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The CARES Act Zero-Sum Game: Intense Competition for Treasury's \$454 Billion

The CARES Act appropriated \$454 billion to the Treasury Department to be used in capitalizing Federal Reserve lending facilities. While that may sound like a lot of money, there is already intense competition for it among different credit and liquidity needs in the economy that will be addressed through various Federal Reserve programs. Unless and until Congress appropriates more money, this is a zero-sum game: a dollar spent for one program is a dollar less for all other programs.

Beyond finding the optimal resource allocation, the other critical driver in this process is the leverage the Federal Reserve is willing to supply against every Treasury dollar from the \$454 billion fund. If a Federal Reserve program extends credit only to investment grade companies or against investment grade collateral, the Federal Reserve will supply about \$10 to every one Treasury dollar, or a 10:1 leverage ratio, according to historical models, because the risk of credit loss is low. But that kind of credit eligibility test would exclude most American businesses, likely to the great frustration of the political branches of government. In contrast, if the lending program were to extend loans to lower-credit businesses, including the thousands of unrated businesses in America, the Federal Reserve might chip in only \$3 to every one Treasury dollar (3:1 leverage ratio), which would yield a much smaller overall lending fund.

Here are the most urgent needs for the \$454 billion:

1. Fixing the Financial "Plumbing" of the Economy. The availability of consumer credit, student and auto loans, real estate mortgage and business loans is entirely a function of secondary financial markets. Direct lenders to consumers and the Main Street economy get liquidity to make more loans only by selling off their prior loans to investors through securitization. Insurance companies, pension funds and other institutional investors buy slices of these pooled loan agreements that are considered "investment grade," i.e., highly rated by credit rating agencies. The problem is that the vast majority of these assets are presently illiquid. Many of these assets were purchased using repo financing from a bank; banks are foreclosing on the assets (their collateral) as values plummet and are selling them at fire sale prices. **The Need:** Using a 10:1 leverage ratio, tens of billions of dollars are needed to broaden and deepen the Federal Reserve's Term ABS Lending Facility to include all investment grade and similarly rated collateral to restore financial sanity to the secondary markets.
2. Making Loans to Businesses. Most American businesses have little to no revenue right now. They will have revenue again—hopefully soon—but in the interim, they need a loan to bridge past this financial crisis. As described above, the amount of money the Federal Reserve makes available to businesses will be almost entirely

a function of the “credit box,” i.e., the eligibility rules for one or more large lending facilities. **The Need:** The majority of the money will go to fulfilling this need. The Federal Reserve should establish as broad a credit box as possible to allow a maximum number of businesses to subscribe for government support, even if the resulting leverage ratio (and corresponding Federal Reserve contribution of funds) is low. Congress has begun work on a fourth economic recovery package; more money for Treasury to further capitalize this and other funds should be a centerpiece of that legislation. Leverage ratios could range wildly based on the credit box, but will likely not exceed 10:1.

3. **Commercial Paper Financing.** Thousands of American businesses use commercial paper—short-term, unsecured promises to repay—to finance their operations. This is especially true for energy, utility and other companies that are extremely capital intensive. Because of its short term, commercial paper is understood as a means for obtaining liquidity, not credit. The commercial paper markets effectively froze a few weeks ago. The Federal Reserve has established a Commercial Paper Funding Facility (CPFF) as a source of liquidity, but it is currently open only to the highest-rated issuers (with a one-time drawing right offered to issuers who have been downgraded to the crisis). **The Need:** Billions of dollars more are needed to capitalize a broader and deeper CPFF that accommodates commercial paper issued by “Tier 2” companies and those with split ratings, which includes many utilities that provide critical infrastructure to the economy. Currently, the CPFF is taking Tier 2 risk on a one-time basis and still using a 10:1 leverage ratio, so no change to that formula should be necessary.
4. **Municipal Bond Markets.** Numerous states and municipalities have bond issuances that were put on hold when economic conditions changed a few weeks ago. These bond issuances finance critical community needs like fixing roads and building schools. These “pipeline” issuances need a market. Congress made the \$454 billion available to the Federal Reserve to establish programs that facilitate lending to state and local governments. **The Need:** The Federal Reserve will be under pressure to create a special fund, or include in a larger all-purpose fund, to create significant demand for municipal obligations to help states and localities meet the basic needs of government operations. As most municipal obligations are backed by first priority tax liens, a leverage ratio of 10:1 or higher for Federal Reserve contribution should be ascribed to these assets.

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