

Solvency & Liquidity Meet Liquency & Solvidity

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We are hearing a lot about liquidity and solvency right now. Often people talk about them as though they are two different things. That can be true at times, but in many cases, there is a complex relationship between the two. That is particularly true for financial companies and banks, which is where this discussion is centered.

Solvency & Liquidity

Let's start with extreme and obvious examples.

- **Liquidity issue.** I borrowed \$100 to fund a deal with someone that will pay me \$110 back next week. The person I borrowed from needs their \$100 repaid today. I need to borrow from someone else for a week to make it through to the \$110 payment. That is a liquidity issue, and if for some reason the market won't lend to me, it is a problem. However, a simple loan or access to a lending facility from a central bank solves the problem. **The liquidity issue is solved by a liquidity solution.**
- **Solvency issue.** I borrowed \$100 to buy an asset. That asset got destroyed and I have no insurance, so now I have nothing. I can borrow as much cheap money as possible, but my problem doesn't even begin to go away. **This solvency issue is NOT solved by a liquidity solution.**

The real world is never so simple. Liquidity, over time, can help with a solvency issue, but it depends on:

- **The strength of the liquidity solution** (we will examine the Swiss solution versus what the U.S. delivered Sunday night).
- **The magnitude of the solvency issue.** Balance sheet (or more precisely equity capital) can be rebuilt over time.

The concept of Long-Term Refinancing Operations (**LTRO**) was an interesting example.

- Basically it allowed European banks to buy new assets (government bonds) and secure financing up to the maturity of those bonds (for a maximum of three years I think), which generated positive carry.
 - That helped support European short dated sovereign debt at the time because a "new" buyer emerged. That helped bank balance sheets as a whole because there was less fear about sovereigns not being able to issue enough debt to cover their maturities.
 - Over time, that small dribble of daily income helps shore up the bank's balance sheet.
- If this is done with enough "umph" up front to support the underlying bond markets and with enough "juice" for the banks to gain extra profit over time, this helps a lot. But it is definitely **"threading the needle."**

Which brings us to where we are today.

Liquency & Solvidity

In the U.S. we had Sunday night sessions to deal most directly with Silicon Valley Bank and Signature Bank. The solutions provided were meant to help the entire banking sector, especially regional banks that were feeling the pressure as attention turned from SIVB to other banks that some people thought

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might be vulnerable. We covered some of this in [I Like Mid Banks, I Cannot Lie](#), [What We Know Post Intervention](#), and on [Bloomberg TV Monday morning](#).

Yesterday CS dominated the headlines, ending the day with a plan announced by the Swiss National Bank that we will analyze as well.

The analysis tries to balance the solvency and liquidity issues with the solutions provided so far.

The U.S. Actions So Far

I'm sticking with a B+. They acted boldly and quickly which is good. But the core problem of "unrealized bond losses" hasn't been sufficiently addressed. At least not in my view of where we are on the continuum of solvency and liquidity.

- **Guaranteeing all deposits**, of any size, immediately. That was bold and strong and should solve the bulk of the issues linked to depositors pulling money out because they were afraid of the risk of keeping it at XYZ bank. Some will still take money out of XYZ bank because of ongoing concerns or the optics of keeping it there. Some customers are cash flow negative and will see their balances decline for reasons other than concerns about the bank. **About 90% of the current "bank run" problem should be addressed by this.**
- **Hurting bondholders.** Bondholders were "primed" in the Silicon Valley Bank and Signature Bank deals. Deposits above the FDIC insured amount, in theory, are unsecured creditors and are pari passu with bondholders. Well, the depositors just got preferential treatment, meaning that if there is not enough value to fully pay off all creditors, bondholders will get less of a recovery. Say that there was \$100 of deposits above the FDIC amount and \$100 of bonds. Say that the recovery of assets was \$180. Under the "old" regime (before Sunday), both the depositors and bondholders would have received \$90 (as they were equal). Now the depositors are getting \$100 and the bondholders are only getting \$80. **Subordinating bondholders to ensure full payment of depositors had many immediate benefits, but also some longer-term costs.** Could this have been handled better?
- **Political Soundbites.** Whether it is a "banker bailout" or "criminal investigations" or some other aggressive political soundbite, they are not helping the situation. For the banks in question, it makes any potential buyer think about the political backlash. For the rest of us, it makes us wonder about the commitment to the solutions (which is maybe why some will take money out of banks, even after the guarantee).
- **The lending at par facility.** This needs its own section.

Borrowing vs Par for "Underwater" Bonds

This is the liquidity solution provided for banks. For up to 1 year, banks can post a high-quality bond as collateral and receive a loan based on the par value of the bond.

Let's say a bank owned \$100 of a Treasury against a \$100 deposit they had received. That bond is currently at 80 cents on the dollar. If the depositor withdrew, the bank had to sell that bond to pay back the depositor (super simplified, but good enough for what we are trying to illustrate).

The bank would only raise \$80 by selling the bond, so it would have to sell other assets or effectively take money out of their equity capital to pay the other \$20. There are accounting issues with bonds that are marked "available for sale" versus "held to maturity", but **the crux of the matter was that the**

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assets earmarked for depositors weren't valued high enough (at the time) to pay back depositors.

One "good" thing is that the bonds in question are liquid and are at virtually no risk of not getting paid back fully according to their original terms. That is very different than in 2007 and 2008 when the assets were of dubious and deteriorating quality.

So, with the new facility, when the depositor requests \$100, the bank doesn't have to sell the bond at a loss. They can pledge it to the facility and receive \$100 for that bond and now, instead of paying interest to the depositor, the bank pays interest to the facility for a year.

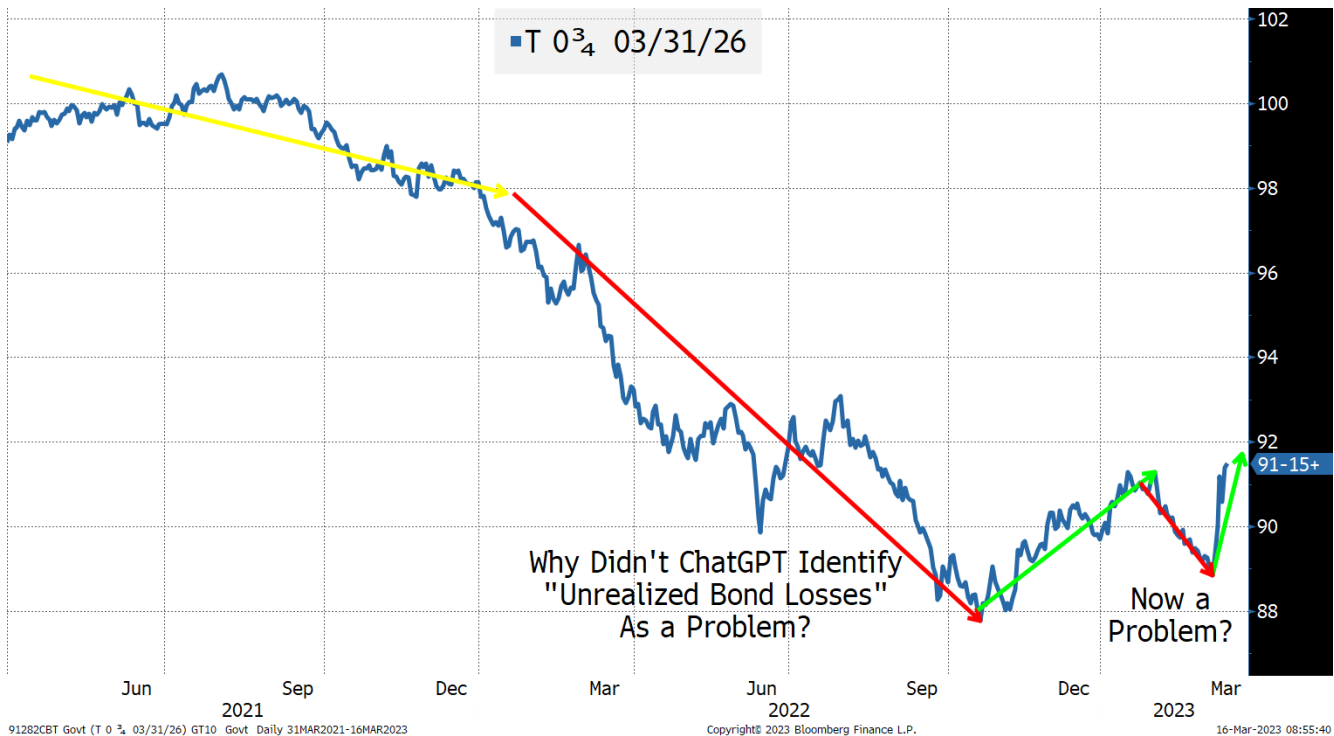
This helps the "liquidity" issue:

- The bank gets the \$100 it had earmarked for a depositor even though the assets that were earmarked are not currently worth \$100.
- By pledging the asset as collateral, they don't "taint" the hold to maturity nature of the asset (making the accounting easier).

This compounds the NIM (and solvency) issue:

- As far as I can tell, the cost of using this facility is more expensive than paying the rate paid on deposits. So, unlike LTRO, this causes larger interest margin losses (or reduced profits) to flow through earnings, which does not stabilize the capital base.

Let's use one of my "favorite" bonds – the 0.75% Treasury maturing 3/31/26 that was issued on 3/31/21. I like this bond because I could see an institution getting deposits in March of 2021 and buying a 5-year Treasury with those proceeds (still seems aggressive to me, but at least it's not a 10-year Treasury). Let's look at this bond.



One question that I asked myself (hoping to bolster my case for banks) was if the recent rebound in Treasury prices "solved" the problem of unrealized losses on bond portfolios. The answer is no. It has done very little. This bond which now only has 3 years to maturity is still worth only 91 cents on the

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dollar. This is up from the recent lows of 89 and well up from the lows of last September when it was only worth 88. I did check out the 1.125% Treasury 2/15/31 (issued in 2021) and it is at 84 today (up from 81 earlier in the month) and was 79 last October. Why was no one talking about unrealized bond losses in September last year, when in all likelihood they were worse? There may have been people writing about it, but it wasn't on my radar screen, and I don't remember seeing it as a discussion topic. Maybe people believed that deposits weren't declining back then, but they were at some institutions (just check out the SIVB deposit charts in Saturday's report).

There will be time for questioning why this wasn't a problem back then and how it became a problem now.

According to the [terms of the program](#), here's what would happen.

- The bank gets \$100 for the bond worth 91 cents.
- The bank pays the one-year overnight index swap rate plus 10 bps (I think this is around 4.7%, but let's say 4.5% to keep it simple).
- The bank, assuming that this bond is not in an "available for sale" book (and is using accrual accounting), will earn 0.75% in income on the bond for earnings purposes for a year. Note: they should be carrying it at book yield, which if they bought it at new issue was 0.75%.
- The bank will have a **negative net interest margin of 3.75%** (i.e., it loses 3.75% on this bond over the calendar year it is in the facility). This is a far bigger hit to NIM than if they were just paying the deposit rate (I haven't seen a deposit rate near 2% let alone 4.5%).
- **That is better than losing 9% today by selling the bond**, but it doesn't help their capital base (or solvency issue).
- All else being equal, at the end of the year, the bond should be at a higher price (the pull to par effect of going from 3 years to 2 years). This helps a bit, but between the carry and the likelihood that the bond is still significantly below par a year from now, **nothing has been done for the solvency concerns.**
 - If this was originally a 10-year bond, the pull to par effect of going from 8 to 7 is even less helpful.

The lending program buys some time, but does absolutely nothing for the bank's capital and the banks will all be worse off having to use this program versus retaining deposits.

Bottom Line on U.S. "Intervention"

The key to any level of success will be if banks can retain deposits. Keeping deposits reduces the negative carry (versus using the facility) and over time, the pull to par effect helps (if they can keep the net interest margin losses to a minimum). However, even that is only really helpful for portfolios that didn't go way out on the maturity spectrum.

I think it buys the weakest banks time to shore up their capital – either through a capital raise or a merger.

If that can occur, the next level banks will be fine. If the "fire break" works, you don't need further protection.

The question are:

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- Do the weakest banks know that they are the weakest banks? Seems obvious, but probably isn't to those in the crosshairs.
- Will they accept capital at the valuations that the buyers are willing to pay? That is a bigger concern as we have seen banks squander precious time (certainly with Lehman) searching for a better deal.

If those questions get answered "correctly," we should be off to the races.

If those questions don't get answered "correctly", I expect more pressure on the weakest banks.

I think we only have a few weeks before the patience of the markets (and the reprieve the Fed/FDIC/Treasury bought us) starts to fade.

I'm optimistic that we will see capital issues addressed via the private sector and that paves the way for a rebound, but sooner rather than later is key (even for me as an outspoken bull).

The "European Solution"

I've run out of time and energy, so will be brief here.

- **Addresses liquidity but not any solvency concerns.** Solvency concerns are being downplayed as non-existent, but markets aren't that kind.
- **Too narrowly focused.** It is a very "Swiss" centric solution. The Swiss National Bank seemed to suggest that "reassuring talk" is an important part of their plan (never forget what Jean-Claude Juncker said). With the CS backdrop, the EU went ahead and hiked 50 bps (highlighting the regional nature of the solution so far) and that will likely get tested by markets.
- **Winners and Losers.** As soon as discussion starts about good banks and bad banks (or about a Swiss bank versus a global bank), the powers that be will start picking winners and losers. Equity holders, Tier II capital holders, etc., are unlikely to fare well. Again, these are all background discussions, but they don't seem comforting.

I give a C- to the Swiss efforts so far as it is too localized, does nothing for capital, and starts to hint at intervention in ways that could impact the rights of certain investors.

While I give the U.S. a few weeks before markets will demand action, I expect that by early next week the luster of the Swiss solution will be gone (without something more substantive).

Time is Not our Friend!

The solutions in the U.S. and in Europe bought time. How much time is yet to be determined and it is up to various institutions to use that time to fix the main problem – capital concerns.

I'm optimistic that we get good resolution on that front, but that is what is needed from here!

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