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News

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Someone Call the Plumber: The Economy's Liquidity Pipes are Clogged

As we noted on **Tuesday**, the Federal Reserve and the Treasury Department are working around the clock to allocate the $454 billion Congress authorized in the CARES Act for credit and liquidity facilities created pursuant to the Federal Reserve's authority under section 13(3) of the Federal Reserve Act. As they undertake that effort, market conditions continue to deteriorate. Perhaps the most convincing indicator is yield changes in the investment grade corporate bond market, which are delivering equity-like returns and **attracting** nontraditional investors. Here are some key market trends we are watching and some thoughts on their public policy ramifications as we prepare to go into the first weekend of April, when rent and mortgage payments begin to come due.

1. There are Still Massive Blockages in the Financial Plumbing of the Economy. The banking system de-levered over the last decade, from about 20:1 in the pre-2008 crisis days to about 9:1 today, due to the Dodd-Frank Act, Basel III capital and liquidity standards, and other regulatory and market structure changes. Today, a significant (and in some markets, the largest) source of Main Street funding for business, student, auto, consumer, and real estate loans are the capital markets, where insurance companies, pension funds, and other large institutional investors provide capital to our economy in exchange for returns that meet their investment objectives (*e.g.*, ensuring retired teachers receive their pensions). The flow of funding through those capital markets is currently clogged because asset prices are temporarily depressed. They are not *actually* worth less, but under the Dodd-Frank Act, they are required to be "marked to market," which has several negative results: (i) margin calls are being made on repo collateral; (ii) insurance companies are being forced to sell assets at depressed prices to meet regulatory capital requirements; (iii) most non-AAA-rated assets are effectively illiquid (some spreads for investment grade assets are 1500 points off); and (iv) new securitization issuances—the way Main Street lenders actually get money to make loans—are nowhere to be found. The Federal Reserve has established a facility to unclog the capital markets—the Term ABS Loan Facility (TALF)—which, if broadened and deepened to make all investment grade (and similarly rated) assets eligible, would give market participants confidence that there is a source of liquidity and a cash backstop in the market.

2. Companies are Prudently Protecting their Liquidity Positions. Most operating companies (and even some regional banks) are funded through capital market financing, so when the capital markets are not functioning properly (as described above), companies begin to buckle down and protect their liquidity. Essentially, companies seek to liquidate assets and sit on cash. We saw this week that some of the most highly-rated investment grade companies that retain the last sliver of access to public debt markets issued bonds even though yields are increasing. They did this because in times like this, cash is king. The golden rule is "get cash wherever you can, and once you have it, use it very wisely."

The reason for this extreme cash conservatism is because businesses do not know where they will get liquidity tomorrow. As described above, the market where they usually get financing is temporarily clogged; unclogging it through a broad Federal Reserve repo facility like TALF would provide significant relief to business lenders, and thus to businesses. While we noted on Tuesday that there is competition for the $454 billion, there is actually opportunity for some alignment here: restarting the capital markets would actually *reduce*, even if only incrementally, the strain on what will be the “large business lending facility” contemplated in section 4003 of the CARES Act. Functioning capital markets would complement the Federal Reserve’s business lending facility to restore capital to most of the economy.

3. The Dodd-Frank Restrictions on the Federal Reserve. During and in the years following the 2008 financial crisis, there was great political frustration that government used its lending powers to provide financing to individual institutions and transactions. **Section 1101** of the Dodd-Frank Act placed new restrictions on the Federal Reserve’s authority to establish lending facilities under section 13(3) of the Federal Reserve Act, including a prohibition on lending to “borrowers that are insolvent.” Our economy right now is starved of liquidity but being promised that help is on the way in the form of Federal Reserve programs. In the coming days, some businesses will consider whether bankruptcy protection is an appropriate means of protecting liquidity. The “B” word has a negative connotation because in popular discourse it is synonymous with failure, but the reality is that bankruptcy is a powerful tool to help a company restructure its balance sheet and preserve the business as a going concern to the benefit of workers, customers, creditors, and communities. If a business elects to file for chapter 11 protection, however, it will be ineligible to receive money from a Federal Reserve facility supported by the $454 billion from the CARES Act under Federal Reserve **regulations**. Businesses will increasingly begin to weigh this trade-off as they wait for guidance from the Federal Reserve on the contours of its loan program(s) and, more importantly, the timing of when cash will become available.

4. What to Do About Rent and Mortgage. Most rent and mortgage payments are due within the first 10 days of the month; many businesses, to protect precious liquidity, will elect to defer payment of rent. By the middle of next week, our economy will have a pretty decent sense of the size and scope of missed rent payments from businesses to landlords, which translates into missed mortgage payments from landlords to creditors. The impact of this phenomenon remains to be seen, but because missed payments constitute *actual* diminutions in value of capital markets assets, the *implied* diminution in value will be much bigger (I would normally qualify this with “unless the market has already priced this in,” but for most of these assets there is simply no market at all). The fastest way to restore confidence in liquidity supply to businesses is to restore the markets from which they normally borrow. However, if May rent and mortgage appear to be jeopardized, Congress may want to consider how to address this in the phase four legislation presently being discussed by the House of Representatives.

5. Administrative Friction. The nation’s bank infrastructure is going to be tested—and strained—in the coming weeks. While online application portals and automation will incrementally decrease the burden, consider what happens when virtually every business in America calls their banker asking what time of what day they can come in for a small business or larger Federal Reserve lending facility loan agreement. Consider further that many bank employees, like the rest of America, are working from their home living rooms to reduce the spread of disease. Finally, banks recall well the perils of the False Claims Act, a statute designed to prevent fraud against the federal government, from the years after the 2008 mortgage crisis, when government agencies forced banks to take back nonperforming loan assets by finding often minor technical errors in loan certification documents. Establishment of these lending facilities is one major task; reducing the friction of getting the actual cash to borrowers through the commercial banking system as an intermediary is yet another.

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