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Contingency Planning (2)

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 3, 1970.

To Chairman Burns

From Peter M. Keir

Subject: Effects of a possible default by a major corporation on its maturing commercial paper.

~~Probably of no interest unless~~ ~~the~~ Limited interest if any.

Among the numerous uncertainties recently troubling members of the U.S. financial community has been the question whether intensified strains on corporate profits and liquidity have seriously increased the odds that some major industrial firm or finance company will find it impossible to roll-over a significant block of outstanding commercial paper at maturity. A situation of this type could develop if doubts about the underlying liquidity and solvency of a particular corporation led investors to shun new offerings of its commercial paper. If, at the same time, the firm's maturing commercial paper were not fully backed by bank credit lines, if the firm had already exhausted its own liquidity reserves, and if no other new source of credit were immediately available, the corporation could be forced abruptly into receivership. Apprehension in market circles about the possible repercussions of such a default has been heightened because the rapid expansion of outstanding commercial paper over the past two years -- both in total volume and number of issuers -- has raised questions about the general vulnerability of the commercial paper market to any sudden cooling of investor interest.

This memorandum considers the range of effects that might be expected to follow from the default of a firm on a significant block of its maturing commercial paper. Two types of effects need to be differentiated: one is the general impact that might develop on attitudes and confidence throughout financial markets if a major firm went into receivership; the other

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is the more direct impact on the commercial paper market itself, on closely related short-term credit markets, and on the banking system. Finally, an important related question is what public policy actions might be taken to minimize the severity of the second category of efforts.

General Impact on Market Confidence

The possible effects of a major corporate bankruptcy on financial confidence are difficult to forecast since they involve a judgement about human psychology. If the firm in question were widely known to be a "swinger"--for example, a "wheeler-dealer" conglomerate--its default would be less likely to generate major secondary repercussions, than the unexpected default of a major corporation which the public had generally assumed to be sound--particularly if the latter were in an industry where no major bankruptcies had occurred since the 1930's. In addition, regardless of the type of firm involved, the response would obviously be much more sensitive to a default that occurred in a period when financial confidence was already under more strain--due for example to persistently declining stock prices and general fears of a liquidity crisis--than it would be when general confidence was less fragile.

Most recently, the relative fragility of securities markets does appear to have lessened somewhat, and members of the financial community do seem to be generally aware that several particular industrial firms are possible candidates for default. However, there is no guarantee that markets will continue to become less fragile, and it is difficult to determine what odds market participants are actually placing on the near-term possibility of a major corporate bankruptcy.

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Impact on Short-Term Credit Markets

The key concern of those associated directly with the commercial paper market is that any default by a major corporate issuer may trigger an abrupt investor reappraisal of the quality of such paper, with a consequent sharp shrinkage in demand. Investors have typically been attracted to commercial paper by its high yield, flexible amounts and maturities, and the high credit ratings of most issuers. In addition, the traditional back-up with bank credit lines has provided an extra assurance of liquidity.

Given this general investor presumption of soundness and liquidity, any development that seemed to cast doubt on the underlying quality of commercial paper could trigger a substantial switch to other short-term investment alternatives. Non-financial corporations are estimated to hold around 70 per cent of outstanding commercial paper, the bulk of the remaining shares being held by life insurance companies, pension and trust funds, colleges and other non-profit institutions taken together. Institutions of these types usually elect to invest their liquidity reserves at high yields only so long as the assets also have a low risk. Consequently, if any real question were to develop regarding the degree of risk involved, they would probably very quickly decide to accept a lower yield on an asset where the degree of risk was not in doubt.

The cut-back in demand for commercial paper occasioned by the changed investor view of underlying quality would, of course, tend to focus on the paper of issuers about which there might already be some question, as well as on that of smaller less well-known issuers. But in any general backing away from commercial paper, investors might easily overreact

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and begin to shun the paper of even well-known issuers as well. In these circumstances, firms that were unable to roll over commercial paper at maturity would be forced to turn to their bank credit lines. To the extent an issuer's paper was not fully covered by firm bank lines, it would have to solicit new bank loans. In situations where regular bank lenders were under severe pressure or there was question about the underlying soundness of the commercial paper issuer, bank funds might not be available and this could trigger further bankruptcies.

Any substantial shrinkage in outstanding commercial paper would thus create a sharp increase in demands for bank credit. The banks directly affected would be forced to bid more aggressively for funds themselves, or to sell other assets. Assuming no change in overall monetary policy, the extent to which the expanded demands for bank credit were also reflected in added general pressures on short-term credit markets would depend in part on how the funds that investors had been holding in commercial paper were reallocated to alternative assets.

To some extent investors might shift from the commercial paper of industrial corporations and finance companies, directly to new commercial paper issued by the banks under pressure. But if bank paper were also viewed less favorably by investors, the switch would more likely be to U.S. Government and Federal agency securities. Even so, larger flows of funds into Treasury and agency issues might reduce yields in these markets sufficiently to make large negotiable CD's at banks -- even at their existing ceiling rates -- more competitive with alternative money market instruments. Freeing up of the CD flow to banks could obviously help considerably to

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minimize the pressure from expanded calls of commercial paper issues on their bank lines.

The degree friction and illiquidity likely to develop, in fact, from a sizeable transfer of credit demands from commercial paper to commercial banks would depend in large measure on how large and how rapid the shrinkage in commercial paper proved to be. The experience with large negotiable CD's over the past few years suggests that U.S. financial markets generally have the capacity to adjust fairly effectively to large-scale redistributions of fund flows. Whether another large adjustment would be absorbed as smoothly in the near-term, given the generally fragile state of securities markets in recent weeks, is, of course, one of the key points at issue.

Unfortunately, there is no very recent U. S. example of a shrinkage in outstanding commercial paper to look to for guidance in judging how large a shrinkage might develop in present circumstances. For this reason, many market analysts tend to look to the Canadian experience of 1965, following the demise of the Atlantic Acceptance Corporation, as a possible model. At the end of 1964, the total volume of Canadian finance and commercial paper outstanding was approximately $1.3 billion. By the end of 1965, following the Atlantic Acceptance failure, outstanding finance and commercial paper in Canada had declined by around $400 million or nearly one third. The lions share of the shrinkage represented a drop in paper held by non-Canadian investors. The magnitude of this decline was clearly exacerbated by the reaction of foreign investors, a situstion that is fairly typical in Canadian financial markets which are particularly sensitive to foreign exchange developments and the reactions of foreign investors, principally U.S. investors.

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Dimensions of U.S. Commercial Paper Market

As the table suggests, the U.S. commercial paper market is vastly larger than the Canadian market, but like the Canadian market before the Atlantic Acceptance Corporation default, the U.S. market has grown very rapidly over the past year, even if one abstracts from the entry of commercial banks.

Total Commercial and Finance Paper Outstanding in the United States
(in millions of $'s; not seasonally adjusted)

	April 1970	April 1969	Change	
			Per cent	Amount
Total outstanding paper	37,881	24,390	55.3	13,491
Amount placed through dealers	13,735	10,076	36.3	3,659
Amount placed directly	24,146p/	14,314	68.7	9,832
Total of bank-related paper included above in the total	6,542	200		

p/ Preliminary.

Number of Commercial Paper Issuers

	1967	1968	1969 (November)
Number	391	475e/	630e/
Percentage		21.5	32.6

e/ Estimated.

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If the U. S. market were to react as sharply to a major near-term default as the Canadian market in 1965, the commensurate shrinkage in outstanding paper would amount to about $11 billion. This is undoubtedly an extreme comparison, given the generally more volatile character of the Canadian market and the observed sensitivity of U. S. investors to unfavorable foreign developments when they are investing in foreign markets. Nevertheless, the Canadian experience does suggest that a shrinkage of several billion dollars in outstanding U. S. commercial paper would be a distinct possibility if the default of a major U. S. corporation were to result in a failure to roll-over a large block of maturing paper.

Frictions created by a shrinkage in outstanding U. S. commercial paper totaling several billion dollars would, of course, tend to be less troublesome if paper that was not rolled over was for the most part fully covered by bank credit lines. A number of the major finance companies that place their paper directly with investors have substantially less then full coverage of their outstandings -- in some cases less then 50 per cent. Similarly, some major industrial corporations that place paper through dealers are not fully covered by bank lines, although their coverage is higher then in the case of the direct placers. However, small firms, and firms with lower credit ratings have almost invarially been required to maintain bank lines at close to 100 per cent of their outstandings.

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Conclusions

On balance, so long as the shrinkage in outstanding paper is limited to several billion dollars, spread over about the same time period as the Atlantic Acceptance experience, U. S. financial institutions can probably respond sufficiently well to the redistribution of funds involved to avoid a serious crisis. The Federal Reserve could help facilitate this result by providing liberal discounting at the Federal Reserve window. This could include conduit loan arrangements to banks that were called upon to lend to commercial paper issuers unable to roll over maturing issues and without full coverage by credit lines, but which nevertheless were good credit ratings.

On the broader question whether a major corporate default would seriously weaken the general confidence of financial markets, the answer is more difficult. But this effect could prove to be even more important than the direct impact on the commercial paper market.

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