

Risks May Suggest a Role for an Extension of Bank Debt Issuance Guarantees

By Steven Kelly

Original post [here](#).

Included in the U.S. Coronavirus Aid, Relief, and Economic Security (CARES) Act passed by Congress in March [was temporary reauthorization](#) of federal bank debt guarantees first (and last) used in the Global Financial Crisis (GFC).

During the GFC, the Treasury used the Exchange Stabilization Fund (ESF) to guarantee money market funds (MMFs) and charged fees to do so. The Federal Deposit Insurance Corporation (FDIC) used a novel legal interpretation to create the Debt Guarantee Program (DGP) and Transaction Account Guarantee Program (TAGP), [both of which saw the FDIC guarantee various forms of bank debt](#) for a fee.

The TAGP provided unlimited insurance to certain otherwise-uninsured transaction accounts while the DGP guaranteed new unsecured debt issuance by banks, bank holding companies, and eligible holding company affiliates (henceforth, “banks”). The DGP—created in October 2008—gave banks approximately a year to issue guaranteed debt and the guarantee lasted to the sooner of either the debt’s maturity or December 31, 2012. This program insured the debt [of 121 entities, peaked at \\$350 billion outstanding, and collected fees of \\$10.4 billion, while paying out only \\$153 million in claims on defaulted debt](#).

After the crisis, Congress barred the FDIC from creating another TAGP and the Treasury from guaranteeing MMFs with ESF funds. However, in the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Congress made it possible for the FDIC to [set up a new DGP if “a liquidity event exists that warrants use of the guarantee program”](#) as certified by the Boards of the FDIC and the Federal Reserve (the Fed) and the Secretary of the Treasury in consultation with the President—but now only if Congress also [approves it directly](#).

The CARES Act preemptively granted this approval, subjected to the condition that the guarantees end no later than December 31, 2020. CARES also temporarily removed the outright ban on creating a new TAGP or an ESF-funded guarantee of MMFs, again provided that both end by year-end.

Congress is now working to pass another major economic relief act. It should consider extending the DGP approval, even if it decides not to extend the authority for money market and transaction account guarantees.

U.S. policymakers have not spoken publicly about debt guarantees in recent weeks. Still, it's clear that an extension of the guarantee authorities would give them valuable flexibility in a future crisis response.

Extending the duration of the guarantees would be particularly valuable. While the issuance period Congress granted in the CARES Act was reasonably consistent with the issuance period of the GFC's DGP (roughly eight and 12 months, respectively), the guarantee period as provided by CARES does not persist thereafter. This may make any new DGP ineffective at supporting term funding or addressing the [persistent effects of the current economic crisis](#). Having an authorized, robust DGP, even if not activated, could provide a financial stability backstop through the end of the coronavirus crisis that reduces the odds of this economic crisis becoming a financial crisis.

Future Financial Sector Strength Is Not Certain

Unlike the GFC, the current crisis did not begin in the financial sector; it does, however, carry the potential for negative implications for the financial sector via numerous channels: particularly loan losses, risk aversion, and liquidity demands. The pandemic's economic effects have thus far been attenuated by the fact that banks had a [historically strong capital and liquidity position \(pp. 41-42, 50-51\)](#) at the outset. If the ongoing pandemic places enough cumulative stress on the financial sector, however, the financing of banks themselves may only come on tighter terms, with shorter maturities, or not at all. This is the [general mechanism](#) by which a recession becomes a [financial crisis](#)—amplifying and perpetuating the economic damage.

We know that, for instance, during the GFC, financial firms either failed or were rescued (publicly or privately) over the course of days, not weeks or months. This is because increasingly short-term funding could not be rolled over, and firms became conditionally insolvent. Lehman Brothers, for its part, was [funding 1/3 of its portfolio in overnight repurchase agreements](#)—“repo”—at the time of its failure. Again, no major banks are near this situation at present, but it's illustrative of how pressures can build absent a sufficient policy response. Market liquidity was strained early in the pandemic before the Fed intervened.

A DGP could help to avoid [this bad equilibrium](#) of increasingly unstable funding of banks, sensitive to drying up at any moment. By allowing banks to retain access to term funding at reasonable rates, guarantees on debt issuance could [ensure](#) that they continue term lending, credit risk assumption and other banking activities that support the economy with more certainty. Banks can avoid having their capital position eroded by increasing interest costs and haircuts on their collateral, or worse: in the case of lenders simply deciding to avoid the risk of funding a bank or banks altogether, even a well-capitalized bank could fail quickly.

A DGP's [fee structure](#) (essentially insurance premiums) can help limit moral-hazard concerns and partially protect the FDIC's Deposit Insurance Fund. The knowledge that guarantees are available as a backstop could itself be enough to prevent private lenders stepping away from term risk. Some of the Fed's lending programs this year have provided such reassurance [without being used extensively](#).

Re-Run on the Financial System at the Outset of COVID-19 Disruption

We saw the aforementioned "[flight from maturity](#)" and outright withdrawals of unguaranteed funding start to occur in [repo](#), [commercial paper](#) and [other](#) financial debt during the onset of the pandemic. There's a risk we could see it again as the health crisis continues, particularly in a so-called "double-dip" recession scenario—what the Fed is calling a "W-shaped" recovery in its bank stress tests (more on this below).

This is particularly the case for foreign banks who lack a stable base of dollar retail deposits. They are especially [dependent](#) upon the unguaranteed dollar funding markets to execute dollar-denominated credit extension. As such, the [run on prime MMFs](#)—primarily institutional, cash stockpiles that purchase risky, short-term private sector assets—in favor of government-only funds (which invest in Treasuries and Agency debt) was [particularly disruptive](#) for these banks.

Approximately \$200 billion flowed out of prime funds in February and March, and over \$1 trillion flowed into government funds by April. This repeated a pattern seen in the GFC and showed that various regulatory reforms have been [inadequate](#) to prevent recurrent disruption; this MMF disruption necessitated the Fed standing up various facilities, [including a backstop to lend non-recourse against banks' purchases of these assets from MMFs](#).

In the wake of this damage, several notable prime funds have even been closed due to the volatility. As quoted [in Bloomberg](#), Nancy Prior, the President of Fixed Income at Fidelity Investments—the largest holder of MMF assets—said upon the closing of its prime institutional funds, "Time and again we've seen a rapid shift from institutional prime funds to government funds." The Bloomberg article also notes, "Prior said Friday that Fidelity believes its institutional clients' liquidity needs are better addressed by government-only funds."

Furthermore, due to profitability concerns as the Fed has cut rates to zero, we've also witnessed some government MMFs rejecting new money and [forfeiting management fees](#) to boost returns. Thus, there is both a borrower and investor desire for more stability in this space.

Even without a new guarantee of prime MMFs—which may be less feasible given the fund shutterings, previous Congressional desire to restrict them outright and the

growing policymaker chorus calling for more MMF reform (see below)—a DGP could help stabilize this funding (and institutional cash management) market.

By wrapping privately-issued bank paper in an FDIC guarantee that pays immediately upon a missed payment, the debt becomes legally eligible for purchase by government-only funds ([15 U.S.C. 80a-2\(a\)\(16\)](#)). This wrapping thus expands the universe of eligible repo collateral for government MMFs, partially alleviating the downward pressure on rates causing government funds to turn away investors looking for safe, liquid stores of value. A DGP might thus allow policymakers to strike the proper balance between longer-term financial stability concerns (several have called for [new restrictions](#) on prime funds to avoid future public backstopping, if not their outright closure) and the availability of short-term credit via money market investors throughout the pandemic.

Maintaining banks' market-based funding will be particularly important if we see another financially volatile period like we saw in March and April. In this period, commercial and industrial (C&I) firms drew on their credit lines with banks for [at least several hundred billion dollars](#) (see also: [page 47 of the Fed's latest Financial Stability Report](#)). Foreign banks alone—those most dependent upon wholesale dollar liquidity—increased their C&I loan book by [about \\$150 billion](#) within a few weeks starting in March. The Fed, meanwhile, did not make any direct nonfinancial credit extensions until [the middle of April](#), and [to date](#), has had less than \$10 billion of such extensions outstanding.

Bank credit lines were able to provide “[instant liquidity](#)” to their customers—many of whom eventually paid them down with longer-term bond financing. While the Fed has begun intervening in the bond and commercial paper markets—which also may taper off before a volatility resurgence occurs, these are still a slower and less inclusive form of financing (and more [public](#)) than drawing on revolving credit. Banks [retaining access to liquidity](#) will be essential in the event of another set of rapid economic shutdowns and cancellations. Indeed, banks' relative nimbleness in extending credit—at least to existing customers—has been seen as an asset when designing other economic relief programs such as the [Paycheck Protection Program](#) and the [Main Street Lending Program](#) (see [Appendix C, p. 10](#)).

It remains a risk that absent a DGP, funding pressures on banks, which become funding pressures on firms, would be worse during a second round of volatility—potentially leading directly to financial firm failures or indirectly via commercial firm failures.

It is also worth noting the potential for a DGP to support the goals of other emergency measures already put in motion.

Capital Supporting Public and Private Bond Markets

Given that the DGP offers the U.S. Treasury’s full faith and credit to the bond issuances of financial institutions, banks can replace their outstanding funding with new AAA-rated term funding. This would have a number of important synergies with outstanding policies.

In addition to the aforementioned funding stability directly helping limit illiquidity-induced bank capital losses from a new round of flight from unguaranteed term funding of banks, this credit quality upgrade could [reasonably be expected](#) to increase the prices of legacy securities. This would reduce the incentive for investors to reallocate to underpriced legacy securities thereby starving new investments of capital—the avoidance of which is a [goal](#) of the Fed’s legacy-bond-buying Secondary Market Corporate Credit Facility (SMCCF), among other facilities. As per the ICE/BofA index, banking firms make up over 20% of the U.S. investment-grade bond market. The collateral upgrade (or, again, even just the announcement of the backstop thereof) and pursuant price appreciation, would also add capital to bond buyers and dealers and reduce their risk metrics—the levels of which both provide [limits](#) on their ability to support bond markets.

Indeed, the Fed has [justified](#) its vast scale of Treasury and mortgage-backed securities purchases and [its temporary exemptions](#) to the constraints of the Supplementary Leverage Ratio as necessary to reduce banks’ and dealers’ balance sheet constraints, so they can continue to intermediate financial markets. (Regulators have also [neutralized](#) the impact of certain [federal lending](#) programs on all regulatory capital ratios.)

As bank balance sheets expand, however, it will be important that bank solvency remains unimpeachable. A second round of stress tests may soon provide an update on banks’ status in that regard.

Stress Test Legitimacy

While the Fed recently completed [its annual Dodd-Frank Act stress test \(DFAST\) of bank capital levels](#), the stress scenarios were designed before the coronavirus pandemic and the tests executed were based on balance sheets from 12/31/19. Given the relative staleness of such data (bank balance sheets have grown [by approximately 12%](#) during the pandemic) and the fact that many economic indicators have already moved more adversely than the stress test’s severely adverse scenario, two extra tests were born.

First, the Fed released with the standard results [the results of a “sensitivity analysis”](#) in which the 33 banks subject to DFAST were also subjected to various coronavirus-related forward-looking scenarios: a “V-shaped” recovery, a more prolonged “U-shaped” recovery, and a “W-shaped” economic recovery in which the U.S. experiences a second wave of economic lockdowns associated with a virus resurgence.

Unlike the standard stress tests, however, the results of this analysis were not released on a by-bank basis, subjecting them to [criticism and skepticism on grounds of transparency and legitimacy](#)—not least because, in the W-shaped scenario, 25% of banks were shown to be nearly at or below their required regulatory minimum common equity tier 1 (CET1) capital ratio. How the banks' [other capital requirements \(p. 22\)](#) would be expected to evolve under the sensitivity analysis scenarios was also not disclosed.

The W-shaped scenario showed the bottom quartile of banks falling below 4.8% CET1 to risk-weighted assets; the minimum requirement is 4.5%. The 4.8% figure also does not include the effect of Q1 and Q2 capital distributions, which reduced aggregate capital by another 50 basis points; see [page 20](#) of the analysis.

Second, the Fed is designing a more robust pandemic scenario and, once released, will require banks to resubmit their capital plans within 45 days. The Fed's Vice Chair of Supervision Randal Quarles has [said](#) the Fed will only release bank-specific information following the incipient additional analysis if it can do so confidently—in other words, if it feels, unlike with June's sensitivity analysis, that the bank-specific data is granular and precise enough.

This may be especially important in the case of firm-specific capital actions; for instance, Wells Fargo booked its first loss since 2008 in Q2, while Morgan Stanley booked a record profit (and even [spoke of increasing capital distributions](#)). Fed officials may decide to issue firm-specific capital actions which, given the scale of the current crisis, may indeed encourage a reallocation by investors from relatively affected institutions in favor of the unaffected—a phenomenon that can be tempered by the presence of public guarantees. Or, in the case of a blanket dividend ban in which regulators also encourage raising fresh capital, the Fed may want to offset any [pursuant increase](#) in banks' cost of capital.

As alluded to, it is generally considered [best practice](#) in a crisis to avoid sparking a run on a relatively weak, but conditionally sound financial institution by releasing bank-specific data. During the GFC, however, the then-unprecedented transparency of the seminal stress tests [helped afford them legitimacy and public trust](#). This was made possible by the fact that the stress tests were backstopped by Troubled Asset Relief Program funds: if a firm was found to need to raise capital, but could not raise capital on the market, [over \\$100 billion \(see p. 270\)](#) of allocated and released TARP funds was left to recapitalize these firms—on [publicly-known terms \(see p. 272\)](#). No such funds exist today.

Thus, the Fed is in a [difficult situation if it wants to use the updated stress analysis to drive firm-specific capital actions](#). As noted, in a more severe scenario, a quarter of tested firms were already near or below CET1 regulatory minimums in the less-developed sensitivity analysis. Again, this is but one of the capital ratios banks must

meet. Given that, unlike in 2009, there is no public capital backstop proactively in place, firm-specific results of any new stress analysis may cause specific banks to experience renewed stress on market-based funding. In the event that public funds are needed to recapitalize these firms, but are not yet appropriated, a “liquidity event” may indeed occur in the interim. By extending its DGP approval before such an event, Congress could buy itself time to negotiate a recapitalization package if that becomes necessary.

As policymakers consider how to appropriately respond in a lasting way to the scale of the current crisis, provisioning for a robust DGP could provide them with the option of a valuable tool going forward.