Cabinet

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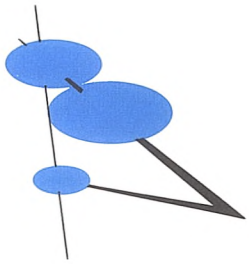
In this issue



March 1971

Commercial Paper: 1970

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Slowing Down the Airlines

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Editor: William Burke

Commercial Paper: 1970

The great commercial-paper boom ended in the summer of 1970. Between early 1966 and May 1970, commercial paper outstanding jumped from $10 billion to almost $40 billion, as more and more firms—and banks also, beginning in 1969—turned to this market as a source of funds.

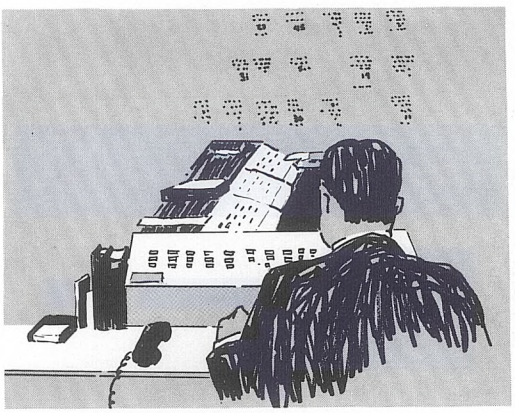
The turning point came amid the financial strains of last spring. The failure of the Penn Central Transportation Company resulted in the first major losses for commercial-paper holders since the 1930's. Within four months' time, outstandings fell by almost $6 billion, and then fluctuated between $32 and $34 billion for the rest of 1970. The market had a much different character at the end of 1970 than it had at the beginning of the year, and certainly a different one than it had five years ago. These shifts are described below, following a general description of the characteristics of the commercial-paper market.

Short-term unsecured debt

Commercial paper is short-term unsecured corporate debt. Because it is unsecured, its acceptability to investors depends upon the financial standing of the issuing corporation and, in consequence, only the larger corporations have the financial strength to use this source of funds. But once a corporation has become a recognized issuer, it can obtain funds with a minimum of formality and at interest rates just above those on Treasury bills. The maturity of commercial paper is under nine months. If an issue has a longer maturity, it must be registered with the Securities and Exchange Commission. The SEC also requires that, in order to escape registration procedures, the funds be for temporary needs and not represent a permanent source of capital.

The commercial-paper market has two divisions—"direct paper" and "dealer paper". Direct paper makes up about sixty percent of total outstandings, although dealer paper has increased more rapidly in recent years. As their names imply, sales of direct paper are handled by the issuer, and sales of dealer paper are made through specialized dealers.

Direct issuers must be prepared to sell their paper on a continuing basis. In practice, only the largest finance companies and banks have the size to utilize the funds generated in this fashion, as well as the reputation needed to justify the prime credit standing essential for investors' acceptance. For the finance companies, commercial paper is their major source of funds. These companies have their own sales organizations, but they also use selected commercial banks and investment dealers as agents.



The second category, dealer paper, is sold through a small number of dealers, with six firms accounting for most of the business. In selling the paper, the dealer traditionally acts as a principal, not as a broker, and buys on his own account from issuers. The dealer obtains his compensation from the spread between the purchase price and the price charged buyers. This spread is now 1/8 percent, plus or minus the effect of any price changes in inventory. Some dealers use an alternative method, handling the selling arrangements for an issue, but without buying the paper. If the sale requires two or three days, the issuer obtains his finance by drawing on his bank line of revolving credit, so that the temporary financing of inventory is borne by the issuer rather than the dealer. But whatever the method used, the dealer plays a key role. It is his function to provide advice about maturity dates and appropriate rates, and to market the issue at the lowest possible cost to the issuer.

For the investor, low risk . . .

As a money-market instrument, commercial paper meets the demand of corporate treasurers and bankers for a safe, liquid asset. Because of the high credit standards required for issuers, commercial paper has a low-risk quality which was an important element in attracting investors to absorb the rising volume of issues in recent years. (Of course, certain notable exceptions developed in 1970.) The standards for dealer paper are maintained by a system of credit ratings operated by the National Credit Office (a division of Dun and Bradstreet), and since 1969 by Standard and Poor's. These two agencies rate prospective issuers according to their liquidity position, bank lines of credit, and recent financial performance, with the highest ratings being denoted as "prime" (NCO) or "A" (S & P). In addition, dealers supplement the work of the rating agencies by making their own assessment before accepting an issuer.

A "prime" or "A" commercial-paper rating is normally required for a dealer to handle the paper of a new corporate issuer. After the Penn Central failure, buyers understandably became even more cautious. Corporate treasurers at that time stopped buying paper without a top rating, and issuers also found it necessary to obtain both NCO and Standard and Poor's ratings.

Normally, an issue is expected to be fully covered by bank lines of credit. The only exception is in the case of the largest corporations, typically direct issuers, whose financial condition is sound and whose total needs exceed the amounts that banks normally could expect to cover. As a result of all these arrangements, the buyer usually assumes a very low risk when purchasing paper.

Yet in contrast to previous practice, the market now permits increasing gradations of risk. There is usually a spread of 1/4 percent between the highest and lowest grades of dealer paper, and a similar spread for different grades of direct paper. Previously, all prime paper of a given type carried the same rate, and the only rate distinction was that between dealer and direct paper.

. . . plus liquidity

In addition to low risk, commercial paper also offers the investor a high degree of liquidity. This is not achieved through a formal secondary market, but rather by the investors' purchases of maturities which closely meet their needs. Indeed, the purchaser can specify the *exact* maturity if he buys direct paper. Maturities range from 270 days down to 5 days and even less. (For very large purchases, say $1 million, overnight transactions can be arranged with some finance companies.) The usual minimum purchase is $100,000; if a smaller amount is involved, the buyer is usually charged a transactions fee by the issuing agent. While buyers are expected to hold their paper until maturity, the usual contract contains a "buy-back" provision whereby the issuer agrees to repurchase the paper without capital loss, but with the yield adjusted to the shorter maturity.

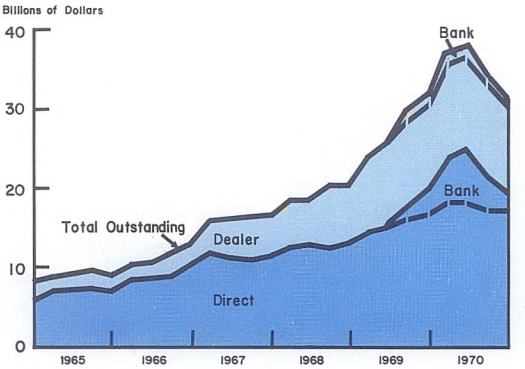
Direct issuers tailor their paper to investors' needs in other ways. Some finance companies have standing arrangements with bank trust departments to sell paper in blocks for allocation among individual trust accounts. These are called "master-note agreements". The finance company pays a specified rate, most commonly the posted rate on 180-day paper, and both sides are able to vary the amounts outstanding upon notice. Outstanding notes are repaid semiannually in order to conform to SEC rules.

For the investor, these agreements provide a means of investing the excess funds of many trust accounts in a single transaction, so as to minimize transactions costs. For the borrowing corporation, master-note agreements generate a sizeable flow of funds. According to some estimates, some finance companies obtain up to 30 percent of their requirements through such arrangements.

Practices differ somewhat for dealer paper. An issuing corporation ordinarily sells such paper in blocks to a dealer, who suggests what the market is looking for in terms of maturities and timing. The minimum transaction is $100,000, and the average runs near $750,000. In some cases, a buyer can arrange for a specific issue, although this is not the usual practice. But as with direct paper, the buyer is expected to hold his purchases until maturity. There are no formal "buy-back" commitments, although dealers will on occasion repurchase paper from a regular customer experiencing unexpected cash needs, or else attempt to find another buyer on a "best-efforts" basis. A high degree of liquidity is normally achieved by the short maturities of the issues.

Although maturities for both direct and dealer paper go up to 270 days, the two tend to concentrate around different maturity ranges. Direct finance-company paper is largely in the under-30 days category. In contrast, dealer paper usually is issued for 30 to 60 days, and thus tends to attract funds of a more seasonal or less transitory nature. Moreover, since September 1970, when

Dealer paper and bank paper show largest gains during boom



bank-related paper became subject to reserve requirements, bank paper has been available only in maturities over 30 days. Under 30 days, the demand-deposit (not the time-deposit) reserve requirement applies, so that bank paper is effectively excluded in this range.

Advantages for the issuer

The issuer of commercial paper has available a relatively low-cost source of funds, compared to bank loans, and a relatively flexible source of funds, compared to other market instruments. But these advantages are open only to those borrowers who have the financial strength to qualify as an issuer, including the ability to issue prime or A-rated paper. Moreover, most issuers have net assets over $25 million—which also happens to be the minimum size requirement for an NCO prime rating.

The issuer's choice between direct and dealer paper depends primarily upon whether he is able to absorb the volume of funds generated by direct issue and to justify the expense of a separate sales organization. The following discussion concentrates first on the choices made by nonbank issuers, and then brings in the options open to banks.

A direct issuer must be prepared to sell paper of varying maturities on a continuing basis, more or less following other issuers' rates in doing so.

When sales are too heavy, an issuer sometimes lowers his rates slightly, but rarely stops selling altogether. The need to meet regular customers' demands and to hold together the network of agents requires continuous participation in the market, and therefore posted rates cannot get too far out of line with the market. As a result, direct issuers frequently have to accept more orders than desired—the so-called "overage" problem —and re-invest the excess in other securities.

In general, a corporation must continuously maintain over $200 million in outstandings before it can justify the trouble and expense of becoming a direct issuer of paper. The only corporations (apart from banks) in this position are large finance companies. Many of these companies are the financial subsidiaries of giant manufacturing or retail corporations, and thus they obviously qualify as prime borrowers. However, some finance companies who could support $200 million in outstandings prefer to borrow through dealers, so as to avoid the problems of running their own sales organizations and of re-investing the periodic overflows of funds that direct issuers must contend with. Consequently, there were only 29 nonbank direct issuers in the market at the end of 1970, compared with over 600 borrowers operating through dealers.

Until 1970, a major attraction of direct paper was its rate-spread advantage over dealer paper; direct rates were typically ¼ percentage point or more below rates on equivalent dealer paper. But now, with a market dominated by risk-conscious investors, more consideration is given to degrees of risk, and individual issues are priced accordingly. With the appearance of the interest-rate spread, the margin between dealer and direct paper has also narrowed, and the best dealer issues sometimes bear lower rates than some lower-grade direct issues. It remains generally true that the highest-grade direct issuers borrow at the lowest cost, but after Penn Central, direct paper can no longer automatically command lower rates than dealer paper. The rate now depends more on the standing of the issuer than on the type of paper issued.

As for dealer paper, the typical issuer is either a smaller finance company or a corporation requiring funds for temporary or seasonal needs. In the latter case, commercial paper supplements other regular sources of finance, such as bank loans. Only in periods of severe credit tightness, such as 1969-70, has commercial paper substituted for bank credit on a large scale. SEC registration requirements limit commercial-paper issues to under 270 days, but these requirements can be waived when funds are raised for temporary additions to working capital, such as for interim financing between long-term bond issues. It may sometimes be difficult to say where "temporary" borrowing shades into "permanent" borrowing, but nonfinancial firms generally try to limit their borrowing to temporary purposes only.

With dealer paper as with direct paper, the issuer has the practical advantage of low relative cost, partly because the commercial-paper rate is usually below the bank prime rate, and partly because compensating balances are higher on bank loans than on unused lines of credit supporting commercial-paper issues. Also, a company issuing paper through a dealer is able to match the timing and maturity of each issue rather closely to his financing needs, just as it can do with bank loans. The dealer provides advice on the details of the issue, according to his view of current market conditions, and then takes over the actual selling of the issue. Finally, there is an insurance element in being a regular issuer, since commercial paper is an alternative source of finance whenever monetary restraint restricts access to normal bank-credit sources.

Growth of bank paper

An important feature of the past two years was the appearance of commercial paper issued by the commercial-banking sector. In adopting the one-bank holding-company form of organization to acquire or form nonbank subsidiaries,

banks found that the holding company could also be the vehicle for issuing commercial paper, a security that banks themselves could not issue directly. Then, in attempting to overcome the loss of funds caused by rate ceilings on large certificates of deposit (CD's), banks began to issue commercial paper through their parent holding companies. Commercial paper was not covered by the Regulation Q rate ceilings, and in addition, it was free from reserve requirements until September 1970.

In selling bank-related paper, the one-bank holding company issues paper in its own name and uses the proceeds to buy loans from the portfolio of its subsidiary commercial bank. Bank holding companies issue both dealer and direct paper. Generally the larger banks issue directly through their own trading facilities and the smaller banks use dealers; however, some relatively small banks sell paper directly to local customers and some quite large regional banks use dealers.

Reserve requirements now apply to holding-company commercial paper used to buy loans from the bank subsidiary, although not to the financing of nonbank operations. The application of reserve requirements has discouraged bank paper with maturities below 30 days. Furthermore, the lifting of Regulation Q ceilings on some CD maturities, plus the declining trend of interest rates, have allowed banks once again to sell CD's. Banks thus have had less need for non-deposit sources of funds, and the importance of bank-related commercial paper consequently has declined since last fall.

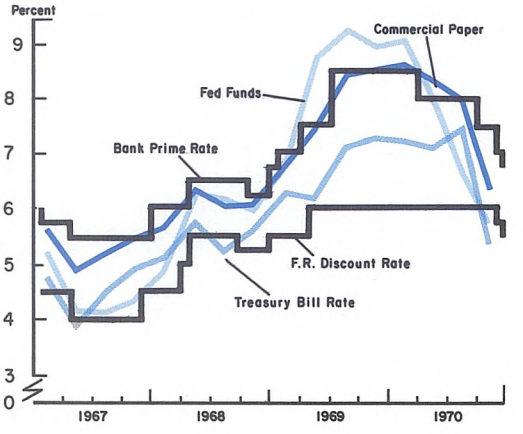
Banks' attitudes toward commercial paper vary considerably. Some regard commercial paper as inferior to CD's as a source of funds, because of such administrative complications as the extra accounting involved for loans transferred to the holding company. These institutions continue to issue paper primarily to maintain a position in the market, in case the need to rely upon it should occur again. Others are inclined to sell either CD's or commercial paper, given equivalent rates, as their customers' needs dictate. Yet despite the recent decline in outstandings, bank-related paper is now an established part of the commercial-paper market.

Towards the peak

Commercial paper as a money-market instrument dates back to the nineteenth century, but its use declined after the 1929 collapse until the last decade or so. Between 1955 and 1965, outstandings increased at a 16-percent average annual rate, and in the next several years the growth rate doubled. Finally, as the boom reached its peak in the first five months of 1970, outstandings increased at a 46-percent annual average rate.

The boom was caused in part by relatively favorable commercial-paper yields, but in particular, by the rising corporate demand for funds in the face of a restrictive monetary policy and falling internal cash flows. In tight-money 1966, non-financial corporations began to look to commercial paper as an alternate source of funds. Also, during this and later years, finance companies increased their direct issues, because of shortages of bank credit and because of the need to finance their heavy expansion of consumer credit.

Issuer obtains low-cost funds with rate usually below prime rate



However, the most striking development during this period was the rapid growth of dealer paper. Between December 1965 and May 1970, nonbank direct paper outstandings rose from $7.2 to $19.3 billion, and the number of direct issuers from 22 to 28. But in the same time-span, dealer paper outstandings jumped from $1.9 to $14.0 billion, and the number of nonbank dealer issuers jumped from about 300 to almost 550. Most of these companies entered the market after 1967.

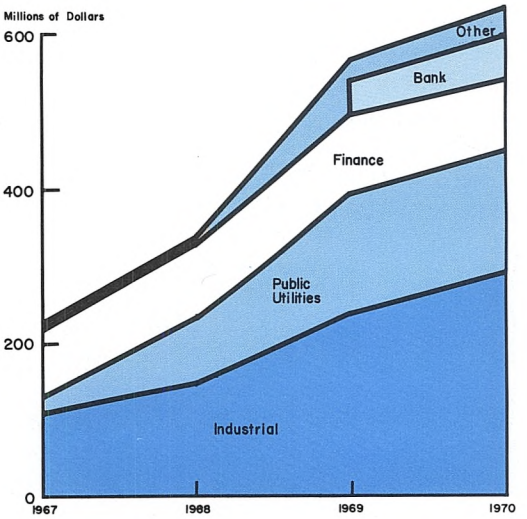
The period June 1969-May 1970 marked the peak of the commercial-paper market. Outstandings increased by more than $1 billion in seven of those twelve months, and increased by more than $2½ billion one month (December 1969). As for market rates, the dealer rate jumped above 8 percent in June 1969 and went to a peak of 9.08 percent in January 1970, while direct rates held just below 8 percent for most of the period before peaking at 8.19 percent in January. Commercial-paper rates had not been this high since the 1920's.

The distribution of NCO credit reports, broken down by industry, details the kinds of companies that turned to the commercial-paper market. The largest number of new issuers were industrial corporations; in December 1967, NCO listed 108 industrial issuers, but by January 1971 the total reached 289 firms. Public-utility firms posted the next largest increase, and there was also a noticeable increase in 1970 in the number of mortgage-financing issuers, reflecting the recent growth of real-estate investment trusts.

Banks did not begin to enter this field in any numbers until 1969, but by the end of 1970 there were 42 bank-related issuers rated by NCO. Most of the major banks' holding companies started issuing commercial paper in 1969.

The direct paper issued by one-bank holding companies accounted for much of the boom in direct-paper issuance during 1969 and 1970. In June 1969, bank-related direct paper amounted

Industrial firms and utilities account for most of paper issued



to only $0.6 billion, but as the big commercial banks attempted to replace the CD money they were losing, outstandings rapidly increased, reaching almost $3 billion by December 1969. By May 1970, the amount of bank-related direct issues stood at $6.3 billion, and the peak was reached at $6.8 billion in July.

In contrast, bank-related dealer paper rose from $0.6 to $1.1 billion between June 1969 and May 1970. Since the holding companies of the largest banks were issuing directly, and since those banks were under the greatest pressures to obtain funds, their borrowing grew much more rapidly than that of the banks which relied on dealer financing.

Down from the peak

On June 21, Penn Central filed for reorganization under the Federal Bankruptcy Act. This action seriously affected the commercial-paper market, for Penn Central had $82 million in paper outstanding at that time. With this shock, buyers of commercial paper began to look closely at other large direct issuers, whose ability to repay their maturing paper also seemed in doubt.

These events occurred against the background of a prolonged stock-market slump, so that the situation had all the earmarks of a classic liquidity crisis. Nonetheless, the commercial-paper market, which was perhaps the most exposed of all, went through the readjustment with only that one major failure.

Various actions were taken to restore confidence by the commercial-paper issuers, by the dealers, by the commercial banks, and by the Federal Reserve System. The commercial banks stepped in to increase lines of credit where these were below corporations' commercial-paper borrowings, and in addition, purchased outstanding instalment receivables of some large finance companies. The banks also arranged more standby lines of credit to forestall future problems. Altogether, these assistance programs probably amounted to $2 billion or more.

The Federal Reserve System acted both directly and indirectly. It liberalized discount policy to support banks who were making loans to support commercial-paper issuers, thereby permitting a sharp jump in member-bank borrowing in June and July. On June 23, the Board of Governors removed the interest-rate ceilings on large CD's with maturities of 30-to-89 days. This action allowed commercial banks to bid for short-term funds directly through CD issuance, rather than indirectly through holding-company sales of paper. In addition, the June 23 policy directive of the Federal Open Market Committee stated that monetary policy should provide temporary support aimed at "moderating pressures on the financial markets."

Once the immediate crisis passed, more permanent reforms occurred in market practices. Dealers began to require borrowers to provide 100-percent coverage by lines of credit. The rating companies began to exercise increasing care in the assignment of ratings. In addition, a combination of shifts in buyer preferences and dealer pressures forced some of the more marginal issuers out of the market. For the first time, a risk differential began to be applied to both dealer and direct paper—this ¼-percent (or more) spread now seems to be an important feature of the market.

Meanwhile, the financial tightness which had initially induced firms to turn to the commercial-paper market finally eased, as the overall demand for funds declined and market rates turned down. All of these changes led to a stabilization of dealer paper outstandings near the $13-billion level; excluding bank-related issues, dealer paper outstandings were at almost the same level in December as in May. Direct issues, again excluding bank-related paper, fell by $2 billion in this period, largely because of the impact of the General Motors strike and the sluggish economy upon the demand for consumer credit. But total bank-related issues meanwhile dropped sharply, from $7.8 to $2.4 billion between July and December, because of the change in Regulation Q ceilings and the application of reserve requirements to one-bank holding-company paper. With the exception of the banks, there was no major exodus of borrowers from the market as it adjusted to the new financial situation.

By the end of 1970, the commercial-paper market was in much stronger shape than had seemed possible during the credit crisis of late spring. With a new foundation in the form of tighter credit standards, the market now has a firmer base for more gradual, but sounder future growth.

Robert Johnston

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Slowing Down the Airlines

The civil air-transport industry recently has seemed to be about as powerless as a new Tristar without its Rolls-Royce engines—a unique situation for an industry which over the years has given the impression of almost limitless power. After contending for years with problems of congested airports and clamoring passengers, the industry now sees its passengers and its profits all but disappearing, and is forced to concentrate on ways of improving efficiency.

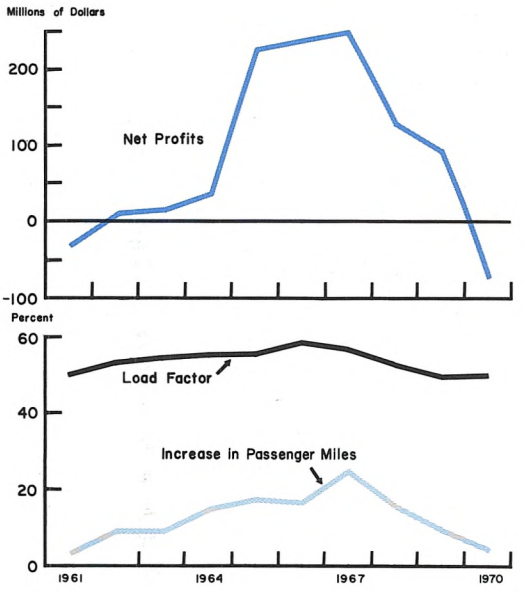
Passenger traffic increased only 4 percent in 1970 for the 12 major airlines (domestic and overseas) and the nine regional (feeder) carriers, in sharp contrast to the 17-percent annual average growth rate of the preceding half-decade. Moreover, what promised in early 1970 to be a moderately poor year turned into a disaster in the fourth quarter, when business travel, already sluggish, failed to pick up as it normally does in the latter part of the year. But throughout 1970, larger planes were put on more routes just as passenger traffic was abating.

Problems of constraints

The weakness in demand came at the worst possible time for the airlines, faced as they were with acres of unfillable seats in their new fleets of wide-bodied jets. The companies had felt constrained to order the jumbo jets, however, because industry studies indicated that any firm which failed to provide the latest equipment lost its market share of passenger traffic. Being vendors of a price-regulated, route-regulated public service, the airlines normally must confine their competitive maneuvers to other areas, such as up-to-date equipment, in-flight comforts, and attractive flight schedules.

The concentration of preferred flight-departure times has always created problems for the airlines. Flight scheduling is a classic problem in linear programming, with managers maximizing their profits not only by keeping planes in the air as much as possible, but also by positioning their planes in the most lucrative locations at prime flying times. The economic impact can be serious if an airline reschedules a flight outside of the most popular hours; for instance, one airline finds that its 5:30 p.m. Dallas-to-Chicago flight has twice the pulling power of an 8:35 flight and five times the attraction of a 10:35 flight.

Profits disappear as growth trend eases in passenger travel



Problems of capacity

The condition of the industry can be neatly summarized by the declining trend in its passenger-load factor—the number of revenue passengers as a percentage of the number of available seats. Between 1966 and 1970, the airlines' load factor dropped from 58 to 48 percent, and the income statement for the major trunk lines shifted from a $239-million profit in 1966 to a $75-million loss in 1970. The break-even point generally ranges around 50 percent, depending on the efficiency of the airline, its route structure, and the level of air fares. But according to an industry rule-of-thumb, few passengers are turned away until the overall load factor reaches 78 percent—a figure rarely approached, even at the seasonal peak, in recent years.

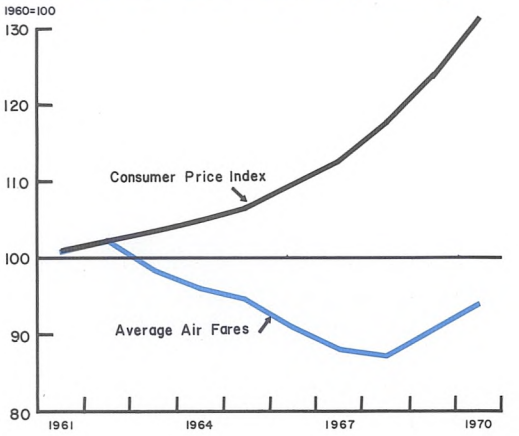
The airlines' initial reaction to the recent drop in capacity utilization was to call on the Civil Aeronautics Board to raise fares. By year-end, however, they did what they could to help themselves by initiating a major cost-reduction campaign.

Airlines trimmed flight frequencies, dropping 644 daily non-stop flights during the course of the year. They also switched to smaller planes, in the process laying up some of the new and expensive ($23 million) jumbo jets. Many lines reduced service frills, by doing away with free newspapers and charging coach passengers $2 for movies and $1.50 instead of $1 for drinks. Many also cancelled equipment orders; between October and December alone, the domestic trunklines scaled down their 1971-73 spending plans for new aircraft from $2.5 billion to $1.7 billion annually. (Eventually, they may reduce the total even more.) Finally, the airlines furloughed some 12,000 employees over the course of the year, or about 4 percent of their total workforce.

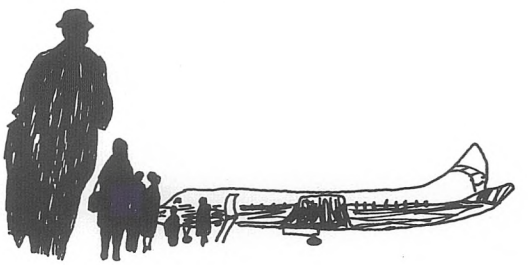
Problems of price

The Civil Aeronautics Board has scheduled a report for next month on its General Passenger Fare Investigation, and has already allowed several temporary increases pending the delivery of the final report. The CAB undoubtedly recognizes the cost squeeze affecting the airlines. Unit labor costs per revenue passenger mile jumped 11.4 percent in 1970 alone, reflecting the incomplete utilization of the new fleets of wide-bodied jets, as well as the heavy start-up costs for those lines granted new Pacific routes.

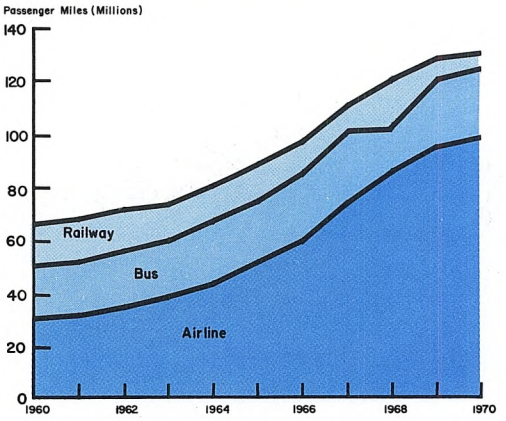
Despite recent fare boosts, air travel remains relatively cheap



The CAB is dealing with a fare structure which still represents a bargain for the average traveler. Despite the increase in average air fares in recent years—3.4 percent in 1969 and 4.0 percent in 1970—average fares still remain 8 percent *below* the 1962 level, in sharp contrast to the 30-percent increase in the consumer price index over the same period. Much of the fare decline can be traced to the proliferation of promotional rates, which by 1969 covered over 40 percent of all domestic air travel.



Airlines dominate intercity passenger travel



The CAB's stated goal is to maintain a fare structure that would provide the airlines with a reasonable rate of return and yet provide the traveling public with as low as possible traveling costs. As for airline revenues, low fares should translate naturally into higher revenues by attracting an increased number of passengers, that is, assuming a high price elasticity for airline fares. (However, the evidence is inconclusive on this point, since business travel at least has a low price elasticity relative to pleasure travel.) As for airline costs, the CAB must evaluate the shifts in costs caused by gyrating capital requirements and changing route structures.

Higher rate of return?

The CAB recently proposed an 11.0-percent average rate of return for the industry—slightly above the 10.5-percent target rate set in 1960. But the actual rate of return—defined as net profits as a percent of investment—exceeded that earlier goal in only two years, 1965 and 1966. In 1969, the industry posted only a 3.3-percent rate of return, and in 1970 it suffered a loss.

During the 1960's, the airlines were able to capitalize on their increased efficiency and still share a surplus with their customers. (According to industry sources, the major trunk lines would have had a $700-million profit in 1970 if they had maintained their 1962 schedule of fares.) But in 1970, despite a 7.4-percent increase in average fares over a two-year period, the industry still posted a loss as costs exceeded productivity gains. Indeed, the 11.4-percent increase in unit labor costs was among the highest in all industries last year.

This year, the CAB has already granted a 2.5-percent increase in fares (January), and the industry expects that over 5 percent more may be added by its April award. The increases requested by the airlines, however, range between 12 and 20 percent. How close the CAB's award will bring the industry to the 11.0-percent target rate of return remains somewhat uncertain, given the general state of the economy, as well as the airlines' general problem of overcapacity and the uncertain response of revenues to higher fares.

Over the longer run, the airlines are determined to reverse the recent slippage of traffic growth, which saw passenger traffic increase only 4 percent in 1970 as compared with the 25-percent peak rate of increase in 1967. Of course, airline traffic may not grow as rapidly in the 1970's as in the 1960's, when passenger traffic tripled and reached 100 million passenger miles. (In the same time-span, intercity bus travel increased about one-fourth to 25 million passenger miles, and rail travel dropped by two-thirds to 6 million passenger miles.) But in an industry where prospects change as fast as a cockpit vista, the current attempts to cut costs and to overcome the overcapacity problem could bring a rapid improvement in load factors and in profits, given even a modest increase in passenger demand.

Joan Walsh