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OPINION

How Bad Was the Silicon Valley Bank Bailout?

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So the feds stepped in to protect all deposits at Silicon Valley Bank, even though the law says that deposits only up to $250,000 are insured and even though there was a pretty good case that allowing big depositors to take a haircut wouldn't have created a systemic crisis. S.V.B. was pretty sui generis, far more exposed both to interest risk and to potential runs than any other significant bank, so even some losses for larger depositors may not have caused much contagion.

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The savings and loan crisis had a lot to do with the very bad decision by Congress to relax regulations on those associations, which were in financial trouble as a result of high interest rates. There are obvious parallels to the crisis at Silicon Valley Bank, which also hit a wall because of rising interest rates and was able to take such big risks in part because the Trump administration and Congress had relaxed regulations on midsize banks.

But here's the thing: The vast bulk of deposits at S.V.B. weren't insured, because deposit insurance is capped at $250,000. Depositors who had given the bank more than that didn't fail to do due diligence on the bank's risky strategy because they thought that the government would bail them out; everyone knows about the F.D.I.C. insurance limit, after all.

They failed to do due diligence because, well, it never occurred to them that bankers who seemed so solid, so sympatico with the whole venture capital ethos, actually had no idea what to do with the money placed in their care.

Now, you could argue that S.V.B.'s depositors felt safe because they somewhat cynically believed that they would be bailed out if things went bad even if they weren't entitled to any help — which is exactly what just happened. And if you believe that argument, the feds, by making all depositors whole, have confirmed that belief, creating more moral hazard.

The logic of this view is impeccable. And I don't believe it for a minute, because it gives depositors too much credit.

I don't believe that S.V.B.'s depositors were making careful, rational calculations about risks and likely policy responses, because I don't

Moral hazard is a familiar concept in the economics of insurance: When people are guaranteed compensation for losses, they have no incentive to act prudently and in some cases may engage in deliberate acts of destruction. During the 1970s, when New York, in general, was at a low point and property values were depressed, the Bronx was wracked by fires, at least some of which may have been deliberately set by landlords who expected to receive more from insurers than their buildings were worth.

In banking, insuring deposits means that depositors have no reason to concern themselves with how the banks are using their money. This in turn creates an incentive for banks to engage in bad behavior, such as making highly risky but high-yielding loans. If the loans pay off, the bank makes a lot of money; if they don't, the owners just walk away. Heads, they win; tails, the taxpayers lose.

This isn't a hypothetical case; it's pretty much what happened during the S.&L. crisis of the 1980s, when savings and loan associations, especially but not only in Texas, effectively gambled on a huge scale with other people's money. When the bets went bad, taxpayers had to compensate depositors, with the total cost amounting to as much as $124 billion — which, as an equivalent share of gross domestic product, would be something like $500 billion today.

The thing is, it's not news that guaranteeing depositors creates moral hazard. That moral hazard is one of the reasons banks are regulated — required to keep a fair bit of cash on hand, limited in the kind of risks they can take, required to have assets that exceed their deposits by a significant amount (a.k.a. capital requirements). This last requirement is intended not just to provide a cushion against possible losses but also to give bank owners skin in the game, an incentive to avoid risking depositors' funds, since they will have to bear many of the losses, via their capital, if they lose bank, so even some losses for larger depositors may not have caused much contagion.

Still, I understand the logic: If I were a policymaker, I'd be reluctant to let S.V.B. fail, merely because while it probably wouldn't have caused a wider crisis, one can't be completely certain and the risks of erring in doing too much were far smaller than the risks of doing too little.

That said, there are good reasons to feel uncomfortable about this bailout. And yes, it was a bailout. The fact that the funds will come from the Federal Deposit Insurance Corporation — which will make up any losses with increased fees on banks — rather than directly from the Treasury doesn't change the reality that the government came in to rescue depositors who had no legal right to demand such a rescue.

Furthermore, having to rescue this particular bank and this particular group of depositors is infuriating: Just a few years ago, S.V.B. was one of the midsize banks that lobbied successfully for the removal of regulations that might have prevented this disaster, and the tech sector is famously full of libertarians who like to denounce big government right up to the minute they themselves needed government aid.

But both the money and the unfairness are really secondary concerns. The bigger question is whether, by saving big depositors from their own fecklessness, policymakers have encouraged future bad behavior. In particular, businesses that placed large sums with S.V.B. without asking whether the bank was sound are paying no price (aside from a few days of anxiety). Will this lead to more irresponsible behavior? That is, has the S.V.B. bailout created moral hazard?

Moral hazard is a familiar concept in the economics of insurance:

I don't believe that S.V.B.'s depositors were making careful, rational calculations about risks and likely policy responses, because I don't believe that they understood how banking works in the first place. For heaven's sake, some of S.V.B.'s biggest clients were in crypto. Need we say more?

And just in general, asking investors — not just small investors, who are formally insured, but even businesses with millions or hundreds of millions in the bank — to evaluate the soundness of the banks where they park their funds is expecting too much from people who are, after all, trying to run their own businesses.

The lesson I would take from S.V.B. is that banks need to be strongly regulated whether or not their deposits are insured. The bailout won't change that fact, and following that wisdom should prevent more bailouts.

And you know who would have agreed? Adam Smith, who in "The Wealth of Nations" called for bank regulation, which he compared to the requirement that urban buildings have walls that limit the spread of fire. Wouldn't we all, even the ultrarich and large companies, be happier if we didn't have to worry about our banks going down in flames?

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