The Fed's Silicon Valley Bank solution is gone. Should we worry?

Almost a year ago SVB imploded. One of the subsequent calming solutions came through the Bank Term Funding Facility. It had a one year shelf life, and will soon be gone. It's actually been abused recently, which required a change of terms. But taking it away is not without risks. A softer exit might have been better, but we see the logic of taking the cake away

The Federal Reserve meets on 1 May

The BTFF's demise can be construed as a sign of Fed confidence in the system

The Federal Reserve has changed the rate charged on the Bank Term Funding Facility (BTFF), and for good reason. Previously the reference rate was 1yr term SOFR (+10bp fee). Term rates incorporate the future, and as the market is discounting rate cuts, the 1yr term SOFR rate trades some 50bp through the overnight SOFR rate. The Fed's action confirms that there were players in the market taking advantage of the arbitrage by borrowing on the BTFF and lending back at a higher in-arrears rate. The Fed has now floored the reference rate to the interest on excess reserves (IOER), which is currently at 5.4%.

That takes away the arbitrage. Which makes eminent sense. But what about the Fed's decision to end the facility on its one year anniversary?

Originally it was set out as a facility that would be available for a year, book ended by the Silicon Valley Bank (SVB) demise on 10 March 2023 and the one year tenor for the facility to conclude on 11 March 2024. But the Fed always had the choice to extend it. The decision not to extend it could be construed as a sign of confidence. No doubt the Fed has done its due diligence on the players that have accessed the facility, and has concluded that the need for an extension is not there.

This is good, as it points to a Fed that is not concerned about the players that have used the facility. In other words they can take it. Moreover, and by implication, the Fed does not envisage a threat of a similar ilk hitting the system down the line. And if something does hit, the Fed points to the discount window as the place to get hands on emergency liquidity. It had been noted that some of the smaller players were not used to discount window access in March last year, with some getting into difficulty that they did not need to get into.

The alternative BTFF, the story went, was an all-embracing rescue programme for some institutions that addressed the deep discount attached to many hold-to-maturity portfolios, by instantaneously liquefying them at par.

The Fed is now directing banks to access the discount window to address any stresses

With the BTFF programme now to end, the Fed directs stressed bank scenarios to the discount window. The primary funding rate there is 5.5% currently (actually flat to the new BTFF floor when the 10bp fee is included). The secondary funding rate is a tad more penal at 6%, for institutions not eligible for primary credit. And there is a seasonal credit rate that depends on circumstances, and now stands at 5.35%.

One issue with the discount window is it does not do what the BTFF facility does, in the sense that one of the criteria is that the "securities should not be subject to any regulatory or other constraints(s) that impair their liquidation". In its truest sense, that would exclude hold-to-maturity securities.

At first glance this is indeed a problem, as one of the pain points for banks that came under pressure last March was via attempts to sell bonds in such portfolios. Accounting treatments vary here from implications of selling to re-classifying to available to sale, which then decide whether there is a hit to income or equity or both.

Either way, forced liquidation or re-classification crystallises the value of the bond at its discount to par valuation, and that feeds through in a negative fashion to either net income or equity or both (depending on what has been done). In effect it makes things worse. Silicon Valley Bank saw an extreme version of this. It's what prompted the Fed's BTFF in the first place.

There are risks though, especially as the Fed's own rate hiking process was a contributor

Given that, is the Fed taking a risk by removing this facility? Well yes and no.

The "no" revolves around the power of the discount window. While there is some fuzziness around the eligibility of hold-to-maturity securities (ineligible on a plain reading), this is offset by quite a wide array of alternative assets that can be posted at the Fed. Most of these are high grade in nature as an obvious minimum criteria. But on top of that, banks can post loans as collateral. There are a whole series of constraints to what types of loans that can be posted, but in reality any half decent bank should be in a position to conjure up a decent portfolio of loans for posting as collateral.

The “yes” centers on the reason the BTFF facility was dreamt up to begin with. In March last year banks could have posted suitable collateral at the Fed to get access to emergency liquidity through the discount window. In many cases they choose not to, and some of the stressed ones engaged in fire-sales of their non-mark-to-market bond portfolios to get access to liquidity. The Fed has noted that some banks were not “in the know” with respect to discount window usage. The Fed now wants all banks to do a test access of the discount window annually, so that they are more comfortable with it, and in part to take away some of the stigma attached to accessing it.

The Fed could have softened the risks by extending by six months instead

Our take on this is the Fed could not keep the BTFF facility as a permanent mechanism, as it would change the characteristic of the hold-to-maturity portfolio. Having the capacity to liquefy this at will would allow banks to both have a stable non-mark-to-market component to its securities portfolio, and mark it to par whenever it wants. Banks could have their cake and eat it. But at the same time, the reason that hold-to-maturity portfolios are at the deep discount to par is because the Fed has hiked rates. In fact it’s been one of the most aggressive rate hiking cycles in decades.

While banks should be able to deal with this, as managing interest rates risk is what they do, the Fed could also have simply extended the facility for another six months. If they did that, likely they would have been cutting rates by then, which would help to soften the (potential) "impact". In the end though, if a bank can’t cobble together a half decent loan portfolio to post at the Fed’s discount window, they should likely not be in the banking business in the first place.

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