US Rates Watch

CP / CD still frozen; Fed needs to do more

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CP / CD relief needed through 13-3 or other regs

On Sunday the Fed cut rates to zero and officially started QE to aid UST market functioning. However they did not announce any facilities specifically directed at the CP/CD market. Without such a program we expect that the CP/CD market will remain frozen in the near term and we will continue to see stress in credit linked front end markets. LIBOR and CP continue to rise versus OIS (Chart 1) and cross currency markets have showed significant signs of stress as investors demand USD (Chart 2). The Fed needs to pursue some or all of: (1) Commercial Paper Funding Facility (CPFF) (2) buy CP / CD directly from dealer balance sheets (3) Money Market Investor Funding Facility (MMIFF). The Fed needs to signal that these programs are coming as soon as possible to reduce credit concerns and calm funding markets. A statement today would help.

Source of CP stress: The CP market is frozen as dealer balance sheets are constrained but corporates need to issue and MMFs want to sell. Corporates rely on the CP market as a reliable source of short-term cash. To the extent corporates are not able to access CP markets they will turn to bank lines of credit, which could raise funding needs for banks and increase market stress. We have already seen total CP issuance start to decline and concentrate in very short tenors (Table 1).

At the same time, MMFs seek to reduce CP holdings to raise cash and build liquidity buffers ahead of an expected increase in investor outflows. We have already started to see outflows from prime institutional funds (Chart 3) and this may spill over into government MMF depending on the severity of quarantines & concerns over access to cash. Prime funds also continue to increase their liquid assets in preparation of outflows.

Prime MMF also key source of dealer non-traditional funding: The prime MMF scramble for cash is leading to a reduction in “evergreen” financing arrangements for dealer non-traditional collateral. “Evergreen” arrangements are where prime MMF agree to keep funding dealer non-traditional collateral for a 35 or 95D period. However, MMF have a right to terminate the “evergreen” on any day and then the repo arrangement just rolls down to eventually maturity (i.e. if terminated the 35D funding becomes 34D tomorrow, etc).

Right now MMF are terminating their “evergreen” financing arrangements to bolster cash. This means that after the 35 or 95D period there will be no funding for this non-traditional collateral. The dealer will then likely have to hold the non-traditional assets on their own books / balance sheet. Dealers will not want to hold these assets and will sell them into the market. This will likely exacerbate the current illiquidity and spread widening in the market.

Note: non-traditional collateral = private label MBS, HY corporates, etc

Refer to important disclosures on page 5 to 6.

Possible Fed solutions tailored to MMF: To address these concerns we think that the Fed needs to buy CP directly from issuers, dealers or MMFs.

- Commercial Paper Funding Facility (CPFF) – The CPFF facility was first introduced in 2008. It allows the Fed to purchase CP directly from issuers, and allows corporates to continue funding themselves despite market stress. Detail here.
- Commercial Paper Dealer Purchase Facility (CPDPF) – We have also suggested the Fed could introduce a new facility to purchase CP directly off of primary dealer balance sheets. The facility would only be used to clear existing inventory off dealer balance sheets and provide an outlet for additional prime MMF sales until they had built sufficient liquidity buffers. Detail here.
- Money Market Investor Funding Facility (MMIFF) – The MMIFF was introduced in 2008 and allowed the Fed to purchase CD, CP and bank notes directly from MMFs and other money market investors (Table 2). Notably, eligible assets had to have remaining maturity of 7-90 days and be issued by one of 50 selected institutions.

All of these measures would likely require for the Fed to invoke 13-3 authority.

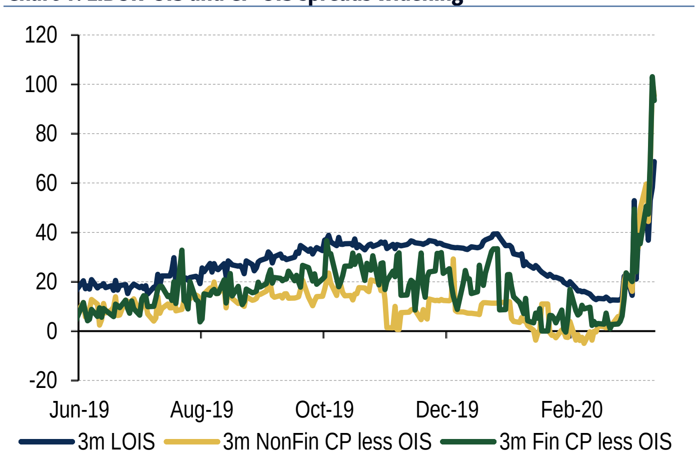
Broader solutions: the Fed could also announce (1) broader regulatory relief for banks & dealers (2) re-establish the Primary Dealer Credit Facility (PDCF).

Regulatory relief: Another solution would be for broad based regulatory relief for the dealers. The Fed could consider relaxing or waiving: (1) SLR (2) reg W. SLR relief would allow dealers to increase their non-risk weighted market making activity. Relaxing reg W would allow for dealers to post their financial asset inventory to a depository institution under the same parent structure. Any announcement would likely come from the Fed or FSOC; we do not know how quickly such regulatory easing could occur.

PDCF: The Fed could also re-establish the primary dealer credit facility (PDCF) which would allow for dealers to post collateral directly to the Fed's discount window. This was last used during the financial crisis and would require 13-3 authority.

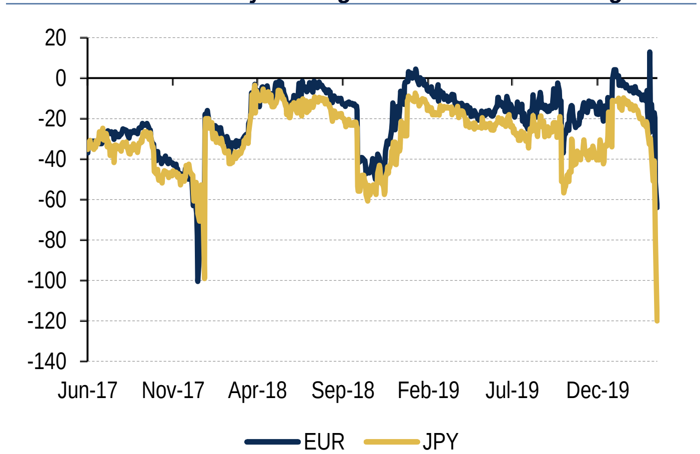
These are unprecedented times. In our view, the Fed needs to keep acting. We trust that they will.

Chart 1: LIBOR-OIS and CP-OIS spreads widening



Source: Bloomberg

Chart 2: 3m cross currency bases signal USD demand and funding stress



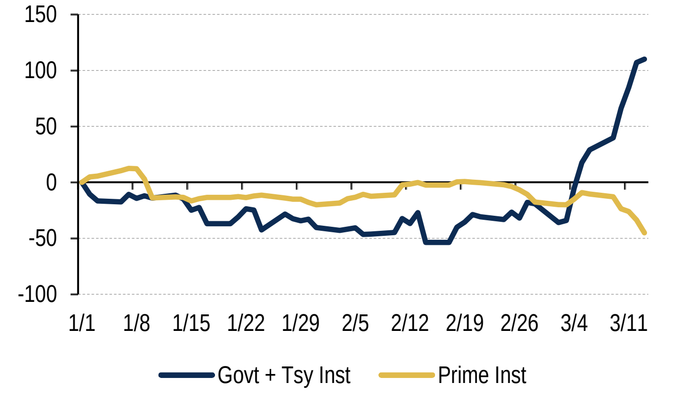
Source: Bloomberg

Table 1: Total CP issuance ($bn)

	Total ($bn)	1-9 day Maturity ($bn)	1-9 day as % total
Mar 9	79.0	60.5	77%
Mar 10	77.4	59.6	77%
Mar 11	70.3	51.6	73%
Mar 12	82.2	62.3	76%
Mar 13	69.9	58.1	83%
2020 Avg	80.1	58.9	74%

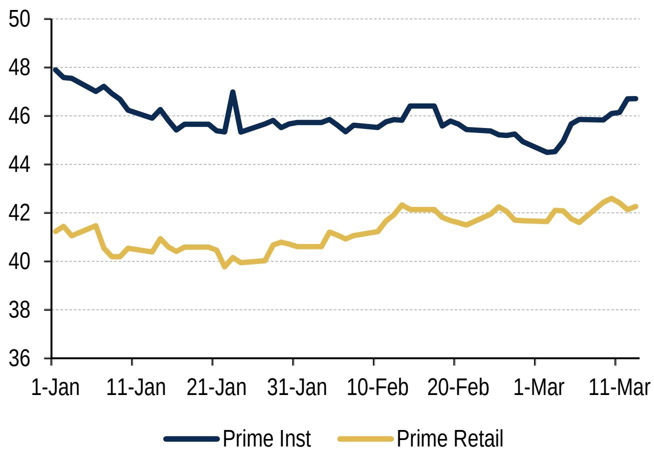
Source: Federal Reserve; Note: statistics reflect all sales of commercial paper to investors by dealers or direct issuers, excluding secondary issues and repurchase agreement and financing issue

Chart 3: Cumulative MMF asset flows ($bn)



Source: Crane Data

Chart 4: Weekly liquid assets (%)



Source: Crane Data

Table 2: Money Market Investor Funding Facility details

Seller	2a-7 MMFs and funds managed/owned by a US bank, insurance company, pension fund, trust company, investment advisor or US state/local govt entity
Buyer	Special Purpose Vehicle, financing purchases through sales of ABCP and loans from NY Fed
Eligible Assets	-USD denominated CD, bank notes, CP. DTC cleared -Must be issued by one of 50 chosen financial institutions, all had short-term debt rating of at least A-1/P-1/F1 -Remaining maturities of at least 7 days & no more than 90 day -Must have a yield of at least 60bp above the primary credit rate at the time of purchase
Total Purchase Amt	$600bn

Source: Federal Reserve

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