Will the Bank of England's commercial paper facility work, and how?

The Bank of England and HM Treasury launched the Covid Corporate Funding Facility (CCFF) last month to restore the functioning of the Sterling Commercial Paper (CP) market. The facility has the potential to shore up the CP market but access to lower or unrated companies remains a challenge

Source: Shutterstock

Main characteristics

The CCFF is buying 1 week to 12 month commercial paper from investment-grade (A-3/P-3 and above) non-financial issuers in the primary and secondary markets. The purchases will be financed by the Bank of England creating bank reserves (the same way quantitative easing is financed) while HM Treasury is the ultimate risk owner of the facility.

The purchase levels and amount eligible depend on the rating of the issuer and are summarised in the table below. This table is merely indicative and additional factors will be taken into account in setting lending limits, such as the issuers' revenue.

Indicative purchase level and limits

Issuer Rating	Purchase spread to OIS	Initial issuer limit
A1/P1/F1/R1	20 bps	Up to £1bn
A2/P2/F2/R2	40 bps	Up to £600m
A3/P3/F3/R3	60 bps	Up to £300m

Source: BOE, ING

The stated aim is to provide large firms with financing to bridge the disruptions created by the coronavirus pandemic and associated confinement measures. We would add to this that its aim is also to palliate dysfunctional money markets caught by surprise by the severity of the economic shock. The Bank of England published a Q&A with operational details of how to access the facility. The Association of Corporate Treasury has also published a slide pack with practical information.

How big can it be?

In our mind, the facility can be successful in two ways. In an ideal world, the mere announcement of a BoE-funded backstop to CP markets should be enough to restore confidence and normal functioning. This would be sufficient if the crisis were endogenous to the CP market, but we suspect the withdrawal of some investors was related to concerns about the underlying credit quality of the issuers, with outflows in the case of money managers, and with possible increases in issuer exposure from other factors (eg revolver credit facilities being drawn).

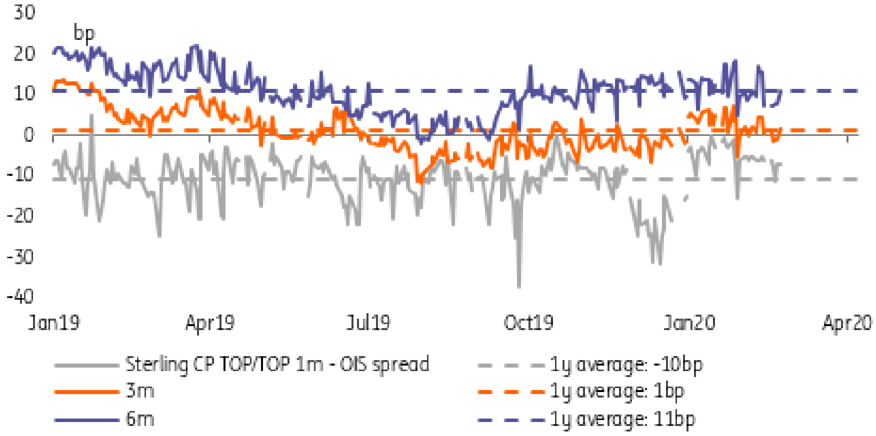
We hardly have any public real-time data on the amount of transactions that occurred in recent weeks, but we suspect CP volumes have plunged and failed to recover since the facility came on line in late March. One clue is that the top/top sterling CP index has not published values since late February. This index relates to top-rated issuers, the ones least likely to lose market access.

This leads us to the second way this programme can be successful: replacing the buyers that have fled the market altogether. The table above shows the maximum theoretical lending to each counterparty. Here too, the lack of data requires us to make assumptions about the number of beneficiaries. As a guide there are 90 issuers in the Bloomberg Barclays sterling corporate bond index that have currently more than one issue included in the index. Using their composite rating to estimate their maximum borrowing, we arrive at £54 billion. This compares with £1.9 billion lent so far via the facility. There are plenty of reasons why this estimate could prove wrong, most notably if companies that are not bond issuers decide to tap the CP market, but we think it provides a useful ballpark.

How much of an impact can it have?

Provided other investors return to the CP market alongside the BoE, CP rates should coalesce around the central bank's purchase levels. Judging from the 1m, 3m, and 6m TOP/TOP commercial paper level prevailing over the past year, the 20 basis point purchase spread over OIS for A-1 rated issuers is generous for long maturities and conservative for shorter ones. This should contribute to skewering issuance towards the longer tenors, in our view.

1m, 3m, and 6m top-rated CP-OIS spread in the past year

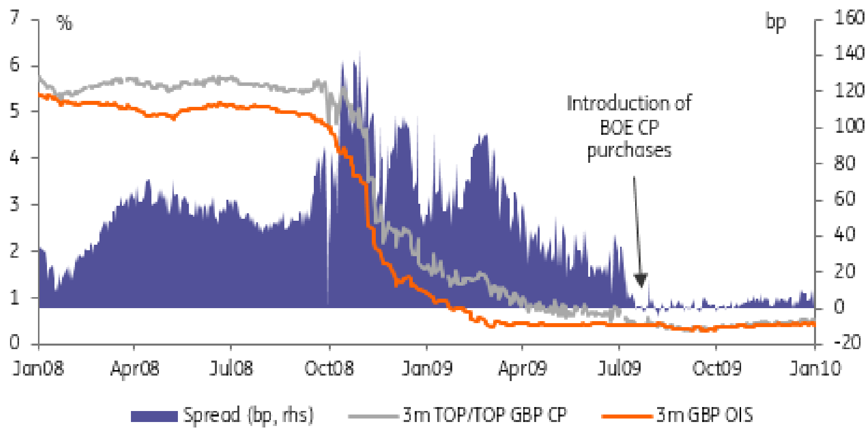


Source: Bloomberg, ING

Taking a few steps back, highly rated 3m CP have traded 43bp above to OIS on average in 2008-09 with peaks well above 100bp in 2008. Much has changed since then but in comparison, the BoE target levels seem designed to stem any aggressive widening of CP spreads, and therefore an increase in corporate funding costs. We would assume that £1bn hardly covers the cash needs of large corporations with a significant loss in revenue and in CP market access, however.

The historical precedent of the 2009 BoE CP purchases is interesting. At the time, holdings of CP peaked at £2.3bn and yet this coincided with a sharp tightening of CP spreads. Clearly, the BoE intervention had a strong signalling impact beyond the mere purchases it carried out, although they took place in 3Q 2009, when the worst of the financial stress was already over.

2009 CP purchases: a little too late



Source: Bloomberg, ING

International comparison

Anther way to judge the parameters of the BoE CCFF is by comparing it to similar facilities put in place in other jurisdictions. The Federal Reserve's CPFF is the most relevant reference point in our view (not just due to the similarity of the acronym).

CPFF's purchase spreads of 100bp and 200bp over OIS for 3m CP appear a lot less generous than the BoE's. The UK programme also appears operationally more flexible as it will purchase CP across maturities whilst its US counterpart will focus only on the 3m tenor.

Another difference is on the limit of the programmes. Both have theoretically unlimited purchasing power but in the Fed's case, the aim is to cap purchases to the amount of CP issuers had outstanding prior to the coronavirus crisis. In the BoE's case, the limits clearly invite firms that were not necessarily participating in this market to use this facility.

Practical considerations and the future of CCFF

In conclusion, we think that the facility is a useful tool in the UK's policy arsenal but could benefit from improvements. Pricing and operational flexibility are two strong points. The wording of the announcement makes it clear that there should be no stigma attached to using it and that it could be considered a first line of defence for large corporates. We also assume that by its nature - short term loans - its use will not attract the same degree of public scrutiny as a bailout or direct government support.

Its exposure limit makes it more challenging for it to have an impact beyond top rated issuers, however. Clearly, lower-rated companies would benefit from greater purchases, but the limits suggest a reluctance to take on credit risk. We would also flag that, unlike other central banks, the BoE is already accepting A-3 rated CP.

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