

Lecture 11: Gorton and Tallman, Ch. 5-8

ECON 43370: Financial Crises

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Information Suppression and Provision

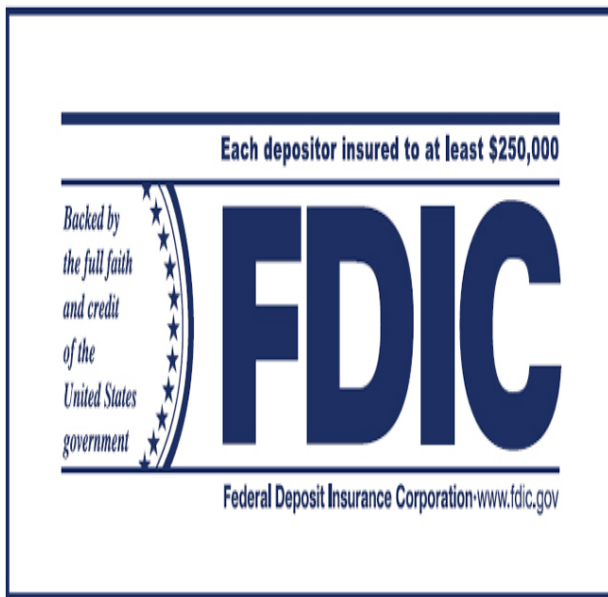
G & T argue that the Clearinghouse did a good job suppressing most bank-specific information during crises

But, in certain circumstances, the Clearinghouse provided some information

These were special bank examinations

The results were opaque: just a seal of approval

Modern-Day Stamp of Approval



Relation to Modern Stress Tests

In 2009, the Fed led stress test of 19 banking groups

- Estimate losses and needed capital cushion in “worst-case” scenarios
- Banks with insufficient capital cushions had to strengthen, potentially with Treasury support

Like 19th century examinations, idea was to restore confidence in the banking system. And it appears to have worked!

Important difference: the 2009 stress tests reported bank-specific information

Questions for Discussion

What made Clearinghouse examinations credible, particularly given opacity?

Why fire executives and boards of directors after an examination?

What's the difference between Clearinghouse loans and Clearinghouse loan certificates?

Why bailout bigger banks and not smaller?

Trusts

Trusts were state-chartered and less tightly regulated than commercial banks

Funded themselves with withdrawable deposits, but these were not used much for check-writing

Typically held small cash reserves compared to regulated banks

Had more latitude in securities financing and loans to stockbrokers

A sort of precursor to the “shadow banking system”

Knickerbocker Trust and the Panic of 1907

Knickerbocker was one of the largest trust companies

Loss of confidence due to involvement of the president in a speculative play on copper

Its clearing bank, National Bank of Commerce, announced it would no longer clear checks for it

RUN!

The Clearinghouse would not come to its aid because it wasn't a member of the Clearinghouse

Precursor to Lehman Brothers in 2008

“Too Big to Fail”

With a few notable exceptions, most large, connected financial institutions have been “bailed out”

Popular conception: existence of too big to fail causes crises

- With implicit promise of bailout, institutions have incentives to get big and interconnected
- Moral hazard: they take excessive risks with the implicit promise
- This eventually blows up

TBTF and Moral Hazard

Is there compelling evidence that moral hazard from implicit bailout guarantees causes crises?

G & T argue not: more concentrated banking systems seem to have fewer crises

In bailouts, typically:

- Creditors made whole
- Management fired and stockholders take big hit
- Orderly liquidation and reorganization

Read: *Bankers' Magazine* editorial (pg. 73)

Continental Illinois

Seventh-largest bank in US in 1984

Got into trouble because of exposure to oil and gas ventures:
declining confidence

Was essentially a wholesale run from uninsured depositors and
short-term money market funding

Was saved by emergency liquidity provision from the Fed and FDIC
takeover

- Depositors were made whole, even if they were uninsured
- Executives and directors were fired, stockholders largely wiped out
- Assets were sold to Bank of America

Past as Present: SVB

Silicon Valley Bank served tech and venture-capital firms, had $\approx$ \$200 billion in assets

Victim of interest rate risk: held lots of long-term government and MBS, got into trouble when short-term rates rose in 2023

Relied heavily on uninsured deposits: \$40 billion in withdrawals on March 9

Basically, the same playbook as Continental Illinois

The Problem of the Counterfactual

We only observe one history

We do not observe what would have happened had policies (public or private) been different

It's a bit of a guessing game: this is why theory and models are important

Two bailouts, no crises: Continental Illinois (1984) and SVB (2023)

No bailouts, intensified crises: Knickerbocker Trust (1907) and Lehman (2008)

George S. Coe speech (1984)

Read this aloud

Currency Famine

“During a panic, depositors want cash, not deposits, but during a panic there is a shortage of cash” (pg. 88)

Modern experience of cash hoarding in 2008 (pg. 88-89)

When cash is scarce, people come up with alternatives

- Loan certificates (settlement within the banking system)
- Certified check

Certified Checks

A certified check is like a check, except the issuing bank guarantees that the funds are available and earmarks those funds for payment

In modern times, use these for very large expenses (e.g., car purchase)

In National Banking Era, certified checks “payable through the Clearinghouse” circulated as bearer instruments

In effect, the Clearinghouse was guaranteeing payment and these checks circulated as money, but at a discount relative to cash: the currency premium

The currency premium revealed expectations about the solvency of the clearinghouse

The Currency Premium and the Implied Probability of Default

Suppose an investor recovers a fraction RR of promised repayments with probability p

With probability $1 - p$ investor recovers face value

P is price, y is yield, r is the risk-free rate (required return if investors are risk-neutral)

Approximately:

$$p \approx \frac{y - r}{1 - RR}$$

Crisis and Policy Sequencing

Reacts to crises typically went in the following order:

1. Suppress bank-specific information
2. Clearinghouse loan certificates
3. Suspension of convertibility (spontaneous, not authorized)
4. Emergence of currency premium

The end of Panics

Roughly:

1. Currency premium hits zero
2. Suspension ends
3. Clearinghouse loan certificates no longer issued
4. End of information suppression

The Role of Gold

Gold (specie) was money (not just an asset backing money; at least after 1879). Gold counted as reserves

Clearinghouse loan certificates essentially bought time – but these were not lawful reserves or circulating money

Currency premia made importing gold profitable

Imports of gold raised confidence

Clearinghouse loan certificates conserved cash $\Rightarrow$ gold replenished
it $\Rightarrow$ confidence recovered

The Currency Premium and Reserve Balances

A regression specification:

$$\Delta CP_t = \alpha + \beta \Delta RSD_t + u_t$$

The currency premium (CP_t) was a proxy for beliefs about the solvency of the banking system

It declined only when reserves (RSD_t) improved

Inflows of gold contributed to this