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Using Commercial Paper in Investment Portfolios (2001, 2007, and 2009) (TIM)

Background. Commercial paper (CP) is a short-term, unsecured promissory note issued by corporations typically used as a source of working capital, receivables financing, and other short-term financing needs. CP has maturities ranging anywhere from 1 to 270 days. Because of the short maturity, federal law exempts CP from registration with the Securities and Exchange Commission.

As an unsecured debt issued by companies, commercial paper carries default risk for investors as compared to U.S. Treasury or U.S. government agency or instrumentality debt.

Originally the CP market was available as a funding source to only the highest credit quality entities. However, innovations such as liquidity programs, credit enhancements, and various special legal structures have made CP a viable financing alternative for entities with lower credit ratings. Accordingly, while investors traditionally relied on the financial strength of the issuing entity, increasingly investors must also evaluate the credit support backing an issue as well as the legal structure of the issuer.

Different Structures of Commercial Paper

In addition to traditional corporate issued commercial paper, there are other types of commercial paper as follows:

Asset backed commercial paper - Asset backed commercial paper (ABCP) programs gained popularity partly as a response to the unsecured status of traditional commercial paper but also as a way for financial institutions to more efficiently finance their receivables through off-balance sheet vehicles. With ABCP, certain assets such as credit card receivables or auto loans and their cash flows, support a specific CP issue. ABCP is usually sold through a conduit, a special purpose vehicle (SPV) established to facilitate the financing. There are different structures for such conduits. Some SPVs pool the assets of many entities from various industries. These multi-seller ABCP programs issue CP backed by the cash flows from all the underlying assets. The goal of such multi-seller programs is to enjoy the diversification from multiple sellers of various industries. Single seller ABCP programs are backed by the assets of one entity, for example a corporation. Consequently, they lack the diversification of multi-seller programs. Historically, such ABCP may have had higher credit ratings than the seller company itself. However, such homogenous assets may pose concentration risk.

Most ABCP programs are partially supported programs, in which the program sponsor or guarantor may legally be obligated to cover only a certain percentage of defaults of the underlying assets or cover limited liquidity requirements related to delinquencies of these underlying assets. There are several programs still in existence that are fully supported, in which the program sponsor is obligated to reimburse CP investors regardless of delinquencies or defaults except in the case of a bankruptcy of the program.

Structured investment vehicles (SIVs) - A relatively newer structure that issues CP is the structured investment vehicle (SIV). SIV programs have evolved away from the traditional funding purpose of CP. Some SIVs take

advantage of spread differentials in fixed income securities, earning interest rate arbitrage profits. SIVs may invest in various asset categories, some of which are difficult to value because they do not trade on any active market. Lacking such a market, their value is based on models that are sensitive to a number of assumptions.

Liquidity Notes - In addition, other variations of CP have been introduced in the market in recent years, including extended liquidity notes (also called extendible or structured notes) in which the maturity of the notes may extend beyond their original maturity date in the case of a default.

Other Features of Commercial Paper

Nationally recognized statistical rating organizations (NRSROs) routinely rate commercial paper issues and regularly review the strength of the credit quality of the issue. In some instances, CP programs have been downgraded rapidly by the NRSROs.

CP may be sold directly to investors by the issuing company (direct issued) or by the underwriting brokerage firm (dealer placed).

Many governments invest in CP as a short-term investment for funds not immediately required, and to provide diversification and competitive rates of return. Typically, governments purchase CP with a buy and hold approach until maturity strategy. While a secondary market exists that can be utilized for sales prior to maturity, there have been periods of disruption due to either issuer-specific events or as a result of a broader market wide disruption. Changes affecting individual issues as well as the overall market conditions can take place so quickly that investors do not have the opportunity to sell the security. For these reasons, CP is generally less liquid than U.S. Treasury or U.S. government agency or instrumentality obligations.

During market disruptions, investors face the scenario where issuers will be unable to issue new CP to refinance the maturing commercial paper and the secondary market disappears. To mitigate this risk, CP is usually backed by bank lines of credit.

State statutes vary as to the ability and limits of governments to purchase CP.

Recommendation. The Government Finance Officers Association (GFOA) recommends that if a government chooses to use CP in its investment portfolio, it cautions government investors to: 1) verify whether commercial paper is allowed under state statute and their investment policy and 2) determine whether they have the expertise to understand, evaluate and monitor commercial paper before deciding to include commercial paper as part of a diversified investment portfolio. Government investors should regularly evaluate whether the incremental yield associated with commercial paper justifies the additional credit and liquidity risk associated with this type of security. Governments choosing to use CP should develop policies and procedures to manage the associated risks. Government investors should consider:

- conducting their own ongoing financial reviews of commercial paper issuers, including periodically reviewing balance sheet information for issuers of traditional CP as well as reviewing monthly or quarterly pool reports for ABCP.
- diversifying by issuer, industry sector or commercial paper type
- placing limits on percentage of portfolio comprised of commercial paper
- placing limits on percentage of commercial paper issued by any one issuer, industry, or type
- restricting investments to shorter maturities that reflect the most active part of the commercial paper market and provide the least opportunity for credit quality changes
- restricting investments in sectors or industries experiencing turmoil, volatility or changes such as major regulatory or technological changes
- recognizing different types of commercial paper, such as corporate promissory notes, asset-backed commercial paper (both multi-issuer and single-issuer programs), SIV issued ABCP (funding paper, or extendible paper) and determining the appropriateness of each for the government's portfolio

- limiting to first tier short-term credit ratings by two NRSROs (for example, A-1, P-1, F-1 or better)
- evaluating underlying liquidity support and credit enhancements such as bank lines of credit or insurance
- maintaining information on each commercial paper issue in the portfolio
- monitoring ratings and ratings outlook on a frequent basis
- establishing a short pre-approved list of CP programs that investment staff is limited to purchasing, which is monitored frequently

References

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