Milbank

Financial Institutions Regulation Group

Client Alert

Downgraded: The Limited Scope of the Federal Reserve’s Corporate Credit Facilities

April 24, 2020

Contact

Douglas Landy, Partner
+1 212.530.5234
dlandy@milbank.com

James Kong, Associate
+1 212.530.5244
jkong@milbank.com

On April 9, 2020, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) issued revised term sheets for two facilities directed at providing liquidity to the corporate debt markets: the Primary Market Corporate Credit Facility (the “PMCCF”) and the Secondary Market Corporate Credit Facility (the “SMCCF” and together, the “Facilities”).[1]

Under the Facilities, the Federal Reserve Bank of New York (“FRBNY”) will lend on a recourse basis to a special purpose vehicle (“SPV”) which will purchase eligible newly-issued whole or pieces of bonds, or eligible secondary market bonds or exchange-traded funds (“ETFs”). The combined size of the Facilities will be up to $750 billion, and the Department of the Treasury (“Treasury”) will make a $75 billion equity investment into the SPV.[2]

The Facilities have garnered significant media attention in the month since they were initially unveiled by the Federal Reserve. When the Federal Reserve released initial term sheets on March 23, 2020, the Facilities were to be made available solely to investment grade corporate borrowers.[3] In the revised term sheets for the Facilities issued on April 9, the terms of Facilities had been expanded further to grant eligibility to so-called “fallen angels”: companies that, as discussed further below, had previously met investment grade ratings criteria, but had recently been downgraded. Again, the Federal Reserve’s moves drew widespread attention, and as noted in media reports, led to a rally in the corporate bond market.[4] However, further evidence suggests that the Facilities’ ratings criteria remain too narrow still, and should be broadened further to include a wider swath of companies to achieve their purposes.

Ratings Requirements for Eligible Issuers

There are a number of eligibility requirements in the term sheets for eligible issuers: for example, as is the case under other facilities established by the Federal Reserve, borrowers must be businesses created or organized in the United States, with significant operations in, and a majority of its operations based in, the United States. Of particular importance with respect to the Facilities, however, is the eligible issuer rating requirement, which is identical for both the PMCCF and SMCCF:

[1] *See* https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a5.pdf and https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a2.pdf.

[2] While the term sheets do not confirm this, the Treasury investment in the SPV will likely constitute a “first loss” equity investment.

[3] *See* https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm. This announcement represented a significant and unprecedented step: direct credit support by the Federal Reserve to large U.S. companies. https://www.wsj.com/articles/federal-reserve-announces-major-expansion-of-market-supports-11584964844.

[4] *See, e.g.*, https://www.wsj.com/articles/fed-moves-spark-corporate-bond-rally-11586454394.

> "The issuer was rated at least BBB-/Baa3 as of March 22, 2020, by a major nationally recognized statistical rating organization ("NRSRO"). If rated by multiple NRSROs, the issuer must be rated at least BBB-/Baa3 by two or more NRSROs as of March 22, 2020.
>
> a. Issuers that were rated at least BBB-/Baa3 as of March 22, 2020, but are subsequently downgraded, must be rated at least BB-/Ba3 by two or more NRSROs at the time the Facility makes a purchase.
>
> b. In every case, issuer ratings are subject to review by the Federal Reserve."

The PMCCF term sheet also states that "Issuers may additionally approach the [PMCCF] at any time to issue additional debt, provided that their rating is reaffirmed at BB-/Ba3 or above with the additional debt by each major NRSRO with a rating of the issuer."

Limitations on Which Eligible Issuers Qualify

We understand that the Federal Reserve was trying to thread the needle in establishing the ratings criteria above. On the one hand, they would like to use the Facilities primarily to buy high-grade corporate debt: this is reflected in the leverage assigned by the Facilities to each kind of debt. The PMCCF states that it will "leverage the Treasury equity at 10 to 1 when acquiring corporate bonds or syndicated loans from issuers that are investment grade at the time of the purchase. The Facility will leverage its equity at 7 to 1 when acquiring any other type of eligible asset."[5]

The SMCCF states that it will "leverage the Treasury equity at 10 to 1 when acquiring corporate bonds from issuers that are investment grade at the time of purchase and when acquiring ETFs whose primary investment objective is exposure to U.S. investment-grade corporate bonds. The Facility will leverage its equity at 7 to 1 when acquiring corporate bonds from issuers that are rated below investment grade at the time of purchase and in a range between 3 to 1 and 7 to 1, depending on risk, when acquiring any other type of eligible asset."[6]

The allowance for recently downgraded issuers reflects the reality that economic activity has lessened throughout the economy and the financial capacity of many issuers has been affected. At the same time, however, the still limited criteria may reflect the requirement of Section 13(3) of the Federal Reserve Act ("Section 13(3)") that the Federal Reserve be "otherwise secured to the satisfaction of the [FRBNY]" and that the security for emergency loans is sufficient to protect taxpayers from losses,"[7] terms that appear to limit the credit risk that the Federal Reserve may accept as part of lending programs authorized pursuant to that provision.

Regardless, the stated purpose of the Facilities is to "serve as a funding backstop for corporate debt issued by eligible issuers," and to "[i]ncrease the flow of credit to … businesses through the capital markets."[8] The size of the Facilities, at $750 billion, is among the largest lending program ever attempted by the Federal Reserve. To accomplish these goals, the Facilities must reach a broad-based group of corporate debt issuers.[9] According to one prominent finance reporter, however, the ratings requirements described above would limit access to the Facilities to no more than a handful of issuers,[10] likely the result of a number of downgrades that occurred prior to the trigger date of March 22, 2020. While these limits will be mitigated in part by the SMCCF's ability to purchase high-yield ETFs, which will include a broad-

[5] *See* PMCCF term sheet, at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a5.pdf. *See also Frequently Asked Questions: Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility,* Federal Reserve Bank of New York, at https://www.newyorkfed.org/markets/primary-and-secondary-market-faq/corporate-credit-facility-faq.

[6] *See* SMCCF term sheet, at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a2.pdf.

[7] *See* https://www.federalreserve.gov/aboutthefed/section13.htm.

[8] *See* https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm.

[9] In fact, Section 13(3) requires that a facility designed under its authority have "broad-based eligibility." https://www.govinfo.gov/content/pkg/FR-2014-01-06/pdf/2013-31025.pdf. If the Facilities only apply to a handful of corporate debt issuers, this requirement may not be met.

[10] https://www.yahoo.com/author/brian-cheung/.

based group of corporate bonds, the ratings criteria likely do not go far enough in allowing the $750 billion available under the Facilities to reach the companies for which they were designed.[11]

Conclusion

We recognize that the Federal Reserve wishes to direct the majority of purchases from the Facilities towards investment grade corporate debt. In order to better support the economy and fulfill the stated intention of the Facilities, however, the Federal Reserve may need to further backdate the ratings downgrade trigger to late February, before the effects of the COVID-19 pandemic had made their way into the corporate debt markets.

[11] We note also that both Facilities contain a limitation on the total amount of the debt of any one issuer the Facilities may purchase, a limitation that includes ETFs containing that issuer's debt.

New York	55 Hudson Yards, New York, NY 10001	
Wayne M. Aaron	waaron@milbank.com	+1 212.530.5284
Douglas Landy	dlandy@milbank.com	+1 212.530.5234
James Kong	jkong@milbank.com	+1 212.530.5244

Financial Institutions Regulation Group

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any member of our Financial Institutions Regulation Group.

This Client Alert is a source of general information for clients and friends of Milbank LLP. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel.

© 2020 Milbank LLP

All rights reserved. Attorney Advertising. Prior results do not guarantee a similar outcome.