Hitting the right note

IN THIS OVERVIEW OF COMMERCIAL PAPER MARKETS AS A SOURCE OF FUNDING, DR PERMJIT SINGH LOOKS AT HOW THE MARKETS ARE FARING IN THE GLOBAL FINANCIAL CRISIS AND HOW THEY MIGHT CHANGE OVER THE NEXT 12 MONTHS, AND ASKS WHAT ADVICE TREASURERS AND BANKERS HAVE FOR THOSE ENTERING THESE MARKETS.

According to the ICMA's Euro Commercial Paper committee, Euro-CP is the largest and most liquid commercial paper (CP) market in Europe with daily traded volumes of €10bn and 350 active users. ECP is just one of many domestic and international CP markets. Other major markets are the US for USCP and for asset-backed CP (US ABCP); ABCP is also available in the eurocurrency markets as euro-ABCP.

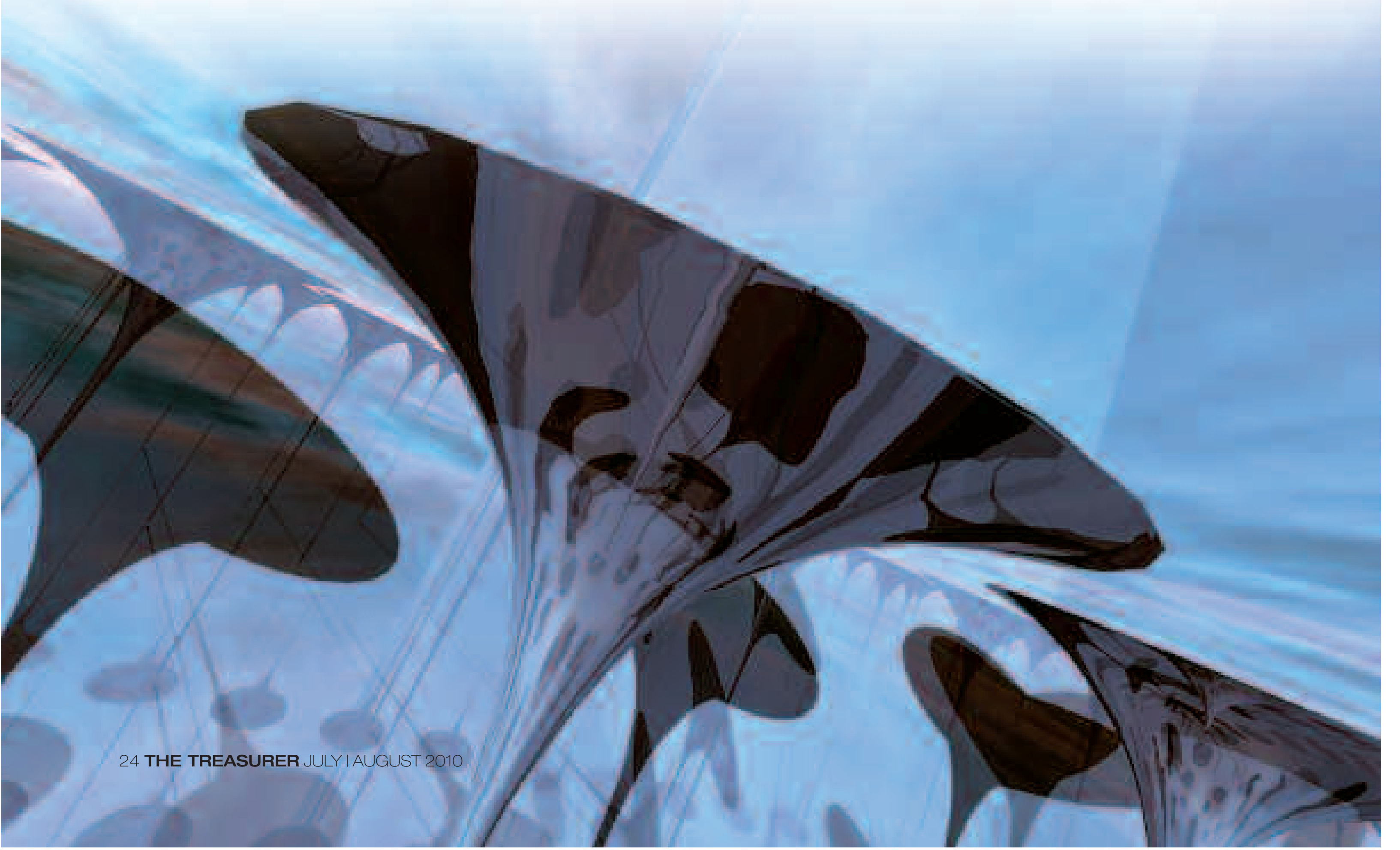
According to Peter Eisenhardt, chairman of the ICMA ECP committee, ECP outstanding was $575bn (of which 6% was euro-ABCP) at the end of April, and USCP outstanding was $1,099bn (of which 36% was US ABCP).

ECP and USCP are 33% and 50% down respectively from their peaks (see Figures 1 and 2), but he believes the CP market will improve and grow as conditions stabilise and economies recover.

The massive growth of long-term securitisation led to the establishment of many arbitrage vehicles (such as structural investment vehicles) that exploited the carry trade in securitised debt by funding themselves in the ABCP market. Their retrenchment, and that of long-term securitisation, went hand in hand with the decline of the ABCP market. The unsecured USCP market has contracted substantially too.

MARKET JITTERS OVER EUROPEAN BANKS Bloomberg reported in May that USCP investors, concerned about European banks' credit exposure to peripheral EU countries teetering on the brink of the financial abyss, have reduced their CP holdings of foreign financial issuers to their lowest in eight months. In the same month Reuters reported that investors have demanded five base points or more additional yield from European banks versus US banks.

According to the Wall Street Journal, BBVA (Spain's second largest bank) failed to renew $1bn of USCP, perhaps signalling investors'



unease over the country's banking sector. However, Eisenhardt cautions against reading too much into the failure: "That could be one rollover and any bank could fail to rollover on any given day at levels they like, even in good market conditions."

Whereas liquidity has been greatest in the 40-60 days window (according to ICMA, almost half of CP matured in under a month, and 83% in under three months), investors have noticeably shortened their holding periods recently owing to market uncertainty, issuer credit risk, and tougher regulatory constraints.

HOW TO USE CP FUNDING Being a short-term money market debt instrument (it can be issued for up to 270-364 days), treasurers will find CP useful for funding net working capital (such as debtors and stock), seasonal expenses (interim and end of year dividend and tax payments), and salaries.

CP, rather like a bank bridging loan, can plug temporary funding gaps relating to longer-lived assets such as acquisitions, until longer-term permanent financing is raised. It can also plug a funding gap caused by temporary market disruption, for example postponement of a bond or equity issue. The emphasis in these cases is to use CP as a stop gap – not as a permanent fixture – to avoid ongoing maturity mismatches between assets and liabilities.

One major corporate interviewed uses CP for interest arbitrage versus its more expensive bank facilities. This is perfectly reasonable as treasurers should, inter alia, endeavour to reduce their company's weighted average cost of funds, and according to Eisenhardt: "issuers have had a strong incentive to arbitrage by issuing in dollars to create cheap swapped euro". Such strategic use of CP should not be confused with the carry trading activities of banks and other speculators who fund in the CP market then invest CP proceeds in longer-dated assets for yield pick-up (riding the yield curve).

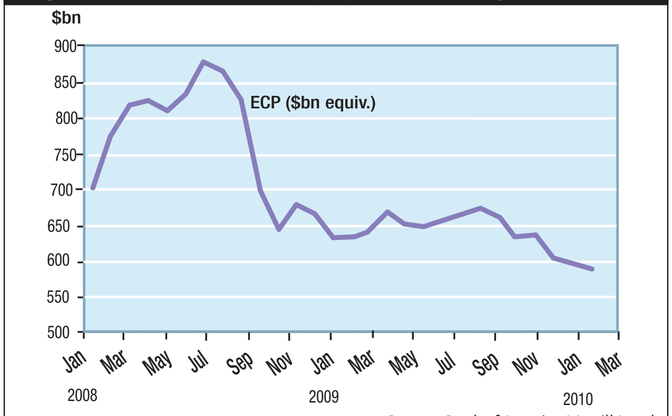
Illustrating its market depth and liquidity, CP has been used successfully and continuously to finance high value high volume current assets in the residential mortgage sector, in conjunction with bank loans and the capital markets.

Daily mortgage loans were funded initially with a revolving bank facility, and after this had ballooned to a certain size it was refinanced with an issue of ABCP. This happened repeatedly, gradually building up the ABCP outstanding liabilities balance over time and matching the balance of outstanding mortgage assets.

REFINANCING MECHANISM As the ABCP balance plus bank debt approached a critical mass, say £500m, they were refinanced with a single long-term securitisation transaction of similar size, and then another cycle began. This refinancing mechanism worked well in the days when a long-term securitisation market was buoyed by asset values heading upwards and onwards. With the massive correction in asset prices, these days the covered bond market might provide an exit route for ABCP. This practical example nonetheless illustrates the ability to integrate CP markets with other debt markets so that through such funding diversification, a corporate's market risk is lowered and value created.

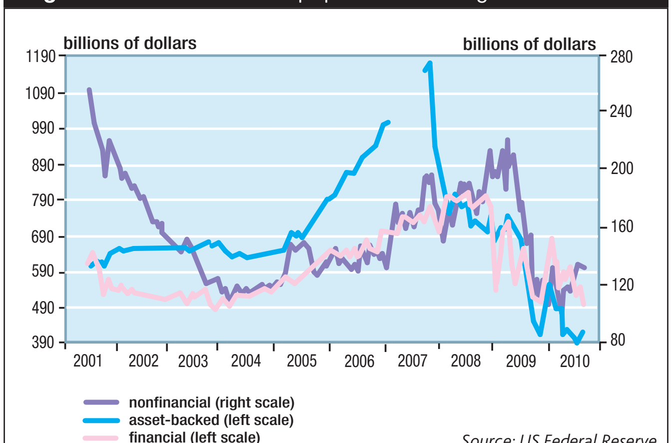
"CP is also a way to maintain a positive and constant engagement with capital markets and investors" says Eisenhardt. CP programmes need not be fully utilised to be of value; even when actively used, one treasurer currently does not use the company's ECP programme more than 15-20% of its capacity.

Figure 1: Euro commercial paper outstanding



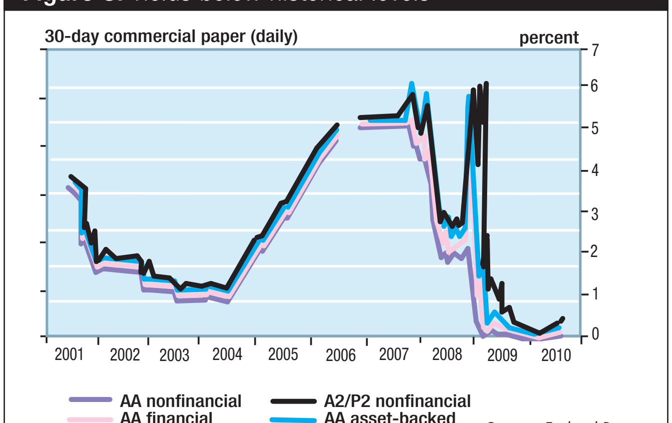
Source: Bank of America Merrill Lynch

Figure 2: US commercial paper outstanding



Source: US Federal Reserve

Figure 3: Yields below historical levels



Source: Federal Reserve

The current systemic turmoil in financial markets has shown that no single market can be relied on so a market should be used neither exclusively nor mutually exclusively by treasurers. For example, remember the flight to quality by ECP investors following the BCCI scandal many years ago that affected unrated CP issuers.

CP markets however have withstood the current market storms comparatively well, helped in no small measure by CP intermediaries being well capitalised and capable, and by the CP market being mature, well documented and regulated, and transparent. The exception however has been, in my opinion, the ABCP market.

ABCP is a relatively new creation and is in essence the short-term equivalent of long-term securitisation; as such it has suffered the same fate – closure owing to a marked lack of transparency in assets pledged as security, and hence investor uncertainty over their fair value.

Since ECP and USCP are unsecured, they have no such problem. Instead each relies primarily on the credit status of entities involved: the issuer and intermediaries. The credit rating of each entity can be looked up far more easily than that of a pool of potentially thousands of discrete, heterogeneous, and constantly-changing assets that secure an ABCP programme.

QUESTIONS OF RELIABILITY Rating agencies have reduced the uncertainty of securitised asset pools and provided a credit rating for ABCP programmes. The question is: are any of these ratings reliable given the way these agencies are remunerated? A sure answer is for investors and issuers to treat ratings with caution and undertake their own due diligence of CP intermediaries and pledged assets.

For unsecured CP, intermediaries include:

- **CP dealer** – several major banks, each one of which has a finger on the pulse of their network of investors. Dealers represent the issuer to the investment community and the investment community to the issuer;
- **issuing and paying agent** – IPA, a bank, usually, that acts as a corporate trustee between the issuer, the clearing system, and CP dealers, and who administers the settlement of CP issued;
- **clearing system (such as Euroclear)** – to record purchases and sales of CP – usually by book entry rather than by physical delivery – and to transfer cash to and from CP dealers and the issuer via the IPA;
- **clearing bank** – to hold bank accounts of the issuer into which, and from which, CP cash is credited and debited;
- **liquidity provider** – one or more banks that step in and provide the issuer with cash if CP investors fail to reinvest maturing CP, or there has been some form of market failure. Treasurers would be well advised to be absolutely sure before launching a CP programme of both the circumstances where liquidity providers can refuse cash (for example for credit-related losses), and of the solvency of those providers.

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CP CAN BE CHEAPER Depending on the bank facility, CP can be 50-100 base points cheaper, says a corporate issuer – but it adds that the cost of CP has risen since the onset of the crisis.

My own analysis using data from Euroclear suggests the average yield to investors on £-denominated ECP with a maturity of three months (rated A1 and issued by a financial institution) has been 11bp below the average three month £ Libor rate.

To compare this CP rate with a comparable bank loan facility's lending rate, one must also add the costs of establishing and running a CP programme, such as paying CP dealers, the IPA, the liquidity provider, and also those costs that would have been avoided had the bank loan been used instead of CP (such as a commitment fee). Even after these costs have been factored in, the fact that CP has flourished, proves it is a viable complement to bank debt for treasurers.

For ABCP programmes, there are also the ongoing administration costs of selecting and assessing the quality of assets the company pledges as security.

Most ABCP is issued via a bank sponsor that provides its own multi-seller conduit. Where the assets are a new asset for the conduit, agreeing administration documentation can be a drawn out and costly legal process (in my experience, it took almost a year before sub-prime mortgage assets were financed through the sponsoring bank's conduit).

The cost of the company providing credit enhancement to the multi-seller should also be factored in. For more on the practicalities and benefits of ABCP, see Getting the most out of ABCP (*Treasurer* July/August 2002).

CP YIELDS REMAIN MODEST According to Bloomberg in May, average USCP rates for 90 day paper from major financial issuers jumped by more than 60% in a month, to their highest level in over a year, reflecting their exposure to the European sovereign debt crisis (French and German financials have each lent over €200bn to Spain, Portugal and Greece).

Even so, yields are still well below those experienced historically and so far in the financial crisis (see Figure 3), the massive jumps in USCP rates seen in 2008 have not occurred. What is evident however, is a premium for longer-dated USCP (see Figure 4) attributable, perhaps, more to credit risk than to liquidity preferences.

Figure 5 shows ECP rates have jumped substantially and now exceed euribor and € LIBOR.

RECOMMENDATIONS In this financial and economic environment, what advice can be offered to treasurers using, or thinking of using, CP? Eisenhardt and a corporate treasurer offer the following guidance:

- maintain a regular market presence to achieve the best results by getting full investor attention;
- there is still a demand from investors for good quality issuers, and perhaps more so now that weaker issuers have been sidelined. Company branding has come to the fore;
- ensure CP is not your primary source of financing, to avoid over-reliance;
- be in the market as often as possible and listen to your CP dealers' advice;
- post CP rates regularly and across the yield curve, but not aggressively;
- accommodate your investors; and
- be able to fall back on bank funds if necessary.

WHAT IS THE OUTLOOK FOR CP? US money market funds – major investors in CP – have been forced by the SEC to limit their maximum weighted average maturity to 60 days from 90, and to hold more highly liquid and higher credit quality securities. These constraints will alter their CP investment strategies and appetites. Treasurers should re-think their issuance strategies accordingly.

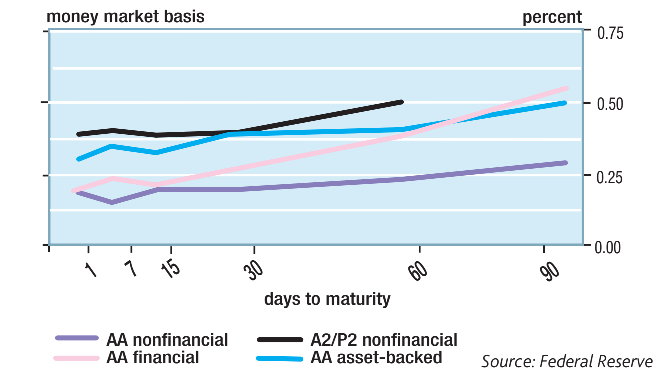
According to ICMA, a) over 30% of ECP issuers are sovereign, supranational, or quasi-sovereign and certain forms of CP are eligible collateral for the ECB and BoE. Both are a strong endorsement of CP and add credibility to calls for ECP to be classed as an eligible security in new liquidity rules being formulated by Basel. If Basel policy makers agree, this will encourage the liquidity of CP market and enhance CP's standing as a competitive source of alternative corporate funding.

The ongoing turmoil of markets is a reflection of many factors, including: EU sovereign debt and budget deficit crises, the future of the EU, currency volatility, low GDP across Europe, inflation, deflation, or stagflation, and high unemployment. A further concern is the stability of European banks – their liquidity and capital – given their exposures to European government debt, on top of their write-offs of consumer and corporate loans.

According to the New York Times, German banks hold $650bn of debt of the four most stricken EU countries, and just 5% of capital to assets, whereas US banks hold 12%.

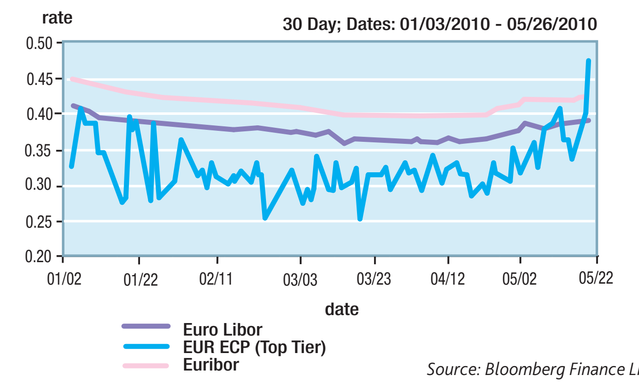
European financial and economic woes might represent a second seismic shock wave of the global crisis that erupted in the US a couple

Figure 4: A premium for longer-dated USCP



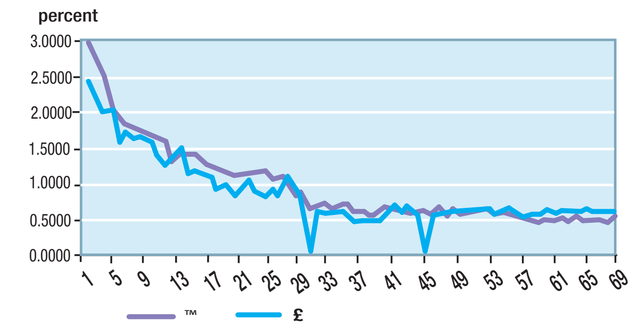
Source: Federal Reserve

Figure 5: ECP rates compared to euribor and € LIBOR



Source: Bloomberg Finance LP

Figure 6: Sterling and € ECP yields, 2009 to mid-May 2010



Source: Euroclear ECP Index

of years ago and shook the world. This wave is likely to have an impact on the ability of treasurers to access CP markets and cause them further problems with accessing bank markets. Furthermore, markets, including CP markets, might be unable to fully digest debt maturing over the next few years that is refinanced and so unprepared treasurers might be crowded out.

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