we've gone from a fractional reserve banking system to a 0% reserve system. Prior to that, as recently as January 2020, the requirements had just been updated to 3% for small banks and 10% for large banks – those with over $122.3 million eligible deposits.

Why would the Federal Reserve remove these restrictions, when historical precedence has shown their important time and time again? In March, the US economy ground to a halt as COVID-10 began spreading rapidly across the nation and countless businesses were forced to close their doors. In an attempt to spur the economy on, the Federal Reserve lifted these restrictions in the hope that the additional loans made by banks might stimulate the economy, and help struggling businesses stay afloat until they could reopen. An estimated $200 billion of previously reserved funds became available to banks.

I'm sure you can already see what the potential risks of such a change are. Bank runs have historically occurred in times of crisis, and a global pandemic is certainly an unprecedented crisis in our modern society. With an uncertain future, was it wise for the Federal Reserve to remove such restrictions? Knowing what we know now, COVID-19, while certainly devastating, has not had as disastrous effects on the US as we had previously thought.

However, we are still in a precarious situation. With COVID-19 still very much present, societal unrest, and an over-extended bull run, it seems the odds of an economic recession are far higher than usual. While the removal of reserve minimums may help with this, it could also lead to far more damage later. After all, the Great Depression would not have gotten to the catastrophic level that it did if it weren't for the bank runs that caused confidence in the economy and banking system to spiral downward.

It is uncertain whether the Federal Reserve will reinstate the reserve requirements or if this is a permanent change. In the case that it is, we still cannot say for certainty whether this new policy will lead to bank runs in the future. However, we cannot discount the fact that historical precedent shows that they eventually will. After all, recessions are inevitable, and without regulations to minimize their damage and maintain national confidence in the banking system, their effects can be exponentially increased.

In addition to the abolition of federal reserve requirements, the Fed also made a temporary change to improve the balance sheets of banks across the country: they allowed banks to exclude US Treasuries and deposits at the Federal Reserve from the denominator of their supplementary leverage ratios (SLR). The SLR is another requirement put on banks to require minimum reserves, regardless of their risk, and it previously ranged between 3-5% depending on the size of a bank. This too was intended to allow banks to continue taking new deposits and lend during the pandemic.

In reality, many banks have used this loosening of cash distribution restrictions to buy back stock and distribute capital to shareholders, which would deliberately reduce their numerator, so that they could afford for the denominator to return to normal. If banks used this expansion of their balance sheets – estimated to be as much as $600 billion nationally – as intended, when the requirement was reinstated, they'd struggle to meet that requirement.

Is there any solution then? Some believe that reserves should be exempted permanently, but Treasuries still included. This would be more in line with global standards. The counter-argument is that it could send the economy back to initial pandemic levels. Banks may be forced to liquidate hundreds of billions of dollars of UST (debt issued by the US) or refuse new deposits.

The SLR has been one of the most important regulations put on large banks after the Great Recession, and these changes to it put the economy at continued risk. Unlike other reserve requirements, the SLR doesn't allow banks to manipulate it by assessing the "riskiness" of their assets. Holding safe assets like Treasuries will not reduce this requirement. As we've seen, banks are not always great at assessing risk, and the SLR protects against this.

While the SLR break will almost certainly be temporary, it may be extended. The Fed has until March 31st to extend the break or end it. But the abolishment of the federal reserve requirement still looms large. In no uncertain terms, it increases the US economy's risk exposure, as increased leverage always does. And this one may not be so easy to reinstate. If 10 years from now, the requirements are reinstated, what will happen to banks? Will they be forced to decline deposits, liquidate assets, and reduce the cash circulating in the US economy? One thing is certain, reinstating regulatory policies is far more difficult than removing them, and by extension, it increases the instability of the economy. As we know, it only takes one domino to cause it to start all tumbling down.