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Spectrum Asset Management

Principal Asset Management℠

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The Fed's Sunday Solution is Underappreciated

What just happened?

- The second order effect of the Fed's rapid and significant rise in short-term interest rates (i.e., 450bps in just one year) has caused unrealized losses in US bank Available-for-Sale (AFS) and Held-to-Maturity (HTM) portfolios.
- First, some accounting rules – **these are important**:
  - AFS bonds are marked-to-market and any gain or loss is recognized on the balance sheet in a contra-asset account called Accumulated Other Comprehensive Income (AOCI)
  - HTM bonds are carried at amortized cost with the assumption that they will return par value at maturity.
  - Neither accounting method recognizes a loss (or a gain) on the income statement – simply said, everything flows through the balance sheet. But when liquidated, the loss (or gain) will flow through income which then finds its way into retained earnings (i.e., common equity tier1).
- Silicon Valley Bank (SVB) was highly concentrated in venture capital reliant technology startups and early/mid stage companies that boomed during the COVID era.
- The boom enabled massive capital raises that were deposited with SVB which grew to be the 16th largest bank in the country.
- Deposit money from a highly concentrated venture capital/tech eco-system was either loaned back to the system or invested in SVB's liquidity, AFS and HTM portfolios.
- The Fed kept interest rates at zero for two years which made reinvestment rates very low for an extended period while SVB's deposits (liabilities) and commensurate assets were growing rapidly.
- When the Fed hiked rates as fast and high as it did, SVB's AFS portfolio, in particular (a source of second order liquidity), built up a large $1.8 billion unrealized loss.
  - SVB's management decided to realize its loss to pick up some current income by reinvesting in higher coupons which crystalized a $1.8 billion (or 13%) cut in common equity tier1 before they had raised new equity under a recapitalization.

        - The bank was already under some deposit withdrawal pressure and the failure of the equity financing incited a deposit run narrative that fueled a bank-run by very concentrated cash strapped young technology companies (i.e., the depositors).
        - The HTM portfolio had a $12 billion unrealized loss (88% of CET1). Fear zoomed that deposit withdrawals would burn into the HTM portfolio and thus cause the whole portfolio to be marked-to-market effectively wiping out common equity.

The Bottomline:

- SVB's sudden announcement of the large booked loss in advance of an anchored equity recapitalization sent an impairment signal to the market causing a massive sudden deposit flight.
    - This bank-run on its deposits collapsed the bank in two days.
    - SVB was rated Aa3/BBB+ for deposits by S&P and Moody's just days earlier.
- Emotional deposit withdrawal contagion spilled over into the banking system impairing equity values and funding spreads of not only other regional banks but the entire banking system – this is a crisis of confidence in the financial system carried deposit impairment fears into the weekend.
- A "**Sunday Solution**" was executed by the Fed, Treasury & FDIC to restore confidence in the banking system and save uninsured depositors.

The Sunday Solution (a double-barreled bazooka):

1. The FDIC extended full recovery to all depositors of Silicon Valley Bank and Signature Bank, a New York City-based bank that failed over the weekend.

2. The Fed created a Bank Term Funding Program (BTFP) for depository institutions under which it will lend 100% face value basis for treasuries, agencies and other qualifying assets for up to 1yr. Such securities represent the bulk of banks' holdings.

For more detail on the Sunday Solution, see Spectrum's report titled, New Fed Loan Facility &FDIC Full Deposit Insurance, March 13, 2023.

Markets are not fully appreciating the Sunday Solution (yet)

- Why it matters:
    - It is *absolute substance* rather than rhetoric.
    - Deposits can move in, out and around the banking system with immaculate liquidity.

    - There could be NO NEED to liquidate Available for Sale (AFS) holdings and certainly NO NEED to blow up Held to Maturity portfolios now that BTFP loans are available.
    - Mis-matched AFS duration is still mismatched, but the Fed has just taken the need to crystalize a loss off the table for 1yr.
    - Unlimited liquidity flexibility (at the face value of collateral) is available which allows banks to kick the can down the road until these high-quality securities reach maturity.

This road can have a happy ending – here's why:

- BTFP is a Quantitative Easing (QE) in disguise because deposits would be switched for BTFP loans and currency would be printed.
- US Treasury term structure rates have just dropped precipitously and any such move self-corrects some unrealized losses in AOCI – the more rates drop, the more AOCI losses decline.
- The Fed facility would essentially enable realized loss deferral by allowing unrealized losses to age closer to bond maturity, thereby allowing discount bond prices to age naturally up toward par.
- If the Fed were to keep kicking the can down the road (like what's been done in Europe over the years) then in, say 5yrs, bonds could mature to par without any realized loss being incurred, and the borrowing bank – the borrowing bank would be paying back the BTFP loans with maturing bond proceeds.
- If rates go up, then maturing AFS bonds (that would have otherwise had to have been sold without BTFP) can be reinvested at higher returns than prior book rates helping to improve NIM; this nuance could also help the Fed stay on a hawkish course (if needed) because a realized loss impact of even higher rates can be largely neutralized by the program.
- SVB's realized loss of $1.8 billion would have been a little over 1 year of normalized earnings. The BTFP would have negated the need to realize this loss and organic earned income could have accrued to further augment CET1 – now, the entire US banking system can do what SVB could not do, that is, keep on funding without concerns of realizing material losses and burning into HTM portfolios.
- **Time and policy really can heal.**

The Fed (and every central bank) should prioritize financial stability in the near term because if they do not, then there will NOT BE a long-term.

- One more 25bp Fed hike and then a pause is our call (the risk would be no cut in the federal funds rate and a pause to monitor the data).
- The liquidity and AFS issues are **high-quality problems** at prices lower than book. They are not problems of impaired assets that may never see par value again. In fact, the Fed lending at par value implies that it knows that par value will return as these bonds age to maturity.
- From a Fed policy perspective, it's basically 2018 all over again, when the market forced the Fed to stop its hikes and follow with three cuts (as "insurance") leading to a bull market and tighter spreads in 2019.
- The Fed can also lean into being satisfied with 3% inflation as the new 2% goal (as this target was the product of a deflation problem). This would steepen the Treasury curve and improve bank NIMs. The Fed might even do a twist by reinvesting run-off in Bills & 2yr treasury notes and selling 10yr and 30yr treasury bonds from its balance sheet.

Takeaways:

- The Fed's BTFP solution completely protects the deposit system from any bank-run. Liquidity will be available when needed - period.
- Accounting issues for banks are addressed so that AFS losses will not necessarily need to be taken, thus supporting equity capital.
- Investors can buy repriced banking paper with absolute confidence that the financial system will not collapse from illiquidity contagion as deposits now have, in effect, been transposed into currency backed by US Treasuries.

This is one of those times to indeed be greedy when others are fearful of junior subordinated US bank paper. Given that liquidity malfunctions are resolved and capital ratios are thick against backdrops of broadly performing loan books; going down a bank capital structure makes sense. Preferred and capital securities offer the highest yield opportunities in decades and spreads are 2.75 standard deviations wide of average spread through the last three credit cycles.

Phil Jacoby
CIO, Spectrum Asset Management

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