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MARKETS

Fed to Launch Commercial Paper Funding Facility Amid Coronavirus Uncertainty

Central bank focuses on dysfunction in $1.1 trillion market for short-term corporate IOUs

The Fed under Jerome Powell has moved over the past two weeks to address growing market strains.

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By Nick Timiraos

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The Federal Reserve said it would start making loans to American corporations, relaunching a crisis-era tool to help calm short-term debt markets that have faced intensifying strains in recent days.

The Fed trained its sights Tuesday on dysfunction in the $1.1 trillion market for short-term corporate IOUs called commercial paper. Companies use commercial paper to finance their day-to-day business operations such as payroll expenses.

While the Fed can't buy corporate debt or lend directly to households and businesses, it can invoke emergency powers to establish lending facilities that, in turn, extend credit.

The steps show how the Fed is repurposing its tools from the 2008 crisis to combat an unfolding economic emergency that is entirely different. Back then, fears about the solvency of key financial institutions spawned a crisis that fueled a broader economic contraction.

Now the problems are in the economy, which needs the financial system and government to tide over businesses and households forced to hunker down to prevent the coronavirus pandemic from overloading local health-care systems.

“What economic policy can do here is to create a safety net for the economy, and particularly for individuals and firms that don’t have buffers, that aren’t able to absorb lost wages or lost revenues,” said Nathan Sheets, a former senior official at the Treasury Department and the Fed who is now chief economist at investment-advisory firm PGIM Fixed Income.

Complicating that task is uncertainty everywhere: about the length and severity of the economic downturn; about the regulatory system’s ability to handle an abrupt deleveraging; and about how financial firms will function with remote operations and alternative work arrangements.

“The problem with trying to create a distinction between economic and financial crises is that it ignores the fact that the real economy and the financial sector are inextricably linked, and thus there is no way to have a crisis in one without it immediately causing a crisis in the other,” said Joshua Shapiro of consulting firm MFR Inc.

In launching the Commercial Paper Funding Facility, the Fed is trying to encourage investors to return to that market to ensure that eligible issuers can roll over maturing obligations. The central bank’s facility will purchase three-month debt from firms with high credit ratings. The Fed deployed a version of the tool between 2008 and 2010, during and after the financial crisis.

“The Fed is trying to break the fear loop that corporates will lose access to the short-term markets by committing that funding will exist,” said Alexandra Wilson-Elizondo, senior credit portfolio manager at MacKay Shields. “It’s a symbol. A healthy commercial-paper market gives companies confidence in the term market.”

Investors who buy longer-dated debt gauge the pulse of short-term funding markets to assess risk. Analysts and asset managers were alarmed to see disruptions in commercial paper, in which yields were higher than those for certain long-dated bonds. That either meant companies were desperate for cash or that buyers had disappeared. If short-term debt instruments are in trouble, that could signal tough times ahead.

As an example of restored faith and a well-functioning high-grade credit market, Exxon Mobil Corp. XOM **-2.58%** ▼ issued debt across various maturities Tuesday, borrowing at a rate of around 4% on a 30-year bond.

Tuesday's announcement marked the Fed's first effort in the current crisis that required consultation with the Treasury Department, potentially opening the door to other joint ventures between fiscal and monetary authorities.

To create the latest facility, the Fed had to invoke special powers by citing "unusual and exigent circumstances" to authorize one of its reserve banks, the New York Fed, to extend credit. In 2010, Congress required the Fed to seek approval from the Treasury secretary before using these so-called 13(3) powers, named for the section of its charter that allows it to set up such last-resort programs.

Treasury Secretary Steven Mnuchin gave his approval to the program Tuesday. The Treasury will also provide $10 billion from its Exchange Stabilization Fund, which has around $94 billion, to cover any Fed credit losses.

Later on Tuesday, the Fed announced another 13(3) lending program that will enable 24 large financial institutions known as primary dealers, which function as the Fed's exclusive counterparties when trading in financial markets, to seek loans of up to 90 days.

The Primary Dealer Credit Facility will essentially function as an overnight loan facility for primary dealers, similar to how the Fed's discount window provides a round-the-clock source of backup funding to banks. It represents the Fed's latest bid to unclog financial markets.

The facility will offer terms as generous as those made available in the fall of 2008. Primary dealers will be able to pledge a broader range of collateral than the government-backed debt required for open-market operations, and the Fed will charge the same 0.25% rate being made available for banks at the discount window.

The commercial-paper market has been strained as money-market mutual funds and other investors seek to sell commercial paper at the same time that demand for short-term borrowing is rising from companies that face unanticipated, virus-related funding needs.

The Fed said it would lend to commercial-paper issuers at a rate of 2 percentage points above overnight lending rates for three months at a time. The facility will last for at least one year.

“The terms are not easy,” said Julia Coronado, a former Fed economist and founder of the economic-advisory firm MacroPolicy Perspectives. “It was a mild disappointment to the market.”

The facility differs from the 2008 version in one important way. While both are only open to firms with strong credit ratings, the new facility will also allow firms that currently have strong credit ratings but whose ratings are later downgraded by one tier to access the facility.

In 2008, the facility took three weeks to launch, and this change could give companies greater confidence that they will able to access credit even if their ratings are downgraded before the facility is fully operating.

Tuesday’s announcement is one example of how policy makers in the days and weeks ahead may need to repurpose old tools and invent new ones to address a working-capital crunch for small and midsize businesses and the self-employed.

Michael Feroli, chief U.S. economist at JPMorgan Chase, said one possible scheme would allow the Fed to provide nonrecourse funding for loans underwritten by banks to small- and midsize companies at the Fed’s primary credit rate, 0.25%.

Such loans could be limited to firms that were in good credit standing as of the start of the year, to avoid lending to enterprises that were distressed before the virus hit. Relying on the banking system could reduce the administrative burden on the central bank or the Treasury associated with underwriting tens of thousands of borrowers.

The Fed has moved over the past two weeks to address growing market strains at a pace that has surprised veterans of the 2008 crisis, which unfolded over many months.

On March 3, the central bank approved an emergency cut in its benchmark federal-funds rate by a half-percentage point. On Sunday, it slashed the rate by a full percentage point, to near zero.

The Fed also announced plans to purchase $500 billion in Treasury securities and $200 billion in mortgage bonds to arrest funding strains in critical markets for government debt, which are typically havens during a crisis. And it has promised to offer unlimited amounts of short-term loans to large banks that are collateralized by government securities.

—Julia-Ambra Verlaine contributed to this article.

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