Rodney's Take

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A Bailout by any Other Name

Silicon Valley Bank (SVB) and then Signature Bank were all the rage online over the weekend, as uninsured depositors worried about their money. They were right to be concerned, as the U.S. Treasury and the Federal Reserve failed to find buyers for the beleaguered lenders. So, they did what came naturally: they created another bailout. Just don't call it that.

SVB has the distinction of lending to venture capital funds and startups, which means the bank's fortunes go up and down with the tech industry, while Signature Bank hitched its star to the crypto industry. When times were good, such as in late 2020 and early 2021, these two banks raked in deposits by the tens and then hundreds of billions and did what banks always do with the money; they split it between long-term investments, or those held to maturity (HTMs), and investments available for sale (AFSs) used to meet deposit redemptions. HTM securities are typically long mortgage-backed and Treasury bonds that banks don't have to mark to their market price because they don't intend to sell them. This is the classic banking system, wherein banks earn long interest rates, which typically are higher than short rates, while paying short-term deposit rates and earning the difference, or net interest margin.

This works until interest rates invert and depositors withdraw their money. When both things happen, banks fail because their HTM bonds are underwater, which is where we are today.

As the Fed pushed the entire yield curve higher, banks lost money on their long HTM securities, just as investors soured on new ventures and crypto firms. This led to depositors at SVB and Signature drawing down their deposits, leaving the banks with negative capital to cover their remaining deposits. SVB had around $200 billion in deposits, but less than $180 billion in securities. That's bad. But don't worry, because here comes the government with the next iteration of bailout.

When they couldn't find buyers over the weekend, U.S. financial officials decided to take a different route by creating the Bank Term Funding Program (BTFP). Or, as it's already being called, the "Buy The F***ing Pivot" program (I'll have more on that in a minute). This new lease on life for failing banks allows them to borrow money from the Fed for a one-year term and pledge their underwater HTM securities *at cost*, to cover the loans. So, what if the bonds have lost 10%, 20%, or even 30% of their value? The Fed will loan 100% of their cost, no matter what. Given that across the banking system HTM securities have lost about $620 billion since the Fed started raising rates (because rising yields push down bond prices) that's a big potential bailout, er, backstop.

To be sure, few banks are in the same position as SVB and Signature today, but some are and more will be in the days ahead, as corporate Treasury officers who handle cash management wake up from their decades-long comas. It used to be that companies kept just enough cash on hand to meet their obligations and parked the rest in short-term Treasury bonds or other safe havens to squeeze out yield. The low- or even no-interest decade of the 2010s made that exercise futile, but not anymore. Just as I've stressed that individuals should be moving to short-term Treasuries, so should companies, and not just for the interest boost. The move takes your funds out of harm's way if your bank has an issue.

Officials across the government are claiming that this isn't a bailout and won't cost taxpayers a cent. That's only true if yields drop far enough by the end of the term that the pledged HTM securities are back in the black; hence, the street name for the new program. The Fed will have to pivot and then drop rates dramatically to make that happen. And even then, we consumers will still pay the price, because our loss of interest income will be what pays for the new bailout. Taxes come in many forms.

Once again, one of the biggest winners in this mess is Jamie Dimon, the CEO of JPMorgan Chase, along with those who run the other large banks in the U.S. The latest bailout from the federal government likely will slow the move out of banks, ensuring that bank bonuses and share prices remain relevant, if not near their recent highs.

There has been some chatter about the FDIC and Fed dropping all pretenses and ensuring unlimited bank balances to preserve the safety of the system. That only works if an entity like the Fed can print money out of thin air with abandon and buy whatever amount of bonds it wants without affecting the financial system. While the Fed didn't crash the U.S. banking system with QE, QE2, Operation Twist, QE Infinity, and then the COVID balance sheet expansion, it definitely made a mockery of price discovery, deprived investors of reasonable fixed-income alternatives, and drove them into risky assets. In the year ahead, we'll find out how much of a price we will pay for this latest intervention. Chances are, it won't be zero.

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Got a question or comment? You can contact us at info@hsdent.com.