Rodney's Take

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The Fed Takes Free Money from Banks

You've got to hand it to bankers; they've never seen a bailout they couldn't exploit. They're like John Candy (Ox) in the movie "Stripes," who explained to fellow trooper Cruiser why Cruiser had to make Ox's bed. "Because we're in Italy!" If they'd been in Germany then it would be different. Right.

The bankers always find another way to win. This time, it's the Bank Term Funding Program (BTFP). Banks can pledge assets, take loans, and earn 55 basis points of free cash. That might not seem like much, but banks aren't dealing in millions: they're throwing around billions of dollars, and it's all courtesy of the Fed. Which means courtesy of us.

When Silicon Valley Bank and Sovereign Bank went under in March 2023, they had billions of dollars of uninsured deposits. The problem was rising interest rates. In the years leading up to 2023, the banks bought long-term Treasury bonds. But as the Fed raised rates, the value of those bonds fell and the banks didn't have enough capital to make good on their deposits as depositors bailed. The Fed came up with the BTFP, which allowed banks to pledge bonds and borrow cash at par. Even if the Treasury bond, because of rising rates, had fallen in value to 75% of its original price (par), the Fed allowed them to borrow 100% of the original price. The Fed reasoned that the bonds would be paid off by the U.S. Treasury eventually, but that implied the bonds would be held until maturity.

This gave Sovereign Bank and Silicon Valley Bank a way out, but it also gave other banks a way in. If the Fed would lend money based on the original bond values, no matter how far they'd fallen, then why not take the loan and put the cash somewhere else until the program ended? Better yet, the Fed charged 4.90% but paid 5.40%, so the arbitrage was just waiting to be picked off.

The BTFP jumped to more than $50 billion in the first few days it existed, and then went to $107 billion as troubled banks came clean. But in the last couple of months of 2023 and first few weeks of 2024, it ballooned to $167 billion. The extra cash represents banks arbitraging the BTFP program now that the Fed has all but told the markets that the Fed has stopped raising rates.

This is a little bit of inside baseball or financial plumbing, but it makes a difference. Programs like the BTFP aren't available to you and me. We cannot pledge assets that have fallen in value and get a loan at the original purchase price. We cannot pay 4.90% in interest and use the funds to buy another asset that pays 5.40% in interest. Those seats are reserved for the banks, courtesy of the Fed. Where do they get the money to loan to the banks? Well, they print it, of course. And every time they do this, they make our dollars, the cash that we worked for, worth a little bit less.

But at least this program of "free money for me, but not for thee" is coming to an end. The Federal Reserve just announced that the BTFP will end as originally planned in March, and any new lending will be at current rates. It's great that the Fed squashed the arbitrage, but I'm not sure I buy it. As I pointed out in my January 2024 *Rodney Johnson Report*, several funding sources look like they will dry up in March, including the BTFP and the Federal Reserve reverse repurchase program. If that happens, the financial system might get clogged, just as it did in September 2019. The Fed has seen this before and would act quickly.

If Jay Powell and his merry band of bankers think the system is wobbly, you can bet they will reopen the BTFP, pay more in reverse repurchase agreement options (RRPs), and generally gift cash to banks. Quantitative tightening can turn into quantitative easing in the blink of an eye. Of course, bankers are waiting for it, because this is where they earn something for nothing. It's great to be a banker, even if they get smacked once in a while.

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