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Discussion: How (in)active was bank supervision during the 2022 monetary tightening?
Investor Attention to Bank Risk During the Spring 2023 Bank Run

FEDERAL RESERVE BANK OF RICHMOND
Richmond ▪ Baltimore ▪ Charlotte

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Disclaimer

The views in this presentation are those of the speaker and do not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Federal Reserve System.

Contributions of the papers

- Who paid attention to bank run risk in 2022-2023?
  - Supervisors downgraded firms
  - Public stock prices became responsive & coalesced around downgraded banks

What would we want from supervisors or expect from efficient markets?

- Risks as exposed by SVB, Signature, Silvergate, First Republic:
  - Share of uninsured deposits, unrealized securities losses

What other ex ante risks should supervisors be looking at and markets be pricing?

Gopalan & Granja (G&G)

- Supervisors' CAMELS ratings of banks decline with:
  - Higher exposure to high interest rates (duration) and securities losses? YES, starting in 2022:Q2,
  - Similar result looking at 1988-1989 (6.6% → 9.8%) and 1994-1995 (3.0% → 6.0%)
  - More runnable deposits? NOT SIGNIFICANT
- Banks respond to rating downgrades by reducing interest rate exposure and increasing liquidity, but modestly

Supervisors downgraded banks ~2022:Q4

- Downgrades increased as rates increased, especially (L)iquidity and (S)ensitivity to risk
- Similar results in past tightening on (L)

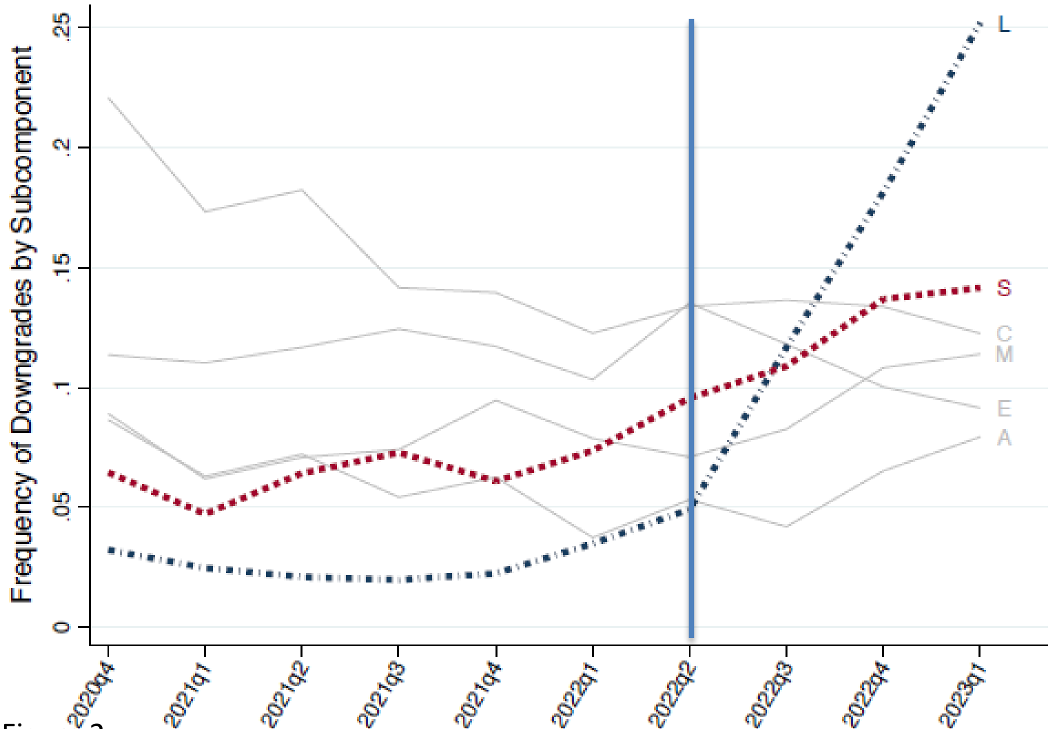


Figure 2

(C)apital
(A)ssets
(M)anagement
(E)arnings
(L)iquidity
(S)ensitivity to risk

Fischl-Lanzoni, Hiti, Kaplan, Sarkar (FHKS)

- Bank stock price responsiveness to uninsured deposits and AFS/HTM losses (beta)
  - Differential performance of stock portfolios sorted by characteristics of 71 banks
- Betas begin insignificant, increased in March & subsided in April 2023
- Betas increased on average, but only for <60% of banks
  - Increased dramatically for banks on downgrade watch
  - Responsiveness to news also increases

News coordinated investor response

- Biggest increase in stock price sensitivity to uninsured deposits and AFS/HTM losses for banks that were downgraded/on watch

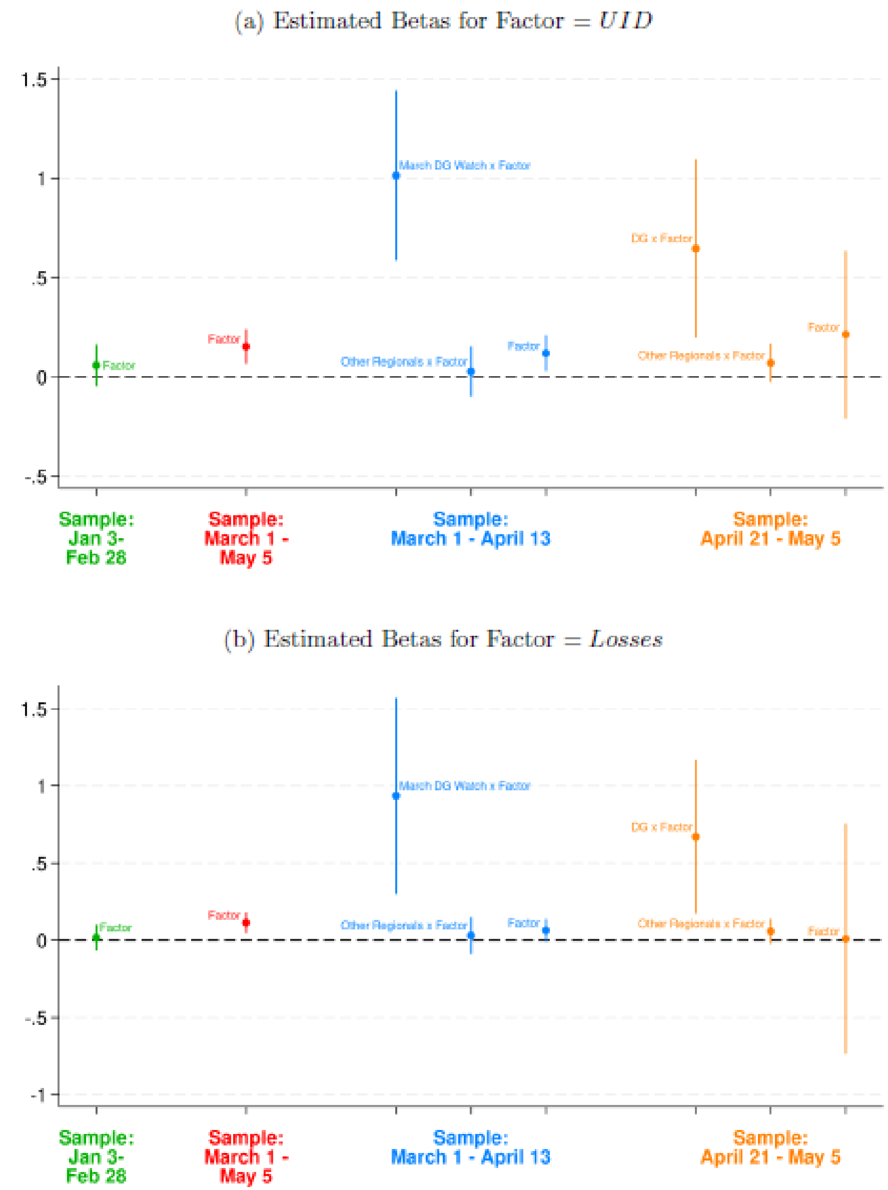


Figure 9

Why does it matter who pays attention?

- Supervision – Goal of supervision is to ensure safety and soundness of financial institutions
  - Suggests importance of reducing extreme left tail of observations
  - Regulation also plays a role in setting parameters of risk
- Investors – How efficient are stock markets at incorporating news? Could markets "discipline" banks or serve as early warning of emerging risks?
  - Expected outcomes more than the left tail
  - Is beta to these factors the best way to measure investor attention to bank risk? Investors could be perfectly disciplining banks based on idiosyncratic risk

This is a very hard question to analyze. Requires a researcher to know ex ante what risks should be identified. Supervisors should perhaps respond more than markets?

1. When should there be a reaction?

Shouldn't supervisors & public markets be acting *before* rates increase?

Yes

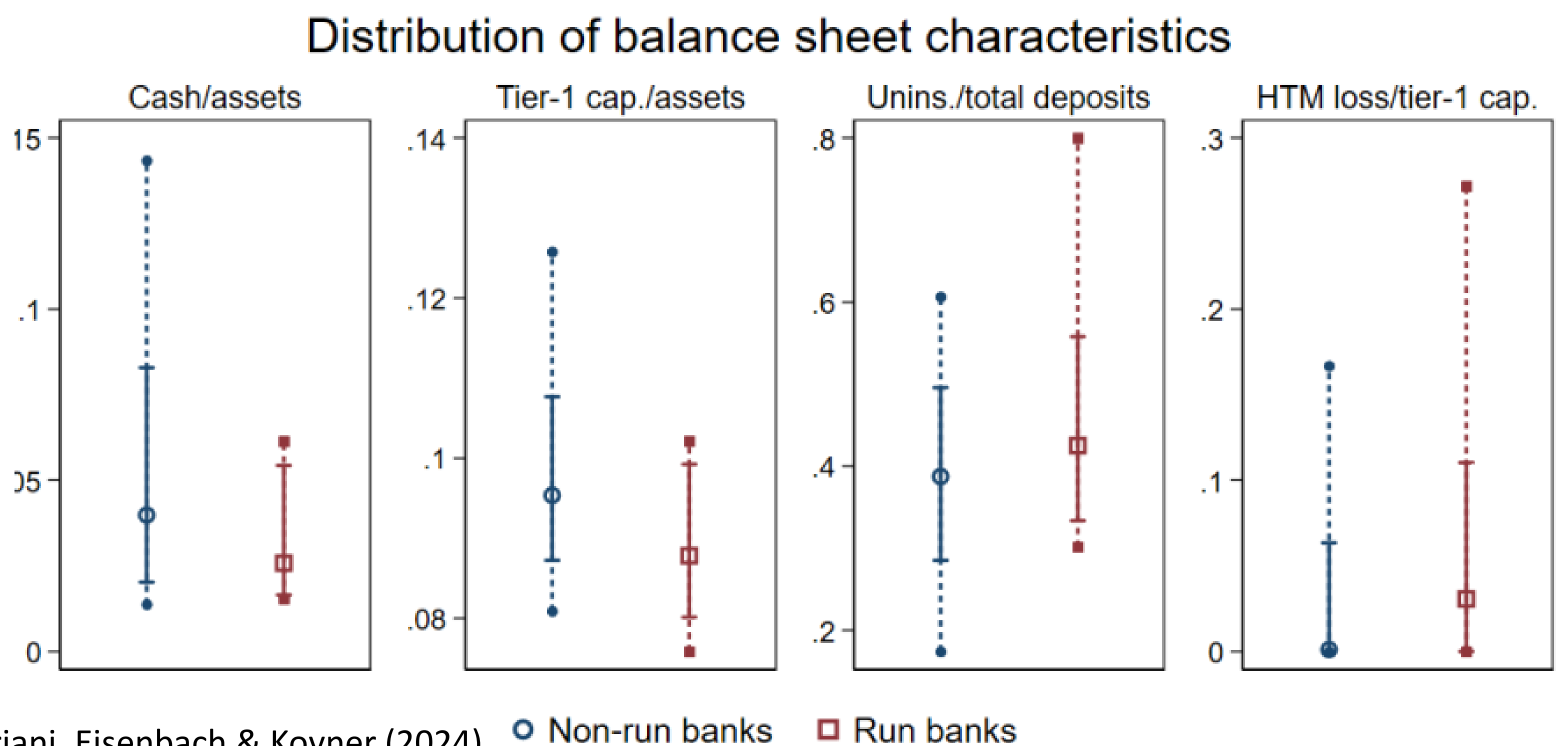
- "Through the cycle" supervision relationship between duration and liquidity rating, not only in tightening
- Investors should price risk of rate hikes in options if not equity prices

No

- Significant (and increasing) disagreement in policy rate forecasts in 2022, particularly the longer horizon forecasts
- Bank runs an equilibrium that does not necessarily occur:
  - Failure of natural hedge from slow deposit repricing
  - Interventions post SVB: Bank term funding program (BTFP)

1. When should there be a reaction?

- Cipriani, Eisenbach & Kovner (2024) identifies runs through payments data and identifies 22 run banks
- Hard to distinguish between run and non-run banks on basis of uninsured deposits & HTM losses alone



Source: Cipriani, Eisenbach & Kovner (2024)

Suggestions

- More focus on *interactions* between variables to narrow in on confluence of variables that makes banks vulnerable
- Public markets:
  - Interact with market forecasts of the rate outlook – only as higher rates become the modal outcome does it make sense for markets to price the risk?
  - When is information known? Information on balance sheets is available well before the call reports are finalized for most public companies
    - Why only 71 banks? (~280 in the FRBNY CRSP-RSSDID link)
- Both:
  - More nonlinear approaches – not sure it makes sense for variation with uninsured deposits or losses to be linear. Below the 25 percentile most exposed, should anything respond to variation?
  - Sectoral composition of uninsured depositors

2. Other insights about information

Supervision:

- Additional analysis of how outcomes vary around supervisory portfolio cut-offs or districts? (paper shows that state & federal supervisors act similarly)
- Which types of banks change actions more based on downgrades? (size, supervisory attention)

Public markets:

- Which types of investors respond to which information?
  - Use 13F filings to examine sales
- Role of bond investors, equity analysts
- How does this compare to past monetary tightening experiences?

3. Drawing conclusions

- Section 6 of the G&G devoted to policy implications
  - Earlier interventions by supervisors would have reduced long duration holdings
  - Impact limited by banks' response to supervisory downgrades

Is the optimal number of bank bankruptcies 0? The optimal number of bank runs? Is it good for supervisors to affect banks' asset allocation choices?

- FHKS conclusions
  - "investors were only intermittently sensitive to high levels of uninsured deposits and securities losses in 2022… reinforcing interpretation of limited investor attention"
    - Equity investors increase betas to risks in first week of March
  - Stock investors coalesce around downgraded banks → equity investors pay attention after the bank runs

Should we be looking for portfolios of run-vulnerable banks to underperform only after SVB? Depends on upside potential of those banks' businesses?

Conclusion

- Bank supervisors noticed risks → G&G suggest they could have done so sooner, encouraged banks to change assets more
- Regulation sets the balance between the supply of lending/access to credit and risks that society and the official sector are comfortable with sustaining. Supervision involves:

  "regulatory compliance, including making qualitative assessments of banks' internal risk management and control processes and enforcing remedial actions tailored to the circumstances they uncover." Hirtle & Kovner (2022)
- What level of interest rate risk does regulation want banks to be robust to?
- Outcomes generally reflect supervision *and* regulation. Is the optimal number of failures zero?

Conclusion (cont’d)

- Equity market noticed risks → FHKS suggests not much, and coalesce around other public information
- Rapid fall in bank equity prices in March 2023 suggests that equity prices may not reflect risks in advance
  - Including SVB which is not included in the analysis
  - Change in pricing behavior of downgraded banks only
- Both papers contribute to literature on information & monitoring of bank risk: bank equities, bank subdebt, bond ratings, supervisor ratings, interbank lending

Thanks for the opportunity to read these papers – you should read both!