

Commercial Paper and the Ratings Agencies

The Credit Cliff

Christopher G. Lamoureux

February 1, 2012

Commercial paper is short-term credit provided to corporate, financial, and structured vehicles directly from the market. It is disintermediated credit (i.e., it does not involve borrowing from a bank).

Kacperczyk and Schnabl (2010): “At the beginning of 2007, commercial paper was the largest US short-term debt instrument with more than \$1.97 trillion outstanding. Most of the commercial paper was issued by the financial sector, which accounted for 92% of all CP outstanding.”

More than 1/2 of all CP was “Asset-Backed CP,” in 2007.

CP has average maturity of 30 days.

It is not subject to registration (it is not a security for the “general public”, and it is to be used for working capital).

CP generally backed by a bank’s back-up credit line.
(Extension of Fed’s lender of last resort service to the disintermediated marketplace.)

By mid-2000’s ABCP was widely used to fund long-term financial assets, esp., MBS’s.

Rule 2a-7 (last amended in 2010) of the Investment Company Act of 1940 provides a critical link between the ratings agencies (formally: Nationally Recognized Statistical Ratings Organizations) and the market. This regulation classifies commercial paper into tiers. Money market funds may invest only in *eligible securities* – those rated as *Tier 1* or em Tier 2. A tier-1 security is rated “1” by at least 2 ratings agencies. A tier-2 security is an eligible security that is not tier 1 (must be rated at least “2” by at least 2 ratings agencies). Money market funds owned 31% of outstanding CP in January 2007.

Corporate Treasurers argue that short-term ratings are simply an afterthought—that the ratings agencies understand long-term credit, and short-term ratings are simply derived from long-term ratings.

The importance of money market funds in the CP market, coupled with 2a-7 gives rise to a large discontinuity in *short-term* borrowing costs if it experiences a long-term downgrade from A to A-, for example.

In 2008 money market funds were subject to a classical bank run.

As described by Kacperczyk and Schnabl (2010), the \$65 billion Reserve Primary Fund experienced a run in September 2008, as it had exposure to Lehman Brothers' commercial paper. This spread throughout the industry.

The US Treasury staunched the bleeding by announcing that all money market investments are insured.

The ensuing collapse in CP was stemmed by the Federal Reserve's CP Funding Facilities

The 2008 run on money market funds and US Treasury's temporary insurance program undoubtedly signals the end of an era. Couple this with historically low short-term rates and money market funds' days may well be numbered.

New SEC regulations:

- ▶ Minimum cash holdings.
- ▶ Increase from 95 to 97% the minimum requirement in Tier I securities.
- ▶ Reduced Term.
- ▶ Stress Tests.
- ▶ Additinal Disclosure.
- ▶ Suspend redemptions
- ▶ *Waiting period for cash-out.* – Proposed.*