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Why is the US financial system so fragile?

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The sheer size of the US economy and some of its financial institutions and the US dollar at the centre of global trade and capital flows makes US banks particularly fragile.

Highlights

- *Why is the fear of a contagion and collapse far more pronounced in the US than elsewhere?*
- *The fragility of US banks lies in the people's psyche over bank bankruptcies and failures, historically, and the government's attitude to such failures.*
- *Repeated occurrences of bankruptcies and bank runs in the US, leave uninsured depositors [businesses and individual depositors with large balances] under the potent threat of bank closures*

The recent Silicon Valley Bank (SVB) crisis has once again turned the spotlight on the US financial system, bringing back memories of US bank closures and the global financial crisis (GFC) of 2008. The question, however, is why are particularly US banks being singled out and considered exceptionally fragile, rather than commercial banking and the financial system more generally across the world. After all, financial institutions are prone to asset-liability mismatches arising from bad loans and also, as witnessed recently, falling prices of government securities.

The most obvious answer to this question is the sheer size of the US economy and some of its financial institutions, the US dollar at the centre of global trade and capital flows, and finally, the linkages of the US banking system to the global real economy. The latter is clearly evident from the immediate effect on tech firms and start-ups in Europe, India and elsewhere soon after the unfolding of the SVB crisis.

While the 2008 GFC crisis was certainly due to financial deregulation since the 1990s that allowed excessive risk-taking by banks aided by the proliferation of derivative instruments like mortgage-backed securities (MBS) and collateralized debt obligations (CDOs) in the leveraging process, the present SVB crisis and subsequent contagion is due to a diametrically opposite reason: over-investment in safe assets, i.e., government securities. The fall in the market price of these securities from rising interest rates was essentially responsible for the run on SVB.

Quantitative estimates of the fragility of the US banks have been reported by the **Hoover Institute**. Assets for the US banking sector are about $2 trillion lower than book value, with the average bank assets on marked-to-market (MTM) basis declining by 10 percent and at 20 percent for the bottom 5th percentile. In comparison, a **report** by Jefferies India Pvt. Ltd. revealed for Indian banks 'losses may not exceed 6 percent of capital for private banks and 15 percent for public sector banks.' Given that the numbers do not look excessively out-of-place for US banks, why is the fear of a contagion and collapse far more pronounced in the US than elsewhere despite the fact that the Fed acted promptly, assuring banks they would have access to a special discount window to swap securities at *par* or *HTM* (held-till-maturity)-value in exchange for a credit in the banks' reserve accounts at the Fed?

The answer to this question is related to psychology, history and politics, not merely economics. In other words, the fragility of US banks lies in the people's psyche over bank bankruptcies and failures, historically, and the government's attitude (not just response) to such failures. The US Federal Deposit Insurance Corporation (FDIC) **reports** some 565 bank failures since 2001 with total assets of over $319 billion. Furthermore, although accounts are fully insured up to $250,000, recovery on uninsured deposits (dividends) has rarely been 100 percent with many instances of abysmally low dividend pay outs. This may be far fewer than the 4,000 bank failures during the Great Depression but nonetheless the number of bank failures over the last two decades still remains substantial.

The fragility of banking is fundamentally related to the possibility of bank runs. Depositors pulling out $42 billion in a single day from SVB showed how susceptible the US banking system is to bank runs when the fear of bankruptcy sets in. As the **Hoover Report** puts it, 'if uninsured deposit withdrawals cause even small fire sales, substantially more [than the presently estimated 190] banks are at risk. Overall, these calculations suggests that recent declines in bank asset values very significantly increased the fragility of the US banking system *to uninsured depositor runs*.'

Neoliberalism is deep-rooted in the US. The belief that in a free market system, individuals must take responsibility for their own condition, and not society or the state, is widespread. No one may resent your making money but do not expect support when you are not. **The Balance** reported in 2021: 'There was a lot of anger about the billions in taxpayer dollars used to bail out the banks [in 2009]. Many people felt there was no oversight … They agreed that banks should not have been rescued for making bad decisions based on greed.'

However, when it comes to an actual financial crisis, not only do depositors come in direct conflict with their neoliberal beliefs but even the state, which festers the neoliberalism, comes into conflict with its own policies because it understands that a bank failure is not just the failure of a single bank but could easily trigger a failure of the entire banking and financial system. It is now common knowledge that the Fed can always bail out a bank or for that matter any debtor – and there is no taxpayer money involved here – the only cost being moral hazard. In the case of systemic risks, the Fed must act to contain the contagion despite the moral hazard of doing so. The alternative will be catastrophic. In fact, the question as to whether rescuing Lehman would have saved the world from the GFC still remains open.

US politicians must, however, convince people that they are not in favour of such bailouts to protect the banks or managers per se, and are only being compelled to do so to protect depositors. While Joe Biden blamed the bank's managers for the SVB crisis, Senator Tim Scott, who sits on the Senate's banking, housing and urban affairs committee, **warned** that 'building a culture of government intervention does nothing to stop future institutions from relying on the government to swoop in after taking excessive risks." **Sheila Bair**, former chair of the FDIC, also levelled equal blame on bank management as on the Fed: 'that doesn't excuse the bank management for not hedging their interest rate risk. They mismanaged too … it's their job to manage around them [interest rate hikes].' At the same time, she asserts that depositors must not be complacent and 'make sure you're under the insured deposit limits.'

Such political posturing, along with repeated occurrences of bankruptcies and bank runs in the US, leave uninsured depositors [businesses and individual depositors with large balances] under the potent threat of bank closures, a possible loss in deposits exceeding $250,000 and consequently, a predisposition to engage in bank runs.

The situation is not quite the same in Europe or even the UK. In Europe, soon after the 2008 crisis unfolded, 'it became **evident** that Europe's banks [were] heading towards wholesale nationalization.' In the UK, the government nationalised the Royal Bank of Scotland when it was bankrupt in 2008. In early 2012, the UK regulator Financial Services Authority (FSA), **claimed** that the UK did not have a single bank failure since 2007: 'no UK banks have entered administration in this period, though of course a number were taken over or received support during the crisis.'

In India too, in recent decades, actual bank closures are few and bank runs, rare. An implicit assumption that the government will not allow banks (at least large commercial banks) – public or private to fail – and thereby force depositors to lose money prevents bank runs arising from the possibility of bank failures. The sentiment against bank bail-ins was evident when the government was compelled to withdraw the Financial Resolution and Deposit Insurance (FRDI) bill in 2018 after popular resentment against it despite the deposit insurance cover having been increased to Rs. 500,000.

So, while the US system remains more fragile, does it result in greater efficiency of its financial sector with a superior allocation of resources (say, in more efficient production or innovation) as compared to other countries? Any possible answer to the stability/fragility-efficiency trade-off issue will only throw up even more complex questions on the optimal extent of state intervention and regulation in financial markets.

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