October 28, 2008

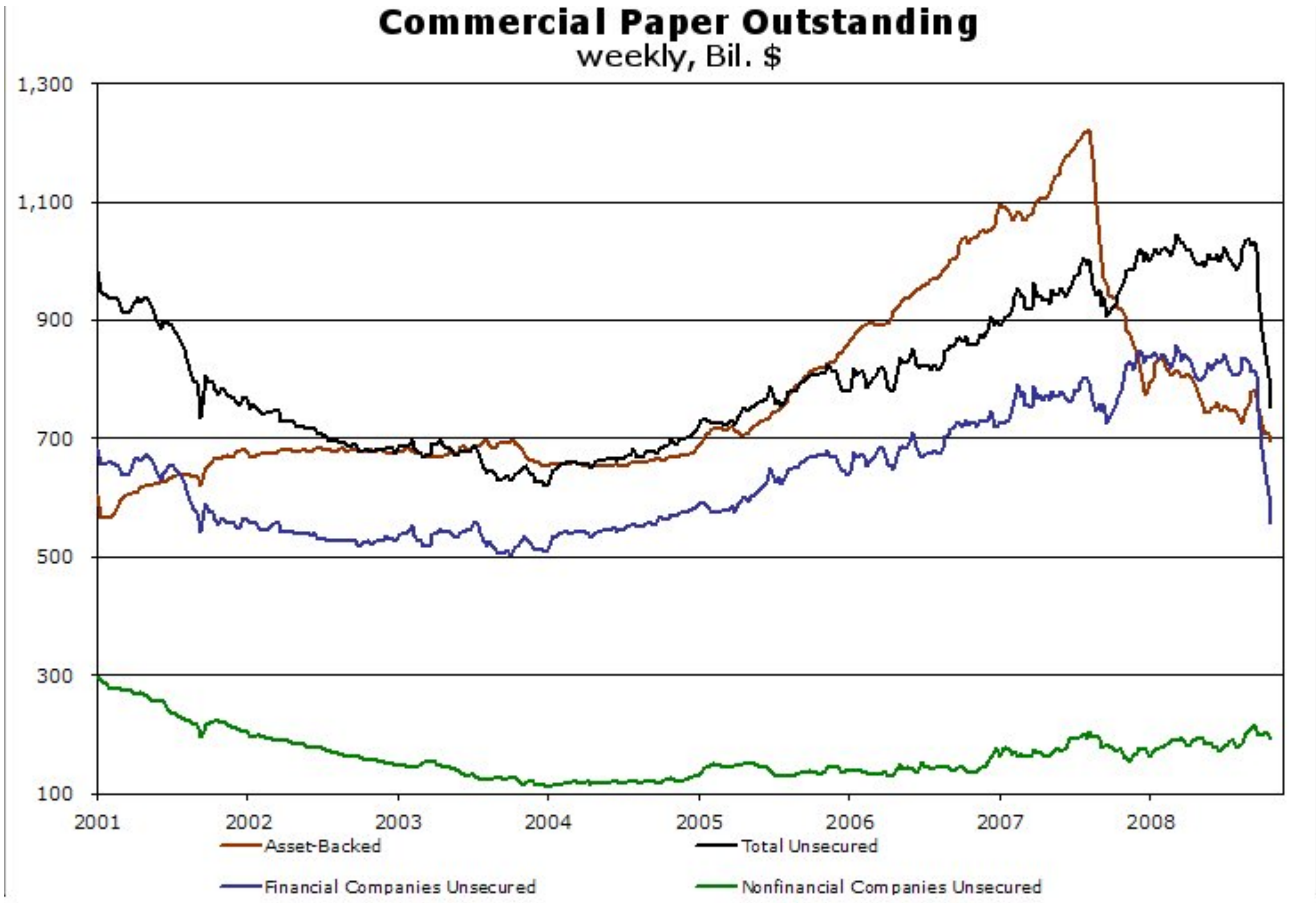
## The Commercial Paper Market and the Fed's Commercial Paper Funding Facility: Part 1 of a 2-part Series

The current financial crisis is a good reminder of how interconnected our financial system really is. The financial tsunami has engulfed seemingly unconnected and obscure corners of the credit market, making them front of mind for a general public that had probably never heard of them before (think SIVs, auction rate securities, monoline insurers, credit default swaps, variable rate demand notes, commercial paper, etc).

Recently, we have heard a lot [here, here, and here] about the issues in the very important but relatively unglamorous commercial paper market. Commercial paper (CP) is a short-term debt instrument issued by large banks and corporations with a maturity of one to 270 days.

Traditionally, companies use CP to finance day-to-day operations, borrowing cash they need to meet payroll or buy materials. Borrowing short-term money gives a company more flexibility to meet short-term needs, and is usually cheaper than issuing long-term debt. Companies can, and often do, roll over their CP as it matures, which effectively turns short-term debt into long-term debt, but at short-term interest rates.

In the past few years the commercial-paper market has grown dramatically, increasing by about 56 percent from 2005 until its peak in August 2007. Much of this growth has been in asset-backed commercial paper (ABCP), which jumped 76 percent over the same period. [Here is the Board's most recent CP report.] In contrast to unsecured CP, which is backed by the name and assets of an entire company, ABCP is backed by a pool of specific assets, such as credit card debt, car loans, and/or mortgages.

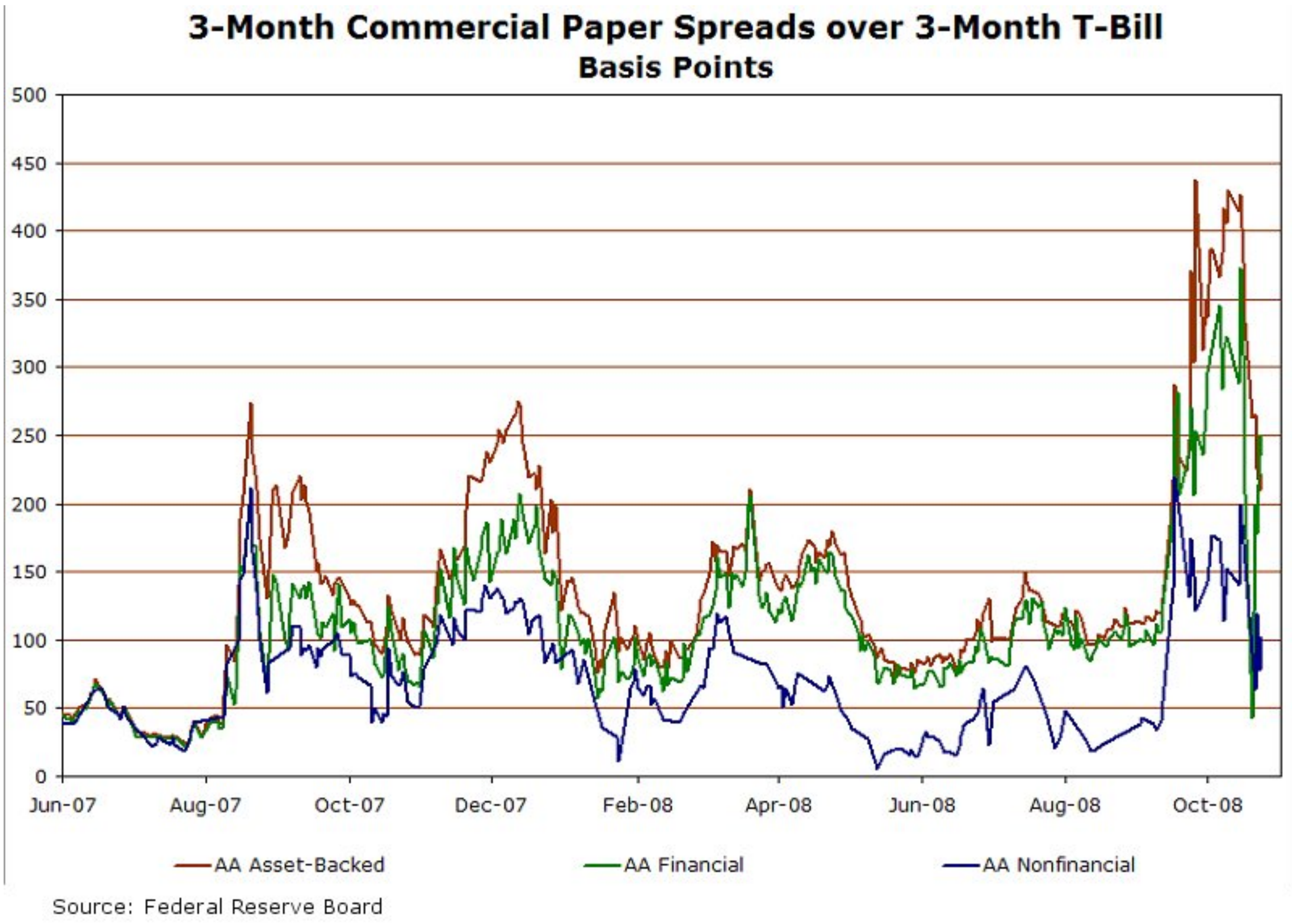


Source: Federal Reserve Board

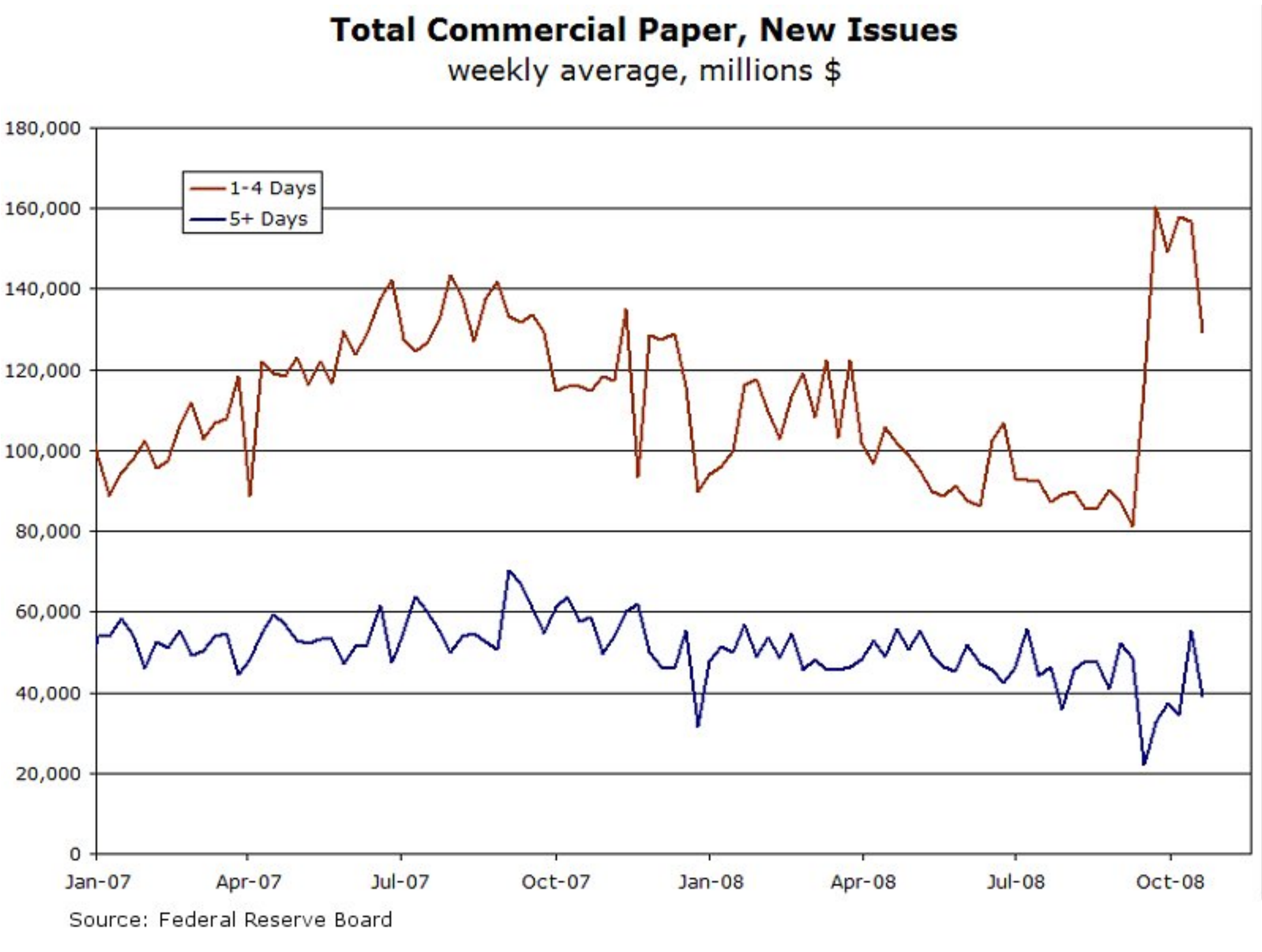
CP generally carries low risk because of its short duration. With unsecured CP, the primary risk is some negative event that threatens the viability of an issuing company's business. But for ABCP, the primary risk is a shock to the value of the underlying asset—such as higher-than-expected mortgage defaults, and an uncertain trajectory for defaults in the future. Recently, both unsecured (especially financial firms) and asset-backed (especially mortgage-backed) CP markets have come under considerable stress.

Money market funds are significant buyers of CP because it typically offers a slightly higher yield than, say, short-term Treasury securities. Money market mutual funds and other institutional investors purchase about 60 percent of commercial paper in the market, according to mutual-fund tracking firm Crane Data.

Following the failure of a number of financial institutions and increased uncertainty about the quality of assets underlying some of the asset-backed paper, the problems in the CP market intensified in September. On the one hand, the demand from money market funds declined as they were faced with a rise in redemptions. This development contributed to a sharp decline in CP outstanding (see chart above). At the same time, investors began demanding higher interest rates in order to buy CP, which contributed to a widening of their spreads relative to the risk-free Treasury rate in September (see chart below).

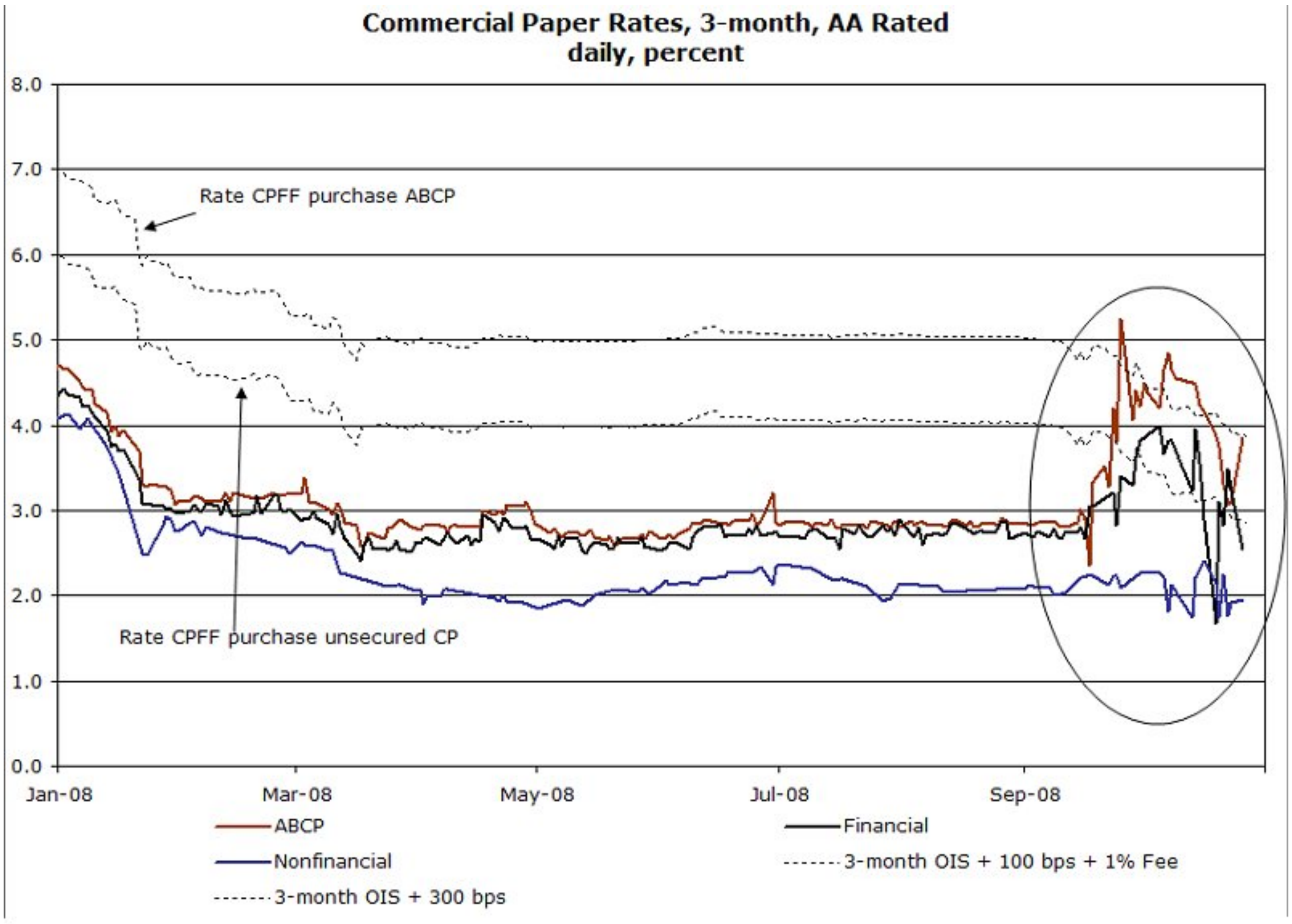



Furthermore, there was a significant shortening in the maturity of new CP issued with only the most trusted programs able to issue out as far as six months at favorable rates, resulting in many firms needing to roll over their paper every day (see chart below).




In response to the deteriorating conditions, the Fed created the Commercial Paper Funding Facility (CPFF) in early October, which went operational yesterday (10/27). According to the Board of Governors, the new facility "is intended to improve liquidity in short-term funding markets and thereby increase the availability of credit for businesses and households." The Board also said that "By eliminating much of the risk that eligible issuers will not be able to repay investors by rolling over their maturing commercial paper obligations, this facility should encourage investors to once again engage in term lending in the commercial paper market."

In the CPFF, the New York Fed will lend to a Special Purpose Vehicle (SPV) which will purchase eligible highly-rated (A-1, P-1, F-1) 3-month CP and ABCP from U.S. issuers. According to the New York Fed, the rate charged on unsecured commercial paper will be the three-month overnight index swap (OIS) rate plus 100 basis points per annum, and the rate for ABCP will be three-month OIS plus 300 basis points per annum. Additionally, for unsecured commercial paper, the New York Fed said "a 100 basis points per annum unsecured credit surcharge must be paid on each trade execution date." Looking back before September, three-month CP rates typically traded very close to three-month OIS rates. The jump in CP rates in September led them to trade much wider than the SPV spread.




Source: Bloomberg, Federal Reserve Board, and Federal Reserve Bank of New York

Short-term debt markets have been under considerable strain in recent weeks as money market mutual funds and other investors have had difficulty selling assets to satisfy redemption requests and meet portfolio rebalancing needs. The CPFF is intended to support the issuers of CP by providing liquidity and supporting term lending in the CP markets. On Oct. 21, the Fed announced the creation of the Money Market Investor Funding Facility, which supplements the previously announced Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, to free balance sheets at money market funds and to encourage them to resume their traditional role in securities lending and participation in other financing markets. This will be the topic of Thursday's blog.

*By Mike Hammill and Andrew Flowers in the Federal Reserve Bank of Atlanta's Research Department.*

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