Fed, Treasury and FDIC Seek to Stabilize the Banking System

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The Fed, Treasury and FDIC announced measures to help ensure that banks have ample liquidity to meet any deposit withdrawals without taking losses, and to reduce the risk of uninsured depositor flight. The plan consists of (1) a new Fed facility (the Bank Term Funding Program, or BTFP) and (2) the FDIC's guarantee of all deposits, insured and uninsured, at Silicon Valley Bank (SVB) and Signature Bank. The Fed also eased margins terms on discount window lending, in line with the terms of the new BTFP. What follows are a few thoughts on these developments

The BTFP provides a backstop source of liquidity for banks that face significant deposit withdrawals. Importantly, banks can pledge high quality collateral at par, not market value, and with no haircut, in exchange for funds at an extremely modest penalty rate. The hope is that simply announcing this facility restores confidence in banks that have sizeable unrealized losses on securities, and prevents deposit flight, especially by uninsured depositors. The facility has the additional potential benefit of preventing asset fire sales by banks (and realization of losses and the associated hit to bank capital). If used, the facility would also increase reserves in the system, which can help alleviate any upward pressure on bank funding costs that recent events might cause.

There are some challenges regarding the end-game for this facility. If it were to receive heavy use, eventually banks would need to pay back the loans, which would require new sources of funding. If banks fail to attract new depositors, that funding would have to come via new debt issuance or capital raising. Of course, authorities are hoping that providing this backstop will stabilize deposits, precluding significant program use.

The FDIC's guarantee of uninsured depositors at the two banks brings political risks, but clearly the administration judged that the political risks of a potentially broader run on banks and its attendant economic consequences would be much greater. Still, this is very much a piecemeal approach. The FDIC and the administration likely considered the bolder step of temporarily guaranteeing all uninsured deposits in the system. That was clearly a bridge too far at this point, since doing so would have required Congressional approval. Congressional approval is not an impossibility, but would likely first require much more significant bank and market stress to get reluctant members of Congress on board.

In the meantime, the narrower path of insuring all deposits of just two banks does not fully mitigate the risk that uninsured depositors at other banks, especially those with large unrealized losses, could rapidly pull deposits and open new accounts elsewhere, to avail themselves of insurance. The FDIC and the administration may be hoping that the benefits of the BTFP will be widely understood, preventing this from occurring. My base case, however, is that smaller banks are likely to see heavy withdrawals of uninsured deposits, as depositors will view withdrawing uninsured funds as the safest option.

This is a highly uncertain environment and it is challenging to imagine that banks, especially smaller ones, simply go back to "business as usual". For the time being, I would expect additional tightening in lending standards and terms, including through price.

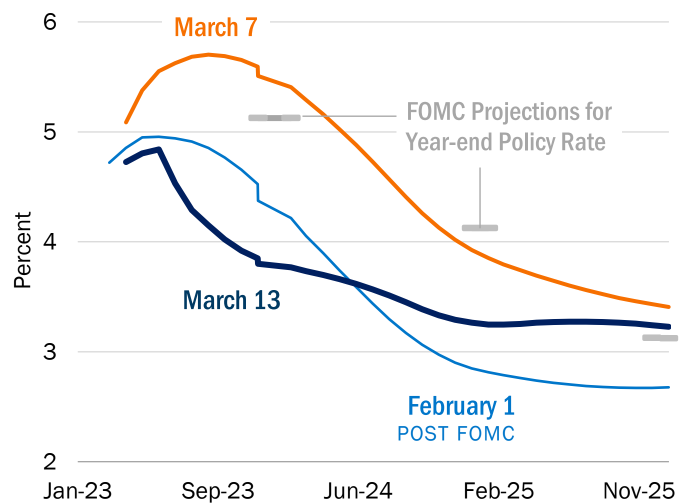
On the surface, the SVB receivership seems like a unique case of a bank with an overly concentrated exposure to one region and one sector, an inordinate amount of unhedged interest rate risk and adverse exposure of both assets and liabilities to rising rates (on the asset side due to losses on fixed income holdings; on the liability side due to the impact of Fed tightening on the venture capital sector and the stability of its deposit base). Still, the event highlights issues facing the banking sector more broadly, especially unrealized losses on securities holdings, pressure on banks to raise deposit rates and slowing loan growth given recession concerns and a deeply inverted curve. None of these issues will fade any time soon. The issue of unrealized losses is relevant as well for European banks; Japanese banks could face similar challenges if the Bank of Japan fully removes yield curve control at some point.

As for monetary policy implications, there is a tremendous amount of uncertainty regarding the way forward. But if Sunday night's policy measures calm markets over the next few days, and primary markets remain open to new issuers, then I would expect the Fed to continue with policy tightening at their meeting next week. At the end of the day, inflation remains well above the Fed's two percent objective. And in tightening further, the Fed would be drawing a distinction between tools used for monetary policy (interest rates and QE/QT) and liquidity facilities used to address financial stability risks. Still, it is a close call between raising rates and at least pausing to assess any wider damage from recent events.

The Fed may also adjust terms of its reverse repo facility, which continues to see heavy usage and drains reserves from the banking system. By lowering the counterparty limit and/or dropping the rate for investing funds with the Fed, the central bank can steer liquidity back into the banking system.

For some time now, I have assessed high odds of a recession starting later this year. Recent developments only increase my conviction, and could bring forward the start of a recession via a contraction in bank lending as well as increased business and household uncertainty that weighs on hiring and aggregate demand. Movements in the yield curve suggest that investors share this view. The 2- to 10-year Treasury yield curve has steepened meaningfully over the past three days, moving from a low of -110 basis points last Wednesday to just -41 basis points today. This reflects market expectations for little additional tightening and a near-term pivot to rate cuts. While curve inversion is typically late in economic cycles, resteepening commonly occurs when markets becoming more focused on **imminent** recession risks.

FIGURE 1: EXPECTED TRAJECTORY FOR THE FEDERAL FUNDS RATE: MARKET AND FOMC



Source: Bloomberg, MacKay Shields, Board of Governors of the Federal Reserve System. Market trajectory for policy rate based on forward 1-month OIS rates. FOMC projections based on median FOMC participant's submission to the December *2023 Summary of Economic Projections*.

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