The ABCs of Commercial Paper

Q&A | May 2024

To gain a better understanding of commercial paper (CP), we conducted two Q&A sessions with Jeff Rowe, CFA. Jeff is the head of portfolio management for liquidity products for PFM Asset Management's (PFMAM) investment advisory team. CP is commonly utilized in short term fixed income portfolios as part of a diversified strategy.

Part one of our Q&A series will talk about the key characteristics of commercial paper, as well as its benefits and risks. Part two will take a deeper look into asset backed commercial paper (ABCP), a specific subset of the commercial paper market.

In simple terms, what is commercial paper?

Rowe: Commercial paper is a type of unsecured short-term debt issued by large corporations, financial institutions, and in some cases special purpose trusts sponsored and administered by a large financial institution. Most CP is unsecured because repayment is dependent solely upon the creditworthiness of the issuer.

Since the late 1800s, corporations have used commercial paper to finance current transactions or working capital needs, such as a company's payroll, inventory, and accounts payable. Over the last 100+ years, CP has become an important component of fixed income debt markets and has grown, per Federal Reserve data, to over $1.2 trillion outstanding.[1]

On the more technical side, commercial paper is exempt from SEC registration through various exemptions provided by the Securities Act of 1933. The issuer, program size, maturity range, backup liquidity lines, and other terms for each CP program are described in a Commercial Paper Offering Memorandum. CP is sold directly to investors by some large issuers, and through a designated group of dealers for many other CP programs.

What are some key characteristics of commercial paper?

Rowe: Historically, commercial paper is issued with maturities of 270 days or less. About two thirds of outstanding CP today matures within three months, and the average maturity of all CP outstanding is about 55 days. In recent years, however, some issuers have begun to issue commercial paper with maturities out to one year. Either way, CP is considered a type of money market security, which is the industry term for fixed income securities which mature in one year or less.

Typically, CP is offered at a fixed rate and trades at a discount, meaning the price to purchase $100 of face value is less than $100 (similar to how U.S. Treasury Bills trade). Interest is earned upon maturity as the difference between the original price paid and the maturing par amount of the security. Floating rate CP is also available from many issuers. With floating rate structures, the CP instrument is typically issued at par (meaning it costs $100 to buy $100 of face value of $100) and pays interest regularly in the form of periodic coupon payments based on an underlying index.[2] The index used today is almost exclusively SOFR, the Secured Overnight Funding Rate, which replaced LIBOR as that index was phased out.

The vast majority of commercial paper programs are rated by the large rating agencies (often referred to as nationally recognized statistical rating organizations or NRSROs). These agencies assign short-term debt ratings based on their view of the creditworthiness and liquidity position of each program. The largest, most liquid commercial paper is typically rated in the highest short-term rating category, called Tier 1, by at least two NRSROs.[3]

1 https://www.federalreserve.gov/releases/cp/.

2 Index not available for investment.

3 Examples of current nationally recognized statistical rating organizations include Moody's Investors Service Inc., S&P Global Ratings, Fitch Ratings Inc., and A.M. Best Rating Services, Inc.

Who typically purchases commercial paper?

Rowe: Money market securities, like commercial paper, are purchased by a variety of investors, including SEC-registered money market funds, local government investment pools (LGIPs), corporations, asset managers, and municipalities. A key characteristic of the investor base is that they are typically institutional investors given that:

- CP often trades in large minimum denominations of at least $250,000, and for some issuers initial sizes of $25 million or more.
- The credit review process necessary to appropriately monitor each issuing financial institution or corporation requires extensive experience and resources.

What is asset-backed commercial paper and what makes it different than traditional CP?

Rowe: While traditional CP is unsecured and backed by the creditworthiness of the issuer, asset-backed commercial paper (ABCP) is a type of commercial paper that is secured by a pool of financial assets. This collateral typically includes assets such as credit card receivables, auto loans and leases, trade receivables, and equipment leases. Certain ABCP issuance may include financial contracts, with one example being repurchase agreements. More information on ABCP will be provided in part two of this series.

What are some potential benefits of investing in CP?

Rowe: The biggest benefit is a yield advantage versus other money market securities, such as Treasury Bills, Federal Agencies and repurchase agreements (repos). While investing in CP does introduce credit risk, these securities are typically of high credit quality and have a relatively low risk of default (for top issuers). There is also the potential benefit of diversification across issuers and industries. Finally, CP provides investors with flexibility in that investors can frequently choose the exact maturity date they want and the investment structure that best fits their needs.

What are some potential risks of investing in CP?

Rowe: All investing contains some amount of risk. While short-term investments usually carry low interest rate risk due to their short maturities, investing in commercial paper adds an element of credit risk, or the risk that the CP issuer does not ultimately pay its obligation when it comes due. Liquidity risk, or the risk that you may be unable to easily sell CP prior it its maturity at a fair price, or that the issuer will have difficulty rolling over its existing CP maturities, is another potential concern. Downgrade risk, or the risk that a rating agency may downgrade the rating of a CP holding negatively affecting its market value and liquidity, is another potential risk.

Finally, interest rate risk, or the risk that the market value of a CP holding may fluctuate based on changes in interest rates, must also be considered, although the short-term maturity of CP makes it typically less susceptible than longer-term investments.

How does PFMAM manage the risks of investing in CP?

Rowe: PFMAM has been managing fixed income portfolios with a safety first mindset for over 40 years. During this time, we've always focused on prudent credit risk for our public entity clients. One of the fundamental ways that we address credit risk is by having a dedicated team of credit analysts who are responsible for performing fundamental credit research, analysis and monitoring. The Credit Research Group that supports PFMAM (a shared resource with U.S. Bancorp Asset Management Inc.) prepares and presents formal credit reviews, determines if an issuer represents minimal credit risk, makes recommendations for inclusion on various approved lists, and conducts regular monitoring of issuers. The resources (both experienced personnel and data costs) to properly monitor credit in this manner are extensive, but we believe are necessary.

We also utilize CP and other credit instruments (like bank negotiable CDs and corporate notes) in a manner which minimizes issuer concentration risk by focusing on diversification. We believe that having a lower allocation to a broader array of names is consistent with prudent risk management practices and limits the adverse impact that any one issuer can have on a portfolio.

Lastly, we always emphasize the importance of liquidity within a client's portfolio. For our LGIP portfolios, this means managing our liquid pools in accordance with Government Accounting Standards Board 79 (GASB 79) which requires a minimum amount of daily and weekly liquidity at all times.[4] In our separately managed account (SMA) portfolios, this means having allocations to sectors such as Treasuries and Federal Agencies, which are typically the most liquid instruments in the short-term fixed income markets. These approaches allow us to not be overly reliant on credit markets for the first line of liquidity in our portfolios.

While this is true for all CP, there are additional considerations when incorporating ABCP in portfolios.

Stay tuned! In our next Q&A with Jeff, we will delve deeper into the ins and outs of ABCP.

4 "Summary of Statement No. 79." Government Accounting Standards Board. https://gasb.org/page/pronouncement?pageId=/standards-and-guidance/pronouncements/summary-statement-no-79.html&isStaticPage=true.

To learn more or discuss in greater detail, please contact us:

Jeff Rowe, CFA
Head of Portfolio Management for Liquidity Products
rowej@pfmam.com