Opinion **Markets Insight**

The policy compromises needed to resolve the SVB implosion

The Fed should tolerate greater banking system concentration while seeking to contain moral hazard and avoiding lower rates

MOHAMED EL-ERIAN

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Mohamed El-Erian YESTERDAY

The writer is president of Queens' College, Cambridge, and an adviser to Allianz and Gramercy

The fate of what was a little-known bank outside the tech world until last week is now of major policy concern this weekend, and not just in the US.

In a narrow sense, it demonstrates that even seemingly small banks can pose systemic risks. In a broader sense, it illustrates the inherent trilemma of the ongoing monetary policy regime change. Namely, the challenge for the Federal Reserve to simultaneously deliver on both its 2 per cent inflation target and the employment part of its dual mandate while ensuring financial system stability.

In simple terms, the fragility of SVB came from the perfect storm undermining both its balance sheet and liquidity. Specifically, it was exposed by the mix of a concentrated deposit base and the eroding of the market value of the safe assets that partially offset this liability.

The spark for the current instability was the need to cover losses on bonds resulting from higher interest rates. There also had been some noise about the quality of the loan book given that parts of the tech sector have been under pressure. The spreading agent was depositor flight as more and more tech business owners and entrepreneurs rushed to move their money out of the struggling bank.

Unusually, regulators decided to suspend SVB's operations during business hours on Friday, delivering the largest individual bank shock since the 2008 global financial crisis and, in nominal terms, the second largest in US history. The weekend has been full of chatter about how the deposits will be managed, whether some companies that held cash at SVB will even be able to meet their payroll next week and speculation on the broader industry impact.

The immediate challenge facing policymakers is how to balance a set of key risks in SVB's resolution process.

First, there is the moral hazard risk that comes from making all depositors whole on the money they have with SVB. If they do not, policymakers have to consider the risks of deposit vulnerability of other small and regional banks as well as the impact on the start-up ecosystem in the US and beyond.

Second, there are the concentration risks associated with the additional flow of business to the largest banks if SVB is closed for good or taken over, including already too-large-to-fail institutions. This would raise concerns over competition in banking for the tech industry, an important sector of the economy.

And third, there is the policy risk if the Fed were to pivot to monetary stimulus while inflation is still a problem.

What makes this a particularly sensitive time is that the SVB policy challenge is also bringing the broader issues to the fore. Let's start with the good news. Despite the complexities of the SVB saga, the risk of repeating 2008's systemic banking crisis is low assuming appropriate policy responses. After all, the banking system as a whole is now much better capitalised and supervised. And it has a much more diversified deposit and loan base than SVB's.

Less good is that SVB has exposed the threat posed by interest rate and credit risks for entities in the banking sector and, importantly, well beyond it. It is a more pronounced threat given the past two years of Fed policy errors in responding to inflation. These included the mischaracterisation of inflation as "transitory" for most of 2021 and then, the timid policy response initially that led to the subsequent need for a rapid four consecutive 0.75 percentage point hikes. And this came after the overly protracted period of ultra-loose "unconventional" monetary policies.

Keeping that in mind, the best way forward for the Fed this weekend is to help resolve the immediate SVB problem by balancing the risks in the following way. It should tolerate greater banking system concentration, seek to contain moral hazard with partial public support for deposits and encourage the larger banks acquiring SVB's deposits and business lines to offer further assistance to depositors. The Fed should also avoid the "co-option" of policy by resisting any relaxation of its interest rate stance at a time it needs to fight inflation.

This is not a perfect solution of course. But it is the better one in this largely Fed self-created hole of being deep in the world of "second best" policies.