

Bank Runs Across a Century: Evaluating Policy Changes and Public Behaviour

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ABSTRACT

This paper offers a comprehensive analysis of bank runs, tracing their evolution from the Great Depression to the COVID-19 pandemic. It explores the fundamental concept of bank runs, their shifting causes and consequences over the past century, and the role of public psychology in exacerbating these events. The paper highlights how the general public's reactions can significantly influence the course of a bank run, noting how panic triggered by news of a bank run can rapidly escalate, causing individuals to rush to withdraw their funds and potentially creating widespread chaos and distress. Furthermore, the paper examines how policy adjustments and new implementations address public psychology and attempt to mitigate the risk of bank runs. It includes detailed assessments of the evolution of the FDIC and capital controls in response to various financial crises. Overall, the paper provides a focused analysis of the historical context and policy responses, evaluating them in relation to different financial crises over time.

Keywords: Bank Runs, Psychology, Withdrawals, FDIC, Financial Crises

1. INTRODUCTION

A bank run occurs when a large portion of a bank's customers withdraw their money in a short period, fearing the bank might go out of business. Multiple factors can influence depositors' trust in a bank (Vukelich, 2023). For instance, rapid expansion or poor investments can make customers nervous. If word spreads that a bank has low cash reserves or limited liquidity, people may rush to withdraw their money.

The panic in a bank run is driven more by psychology than actual insolvency or bankruptcy.

People's immediate reaction to speculation or uncertain news is panic and chaos. The shout of "run" can incite as much fear as a shout of "fire" in a crowded room. This panic can cause depositors to rush to withdraw funds, not only from the affected bank but also from other banks, fearing a wider collapse. Bank runs are often seen as contagious, capable of causing a domino effect that leads to the failure of multiple banks nationwide. A recent example of a bank run, which led to a domino effect, occurred at Silicon Valley Bank on March 9, 2023. Almost immediately after, panic and depositor psychology triggered similar runs at Signature Bank and First Republic Bank on March 10.

The purpose of this paper is to conduct a comparative analysis of the bank runs that occurred during and beyond the two major financial crises: the Great Depression and the Great Recession. During the Great Depression, approximately 9,000 banks failed, whereas around 465 banks failed during the Great Recession. This stark disparity highlights the effectiveness of the measures and policies implemented after the Great Depression to prevent such widespread panic and financial chaos.

By examining the causes, scale, and impact of these bank runs, this paper aims to illustrate how regulatory changes and safety nets, such as the establishment of the Federal Deposit Insurance Corporation (FDIC) and the introduction of the insurance coverage limit, have fundamentally altered the banking landscape. These changes have enhanced depositor confidence, reduced the likelihood of panic withdrawals, and stabilized the banking system during times of economic stress.

Furthermore, this analysis will delve into the psychological aspects of bank runs, exploring how depositor behaviour has evolved in response to these

regulatory measures. By understanding the historical context and the subsequent improvements in banking regulations, this paper will provide insights into how modern financial systems can continue to safeguard against the destabilizing effects of bank runs.

2. HISTORICAL BACKGROUND

Since the Great Depression of the 1930s, U.S. public policy toward banking and financial services has prioritized safety over competition and efficiency. The 1930s were marked by an economic and financial catastrophe, with the U.S. economy experiencing its worst crisis in history. The number of commercial banks declined by 40 percent, from about 25,000 to around 14,000 between 1929 and 1933. The bank failures had devastating effects on the economy, leading to a significant loss of savings as many individuals and businesses saw their deposits vanish due to the absence of deposit insurance. This loss of wealth severely reduced purchasing power and consumer confidence, triggering widespread panic and bank runs that further destabilized the banking system. The resulting contraction of credit made it nearly impossible for businesses to obtain loans for operations and expansion, and for consumers to finance major purchases. Consequently, economic activity plummeted, contributing to sharp decline in GDP and soaring unemployment rates, with unemployment reaching approximately 25% at the height of the Depression. This economic paralysis deepened and prolonged the Great Depression, making recovery a slow and arduous process.

The FDIC was established in 1933 in response to the widespread bank failures and financial panic during the Great Depression. The primary purpose of the FDIC was to restore public confidence in the banking system by providing federal insurance for bank deposits. When the FDIC was established, the initial insurance coverage limit was \$2,500 per depositor per insured bank. This amount was intended to cover the vast majority of individual deposit accounts at the time, thereby reassuring most depositors that their money was safe even in the event of a bank failure. The coverage limit was later increased over time, with the FDIC currently insures deposits of up to \$250,000 per depositor per insured

bank. The FDIC insurance meant that even if a bank failed, depositors would be reimbursed up to a certain limit, protecting their savings from loss. By assuring depositors that their money was safe, the FDIC aimed to prevent the bank runs that have exacerbated the financial crisis, stabilize the banking sector, and promote financial stability and economic recovery.

Indeed, the creation of the FDIC marked a crucial step in reforming the banking system and ensuring greater protection for individual depositors. However, banks faced similar challenges of bank runs during the financial crisis of 2007-2009, although the nature and scale were somewhat different from those of the Great Depression. Even though the FDIC increased the insurance limit from \$100,000 to \$250,000 in an attempt to further enhance public confidence, during and after the Great Recession a few hundreds of banks failed in the U.S. due to financial instability, though not all of these failures were directly caused by traditional bank runs.

Moreover, countries in Europe and Asia faced similar challenges related to banking and financial instability, with some countries in those continents imposing capital controls to prevent bank runs. Although capital controls were seen as orthodox in the neoliberal era that began in the late 1970s, during the Great Recession emerging consensus revealed that capital controls can play a legitimate role in promoting financial stability. From 2009 to early 2011, a number of developing nations resorted to capital controls to halt the appreciation of their currencies, and to pursue independent monetary policies (Gallagher, 2012).

In general, capital controls are seen as macro-prudential regulations that can help manage risks. Measures are usually differentiated as being “price-based” or “quantity-based” controls. Quantity-based controls involve explicit limits or prohibitions on capital account transactions, such quantity-based measures on inflows may include a ban on investment in money market instruments, limits on short-term borrowing, and restrictions on certain types of securities that can be owned, restrictions on minimum stay requirements and end-use limitations, limits such as ATM withdrawals were also put in place, to avoid bank runs, which was considered as

a quantity based restriction to control the circulation of capital within the country.

Many of the above have been used by nations such as China, India and Greece. One of the most recent examples in the world of capital controls is Greece which introduced capital controls in 2015 when its bailout extension period came to an end. The European Central Bank did not agree to extend the level of Emergency Liquidity Assistance, which had been extended as support to Greek banks. As a result, the country's government was forced to halt the operations of commercial banks in the country for about 20 days. Heavy controls were put on bank transfers from Greek banks to foreign banks and a limit on cash withdrawals up to 60 euros was put in place. If not for the controls, the Greek banking system was close to collapse (CFI Team, 2024).

As we move forward into history towards COVID-19 we see more bank runs in the midst of the

3. DISCUSSION

By analysing the patterns, in all the above crises we understand that no matter what measures are put in place, regardless of a steep decline, bank failures and run on banks still continue. After the Great Depression, the FDIC was put in place, the initial insurance coverage limit was \$2,500 per depositor per insured bank. Gradually because of this there was a drastic decrease in the bank failures. By the time of the Great Recession, however, they hadn't completely disappeared. To facilitate the following, the FDIC increased its insurance limit from \$100,000 to \$250,000 at the time being hoping to further reduce the bank runs and failures.

Apart from that, capital controls and quantity-based restrictions were employed in many countries, by means of ATM withdrawal limits, restrictions on minimum stay requirements and end-use limitations, so as to avoid bank runs. At this point, it was anticipated that bank runs would continue to decline over time. In the unlikely event of a future financial crisis, the existing measures were expected to be sufficient to prevent such occurrences.

Eventually moving towards COVID-19, similar patterns were observed in the economy and financial

pandemic. Firms had stopped working, due to the pandemic and hence could not generate revenue, similarly, common people and members in households had lost their jobs or were laid off had less income, and due to this neither firms nor households were able to repay their loans. This resulted in copious losses thereby negatively affecting profits and bank capital. Due to this, chances of faster recovery became less probable, and banks expected further losses, and also increased the chances of bank failures by alarming rates.

In summary, while ongoing changes, improvements, and revisions have been made to address crises, the same fundamental problems persist, albeit to a lesser extent.

markets. The 3 weeks in March 2020 were an unprecedented "stress test" on the ability of banks to supply liquidity. The test, induced by the COVID-19 pandemic, was unexpected to most firms and banks, nonfinancial in nature, and affected all industries and regions in the economy (Li, Strahan and Zhang, 2020). Firms that had stopped working, missed out on revenues, and therefore were not able to repay loans. Similarly, households with members who have lost their jobs or were furloughed had less

income, and therefore were not able to repay their loans (Beck, 2020). This resulted not only in lost revenue but also in losses, negatively affecting profits and bank capital. Due to this swift recovery became less likely, and banks expected further losses, banks also faced increasing demand for credit, as firms required additional cash flow to meet their costs even in times of no or reduced revenues. Losses and lower capital buffers in banks had negative spillover effects, which led to making banks solvency positions even worse and also undermined the broader economy.

In order to avoid panic and havoc the FDIC even considered introducing an unlimited insurance amount for deposit accounts to ensure that the people felt safe and secure about their money. For obvious reasons we understand that doing this would not be feasible to a certain extent, pertaining to the

fact that the U.S. government only has a limited amount of funds and cannot assure all the people's money without going into debt. Although not formally implemented, the rationale was to address the public's psychology and emotions. By assuring depositors that their funds would be fully protected in the event of a bank run, the aim was to prevent panic and chaos. Such assurances were intended to avoid a rush of withdrawals not only from the affected bank but also from other banks, thereby reducing the risk of a broader financial collapse and mitigating the domino effect that could lead to multiple bank failures.

A significant reason for the FDIC's adjustments to its insurance limit and policy revisions over time has been to align with public psychology and enhance depositor confidence. By making individuals feel more secure, these changes aim to prevent panic-driven withdrawals from banks, thereby reducing the likelihood of bank runs. This tells us that subjects underlying emotions such as fear, sadness or happiness play a huge impact on their consequent actions. As argued by Dijk (2017), the presence of background fear significantly increases the likelihood of withdrawal and a subsequent bank run, hence to appeal to this reaction itself, the FDIC made policy changes.

It is essential to recognize that psychology affects both public perception and banking behaviour, with complex consequences. Many banks, particularly large, systemically important institutions deemed too-big-to-fail, often faced less stringent regulatory oversight (Eigner and Umlauf, 2015). These institutions were allowed to set their own capital levels with minimal regulatory constraints, benefiting from both implicit and explicit government guarantees. This environment reduced market discipline, leading banks to take excessive risks while maintaining dangerously low capital ratios and relying on highly volatile funding sources. As a result, the potential for failure and bank runs increased.

In summary, psychological factors can influence various aspects of the banking system, driving both positive and negative outcomes that shape future regulatory and operational actions.

4. CONCLUSION

In conclusion, this paper presents a comprehensive analysis of bank runs over the past century and highlights key findings. A bank run occurs when a significant portion of a bank's customers withdraw their funds simultaneously, often driven by fear of the bank's potential collapse. This panic is frequently induced by psychological factors rather than actual financial instability, leading to a cascade of withdrawals that can jeopardize other banks.

The paper compares the occurrences of bank runs during the Great Depression and the Great Recession. The Great Depression witnessed approximately 9,000 bank failures, whereas around 465 banks failed during the Great Recession. This stark difference underscores the success of post-Depression reforms, particularly the establishment of the FDIC, which guarantees depositors' funds up to a certain limit, thereby bolstering public confidence and curbing panic. Over time, the insurance limit was increased to enhance depositor trust and prevent widespread withdrawals.

Historical analysis reveals that the severe economic impact of bank failures during the Great Depression led to the creation of the FDIC in 1933, initially insuring deposits up to \$2,500, which was later raised to \$250,000. Despite these safeguards, bank runs and failures persisted during the Great Recession and subsequent crises, including the COVID-19 pandemic.

In response, the FDIC revised its policies, raising the insurance limit to \$250,000 post-Great Recession and implementing measures to stabilize banking systems globally, including capital controls. During COVID-19, the FDIC even considered introducing an unlimited coverage promise to mitigate public anxiety and prevent bank runs, despite the practical limitations of such a measure.

This analysis underscores the critical role of depositor psychology in maintaining financial stability. While regulatory changes and safety nets like the FDIC have significantly mitigated the frequency and impact of bank runs, psychological factors remain a decisive element in depositor behaviour and the overall stability of financial systems. Despite various measures, the persistence of bank failures and runs demonstrates the ongoing

influence of psychological dynamics in the banking sector.

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