Getting a short-term fix

The highly liquid commercial paper market is a valuable funding tool that should not be ignored, says Andrew Moorfield of bfinance.co.uk.

Commercial paper (CP), the common term for short-dated interest bearing (or discounted) debt securities, is normally issued pursuant to a programme which will typically set an overall maximum for outstandings and provide for periodic renewal.

Although CP refers to any floating rate debt issued for periods of up to one year, most issuances generally have a tenor of up to 90 days. Furthermore, due to a lack of investors – and limited issuer liquidity – CP rarely is issued for a period of more than 120 days. As with medium term notes (MTNs), CP can be issued into one of two major markets:

- **United States (USCP)** – these issuances are denominated solely in US dollars and are governed by Securities and Exchange Commission (SEC) regulations. As with the MTN market, the USCP market is considerably more liquid than its European counterpart. This means European issuers generally receive more aggressive pricing for dollar issues in the US market than for a similar issue in the European market; and
- **Europe (ECP)** – when issued in the euromarket, CP is commonly called 'Euro-commercial paper' or 'ECP'. These issuances can be denominated in a range of currencies and are generally placed with investors in the euro-zone countries. With the advent of the euro, ECP issues are increasingly denominated in euros. ECP is usually non-interest bearing and is, therefore, issued at a discount to face value. However, interest-bearing ECP can also be issued for all but the shortest maturities.

In broad terms, US investors tend to base their portfolio decisions on the credit profile of the issuer. Whereas European investors tend to focus more on the yield of the investment in any rating category.

Issuing mechanics

CP is typically used to meet companies' working capital and short-term funding requirements and the timing of a CP programme may be determined by working capital cycles. For larger corporates, however, a CP programme may facilitate near-permanent outstandings in the debt market.

CP is sold through a dealer panel of banks which distributes, or places, the paper to fixed income investors. Because many banks will have a reasonable claim to a capability in marketing CP to suitable investors, a treasurer will often find it difficult to select a dealer group from his banks. The temptation to reward a large number of banks with a CP dealer role is self-defeating because banks will often find it difficult to distinguish themselves in a crowded dealer panel. Rather, three to four banks that cover most big investor accounts can adequately cover the largest programmes.

Banks should be selected using typical capital market criteria, such as the breadth of salesforce coverage, the number of dealerships and the feedback from their investors. Dealer groups need to be selected based on their ability to supply complementary, rather than overlapping, investors, because this will ensure the widest marketing of a treasurer's CP programme.

Successful programmes require a consistent level of paper to be issued. This consistent volume will ensure the treasurer receives due attention from his or her banks' dealers, while reassuring the dealers that they will be able to obtain a regular supply of paper with which to market the issue to their fixed income investors.

As marketing CP is often done on a same-day basis, dealers must be able to establish how much supply they will receive each day to plan their marketing efforts. Treasurers who recognise these requirements will generally be rewarded with a greater level of servicing from their dealer group – resulting in longer-term pricing efficiencies.

In addition, review panels should be held regularly and the dealers made aware that they are subject to review – and therefore potential replacement. This will also provide an incentive for non-dealer relationship banks that the CP business could potentially form part of their client revenues.

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Rating sensitivity

Although CP programmes can be established with only one credit rating, pricing efficiency is usually increased with a rating from two recognised credit agencies – usually Standard & Poor's and Moody's Investor Service – because many institutional investors require that their investments receive a minimum of two ratings.

A short-term credit rating does not require the issuer to also obtain a longer-term rating. But ratings agencies will often provide the issuer with an (unpublished) long-term rating. Relative to long-term ratings, short-term ratings are more resilient to credit events because of the shorter maturity of CP debt. Although the relationship between long-term and short-term ratings is not mechanistic, a two sub-grade change (for example, from A+ to A-) in a long-term rating will often result in a similar (directional) change in a short-term rating.

Funding availability

The USCP and ECP markets are well-established and highly liquid. Although it is unlikely that either market will suffer from a complete lack of liquidity, both have witnessed dramatic price increases as a result of market instability and/or external events. During the Russian default crisis of October 1998, for example, pricing for issuers at the lower end of the investment grade credit spectrum increased substantially (to the extent

that some issuers found it difficult to raise CP funding and were forced to draw on bank lines). However, given that CP investors still required a 'home' for their investments, highly-rated issuers (A1/P1 and stronger) actually received dramatically improved pricing.

As liquidity cannot be guaranteed in the CP market – especially for lesser rated issuers, as seen in October 1998 – ratings agencies require that issuers obtain CP back-stop lines from financial institutions. Generally, back-stop credit lines must match the maximum expected outstandings of a CP programme – although there can be an allowance for use of idle cash balances, which some issuers argue can be used as an alternative to back-stop protection.

Back-stop credit lines comprise a commitment charge and a drawn fee. When calculating the cost of CP funding, issuers need to add the commitment fee to their overall funding costs. This will allow issuers to compare the total cost of CP funding relative to alternate funding sources – usually bank funding or MTN issues.

Relaxation of credit lines?

There has been an increased awareness among the ratings agencies that highly rated issuers enjoy significant liquidity under their CP programmes and are unlikely ever to draw upon backstop facilities. Issuers face two credit risks under their CP programme:

- **credit event** – these are generally foreseen by ratings agencies and impact longer-term ratings before having an impact on short-term ratings; and
- **market event** – these cause much disruption to the CP markets, severely impacting liquidity for issues. As experienced in October 1998, market events often have a beneficial impact upon stronger-rated issuers as investors undergo a flight to quality.

Because these risks can be quantified as either foreseeable or unlikely for stronger rated short-term debt programmes, there has been an increased trend towards relaxing back-stop credit line requirements for higher rated issuers. Proposals currently circulating the market would remove the requirement for back-stop facilities for the highest rated issuers and would also limit the requirement for strong issuers (A1/P1) to CP maturities of less than 30 days.

However, until proposals are codified by the two ratings agencies, treasurers will be required to continue to obtain 100% coverage with back-stop funding.

Extendible commercial notes (ECNs) are an alternative to back-stop lines, which have emerged from the USCP market. ECNs effectively have credit lines embedded in the CP note. If a credit event occurs and the issuer needs to draw upon their back-stop lines, the treasurer is able to extend the commercial note for a defined tenor. In return, the investor requires a premium from the issuer for investing in an ECN. As the ECN concept expands into Europe, it is likely that ECNs will represent a big funding opportunity for UK treasurers.

Fee-cutting

Issuers can pay fees to their CP banks as a monetary incentive for marketing their programmes, compared to other programmes that pay no or minimal fees. Dealers have been known to 'push volume' by cutting their fees as opposed to marketing a CP programme though their sales force. Although there is an immediate positive impact on an issuer which will benefit from an increase in investor demand, as the dealer is effectively subsidising the CP, this demand can only be regarded as temporary. Furthermore, a fee-cutting bank will cause disruption across an issuer's CP programme, because other dealing panel banks are placed at a disadvantage relative to the fee-cutting bank that is placing paper at a subsidised rate. Moreover, fee-cutting is not sustainable, and once a dealer no longer cuts fees it will need to revert to a higher price to market an issuer's CP programme.

In the longer term, an issuer's CP programme will suffer from fee-cutting, because the issuer will have a disgruntled dealer group and will have increased long-term pricing. Also, in the often incestuous capital markets environment, it is difficult for an issuer to lose the label as a fee-cutter once it has been established.

Policing of fee-cutting is difficult. It is almost impossible to prove and often helped by dealers who can be somewhat over eager to suggest the rumour of fee-cutting among their peers. Fee-cutting allegations should also be treated with caution. Often, they may be aggressively placed deals by CP dealers. However, if a transaction is executed at a particularly aggressive rate, then it needs to be investigated by the treasurer. Experience also suggests that, in the USCP market, dealers will probably tell the treasurer an aggressive deal simply was a good deal. In the ECP market, dealers tend to more often cite fee-cutting.

Treasurers will need to be seen to investigate occurrences of fee-cutting on the basis that the activity may not be proven, but at least dealers will be confident that the treasurer is on the ball. Additionally, dealers should be made aware that CP is an important element of the corporate/bank relationship and should not be viewed as a standalone business.

One method to reduce fee-cutting is to ensure that dealers feel they have a free and open dialogue with the treasurer. Such a dialogue allows a dealer to inform the issuer he has been unable to sell an allocated volume in one day, yet also request the same volume be placed on the next day, without risk of penalty.

The approach wherein dealers must bid for a treasurer's CP issuance, rather than being allocated a share of the programme, is known as 'jump ball'. By removing this mechanism to dealer management, the dealer incentive to place a volume of CP without suitable investor demand is also eliminated, so reducing the incentive to cut fees. The move to same-day settlement in the ECP market will assist such a style of more flexible day-to-day dealer management.

Conclusion

The CP market should be viewed as a valuable funding tool for treasurers. It is well established and highly liquid, providing treasurers with a source of aggressively-priced funding from a range of professional investors.

As with all capital market activities, the most successful CP programmes require open and consistent dialogue with a treasurer's dealer panel and regular reviews. Keeping the dealer panel limited to a relatively small number of qualified relationship banks and establishing clear goals early on also greatly adds to this. ■

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