Federal Reserve Amends Pricing, Adds Municipal Issuers, and Makes Other Changes for Recently Established Commercial Paper Funding Facility

On March 17, 2020, the Federal Reserve Board announced the establishment of two emergency funding facilities that closely mirror facilities established in 2008 during the last financial crisis in providing liquidity to both short and long term funding markets. The facilities are generally directed at government backed and private issuer rated, traded securities, as well as some traded equity securities, not less liquid credit markets, such as bank loans to unrated companies. On March 23, 2020, the Federal Reserve added municipal issuers and amended the pricing for the commercial paper funding facility announced on March 17 and issued other "program terms and conditions" posted on the website of the Federal Reserve Bank of New York. To reflect these changes, this client alert replaces in full our March 19, 2020 client alert, "Federal Reserve Establishes Special Commercial Paper Backstop and Primary Dealer Funding Facilities."

The commercial paper facility is directed at issuers (and carries a higher than "normal" interest rate). The primary dealer facility is directed at providing those dealers (most of which are broker-dealers affiliated with commercial banks)[1] with liquidity on a par with the liquidity provided to commercial banks through Federal Reserve Bank "discount windows" for securities they hold. Both facilities provide for short term loans (no longer than 90 days), but the lenders under those facilities can renew such financing, at their discretion, through new loans or commercial paper purchases.

Commercial Paper Funding Facility. This facility (the CPFF) closely tracks the 2008 commercial funding facility established during the last financial crisis. As with that facility, the Federal Reserve Bank of New York will lend to a special purpose vehicle (SPV) that will use that funding to purchase rated three-month U.S. dollar denominated commercial paper.

The CPFF provides that eligible "issuers are U.S. issuers of commercial paper, including municipal issuers and U.S. issuers with a foreign parent company."

Whereas the 2008 facility required the commercial paper be rated A-1/P-1 by a major rating agency (recognized statistical rating organization or NRSO) the new facility will permit a one time purchase of A-2/P-2/F-2 rated paper, if the issuer was rated A-1/P-1 on March 17, 2020.[2] Such purchase would be limited to the amount of commercial paper the issuer had outstanding "the day before it was downgraded."[3] Otherwise, the purchased commercial paper must be rated A-1/P-1/F-1. As with the 2008 facility, commercial paper rated by more than one NRSO must receive the minimum rating from at least 2 NRSOs.

Also similar to the 2008 facility, purchases of commercial paper from any issuer are limited to the largest amount of commercial paper such issuer had outstanding during the one year period from March 16, 2019, to March 16, 2020 (i.e., the day before the facility was announced)[4] minus the amount of such paper held by investors other than the SPV (i.e., the SPV is only intended to support the issuer maintaining total CP funding up to its largest amount of such funding during the 1 year plus one day period preceding March 17, 2020).[5]

The interest rate for commercial paper purchases under the CPFF will be 1.10% plus the overnight index swap (OIS) rate, except that commercial paper rated A2/P2/F2 at the time of purchase will be purchased at the same 2% spread over OIS as for all purchase under the original pricing announced on March 18, 2020,[6] and each issuer using the facility will be required to pay a fee equal to 0.10% of the maximum amount of commercial paper it had outstanding during the one year and 1 day period described above (*i.e.,* 10bps on the maximum amount of CP the SPV can purchase from that issuer).

In another modification to the terms announced on March 18, 2020, purchases of ABCP will not be made "from issuers that were inactive prior to the creation of the CPFF. An issuer will be deemed inactive if it did not issue ABCP to institutions other than the sponsoring institution for any consecutive period of three-months or longer between March 16, 2019 and March 16, 2020."

Other terms of the facility are outlined in the "program terms and conditions" attached as Attachment I to this client alert.

Primary Dealer Credit Facility. Similar to the 2008 term securities lending facility that permitted primary dealers (PDs)to bid on funding for certain term securities they held in inventory, this new facility (PDCF) is available only to primary dealers.[7] Unlike the new CPFF, the PDCF is intended to support liquidity in longer term debt and even equity markets (as well as commercial paper markets). Any PD can receive a short term loan from the FRBNY collateralized by securities eligible for FRBNY "open market" operations (i.e., "OMO eligible securities), plus Treasury strips, and "investment grade corporate debt securities, international agency securities, commercial paper, municipal securities, mortgage-backed securities, and asset-backed securities; plus equity securities.[8]"

Any such collateral must be rated investment grade (defined as BBB- or higher), except CDOs, CLOs, and CMBS must be rated AAA and commercial paper must be rated at least A2/P2.

In addition, all pledged collateral must be eligible for pricing by Bank of New York Mellon as the clearing bank for the transactions and be valued "according to a schedule designed to be similar to the margin schedule for lending by the Discount Window, to the extent possible."

The facility extends to primary dealers funding similar to discount window lending by Federal Reserve Banks (with more limited eligible collateral), much like the primary dealer funding facility first established in March 2008 following the Bear Stearns "rescue." The lending rate will be "equal to the primary credit rate in effect at the New York Fed offered to depository institutions via the Discount Window."

On March 15, 2020, the Federal Reserve Board reduced that rate to 0.25% (from 1.75%) to reflect a simultaneous reduction in the federal funds target rate and to reduce (virtually eliminate) the spread between the primary credit rate and the target overnight rate.[9] Thus, unlike the rate for loans under the CPFF, there is no "penalty" feature to the interest rate, which is consistent with the Federal Reserve's desire, expressed in its March 15, 2020, press release announcing the reduction in the discount rate, that banks freely use the discount window with no thought of negative consequences, reputational or otherwise. Presumably, the Federal Reserve intends the same for PDs under the PDCF.

Other terms of the facility are outlined in its "term sheet" attached as Attachment II to this client alert.

For More Information

If you would like further information concerning the matters discussed in this article, please contact the Chapman attorney with whom you regularly work.

1 The FRBNY website currently lists 24 primary dealers. https://www.newyorkfed.org/markets/primarydealers

2 Subject to the same requirement noted above that, if rated by more than one NRSO, at least two NRSOs had assigned such rating.

3 As announced on March 18, 2020, the limit was the amount of commercial paper the issuer had outstanding on March 17, 2020.

4 The 2008 facility limited purchases to the outstanding commercial paper of the issuer during the 8 month period from January 1 through August 31, 2008.

5 This limits purchases by the SPV. After the SPV makes purchases, outside funding could cause an issuer's outstanding commercial paper to exceed the largest amount it had outstanding between March 16, 2019, and March 16, 2020, but the SPV could only make additional purchases to the extent such limit would not be exceeded.

6 As announced on March 18, 2020, such purchases were to have "separate pricing."

7 Footnote 1 above lists the current primary dealers.

8 Excluding exchange traded funds (ETFs), unit investment trusts, mutual funds, rights and warrants.

9 https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315b.htm

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Commercial Paper Funding Facility: Program Terms and Conditions

Effective March 23, 2020

Facility

The CPFF will be structured as a credit facility to a special purpose vehicle ("SPV") authorized under section 13(3) of the Federal Reserve Act. The SPV will serve as a funding backstop to facilitate the issuance of term commercial paper by eligible issuers.

The Federal Reserve Bank of New York will commit to lend to the SPV on a recourse basis. The New York Fed will be secured by all the assets of the SPV. The Department of the Treasury, using the Exchange Stabilization Fund, will make a $10 billion equity investment in the SPV.

Assets of the SPV

The SPV will purchase from eligible issuers three-month U.S. dollar-denominated commercial paper through the New York Fed's primary dealers. Eligible issuers are U.S. issuers of commercial paper, including municipal issuers and U.S. issuers with a foreign parent company.

Except as provided below, the SPV will only purchase U.S. dollar-denominated commercial paper (including asset-backed commercial paper ("ABCP") that is rated at least A1/P1/F1 by a major nationally recognized statistical rating organization (NRSRO) or, if rated by multiple major NRSROs, is rated at least A1/P1/F1 by two or more major NRSROs, in each case subject to review by the Federal Reserve.

An issuer that, on March 17, 2020, was (1) rated at least A1/P1/F1 by a major NRSRO or, if rated by multiple major NRSROs, was rated at least A1/P1/F1 by two or more major NRSROs; and (2) is subsequently downgraded, will be able to make a one-time sale of commercial paper to the SPV so long as the issuer is rated at least A2/P2/F2 by a major NRSRO or, if rated by multiple major NRSROs, is rated at least A2/P2/F2 by two or more major NRSROs, in each case subject to review by the Federal Reserve.

The SPV will not purchase ABCP from issuers that were inactive prior to the creation of the CPFF. An issuer will be deemed inactive if it did not issue ABCP to institutions other than the sponsoring institution for any consecutive period of three-months or longer between March 16, 2019 and March 16, 2020.

Limits per issuer

The maximum amount of a single issuer's commercial paper the SPV may own at any time will be the greatest amount of U.S. dollar-denominated commercial paper the issuer had outstanding on any day between March 16, 2019 and March 16, 2020. The SPV will not purchase additional commercial paper from an issuer whose total commercial paper outstanding to all investors (including the SPV) equals or exceeds the issuer's limit.

For an issuer that, on March 17, 2020, was (1) rated at least A1/P1/F1 by a major NRSRO or, if rated by multiple major NRSROs, was rated at least A1/P1/F1 by two or more major NRSROs; and (2) is rated at least A2/P2/F2 by a major NRSRO or, if rated by multiple major NRSROs, is rated at least A2/P2/F2 by two or more major NRSROs, the maximum amount of the issuer's commercial paper that the SPV will purchase is the amount of U.S. dollar-denominated commercial paper the issuer had outstanding the day before it was downgraded.

Pricing

For commercial paper rated A1/P1/F1, pricing will be based on the then-current 3-month overnight index swap ("OIS") rate plus 110 basis points. For commercial paper rated A2/P2/F2, pricing will be based on the then-current 3-month OIS rate plus 200 basis points.

At the time of its registration to use the CPFF, each issuer must pay a facility fee equal to 10 basis points of the maximum amount of its commercial paper the SPV may own.

Termination date

The SPV will cease purchasing commercial paper on March 17, 2021, unless the Board extends the facility. The New York Fed will continue to fund the SPV after such date until the SPV's underlying assets mature.[1]

1 The Board may review and make adjustments to the terms and conditions described in this term sheet. Changes will be announced on the Board's website.

Term Sheet for Primary Dealer Credit Facility (PDCF)

Borrower Eligibility

- Only primary dealers of the New York Fed are eligible to participate in the PDCF.

Eligible Collateral

- Collateral eligible for pledge under the PDCF includes all collateral eligible for pledge in open market operations (OMO);[1] plus investment grade corporate debt securities, international agency securities, commercial paper, municipal securities, mortgage-backed securities, and asset-backed securities;[2] plus equity securities.[3] Foreign currency-denominated securities are not eligible for pledge under the PDCF at this time.

- Collateral that is not priced by the clearing bank will not be eligible for pledge under the PDCF.

- Additional collateral may become eligible at a later date upon further analysis.

Term

- Loans will be made available to primary dealers for a term of up to 90 days.

Rate

- Loans made under the PDCF will be made at a rate equal to the primary credit rate in effect at the New York Fed offered to depository institutions via the Discount Window.

Prepayment

- Borrowers may prepay loans at any time.

Time of Day

- During Fedwire hours.

Custody Rules and Arrangement

- Dealers will communicate their demand for funding to their clearing bank. The clearing bank will verify that a sufficient amount of eligible collateral has been pledged by each primary dealer participating in the PDCF and notify the New York Fed accordingly.

- Once the New York Fed receives notice that a sufficient amount of margin-adjusted eligible collateral has been assigned to the New York Fed's account, the New York Fed will transfer the amount of the loan to the clearing bank for credit to the primary dealer.

Collateral Valuation

- The pledged collateral will be valued by Bank of New York Mellon according to a schedule designed to be similar to the margin schedule for lending by the Discount Window, to the extent possible.

Loan Size

- Loans will be limited to the amount of margin-adjusted eligible collateral pledged by the dealer and assigned to the New York Fed's account at the clearing bank.

Recourse

- Loans made under the PDCF are made with recourse beyond the pledged collateral to the primary dealer entity.

Program Termination

- The PDCF will remain available to primary dealers for at least six months, or longer if conditions warrant.

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1 An addition to OMO-eligible securities are Treasury strips.

2 For the following securities types, only AAA-rated securities are accepted: commercial mortgage-backed securities (CMBS), collateralized loan obligations (CLOs), and collateralized debt obligations (CDOs). Other eligible securities as specified above are accepted if rated investment grade (such that BBB- securities and above). Specifically, investment grade commercial paper is accepted: commercial paper rated both A1/P1 and A2/P2.

3 The following equities would not be eligible: exchange traded funds (ETFs), unit investment trusts, mutual funds, rights and warrants.