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Lombard Street and Pandemics

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The Fed's liquidity injections appear not to be working.

All segments of funding markets – secured, unsecured and FX swaps – continue to show growing signs of stress. The Fed may have to do more still.

In the U.S., we watched, but didn't feel the funding impact of large banks in other countries being asked to help their economies. Now that U.S. banks are asked to do the same, dollar funding markets are starting to feel the impact.

As U.S. banks increase their lending to the real economy as corporations draw on credit lines and banks lend more to households and firms, lending will consume more balance sheet and risk capital, and that will leave less room for market making and arbitrage, which under current circumstances are "luxury".

The breakdown of o/n repo markets yesterday tell us that balance sheet is now getting scarce to conduct even the most basic type of market making.

As banks are pulling back from market making, the Fed and other central banks need to assume the role of dealer of last resort...

The Fed needs to become a buyer of CDs and CP, but <u>not</u> through the CPFF.

The Fed needs to offer dollars on a daily frequency through the swap lines, and other central banks need to lend dollars on to both banks and non-banks.

The Fed needs to broaden access to the swap lines to other jurisdictions as dollar funding needs are large in Scandinavia, Southeast Asia, Australia and South America, not just in the G-7. The dollar funding needs of both banks and non-banks is what's at risk and the assets that are being funded are U.S. assets – Treasuries, MBS and credit – so the Fed has a vested interest.

A hallmark theme of the post-QE global financial order has been the secular growth of FX hedged fixed income and credit portfolios at non-bank institutions like life insurers and asset managers from negative interest rate jurisdictions – the new shadow banking system, epitomized by money market funding (FX swaps) of capital market lending (Treasuries and the full credit spectrum).

Carry makes the world go round and as banks do more for the economy central banks will have to backstop the shadow banking system – yet again…

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The Fed's liquidity response may not trickle down to every corner of the financial system.

The liquidity response doesn't address the functioning of unsecured funding markets, and the effectiveness of the FX swap lines may be limited by its operational details and reach.

It feels like the Fed needs to do more still.

We are concerned about four areas: liquidity in the CD and CP markets; the frequency with which the Fed plans to do swap line operations and the FX points where it's active; and the funding needs of institutions and regions that aren't embraced by the swap lines.

First, the initial shock to the CD and CP markets came from the equity market collapse and the flows it triggered whereby cash started to flood back from securities lenders' cash collateral reinvestment accounts to short sellers' accounts. Given that seclenders invest cash in the CD and CP markets and short sellers invest mostly in Treasury bills, these flows turned seclenders into net sellers of CD and CP, precisely when issuance from corporations and banks is picking up. Outflows from prime money funds have been small to date, but given ongoing stresses in funding markets and heightened risk aversion, prime funds could see more outflows this week as investors take refuge in the safety of government money funds. Such a rotation would further hurt demand for CD and CP this week and will continue to pressure funding spreads including U.S. dollar Libor-OIS.

It isn't reasonable to expect real money accounts – reserve managers and bond funds – to substitute demand from seclenders and prime money funds as reserve managers are raising dollar liquidity themselves to help banks in their jurisdictions and bond funds have better yielding opportunities to harvest elsewhere if they are not struggling with outflows.

We do not think that the right solution here is re-activating the CPFF. The legal aspects of onboarding issuers takes time and liquidity can kill you quick. Our recommendation would be for the Fed to come to an agreement with the U.S. Treasury whereby the latter provides a "first-loss buffer" on any financial or non-financial CP the New York Fed buys in the primary or secondary market. The first loss buffer would ensure that the Treasury takes the credit risk and the Fed only takes the liquidity risk such that the Fed feels "secured to its satisfaction" – which is what the Fed cares about most in a crisis situation.

The money to fund such a first loss buffer is already in the system – it's sitting in the Treasury General Account. Putting up $50 billion of the $400 billion sitting idly at the Fed would provide sufficient comfort for the Fed and near immediate support for the market – the Bank of Japan and the Bank of Canada already buy CP in their domestic jurisdictions.

This template could then be extended to corporate bond purchases by adding more buffer and as President Dudley would say "going out the curve and down the credit spectrum".

Second, the swap lines are now active but it feels like the operational aspects of it need to be fine-tuned. Currently dollars are being offered weekly, but the FX swap market trades like they should be offered daily, and not only at weekly and three three-month maturities but at ultra-short tenors as well, similar to how the Fed lends in the repo market.

Third, the swap lines are open only for banks and that is a fault line in the system.

The swap lines were originally designed to help the funding needs of banks during 2008; they work by the Fed lending dollars to other central banks which then lend it to banks.

But since the financial crisis, non-banks eclipsed banks as the biggest borrowers in the FX swap market: a hallmark theme of the post-QE global financial order has been the secular growth of FX hedged fixed income and credit portfolios at non-bank institutions like life insurers and asset managers – the new shadow banking system epitomized by money market funding (FX swaps) of capital market lending (Treasuries and credit).

Unless these non-bank entities get access to dollar auctions – from local central banks – FX swap spreads may remain wide if banks won't serve as matched-book intermediaries.

There is a growing risk that such intermediation will fracture as the assets that FX swaps fund include not only Treasuries but credit and CLOs too. Credit quality is fast deteriorating across various sectors and that makes it riskier for dealers to fund some life insurers through FX swaps, just like it became riskier to fund some insurers during the 2008 crisis.

Over the past five years balance sheet and the availability of reserves were the main drivers of spreads in the FX swap market. It's time to think about credit risk creeping in to funding markets through the asset side of some portfolios funded through FX swaps.

Fourth, the geographic reach of the swap lines is too narrow.

The Fed has swap lines only with the BoC, the BoE, the BoJ, the ECB and the SNB, and that's because the 2008 crisis hit banks mostly in these particular jurisdictions.

But the breadth of the current crisis is wider as every country is struggling to get dollars. The dollar needs of Sweden, Norway, Denmark, Hong Kong, Singapore, South Korea, Taiwan, Australia and Brazil and Mexico seem particularly striking for a variety of reasons.

Scandinavia countries, like Japan have large dollar needs due to institutional investors' hedging needs and only Norway is endowed with large FX reserves to tap into. Mexico is dealing with a terms of trade shock due to the collapse of oil prices. Southeast Asian countries that serve as banking centers need U.S. dollars to clear dollar payments and countries like South Korea and Taiwan have life insurers with meaningful hedging needs.

The Fed's dollar swap lines need to go global, the hierarchy needs to flatten.

The message for central banks that emerges from this brief note is this:

backstop not only the banks at the core of the financial system, but also markets and non-banks. The market backstops should include the CD and CP market where we need a buyer of last resort as the structural buyers of paper are losing cash fast; the backstop of the FX swap market should include daily operations at more points along the FX curve.

Like primary dealers offer round the clock liquidity across timezones, dealers of last resort – the central banks of the swap network – should offer dollar liquidity round the clock too.

Finally, like primary dealers, who trade with anyone with an ISDA, dealers of last resort should too: the Fed by broadening access to other central banks and other central banks by broadening access to dollar auctions to non-banks like life insurers and asset managers.

Demand on bank balance sheets will increase from here to provide credit locally for the real economy – that will consume balance sheet and risk capital and will naturally leave less room for market making and arbitrage, which under current circumstances are luxury.

While it's too much to ask central banks to lend to the real economy, it's not too much to ask them to become more active in making markets as banks free up balance sheet for lending more to the real economy. The breakdown of o/n repo markets today tell us that balance sheet is now scarce to conduct even the most basic type of market making.

Charts showing Target2 balances became known as the visual representation of the ECB clearing payment imbalances between northern Europe and southern Europe through the balance sheet of local central banks within the eurozone. Now it's time for the Fed to do the same globally with other central banks and for those central banks to lend broadly – after all what is at stake here is the funding of U.S. assets: Treasuries, MBS and credit.

In the U.S., we watched, but did not feel the funding impact of banks in other countries being asked to help their economies. Now that U.S. banks are asked to help the economy, dollar funding markets are starting to feel the impact. When the U.S. sneezes…

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