Bond Blog

PGIM FIXED INCOME

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The SVB Fallout - from the Fed to Geopolitics

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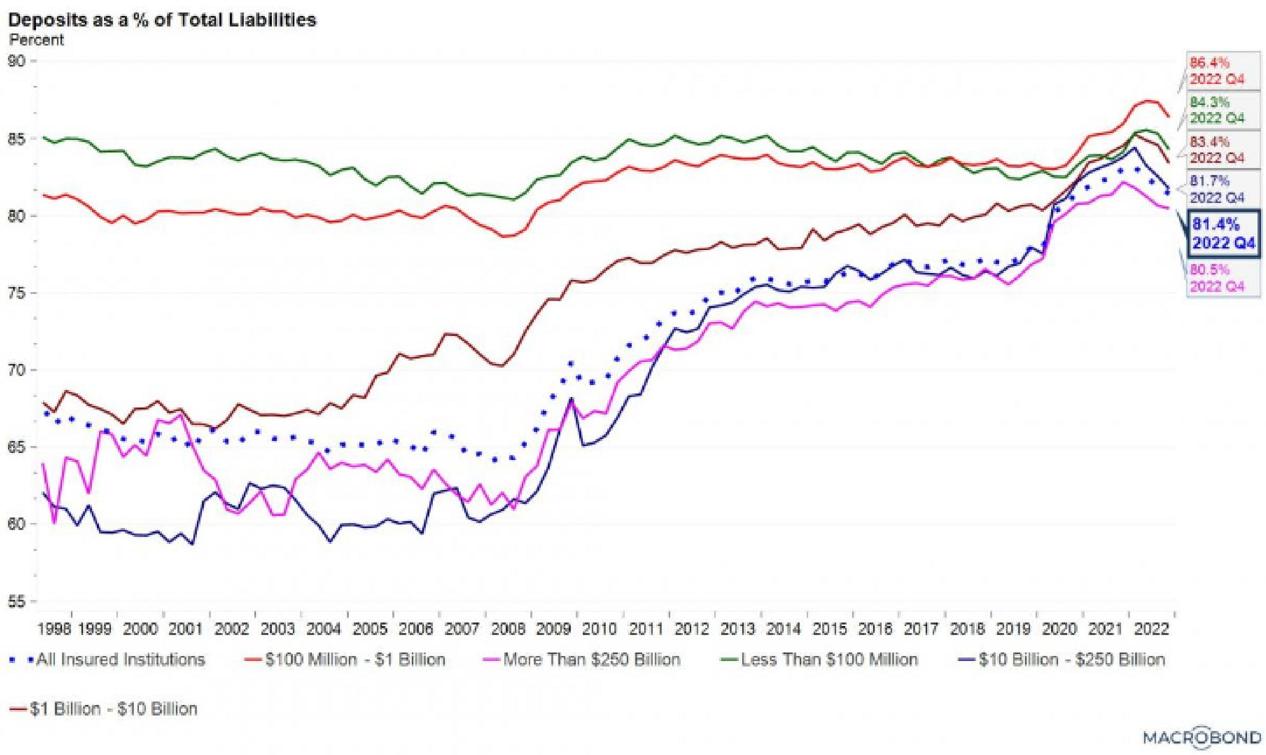
The abrupt failure of Silicon Valley Bank (SVB) and the renewed pressure on Credit Suisse are the latest in a series of global shocks affecting the capital markets. Saying this is a fluid situation is of course a gross understatement, but we can at least sketch out initial conclusions from Federal Reserve policy to geopolitics.

What are the broader risks?

Policymakers judged - correctly in our view - that while SVB's risk management practices were an egregious outlier, its vulnerabilities weren't unique. Unrealized losses on securities holdings across the U.S. banking sector were mounting well above $600 billion by the end of last year. Deposits were growing as a share of U.S. banks' total liabilities, to about 80% on average at the end of last year - and about 5 percentage points higher on average for smaller banks (Figure 1) - but they were flowing out for the past three quarters. Why? Savers could finally take advantage of juicier yields available in risk-free securities. By the end of last year, only about half of total deposits in the U.S. banking system that remained were insured by the FDIC, leaving almost $10 trillion in uninsured deposits.

FIGURE 1: The post-pandemic jump in deposits, particularly among smaller banks



Source: PGIM Fixed Income, Federal Reserve, Macrobond.

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What's the takeaway? Hundreds of millions of savers and tens of millions of small businesses were at risk. And the perverse lesson of the GFC is that even if your neighbor is smoking in bed and lights his house ablaze, firefighters still must put it out to save the entire neighborhood from burning down.

Will policymakers' responses be enough?

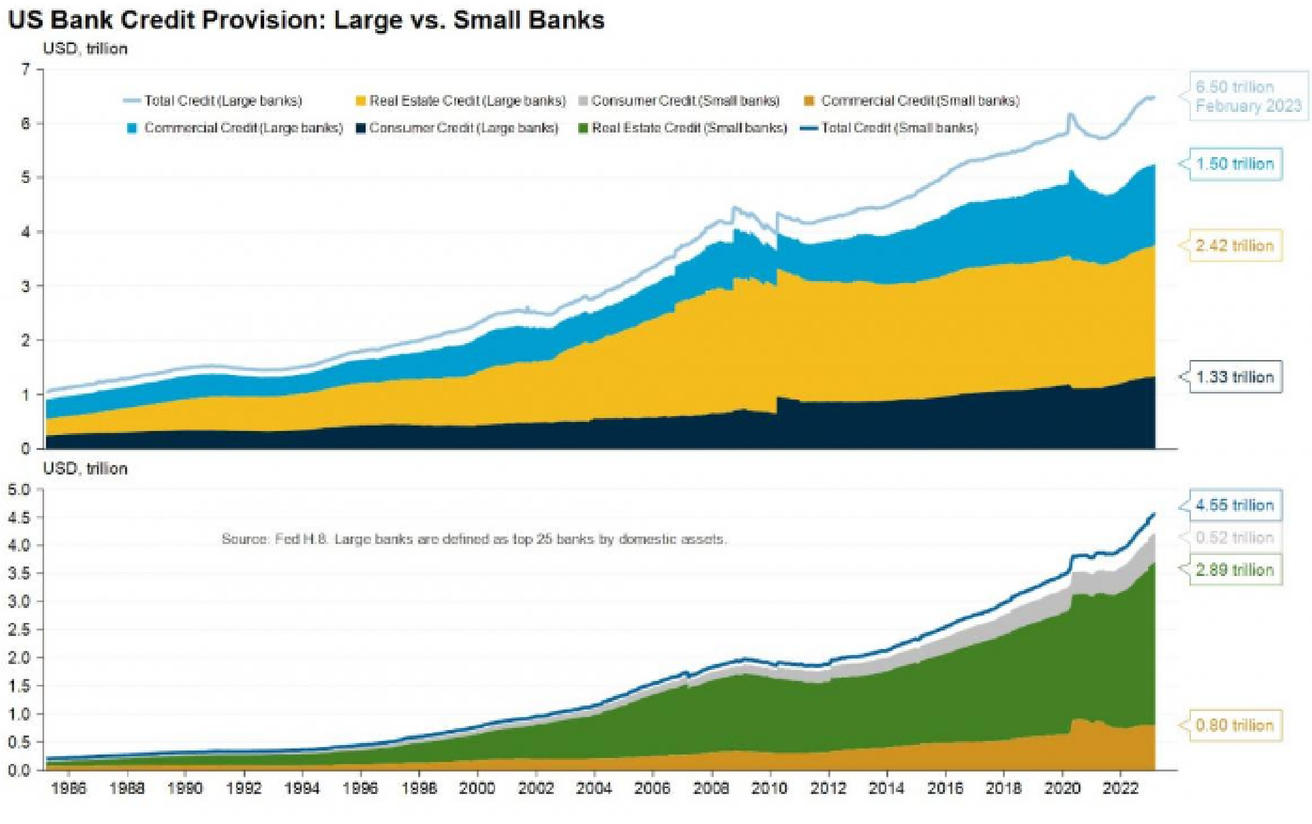
That's why the Federal Reserve, U.S. Treasury, and Federal Deposit Insurance Corporation (FDIC) had no choice but to move quickly and forcefully over the weekend to once again rescue the financial system.

The authorities correctly declared that SVB contagion posed a risk to the U.S. financial system as a whole. Doing so allowed the FDIC to make uninsured depositors at SVB and Signature Bank fully whole by using the levies charged to all insured U.S. banks. Declaring a "systemic risk exemption" also allowed the Fed to create a Treasury backed emergency facility (Bank Term Funding Program, or BTFP) to provide cash against Treasuries and MBS collateral valued at par, which is tantamount to a backdoor capital injection. What was left on the table? The FDIC didn't do was guarantee all uninsured depositors - following the Dodd-Frank regulatory reforms of 2010, only an act of Congress can do so. And the Fed didn't adjust its balance sheet policy, nor did it signal any change to interest rate policy.

Taken together, policymakers' actions were necessary, but we don't yet know whether they'll be sufficient to stem contagion risk. It depends in part on whether banks are willing to stick their neck out and borrow from the BTFP, or whether the stigma of doing so will be too much to bear. In 2020, Fed policymakers tried to lessen the stigma of borrowing from the discount window by encouraging healthy and solvent banks to borrow from the facility at once and with delayed disclosure. A similar initiative may now be in the works.

Much also depends on what happens to credit conditions. Smaller institutions tend to make more loans than larger banks - about 20 percentage points more as a share of their deposits - and they account for about 40% of overall bank lending in the U.S. (Figure 2). So, if contagion engulfs otherwise healthy regional banks as depositors seek safer haven in larger banks, the damage to economic growth could be quite substantial. So could the negative spillovers from banking stress in other parts of the world - especially Europe - that are also experiencing interest rate shocks and large unrealized losses, without the same degree of banking union and/or backstop support from their respective fiscal authorities.

FIGURE 2: The Importance of Credit Provision from Smaller U.S. Banks



Source: PGIM Fixed Income, Federal Reserve, Macrobond.

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What are the short- and long-term implications?

Fed policy: Our judgment is that next week's 25 bp hike by the Fed will be the last in this cycle, for three reasons:

(1) While it's still possible that this episode will have a quick conclusion, emerging signs of contagion to Europe suggest that's unlikely - this episode will have a long tail. Tighter financial conditions - especially through a pullback in bank lending, but also mounting spillover risks from abroad - are at least a partial substitute for tighter monetary policy and will sap momentum in the labor market as well as services inflation;

(2) the odious spectacle of rescuing the banking sector yet again means the U.S. government (Congress) will likely feel reluctant to fully backstop all depositors, leaving the Fed less space to use interest-rate policy strictly for macroeconomic management; and

(3) the balance of risks have undoubtedly shifted - the risks from too much tightening are now at least equal to, and likely larger than, the risks of doing too little. We expect Fed Chair Powell to pair a final rate hike next week with a message that Fed policy will then go on an extended pause, with the possibility of resuming rate hikes later - or initiating rate cuts - in the second half of the year. In reality, financial conditions, rather than the Fed, are now in charge, and the next series of moves will probably be 50-75 bps of rate cuts later in the year.

Regulation: As much as SVB was a failure of risk management, it was also an abject failure of regulation and supervision. Too big to fail became "too small to see" as Dodd Frank regulations on mid-sized banks - including stress testing - were rolled back by Congress and the Fed after 2018. Vigilant supervision could have compensated, at least in part, by putting even elementary questions to SVB's management about its duration hedges, or lack thereof, but that didn't appear to happen. Americans have every right to feel furious that these lessons are again being learned the hard way. Therefore, expect regional banks to face higher capital and liquidity standards, more stringent stress testing, and clawback mechanisms for executive compensation. More broadly, amid the shakeout in smaller banks and bloating of our largest banks' balance sheets, government authorities will need to revisit whether "too big to fail" has re-emerged as the unintended byproduct of their rescue efforts.

Institutional credibility: Without question, protecting hundreds of millions of savers and tens of millions of small businesses was the right thing for policymakers to do over the weekend. But interventions are never costless. In this case, the Fed's rules for assessing collateral pledged by banks in exchange for cash were instantly changed, such that the assets are now valued at a hundred cents on the dollar, far more than they're worth in the market. The FDIC's cap on insuring deposits up to $250,000 in size was also lifted to make whole all depositors at the failed banks. Changing the rules to suit the circumstances may have been necessary to prevent a system-wide panic - we'll never know the counterfactual - but in doing so, the credibility of the post-crisis rules may suffer.

Geopolitics: The excesses within the core of our financial system have now been exposed with alarming regularity. One can't help but notice that just as we're trying to protect savers and small businesses from our failures within, China is embarking on a charm offensive in the Middle East and Ukraine to exert leadership abroad. Indeed, this episode will serve as a reminder that we must shore up our fragilities at home to project leadership abroad in an environment of intensified global competition. If there's a silver lining, let's hope it's a sober wake up call to our leaders about the dangers of making ourselves a global spectacle with another debt limit drama in the months ahead.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as 3/15/2023.

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