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# Commercial Paper Demystified

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April 2019 | Kevin Berents, Head of Credit Research

The commercial paper (CP) market has evolved over the last century, originating as a short-term funding mechanism for large, non-financial corporations and developing into a systemically important financing segment of the global economy. CP has provided a way for issuers to smooth current account cash flows such as operating expenses, inventories, and receivables. In its early history, CP was a high denomination market only accessible to large issuers and investors. The CP market's first significant growth spurt happened in the 1970s, driven by demand with the advent of the money market mutual fund ( MMMF). As the MMMF industry grew, smaller investors gained a way to access the CP market. MMMFs are both large and sophisticated enough to efficiently trade in the CP market and, in turn, they sell shares to retail investors thus increasing CP trading volume.

The next significant growth spurt in the CP market came in the 1980s, particularly with the creation of asset-backed commercial paper (ABCP), a type of commercial paper backed by receivables primarily from loans like credit cards or auto loans. In 2001, the ABCP market volume was just over \$600 billion, representing 38% of the total CP market. By August of 2007, the total CP market volume peaked at just under \$2.2 trillion, and the ABCP market made up an enormous 56% of that market or \$1.2 trillion. As a testament to the CP market's growth, by the time the global financial crisis escalated in 2007-08, the systemically important nature of this market forced the Federal Reserve and the U.S. Treasury to step in and take action to restore investor confidence and mitigate the risk of a refunding disruption.

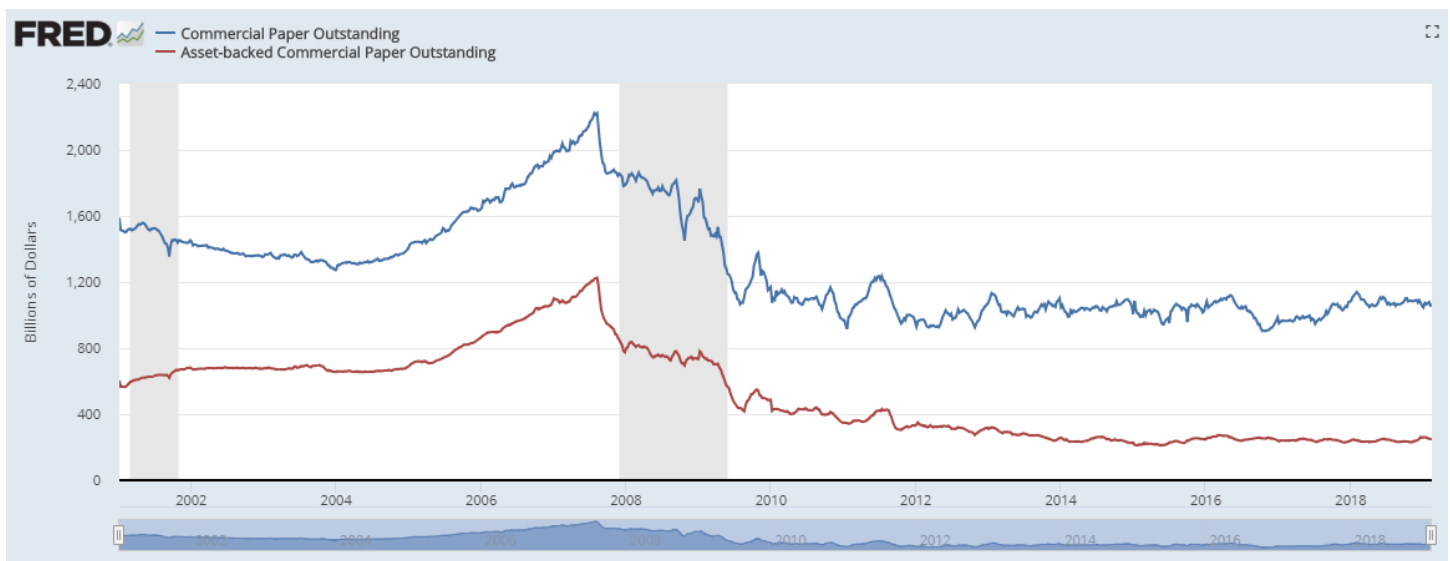
Often, CP issuers pay off maturing paper through the issuance of new paper; this is known as "rolling over" the debt. During the 2007-08 crisis, there was a concern that issuers would not be able to rollover their commercial paper. By supplying liquidity to the commercial paper market, the government ensured that financially solvent CP issuers would not face a cash crunch when attempting to rollover debt. Serious disruption or failure of this critical funding source had the potential to exacerbate the economic crisis in a dramatic way. By all accounts, America was witnessing the beginning of its worst economic environment since the Great Depression. This defensive measure employed by the Treasury and Fed was implemented not to remove default risk but rather to keep the markets functioning normally.

## Asset-Backed Commercial Paper Market Size

CP is exempt from Securities and Exchange Commission (SEC) registration. To be exempt from SEC registration, the proceeds from the sale of CP must be used to fund current transactions. The average maturity on CP is 30 days but can be issued with a maturity of up to 270 days. This market has provided a short-term funding mechanism for both financial and non-financial companies at a lower cost than bank loans. Generally, CP is classified into

three broad categories: non-financial, financial, and asset-backed. The sheer breadth of this market illustrates its importance to our economy. Whether the CP is placed through a dealer or placed directly by the CP issuer, it provides a lower cost, short-term, unsecured (excluding asset-backed) source of credit for large corporations, large industrial firms, public utilities, financial institutions, and consumer finance corporations.

The ABCP market is decidedly smaller than its August 2007 peak, when ABCP represented more than half of the \$2.2 trillion CP market at large. In the wake of the 2007-08 global financial crisis, the CP market is collectively smaller at approximately \$1.06 trillion with ABCP outstandings at \$246.7 billion as of February 2019 as illustrated in the chart below.



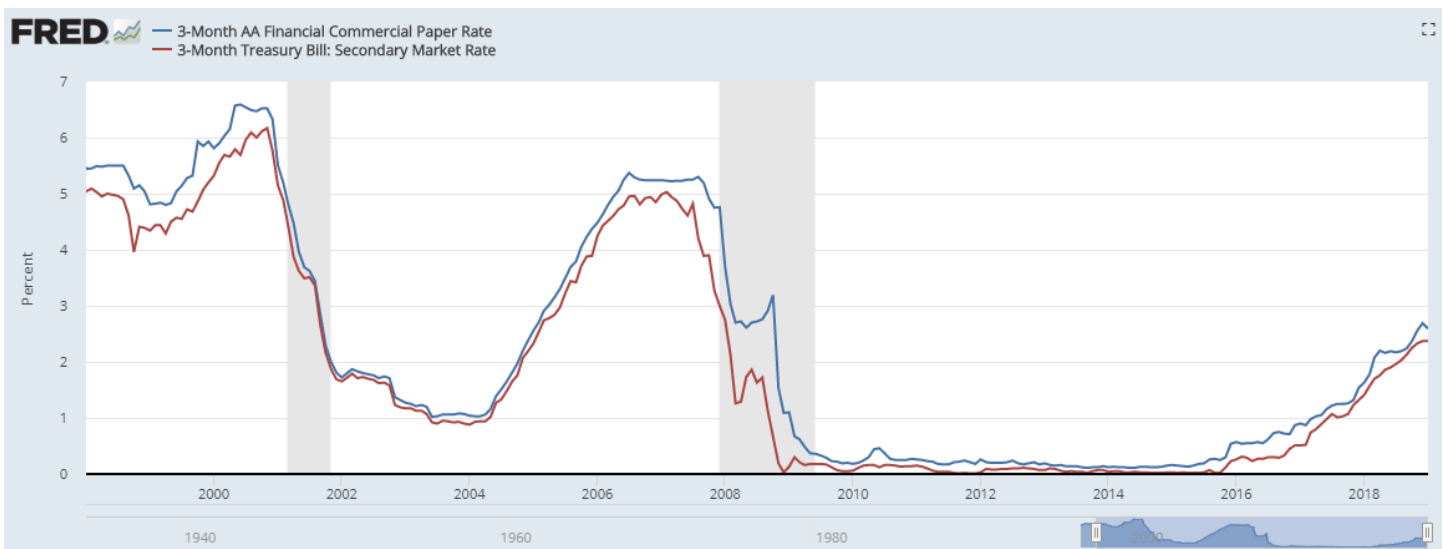
Source: Federal Reserve Economic Data (FRED), St. Louis Federal Reserve Bank

## Commercial Paper 101: History and Characteristics

It has been argued that the evolution of the commercial paper market has enabled the U.S. economy to function more efficiently. At its core, traditional CP has the following structure or characteristics:

- CP is essentially an unsecured promissory note issued by a financial or non-financial entity for a specific dollar amount and maturity date.
- CP is a low-cost alternative to bank loans due to exemption from SEC registration. The exemption is based on Section 3(a)3 of the Securities Act of 1933 (the Act) that requires proceeds derived from CP, with a maximum maturity not to exceed nine months, be used to finance current transactions.
- The CP structure applies to paper that does not involve a public offering and is generally sold only to accredited investors either directly or using a dealer.

- ABCP may also be exempt from registration if it is fully supported by a bank guarantee as provided in Section 3(a)2 of the Act.
- CP is issued for short maturities, typically averaging 30 days to maturity but could range up to 270 days. In fact, as previously mentioned, many issuers rollover CP by selling new paper to pay off maturing paper.
- CP is generally issued in large denominations of \$100,000 or more. The combination of large denominations and short maturities typically limits the CP market to large institutional investors and MMMFs.
- Like T-bills, CP is typically a discounted security where the investor purchases at a price less than par and receives face value at maturity.
- CP provides slightly higher yields relative to T-bills with the same maturities because of the moderate counterparty risk inherent in CP as T-bills are backed by the full faith and credit of the U.S. government. The average spread between three-month T-bills and three-month 'AA' CP between January 2001 and January 2019 is 30 basis points. In the aftermath of Lehman Brothers filing for bankruptcy, the spread peaked at 325 basis points in October of 2008. The average during the crisis years, October 2007 to October 2008, was 136 basis points. As illustrated in the chart below, CP spreads have been tight relative to T-bills outside of the crisis years. As of January 2019, the three-month 'AA' CP spread over three-month T-bills is 22 basis points.



Source: FRED, St. Louis Federal Reserve Bank

## Asset-Backed Commercial Paper 101: History and Characteristics

Asset-backed commercial paper (ABCP) is commercial paper that is “backed” by a specific, designated flow of funds. The flow of funds backing the paper most often come from accounts receivable, whether they be from car or credit card loans, leases, trade receivables, or student loans, etc. If the originator can bundle the receivables into pools and sell the pool, then it has capital to sell more products, generate more receivables, and repeat the process.

What is the genesis of this market? What need did it fill? Simply put, it provides liquidity for originators. They move their product off the balance sheet quickly (treated as a sale of assets for accounting purposes) thus freeing up capital to generate new product. What is the product? On the consumer side, the highest volume of assets backing the paper are receivables from credit cards, auto loans, home mortgages, student loans, etc. ABCP can be backed by commercial receivables as well such as trade receivables, leases, equipment loans, etc. Loan originators (finance companies, banks, leasing companies, etc.) were not the only beneficiaries of the growth of ABCP. Investment and commercial banks also had incentive to push this market, as they could replace the traditional interest income from lending lost to the ABCP market with fee income from structuring these deals. As the commercial banks were losing borrowers to the CP market anyway, the asset backed structured deals allowed them the opportunity to participate as sponsors, administrators, and support providers. Banks may also use ABCP programs to generate liquidity via repurchase agreements. Historically, this accounts for nearly 30% of underlying exposure in the ABCP portfolio for Public Trust Advisors, LLC (Public Trust).

ABCP is structured as a conduit vehicle. These structures are full of jargon, so below is a bit of a glossary by way of an example.

**Glossary** (see the ABCP flow chart on page 6 for a real-life example):

- A finance company, **the originator**, generates a high volume of consumer loans, say auto loans for this example. The auto finance company would like to sell these loans and generate cash so it can make more loans.
- **Securitization**: The originator bundles a group of loans into a **pool**, packaged to sell. A pool represents a particular asset type from a seller or originator. For example, the auto finance company, such as Toyota Motor Credit Corp., might sell its auto loan receivables balance to a special purpose vehicle (SPV). An SPV is a **bankruptcy-remote entity**<sup>[1]</sup> that acquires and finances specific assets, in this case

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[1] Bankruptcy remote is a term that describes the relative position of one company as it relates to bankruptcy with regard to others within a corporate group. Many a times, when a company that is part of a larger corporate group of businesses files for bankruptcy, creditors of the company in bankruptcy may attempt to seek debt satisfaction from other companies in the group. The concept of remote bankruptcy prevents such action. No matter the negative financial condition of entity in bankruptcy, the related holding company, subsidiaries or affiliate enterprises will be unaffected. <https://www.definitions.uslegal.com/b/bankruptcy-remote/>

the receivables of the auto lender. The auto loan receivables would collectively be referred to as a **pool**. The auto finance company may be both the originator and the servicer by virtue of being responsible for collecting the loan balances. As originator only, the finance company owns the loan receivables while as servicer, it does everything necessary to collect on the receivables such as monitoring the accounts, speaking to obligors, and calling obligors when one is late. In other words, the servicer does everything possible to collect from a late, overdue or defaulting obligor.

### Who buys the pool?

- As stated above, a special purpose company or **special purpose vehicle** (SPV) is established for the sole purpose of purchasing the packaged loans from the originator and issuing securities (ABCP). The receivables from the underlying loans service the ABCP debt. However, CP is short paper (less than 270 days), and the underlying loans have a longer maturity (years). It may be necessary to “rollover” or issue new ABCP as the previous issue matures to maintain the cash flows necessary for the structure to work.
- The SPV is **sponsored**, usually by a large financial institution. The credit quality of the sponsor plays a major role in the conduit structure and credit quality assessment.
- The SPV also needs an **administrator** that selects loans to be packaged and manages all necessary funds flows for the conduit to work as it is designed.

This whole structure can simply be thought of as a way to bring all future loan payments forward to the present thereby providing liquidity to the originator and allowing for more loan generation. The sale of one pool of assets funds the next round of loans for the originator. The SPV provides the conduit for bringing market dollars (from investors) to the finance company more quickly than if it had to wait for the loan payments from the people who bought cars.

### ABCP's Role in the Broader Economy: An Example

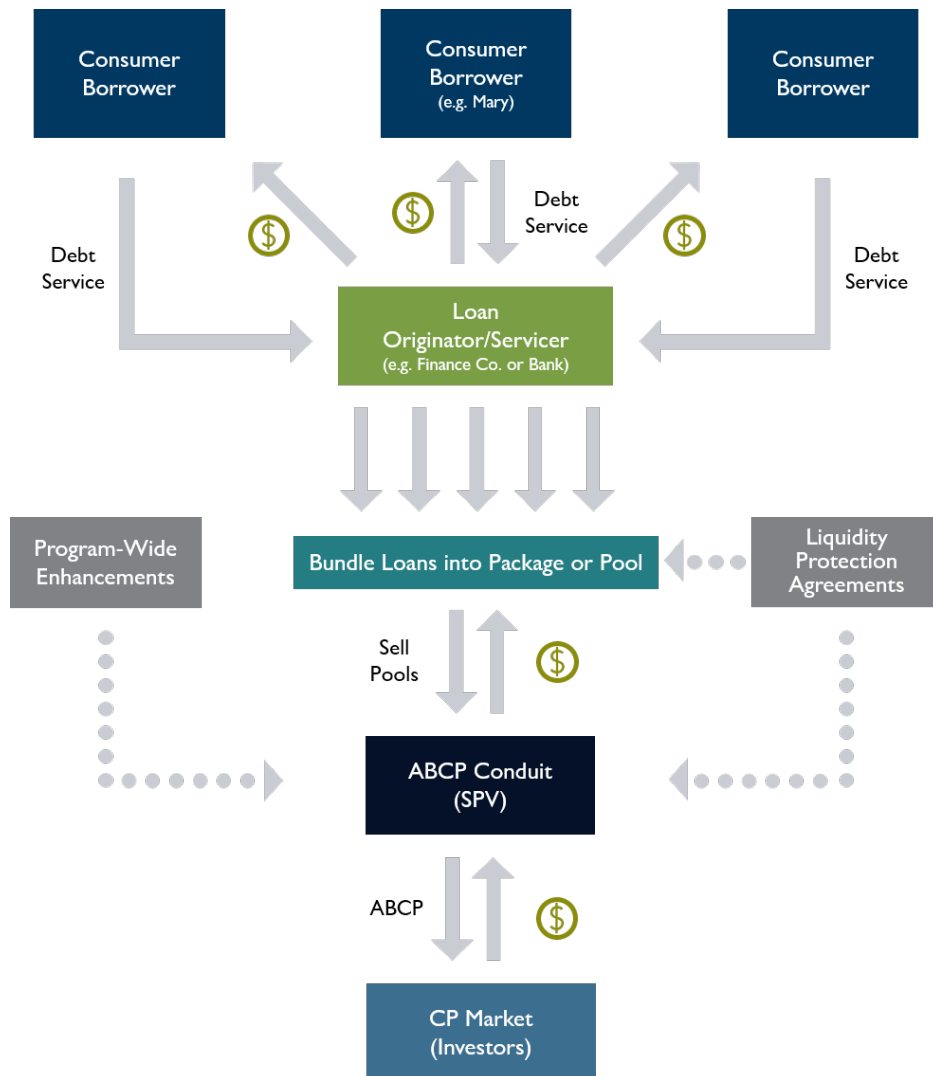
Mary works for a utility and receives a paycheck that is likely financed from ABCP issuance and backed by receivables of the utility company. Receivables are bills yet to be paid by the utility customers and serve as collateral to the ABCP. One of the conditions of CP issuance is that proceeds fund a current transaction (according to SEC rules) and both the paycheck and the receivables backing the ABCP qualify as current accounts.

Now, Mary's paycheck can flow through the economy. She is doing Saturday morning errands in her car and stops by a gas station whose gas supply is financed through receivables from gas station retailers. In this case, the gas station (or retailer) receivables

serve as collateral from the refiner (originator in the flow chart) in an ABCP financing. Mary may even pay for the gas with a credit card, and this creates a new receivable, as well! The credit card receivables are bundled into collateral packages (pool in the flow chart) to pay for a maturing ABCP, financing the financial institution's (originator) credit card operations or activities. Further, Mary did not pay cash for her car. She makes car payments for her balance due, and those payments are also bundled (pool) as security to financing the current activity of the car manufacturer.

Each employee, whether at the refinery, the gas station, or the car manufacturer, receives a paycheck and purchases something, the linchpin of economic growth. While the manufacturer (originator) gets inexpensive financing, the investor gets a short-term, collateralized, and safe investment while the consumer gets purchasing power. The flow of funds enabled by the ABCP facilitates additional economic activity. One consumer, Mary, and one paycheck flow through multiple ABCP vehicles simultaneously, creating a multiplier effect.

### ABCP Flow Chart



Risk = Any of the solid arrow breaks

Protection = Back-up liquidity and/or credit from highly rated source of support (dotted arrows)

## ABCP: Performance and Risk Considerations

With any investment, there are risks. For ABCP, the most notable risk is the potential disruption of cash flows or access to the ABCP markets. For example, the underlying package of loans backing the security may not perform as expected or there may be a market disruption. This could prevent the ABCP from rolling over or the issuance of new securities to pay off the old debt. This chain of events is exactly what was feared by the Fed and Treasury during the 2007-08 global financial crisis, forcing them to intervene in the market.

The main risks for ABCP investors are:

- Asset deterioration in the conduit's underlying portfolio;
- Potential timing mismatches between the cash flows of the underlying assets backing the CP and the repayment obligations of maturing CP;
- A conduit's inability to issue new CP; and
- Risks associated with asset servicers.

Fortunately, the SPV conduit structure has features that mitigate these and other risks. To continue our example, we introduce more terminology to the structure.

The SPV structure includes multiple levels of support to mitigate the major risks:

- **Liquidity Support** is designed to bridge potential cash flow mismatches. The conduit may have many pools of loans at any one time. Each pool of loans will have liquidity support, as defined in the legal structure of the conduit. Examples of support at this level are Liquidity Asset Purchase Agreements (LAPA), Credit Asset Purchase Agreements (CAPA), Liquidity Loan Agreements (LLA), Cash Collateral Agreements (CCA), and/or Letters of Credit (LOC). A specific support provider is named in the conduit structure and quite often is the sponsor of the conduit or a group of support providers led by the sponsor. The strength of the support provider is a significant element in the credit assessment of the program.
- **Program-Wide Enhancement** serves as a final backstop for the program. This backstop is a last line of defense that would come into play only if the liquidity agreements have not provided sufficient support or there is risk of default. It is designed to support whatever has not been covered by the other support mechanisms.
- Each pool has an expected delinquency, loss rate, collection period, and other characteristics that, when taken collectively, become the basis of projected loss level.



The program administrator determines and establishes an amount it will lend based on these projections and its variability. The receivables amount in excess of the SPV advance to the seller/originator is called **overcollateralization**; it effectively serves as a cushion against unanticipated losses.

Due to the various support facilities built into the conduit, ABCP programs are usually highly rated by credit rating agencies which is important to attract investors including highly rated U.S. based and international money market funds.

SPV maturing debts are paid off in one or a combination of three ways:

- Collection of receivables;
- Reissuance of new ABCP; and/or
- Utilization of a liquidity facility or program-wide credit enhancement.

## ABCP Conduit Structures

ABCP conduit structures are typically single or multi-seller conduits or securities arbitrage conduits. Public Trust has traditionally only participated in multi-seller conduits.

- Single seller conduits are structured to purchase receivables from one seller. This type of ABCP conduit structure usually has one asset type and, as with all ABCP conduits, has liquidity enhancement at the pool level and overcollateralization.
- Multi-seller conduits have multiple pools and sellers/originators, invariably administered by banks with a broad client base requiring receivables financing. Assets are credit enhanced in an amount sufficient to ensure investment grade ratings for the ABCP.
- Securities arbitrage conduits are usually managed by commercial banks or asset managers seeking to benefit by exploiting term rates, i.e. differences between short-term funding costs and long-term asset returns. Securities arbitrage conduits have significant reliance on credit enhancement and/or liquidity enhancement from a highly rated bank to protect investors from significant decline of the securities rating or cash flow shortfall. The number of these programs has declined greatly in the wake of the global financial crisis, as securities proceeds have been collected and not rolled over or reinvested. Conduits can either be partially supported or fully supported by the sponsor; this plays an important role in conducting the credit analysis. The

performance of the underlying assets as well as the strength of the support providers is critical when assessing a partially-supported program, while a fully-supported program is more directly connected to the strength of the sponsor and support providers.

## ABCP's Secret Sauce

ABCP has been a sound addition to cash management portfolios for many reasons including diversification benefits, yield advantage over other cash investments, and flexible terms. For diversification, risk exposure to the investor is primarily to the underlying asset pool or pools rather than to the credit risk of a single issuer. ABCP is typically backed by well-diversified assets. Additionally, several sellers are behind several distinct asset classes. In contrast, standard CP exposes the investor to a downgrade credit rating or outright default of the issuer. The SPV factor insulates investors from the sponsor's other balance sheet risk, as the SPV is a bankruptcy-remote entity (see the footnote on page 4 for definition). In a bankruptcy scenario, ABCP investors are not in line with other creditors. The underlying pools of assets in the conduit serve as collateral for the investors.

ABCP is understood and followed by a smaller group of investors as some investment firms may not have the requisite staff and/or expertise to effectively analyze ABCP programs. The smaller buyer or investor base and greater due diligence burden translates into a higher yield to attract investors for which money market funds can benefit. As of January 2019, ABCP traded at as much as a 12 basis point premium to traditional CP of similar duration. Because ABCP maturities range from overnight to 270 days, portfolio managers have the opportunity to customize their exposure to fit or be consistent with their portfolio management or construction strategy or tactic. This flexibility is a particularly attractive and important benefit to managers of cash portfolios.

In 2008, the Fed and Treasury clearly saw the incredible importance of the commercial paper market when they stepped in to prevent disruption. Ever since, the CP market has remained largely beneficial to many participants in the markets and the economy as the use of this short-term lending fuels economic activity, helping both the consumers and providers of goods and services. This market is also useful to managers of short-term, liquid assets in that it provides the opportunity for a slight increase in yield and the ability to match fund flows by laddering investments as well as providing diversification of holdings.

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