Caron’s Corner Transcript – 3.13.2023

Another Fine Mess: A Date with Lending Facilities and a Policy Mistake

- The primary focus for the market is on stemming a financial crisis from stresses in the small- and mid-sized banking sector by creating lending facilities to safeguard these banks and their depositors.
- This does not seem like a GSIB - Global Systemically Important Bank - problem, but rather a small- and mid-size specialty bank issue.
- The secondary focus is trying to figure out what the Fed’s policy response might be. Do they go ahead with a 25 basis point hike next week - 50 basis points is all but off the table I would think - and then, do they intend to keep going?
- This is a good reminder that we can’t predict the future. A diversified portfolio is helpful and it’s better to be balanced - and control risk - than be defensive.

Jim Caron: This is Jim Caron, Co-CIO of Global Balanced and Risk Control strategies. Well, it looks like we're in another fine mess and we may have a date with lending facilities and possibly a policy mistake. The primary focus for the markets right now is on stemming a financial crisis from stresses in the small- and mid-sized banking sector by creating lending facilities to safeguard these banks and their depositors. This does not seem like a GSIB problem, a Global Systemically Important Bank problem, but rather a problem with small- and mid-sized specialty banks.

The secondary focus is trying to figure out what the Fed policy response might be. Do they go ahead with a 25 basis point rate hike next week or not do it at all? My guess 50 basis points is all but off the table at this point. Or, do they intend to keep going business-as-usual in terms of rate hikes? Both of these points have the markets on edge. So let's get into it.

The first question that we have to really address is whether the crisis is in fact being averted by some of the actions that have been taken. I think it's too soon to say, but the lending facilities created make chances good. As we know, the stress has been put upon SVB (Silicon Valley Bank) that does specialty lending to the tech sector. One of the main issues was the rapid rise in interest rates that lowered the value of some of the high-quality assets that SVB owned, such as US Treasuries, mortgage-backed securities and agency securities. When depositors tried to redeem their deposits, the proceeds of those securities was unable to cover the demand from the depositors. As you know, rates go up, bond prices go down and this created stress in the system. But one should note that this situation is distinctly different from the global financial crisis (GFC) because of one important feature - collateral.

The collateral today, generally speaking, is of much higher quality in the form of easy-to-price, transparent and liquid assets held by the banks such as short-dated Treasurys, mortgages, agencies, emergency mortgages and agency securities, that will all likely mature at par or 100 cents on the dollar. Remember how it all works. If you have a deposit in the bank that's a liability to the bank and the bank

has to buy an asset, typically in the form of a security, to hold against that liability. In this case, the banks are buying these high quality assets like US treasuries, mortgages and agencies. But this means that a lending facility must address the shortfall of today's mark-to-market price of the bonds versus the price at maturity.

Enter the BTFP - the Bank Term Funding Program. The Federal Reserve, the US Treasury and the FDIC (Federal Deposit Insurance Corporation) released a joint statement on Sunday night (March 12) announcing the creation of the BTFP. The program aims to provide banks with a stable source of funding to meet customer withdrawal requests in the wake of the rapid failures of Silicon Valley Bank, as well as Silvergate and Signature Bank in New York. This facility allows banks to post their high quality collateral like US Treasuries, mortgages and agencies and any qualifying assets to the Fed. The definition of “any qualifying asset” is a pretty broad, but they're able to post it to the Fed with this facility at par value, NOT mark-to-market value. This means that if the value of the securities went down to say 80 cents, they're actually going to get a loan for par, for 100 cents on the dollar, and they don't need to post margin to do this. These are very, very favorable terms. The cost of this loan from the BTFP is very favorable. It's one-year OIS (Overnight Indexed Swap) plus 10 basis points and there will be little to no stigma to use the facility. The reason this is happening is to prevent banks from selling these high quality bonds at a price below par and crystallizing a loss that permanently impairs their capital. This is a powerful facility.

The key message here is that this event is less systemic because the collateral is high quality. This BTFP facility is willing to receive say a US Treasury price at 80 cents on the dollar and lend to the trouble bank a full dollar and take the US treasury as collateral. Again, this is a very powerful facility. Of course, the bigger question is if we see a string of more troubled small and mid-sized banks popping up, which only adds to stress and anxiety and creates a crisis of confidence. It begs the question if still more needs to be done. For example, does the government need to make explicit a guarantee of uninsured deposits that exceed $250,000 across the banking sector? This is yet to be seen. The situation remains fluid and we will have to wait and see. No guarantees. The facility is a fix, but we are encouraged by the rapid deployment, magnitude and scope of this facility. More to come, perhaps.

Now let's talk about a date with a policy mistake. What's the Fed going to do amidst all of this? Well, let's not forget that Powell signaled just last week the intention for the Fed to be more hawkish in order to tame inflation. But, have things changed enough in the last few days to change his mind? Well, we think so, but we will have to wait and see. It should be noted that the Fed is technically in a blackout period and can't communicate or comment on Fed policy before the March 22 meeting. But let's see if they make an emergency exception. This time around markets may remain on edge until they get word from the Fed that they may table aggressive rate hikes at least for now.

But the market seems to be pricing this in anyway. Even in the absence of Fed comments, bond yields, particularly on the front end, have gone down quite considerably, but one can never be too sure or too careful. Banks will likely tighten lending standards further and this will be a tightening on its own, so maybe the Fed has less to do after all. This could be because smaller companies, who tend to borrow from smaller banking sector banks, will see tighter lending standards and then start laying off workers or

at least not hiring as quickly. This would lower wage inflation and increase labor supply, which is what the Fed has been hoping to achieve by hook or by crook.

So what's the moral of the story? Well when rates rise quickly, things break and we can't ever fully rule out a policy mistake because the Fed cannot fine tune a slowdown. Our motto is, as usual, we cannot predict the future. A diversified portfolio is helpful and it's better to be balanced and control risk than be defensive. We will watch developments closely and we'll be back with more updates.

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