

THE DAWN OF THE ECP ERA



JOHN DELANEY OF GOLDMAN SACHS EXAMINES THE REASONS FOR RECENT GROWTH IN THE MARKET AND POINTS OUT THE PARTICULAR ELEMENTS WHICH STAND OUT.

The euro commercial paper (ECP) market has suddenly come of age. With outstandings of over a quarter of a trillion dollars and supporting issuers with multi-billion euro programmes, the market is approaching the critical mass and offering the liquidity that market participants had hoped for. Following a period of stagnation in the ECP market during the early 1990s, outstandings have since tripled. Without doubt, the introduction of the euro in January 1999, was a seminal event. Since then, the market has increased by more than 95% to a record of \$259bn.

Borrowers continue to be attracted to the market as a competitive source of working capital and acquisition finance whilst also providing the strategic benefits of a diversification of funding sources.

Outstandings remain dominated by the dollar which in part reflects the fact that the market is a global market rather than just a European market. The percentage of the market denominated in euro has remained relatively consistent since the introduction of the new currency.

The major class of borrower is banks accounting for almost half the market. The area where we expect future growth is in the corporate and asset backed sector.

RECENT TRENDS. Two key areas of growth that we have observed recently are an increased appetite for asset-backed programmes and lower rated credits.

Asset backed issuers fall into two categories (i) structured investment vehicles (SIVs) and (ii) receivables conduits. SIVs are finance companies which purchase financial assets and fund these through issuance of EMTNs and commercial paper. Their conservative and active management of these assets enable the vehicles generally to be rated AAA.

Increasingly popular are receivables conduits. These are off balance sheet vehicles set up by commercial banks. The vehicle purchases receivables from the bank's corporate clients and finances these in the commercial paper market. For the bank, this means its loan to the corporate is transferred to the vehicle, thereby enabling it to make better use of its equity; for the corporate, this sometimes

represents a more attractive borrowing cost.

At present the asset-backed market represents only 10% of the ECP market. By contrast in the US, asset backed CP (which is dominated by receivables conduits) represents 40% of the market. The scope for the development of this market in Europe is tremendous given the self imposed pressure on banks to make more effective use of capital.

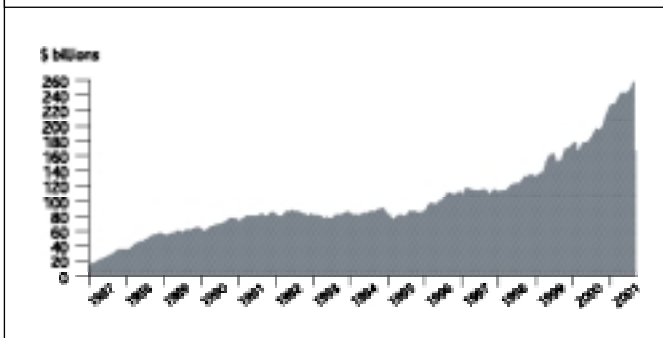
The other major development has been the growth in lower rated ECP. We have seen explosive growth in this sector, which is dominated by borrowers with a short term rating of A2/P2. From very low outstandings, this sector of the market now totals \$14bn. Issuers active in this area include borrowers such as Hanson, Allied Domecq, Philips, Tupperware, Conoco and General Mills. The emergence of investor demand for A2/P2 rated credits is very encouraging and supports the expectation among market participants that the introduction of the euro would lead to the development of a market governed by demand for credit amongst European investors. This trend has been reflected in the term credit market and now is mirrored in the short term market.

CATALYSTS FOR GROWTH. We observe two important catalysts for growth of the European money market. These are the development of a short dated funding market with maturities of less than one week, and further relaxation of the regulatory regime in the euro zone for the money market fund industry.

Short dated funding market. The development of a short dated funding market will primarily be driven by the introduction and adoption by the market of a same day settlement period. At present the market settles notes on a T+2 basis.

If we consider the commercial paper market in the US, we observe a market that supports outstandings of currently \$1.5trn. Interestingly, 65% of the issuance in this market has a maturity of 10 days or less. By contrast, issuance in the ECP market is generally of a maturity of two weeks or more. Anecdotal evidence suggests that there are many borrowers and investors that would like to make either very short term (one to three day) investments or borrow money for a few days based on the limited certainty of their cash

FIGURE 1
MARKET OUTSTANDINGS.



flows.

Therefore if we assume that the pattern of the US can be repeated in Europe, then the addition of a short dated market could increase the size of the ECP market three times to \$750bn.

The existence of an efficient short term funding market will also increase the perception of liquidity in the ECP market. It will enable borrowers to increase their reliance on the disintermediated market knowing that they can get funding on an overnight basis if longer-term transactions are unavailable.

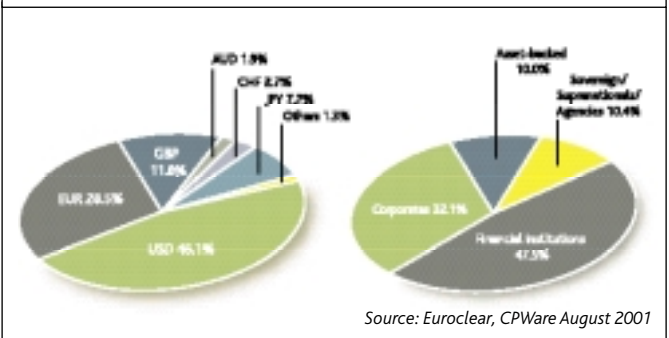
In our opinion the key catalyst for the development of a short dated sector of the ECP market will be the introduction of a facility to settle ECP on a same day basis. The USCP market enjoys a same day settlement capability through the Depository Trust Company (DTC). In Europe the process has been complicated by the existence of two competing settlement houses, namely Euroclear and Clearstream (formerly Cedel) and the slow communication of the identification number for each transaction – the ISIN code.

In this respect one of the most encouraging developments in this area has been the establishment of an initiative between Euroclear, Clearstream and DTC to establish a messaging system called EPIMS (Euro Pre-Issuance Messaging System). A similar system exists in the US and is used to communicate efficiently the transaction details between the relevant parties ie the issuer, issuing and paying agent, dealer and DTC. In our view, the co-operation between the settlement houses combined with the experience of DTC in this area is a very encouraging sign that a workable system will be introduced. The consortium plans to begin testing the system later this year.

The effect will be that issuance details and ISIN codes can be communicated between the relevant parties in a matter of minutes rather than hours which is the case at the moment. By reducing the execution time for the transaction, we will move one step closer to an effective same day settlement system.

Regulatory regime. The other major catalyst for growth of the ECP market will be the redefinition of the investment parameters for investment funds, or UCITS, funds in Europe. The activity of UCITS funds are governed by the UCITS Directive 1985. This piece of Europe-wide legislation effectively limits the ability of funds to purchase ECP to 10% of the funds' assets. However funds are able to purchase CP issued in European domestic markets. This distinction is based on the notion of the domestic markets being 'regulated' compared with the ECP market which is deemed to be unregulated according to the interpretation of the legislation. Given that money market fund assets in Europe exceed \$400bn, this restriction

FIGURES 2 & 3
BREAKDOWN BY CURRENCY AND ISSUER TYPE.



significantly reduces the cash available for investment in ECP.

However, the UCITS Directive is currently being redrafted by the European Parliament and EU member states. Weaknesses in the existing legislation have been noted and proposals have been made to broaden the scope of investment in ECP that these funds can make. Passage through Parliament and the various drafting committees will determine the final content of the new directive. Following ratification (expected early 2002) this will need to be implemented at the national level in the individual countries. Provided that national implementing legislation is not applied restrictively, the new rules should increase the funds available for investment in ECP and provide further impetus to the growth of the market.

GLOBAL APPROACH. The trend we observe currently amongst borrowers is to approach their borrowing on a global basis ie co-ordinating their borrowing across all the major money markets - in the United States, Europe and Asia. This strategy is one that has been adopted by many issuers both large and small.

The prime objective for borrowers is to maintain visibility with the largest number of investors globally. By using the dealer group to market the name and credit amongst investors, the borrower is able to increase significantly its access to buyers of money market products. The key issue for borrowers is to select dealers that will enable it to access this worldwide investor base and are committed to sponsor the issuer with investors on an ongoing basis. We observe borrowers choosing a global CP programme as a platform to achieve this market access however this is clearly not essential aspect of this approach.

OUTLOOK. There will clearly be further development in the use of electronic means of distributing ECP. Several dealers have produced websites for ECP and there will no doubt be an increase in the interest to create a co-mingled/multi-dealer site given the success of the Tradeweb product in the US.

In conclusion, we have seen encouraging growth in the ECP market over the last couple of years with the undoubted turning point having been the introduction of the euro. The ECP market has developed in terms of its access for weaker credit and the willingness of investors to access more structured credit such as asset backed ECP. Many market participants therefore consider the outlook to be encouraging for the further growth of the market and its increasing importance as a consistent and reliable source of short term financing for corporate borrowers.

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