Overview

On October 7, 2008, the Board of Governors of the Federal Reserve System (Board), with the support of the Treasury Department and by the unanimous vote of its five members, approved under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343) the establishment by the Federal Reserve Bank of New York (the Reserve Bank) of the Commercial Paper Funding Facility (CPFF). The CPFF complements the Federal Reserve's existing credit facilities to help provide liquidity to term funding markets. The CPFF would provide a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle (SPV) that will purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers.

Background and Details on the CPFF

Commercial paper is an important source of short-term funding for large financial and nonfinancial businesses. In addition, the asset-backed commercial paper (ABCP) market is an important source of funding for smaller businesses that do not have direct access to capital markets. In particular, businesses can finance their receivables by selling them to an ABCP program. At the end of 2007, there was nearly $950 billion in unsecured commercial paper and nearly $840 billion in ABCP outstanding.

The commercial paper market has been under considerable strain in recent weeks as money market mutual funds and other investors, themselves often facing liquidity pressures, have become increasingly reluctant to purchase commercial paper, especially at longer-dated maturities. As a result, in the period leading up to October 7th, the volume of outstanding commercial paper had shrunk, interest rates on longer-term commercial paper had increased significantly, and an increasingly high percentage of outstanding paper had to be funded on an overnight, rather than on a term, basis. A large share of outstanding commercial paper is issued or sponsored by financial intermediaries, and their difficulties placing commercial paper also made it more difficult for those intermediaries to play their vital role in meeting the credit needs of businesses and households. These factors, when
combined with the ongoing stresses in other parts of the credit markets, presented significant risks to the ability of businesses and households to obtain funding and to economic conditions in the United States.

In light of the foregoing, the Board determined that unusual and exigent circumstances existed that warranted approval of the CPFF. As previously announced, the Treasury Department also informed the Board that it believed establishment of the CPFF was necessary to prevent substantial disruptions to the financial markets and the economy. For these reasons, the Treasury Department made a special deposit of $50 billion at the Federal Reserve Bank of New York in support of the facility.

By eliminating much of the risk that eligible issuers will not be able to repay investors by rolling over their maturing commercial paper obligations, the CPFF will encourage investors to once again engage in term lending in the commercial paper market. Added investor demand should lower commercial paper rates from their current elevated levels and foster issuance of longer-term commercial paper. An improved commercial paper market will enhance the ability of financial intermediaries to accommodate the credit needs of businesses and households.

Structure and Basic Terms. The CPFF is structured as a credit facility to a special purpose vehicle (SPV) authorized under section 13(3) of the Act. The Board expects that the SPV and the CPFF will be operational around October 27, 2008. The following provides an overview of the terms and conditions that are expected to govern the CPFF at this time. The Board and Reserve Bank continue to work monitor the commercial paper and financial markets and to consult with market participants and, accordingly, the terms and conditions governing the facility may be modified in the future if appropriate.

The SPV will serve as a funding backstop to facilitate the issuance of term commercial paper by eligible issuers. The Federal Reserve has committed to lend to the SPV at the target federal funds rate (currently 1.5 percent). Draws on the facility will be on an overnight basis. There is no aggregate cap on the amount of funds the Federal Reserve may lend to the SPV to support the CPFF. However, as a practical matter, the aggregate amount of loans that potentially could be made to the SPV is limited to the sum of the maximum amounts of commercial paper that eligible issuers may sell to the SPV, as described below under “Limits per Issuer.”

Assets Eligible to be Purchased by the SPV. The SPV will purchase directly from eligible issuers 3-month U.S. dollar-denominated commercial paper
at a spread over the 3-month overnight index swap (OIS) rate. The spread will be equal to 300 basis points for ABCP and 100 basis points for unsecured commercial paper. In addition, unsecured commercial paper will pay a 100 basis points per annum additional fee that will be waived if the issuer provides a collateral arrangement for the commercial paper that is acceptable to the Reserve Bank or obtains an indorsement or guarantee of its obligations on the commercial paper that is acceptable to the Reserve Bank.

Commercial paper (including ABCP) purchased by the SPV must be rated at least A-1/P-1/F1 by a major Nationally Recognized Statistical Rating Organization (NRSRO) and, if rated by multiple major NRSROs, must be rated at least A-1/P-1/F1 by two or more major NRSROs. The SPV will only purchase commercial paper issued by U.S. issuers (including U.S. issuers with a foreign parent).

**Security for Advances.** The CPFF includes several terms designed to ensure that the debt obligations discounted by the Federal Reserve under the CPFF are “indorsed or otherwise secured to the satisfaction of the Federal reserve bank” providing the funds, as required by section 13(3) of the Act.¹ All advances to the SPV will be made with full recourse to the SPV and will be secured by all the assets of the SPV. In situations where the obligations acquired by the SPV are ABCP, the Federal Reserve’s advances also will be secured by the assets that support the commercial paper. As noted above, issuers of commercial paper that is not ABCP will pay an additional fee, provide acceptable collateral, or have the paper indorsed. Moreover, at the time of its registration to use the CPFF, each issuer must pay a facility fee equal to 10 basis points of the maximum amount of its commercial paper the SPV may own (borrowing limits are discussed below). All fees will be retained by the SPV to provide an additional cushion against losses.

¹ Specifically, the Board consistently has viewed the term “discount” under section 13(3) of the Act to include a Reserve Bank extension of credit to an individual, partnership or corporation (a loan to an individual, partnership or corporation by a Reserve Bank on the note of the borrowing individual or entity) as well as a purchase by a Reserve Bank of third-party notes held by an individual, partnership or corporation (IPC). See Board Circular X-7215-a, “Discounts for Individuals, Partnerships and Corporations,” 18 Federal Reserve Bulletin 518-519 (Aug. 1932) (Reserve Bank may discount for IPCs notes “which are the obligations of other parties actually owned by such [IPC]s, and indorsed by them, or the promissory notes of such [IPC]s indorsed by other parties whose indorsements are satisfactory to the [Reserve Bank]”).
**Limits per issuer.** To prevent the potential for abuse of the facility by eligible issuers, and to help ensure that the facility is available to meet the needs of a wide range of eligible issuers, the amount of commercial paper that a single eligible issuer may sell to the SPV is subject to a cap. Specifically, the maximum amount of a single issuer’s commercial paper the SPV may own at any time will be the greatest amount of U.S. dollar-denominated commercial paper the issuer had outstanding on any day between January 1 and August 31, 2008. The SPV will not purchase additional commercial paper from an issuer whose total commercial paper outstanding to all investors (including the SPV) equals or exceeds the issuer’s limit.

The maximum amount of CP that could be financed by the facility is approximately $1.8 trillion, which is the sum of the limits across eligible issuers. Because the facility is designed to be a backup source of funding, the actual amount that will be financed may be considerably less.

**Termination date.** The SPV will cease purchasing commercial paper on April 30, 2009, unless the Board agrees to extend the facility. The Federal Reserve will continue to fund the SPV after such date until the SPV’s underlying assets mature.

**Expected Costs.** In light of the high-quality commercial paper to be acquired by the SPV and the security to be provided the Federal Reserve to support any advances made to the SPV, the Board does not expect at this time that advances under the CPFF will result in any losses to the Federal Reserve or the taxpayer.