

BY KARTIK ATHREYA

## Why Do Bank Runs Happen?

The first half of 2023 has reminded us once again that banks are not immune from failure. In early March, Silicon Valley Bank (SVB) suffered a run on deposits and quickly collapsed. Its closure was followed by the failure of Signature Bank, a smaller bank, two days later. And even more recently, regulators exerted considerable effort to arrange the sale of First Republic Bank to a larger bank. The Fed was responsible for supervising and regulating SVB, and it recently issued its report examining what went wrong. I encourage you to take a look.

As the news is unsettling, it's worth taking some time to understand how bank runs happen. Doug Diamond, who is a longtime consultant at the Richmond Fed, and Philip Dybvig were awarded the Nobel Prize in economics last year for developing a model that sheds light on this question.

Their model tells us that banks can be seen as simultaneously doing two core things smartly for two groups of actors, savers and borrowers. It is anticipated that some savers, who can be firms or individuals, will need flexibility and hence need a place to deposit their cash and access it in case they have a sudden or unanticipated expenditure. Borrowers, on the other hand, often need financing for long-gestation projects – think capital investments for businesses or mortgages for homeowners. In normal times, banks provide intermediation, channeling savers' deposits to borrowers in need of long-maturity loans.

And this can all work: Since only a portion of savers are expected to need their cash quickly, those predictable withdrawals can be properly handled – just as with any insurance arrangement – as the bank can hold aside some liquid funds to meet those payment needs.

A problem arises, though: Can this all work when savers who do *not* have immediate liquidity needs withdraw their money simply because they think others will do the same? Plainly, no. The bank won't have all the cash because – and this is the idea – it parked the funds in the long-gestation projects. Also, should the bank call in the outstanding loans it made to the borrowers, those borrowers couldn't return the money quickly because it was tied up in those illiquid assets, ones that, if liquidated, would yield little value. (Think about “half a factory”; how much would you pay for that?)

If this is the case, why put both functions under one roof? First, absent a run, this “banking” arrangement benefits everyone involved: The depositor who needs to withdraw early can actually enjoy part of the benefits that come

from longer-maturity projects. There is risk sharing among depositors. Maturity transformation has social value. Two additional reasons are that first, banks can better monitor their borrowers and use this information to extend credit more cheaply, readily, and flexibly than more arms-length financing arrangements. Second, the inherent fragility of financing the long-term projects with deposits that can be withdrawn at a moment's notice may limit risk-taking in a bank's borrowing and lending practices.

Diamond and Dybvig's model suggests value to deposit insurance, something that many societies have long instituted. Once in place, there'd be no reason to fear a run

– so long as “most” of a bank's deposits were indeed insured. Currently, the Federal Deposit Insurance Corporation insures individual deposits up to \$250,000 per person per bank unless the government grants the failed bank an exemption that guarantees all their deposits.

But if savers with more than \$250,000 deposited at smaller community banks feared that their money wouldn't be insured (or might simply become temporarily unavailable as the bank was wound down), what then? Run risk would remain, especially in the plausible case that they decide to move their money to larger banks they view

as “too big to fail.” (There is some evidence of this trend in recent months, although it has leveled off.) Unfortunately, if these depositors fled, the smaller banks would no longer be able to intermediate between savers and borrowers. That means tighter credit for those that rely on those banks for their long-term investment needs. And that would be problematic for the wider economy, given that the roughly 4,700 community banks across the country provide roughly 36 percent of all small business loans, and where smaller banks do a large share of all commercial real estate lending.

As for a solution to the more general problem of runs in banking, in the short run, extending the government's safety net can work to limit fears. But in the longer run, insuring more and more deposits isn't necessarily ideal, as it increases both the regulatory burden and banks' risk-taking incentives. So, more generally, avoidance of hard choices about which banks should be allowed to fail when depositors lose confidence will likely create expectations of greater public support of failing banks, with all the attendant distortions and pernicious incentives that come with it. **EF**

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