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COMMENTARY By Steven Grey May 5, 2023 3:00 am ET

The Bank-Depositor Blame Game Helps No One

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In response to the regional banking crisis, a number of prominent free-market absolutists on Wall Street and in Washington have voiced adamant opposition to any bailout of bank depositors. It's a classic "moral hazard" argument. Unless depositors experience what would in some cases be catastrophic losses, they will continue to carelessly entrust their hard-earned cash to reckless banks, which in turn will only encourage those banks to take more ill-advised risk. In short, the depositors are to blame, and they must be punished.

It's an argument that only a die-hard optimist could love.

Experienced bank regulators repeatedly failed to pre-empt the banks' balance-sheet problems. Expecting depositors to accurately assess them, too, is tantamount to making airline passengers responsible for the proper maintenance of the aircraft that carry them aloft. It's all but asking for the plane to crash.


The markets have beaten moral-hazard purists to the punch, writes Steven Grey.
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In times of crisis, context is key. There are more than 4,000 insured commercial banks, according to the Federal Deposit Insurance Corp. At the end of the day, given the nature of the business and the large number of participants, it's irrational to expect all of them to be well-managed.

The economic reality is that we have every reason to expect banks to blow up. They borrow short, lend long, and do so with vanishingly thin reserves of liquidity. It's a business model based on a deliberate mismatch of duration that renders them permanently vulnerable to potentially lethal liquidity crises. In reality, we should be both surprised and relieved that banks financially detonate so rarely.

The extreme nature of Silicon Valley Bank's missteps makes it easy to frame them as an outlier, the Cocaine Bear of regional banks. Not hedging substantial bond positions in its available-for-sale portfolio was an overtly risky reach for yield that was destined to end badly. Likewise for First Republic Bank's sailor's dive into interest-only, super-jumbo mortgages.

The reckless, rogue bank is a characterization that's conveniently reassuring, because we of course want to believe that the recent spate of bank failures are isolated anomalies rather than the first victims of a tsunami about to batter the U.S. banking system. But the odds of First Republic being the final victim are slim. The Fed has effectively ensured it.

For about a decade and a half banks bought U.S. government bonds not because they offered any meaningful yield but because the Fed left them no reasonable alternatives. It was an explanation that became a quantitative-easing catchphrase: "there is no alternative." When I wrote about this issue back in March of 2020, duration on the Bloomberg Barclays Global Aggregate Treasuries Index had just hit a record 8.6 years—meaning that every 1% increase in average yield would trigger a price decline of around 8.6%.

When in March of 2022 the Federal Reserve began tightening credit at the fastest pace in 40 years, it triggered perhaps the most counterintuitive crisis the U.S. banking system has ever experienced: hundreds of billions of losses on U.S. government bonds that present no credit risk, should not be hedged (if designated as hold-to-maturity), and are technically considered risk-free.

Given how oppressive she was during the relationship, our breakup with TINA was always going to be ugly. But the irony! Essentially, a wide swathe of the U.S. banking system may be on the cusp of collapse because too many depositors suspect that their banks own too many risk-free bonds issued by their own government, the most trusted lender and debtor on the planet.

Clearly, the only logical answer is to punish depositors into a panic that quickly engulfs the entire banking system, and in the process collapsing the same flow of credit that we all depend on to economically function. That'll teach them! I mean us! I mean them!

If the moral hazard purists pining for victims to discipline haven't yet noticed, the market beat them to the punch. Countless bank shareholders, bondholders, and employees have been financially devastated—notwithstanding the knock-on effects. Anyone who thinks that not enough punishment has been inflicted should have a chat with the purchasers of Credit Suisse contingent convertibles. (Try to catch them when they're not so choked with rage at being wiped out that they're unable to converse).

As for the depositors, blaming the victims is almost always bad form. In this case it also makes no practical sense. To some, bailing out any and all depositors may lack a certain moral satisfaction. But enlightened self-interest suggests it is the best course of action. Because let's not forget, the same government that's "rescuing" depositors both created the bomb sitting on bank balance sheets and lit the fuse.

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