

Edge Weekly

My Say: The Fed dodges a bullet — for now

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What a month March had been. Over a three-week period, four mid-size US banks had to be rescued and one large Swiss bank had to be folded into another. Meanwhile, a German bank had to suffer serious erosion of its equity value.

It started with Silicon Valley Bank (SVB) needing to be rescued following a run by its depositors, on news of its loss of some US\$2 billion (RM8.8 billion) from the sale of US government bonds it had been holding. It appears that SVB was holding a huge portfolio of long-dated government bonds — a clear case of a serious duration mismatch.

Surprisingly, no one, not even the banking regulators, seemed to have been watching interest rate risks, even as the US Federal Reserve had been raising rates rapidly. Rising rates affect the value of items on a bank's balance sheet. Both assets and liabilities are affected, with the impact being determined by the duration of each item.

Given the intermediation function of banks, the duration of assets is invariably longer than that of liabilities, a large part of which would be deposits. Thus, a bank holding large amounts of long-dated bonds would have a disproportionately large asset side duration and, accordingly, a large duration gap, making it highly susceptible to even small interest rate rises.

For example, when interest rates rise, a bank with an asset side duration of five and liability side duration of two would see the value of its assets fall 2.5 times more than that of its liabilities. The result would be a need to write down its equity capital in order to account for the bigger loss in asset value.

If the size of the needed write-down is large relative to equity, the bank is technically insolvent. Such risk is typically managed through the use of interest rate derivatives, loan portfolio swaps and other derivatives.

Ironically, the Fed's attempt to contain inflation led to supposedly risk-free bonds of the US government turning toxic. These are the very instruments that banks and regulators have designated as high-quality liquid assets (HQLA).

While regulators were quick to claim that the problems at the four banks were isolated and blamed the banks' management for poor risk management, a recent academic research paper claims that some 200 US banks may be holding similar sized positions in US government bonds. Meaning, they could all evaporate just as quickly as SVB did. Perhaps realising the potential magnitude of the problem, the Fed and other regulators pulled out all the stops to salvage the situation and prevent further fallout.

They may have temporarily succeeded but at huge potential cost. The contingent liability created for the government is massive and the Fed's credibility may also be on the line. The most damaging may be the messaging and the incentive issues it raises. In their desperation to avert contagion, several red lines were crossed.

For example, the Federal Deposit Insurance Corporation undertook to guarantee all deposits at SVB and the other troubled banks, even those above the insurance

threshold. In addition, troubled banks would be able to sell their bond holdings at face value and not necessarily at market value to the FDIC.

Finally, regulators have allowed banks to sidestep the need to mark-to-market their bond holdings, even those in their trading book, for a one-year period. For a time, there was even talk of the US government guaranteeing all bank deposits in the country, an estimated US\$26.5 trillion.

More than the contingent liability created by the rescue, the real damage is in the heightened moral hazard arising from the changed expectations of bankers and their incentive to take on risk. This rescue effectively rolls back several years of trying to discipline banks.

Bad policy signals give rise to perverse incentives. For example, the flat yield curve, arising from monetary policy looseness and interest rate repression even prior to the sub-prime crisis of 2008, incentivised banks to go down the credit quality chain and originate sub-prime loans.

Flat yield curves rendered traditional banking unprofitable. Banks had little choice but to go sub-prime to maintain profitability, and the ability to securitise and offload them made it a logical proposition. With the outbreak of the global financial crisis in 2008, banking regulations as usual were once again tightened but a new kind of intervention, quantitative easing (QE), came into being. Though banking rules were tightened, monetary policy was not.

Years of loose money and ultra-low interest rates followed. The outbreak of Covid-19 only pushed this looseness several notches higher and QE flushed the system with tonnes of liquidity. While the liquidity fuelled stocks, bonds, cryptos and every other financial asset to boom, a portion got recycled as bank deposits.

Rising deposits required banks to put the money to work and the most regulatory-compliant way was to invest in “safe” government bonds. However, since the yield on short-term bonds were next to nothing, a spread could only be earned with long-dated bonds. Exactly what SVB and, it now appears, hundreds of other US banks may have done.

Looking at the many previous banking crises and now this, it is clear that regulation alone cannot be the answer. If credit risk was the cause of the sub-prime crisis, it was interest rate risk this time and there is no telling what it would be the next time.

Nothing gets resolved when new regulation simply alters bank behaviour and leads to another crisis and breakage. Pressing on one end of an enclosed tube simply swells the other end — nothing changes.

The real flaw may be the banking model itself. The multitude of new banking regulations over the years may simply have added new props to hold up a seriously flawed, badly broken and highly fragile edifice.

That the banking model is flawed is not a new realisation. Even as early as the 1930s, following the Great Depression, there were calls for a redesign of banking. The Chicago plan and its variants offered alternative designs that would have essentially broken up banks into a deposit-taking unit that holds 100% reserves and so would be immune to runs and a credit extending unit that would be structured on a mutual fund model with risk-taking equity holders offering the funding.

Several other variations of the basic Chicago plan idea have emerged, but none have been adopted. In fact, Bank Negara Malaysia's Islamic Financial Services Act, 2013 (IFSA 2013), if properly executed, would have moulded Malaysian Islamic banks close to the Chicago model.

That, despite the many banking conflagrations and the huge social cost, no government has undertaken the needed redesign of banks is perhaps testimony to the power of money over politics. However, where political will had not, technology may now offer a chance. Technology now enables the payments system, for which society had been dependent on banks, to be replicated independently outside the banking system.

Thus, a banking system redesign should now come at a much lower cost of disruption. Policymakers need to take the bull by the horns if there is to be a proper resolution to recurrent banking crises. The Fed may have dodged a bullet this time by kicking the can down the road, but nothing has been solved. A bigger bill may come due soon.

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