Collateralized Commercial Paper: A New Breed or ABCP 2.0?

"Change is the law of life. And those who look only to the past or present are certain to miss the future."

— John F. Kennedy

Abstract
Collateralized commercial paper (CCP) made its debut last November to institutional cash investors. This new structure allows investors to purchase commercial paper from entities conducting term repos with broker-dealers. New regulatory changes for money market funds and tri-party repo markets provided logical explanations for its introduction. Some of the CCP features investors should be aware of include liquidity, maturity, and credit transformation as well as dealer funding diversification. We think the structure of CCP differs from multi-seller ABCP programs and more closely resembles repo-backed conduits. We advise investors to look to the issuer's standalone credit, quality and terms of the asset collateral, legal and operational considerations and regulatory uncertainty before investing in specific CCP issues.

Introduction
At first it was the search for yield, then came complacency, turmoil, fear, uncertainty, and again the search for yield – for some, the corporate cash investment business has come full circle. While the auto-pilot style of treasury cash management is largely discredited today, we must ask ourselves - can the past help us identify and avoid a future crisis?

Turmoil forces change, either through human adaptation or through external forces, and it's hard for anyone in the markets to ignore that 2010 was the year of financial regulation. Perhaps by coincident, a new type of investment called collateralized commercial paper (CCP) made its debut to institutional cash investors last November. One program does not make a trend, but since its launch, word on the Street is that several Wall Street firms are working on similar offerings, which are likely to hit the market soon.

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At the time of this writing, it appears that large prime money market funds are the main investors in this new CCP. It is conceivable that, over time, other cash vehicles and separately managed accounts may invest in this newfangled money market instrument. As managers of short-duration portfolios, we wanted to share our views on it, particularly its impact on the broader corporate cash market. Considering its new nature, we are aware of the limitations of our analysis and want to advise our investors to be mindful of, and carefully evaluate, its development.

Collateralized CP Explained

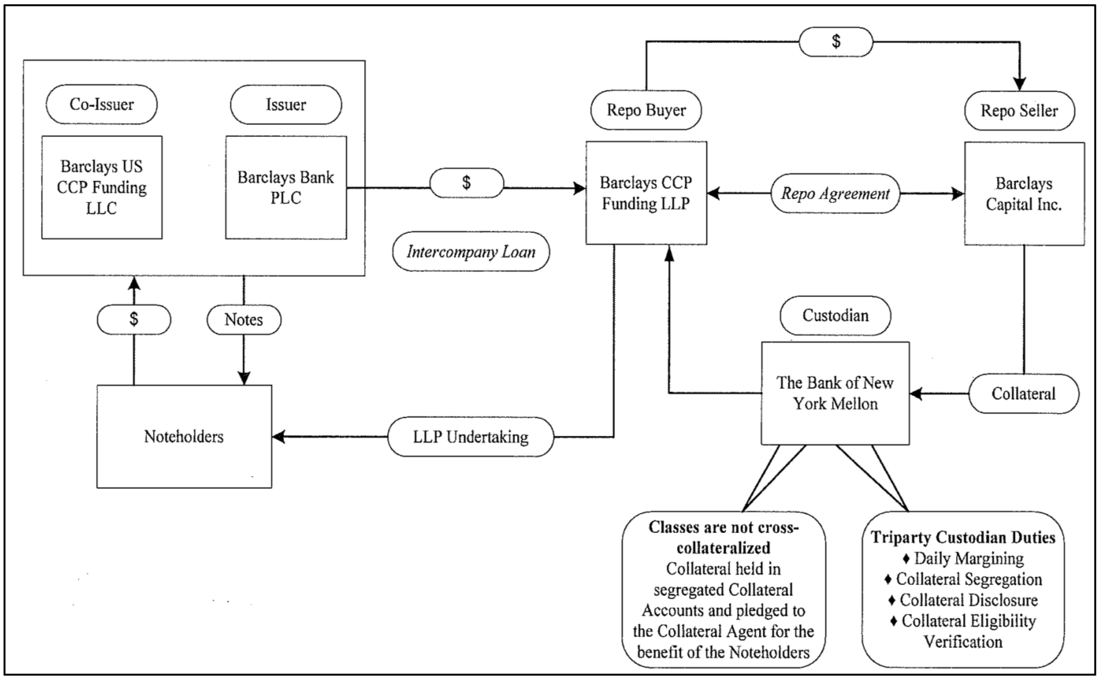
Barclays Bank PLC, a U.K.-based global financial firm, was the first to come to market with Collateralized Commercial Paper Notes Series 2010-1, a $10 billion CCP program, in late November 2010[1]. As of April 26, 2011, the program has $4.94 billion outstanding[2]. Market rumors also place JPMorgan Chase among several major banks currently considering the merit of this new program structure[3].

Unlike conventional CP programs, which are unsecured promissory notes from banks and business borrowers for short-term financing needs, the Barclays CCP is issued by the bank with additional asset collateral in the form of repurchase agreements ("repos"). The program funds the bank's broker-dealer subsidiary's term repo positions affected by the revised money market regulation known as SEC Rule 2a-7[4], which became effective in February 2010.

Before taking any deep dive into the complex structure of CCP, one should know that the credit quality of the Barclays CCP program is functionally equivalent to unsecured CP issued by Barclays because the issuer remains the same in both cases. Further, we do not hold an adversarial credit opinion on Barclays. We use the name because it is the only issuer of its kind today.

As Figure 1 on page 3 indicates, Barclays Bank ("BARC, parent") issues CCP notes with co-issuer Barclays US CCP Fund LLC ("LLC"), a US-based special purpose vehicle (SPV) that shares joint obligations with the parent. Investors receive CCP notes in exchange for cash invested. The proceeds go to Barclays CCP Funding LLP ("LLP"), another SPV whose sole purpose is to conduct repos with Barclays Capital ("BARCAP") Inc., the broker-dealer arm of the parent. At maturity, principal is returned through a loop connecting BARCAP, LLP, LLC/BARC and investors. Should both BARC and LLC fail to honor the obligations, investors may take possession of the repo collateral held by LLP with "limited recourse[5]." LLC, LLP and BARCAP are all separate legal entities and are 100% owned by BARC, the parent.

Figure 1: Structural Diagram of Barclays CCP



Source: Barclays Bank PLC PPM

Probable Reasons for the Creation

With the above diagram looking rather intimidating, one may ask why a bank would go through the trouble of structuring a CCP note if it still bears the credit risk and the cost of funding may actually be higher, at least initially, to compensate investors for the complex structure. Also, why would large institutional investors want to buy something with such a complex structure? With limited information publicly available, we think there are several possible explanations.

a. Credit Enhancement: With the casualties of Bear Stearns and Lehman Brothers fresh in everyone's memories, short-term investors may need more incentive to lend to highly-leveraged financial borrowers; broker-dealers in particular. Using asset collateral in addition to the issuer's general balance sheet strength may prove more palatable than plain unsecured CP borrowing. This "double-safety" feature reminds us of the covered bond market in Europe, where banks pledge their own balance sheets in addition to underlying mortgage collateral to covered bond investors[6].

b. Maturity Arbitrage: The revised Rule 2a-7 may be a more impactful reason. When broker-dealers finance securities held on their books, they are encouraged by regulators to use term repos to improve funding stability[7]. Term repos typically have maturities greater than seven days and are now considered "illiquid" securities by Rule 2a-7. Thus, they are now confined to 5% of a money market fund's holdings compared to 10% prior to the rule revision, and are excluded from the new 30% weekly liquidity bucket. The CCP structure essentially allows the funds to hold the same term repo positions concealed as commercial paper, such that they do not receive the illiquid designation. A CCP note qualifies as weekly liquidity if it matures within seven days regardless of the maturity terms of the underlying repo collateral. Transformation completed!

c. Capital Arbitrage: A third likely explanation is the potential for capital arbitrage by the issuer, which is a topic beyond the scope of this paper. Using the Barclays CCP example, although LLP, LLC and BARCAP are all 100% owned by BARC, securities sold by BARCAP to LLP may receive more favorable regulatory treatment and require less firm capital than if the securities were held outright by BARCAP . We do not know or imply if this is the case with Barclays, only that the structure may allow such treatment in certain regulatory regimes in certain countries. If so, CCP would enable issuers to commit less capital or use more financial leverage.

d. Funding Costs: A fourth explanation is the potential for lower funding costs associated with CCP for the broker-dealer than both term repo and unsecured CP. The thinking goes that after investors grow more comfortable with the new structure, CCP should allow issuers to pay less because of the issuer's direct obligation and the additional collateral. We are skeptical of the merit of this consideration, since asset-backed commercial paper ("ABCP") programs with 100% parental support almost never achieved lower cost of funds than their parents' unsecured debt.

A New Breed or ABCP 2.0?

The use of SPVs and the presence of asset collateral cause some to question whether the CCP creation is a revamped type of ABCP. This is a valid concern since the recent credit crisis partially resulted from subprime mortgages and financial receivables of dubious credit quality infiltrating the vast anonymous asset pools backing ABCP programs and structured investment vehicles ("SIVs"), a variant ABCP structure. The off-balance sheet SPVs, typically having full liquidity support from sponsoring banks, provided side pockets for banks to profit from additional asset pools without having to disclose their existence. The recent regulatory overhaul has resulted in on-balance sheet consolidation of ABCP and higher costs to administer them. Could CCP be a way to circumvent regulations in hiding leverage or assets?

As of this writing, there is no consensus from regulators and industry insiders whether CCP should be treated as an unsecured obligation of the issuing bank or subject to the same treatment ABCP receives. We think there are fundamental differences between CCP and the traditional receivables-backed, multi-seller ABCP programs. We did, however, find a trace of resemblance in repo-backed conduits, a type of ABCP program in existence for more than a decade.

Differences from Multi-Seller Conduits: In contrasting the two types of structures, we believe major differences exist in issuer, backup liquidity, and asset collateral characteristics.

a. Issuer: As we noted earlier, CCP notes are direct and unconditional obligations of the parent rather than that of a legally separate SPV, where investors do not have legal recourse against the parent. In this respect, CCP works just like unsecured CP issued by the parent.

b. Backup Liquidity: Unlike most multi-seller programs, where the parents provide 100% backup liquidity, CCP does not maintain liquidity facilities. Conceptually, issuers may structure the maturity schedules of underlying repo contracts to coincide with the maturing CCP notes. Investors, however, need only to look to the overall liquidity capabilities of the parent notwithstanding the funded status of the SPV.

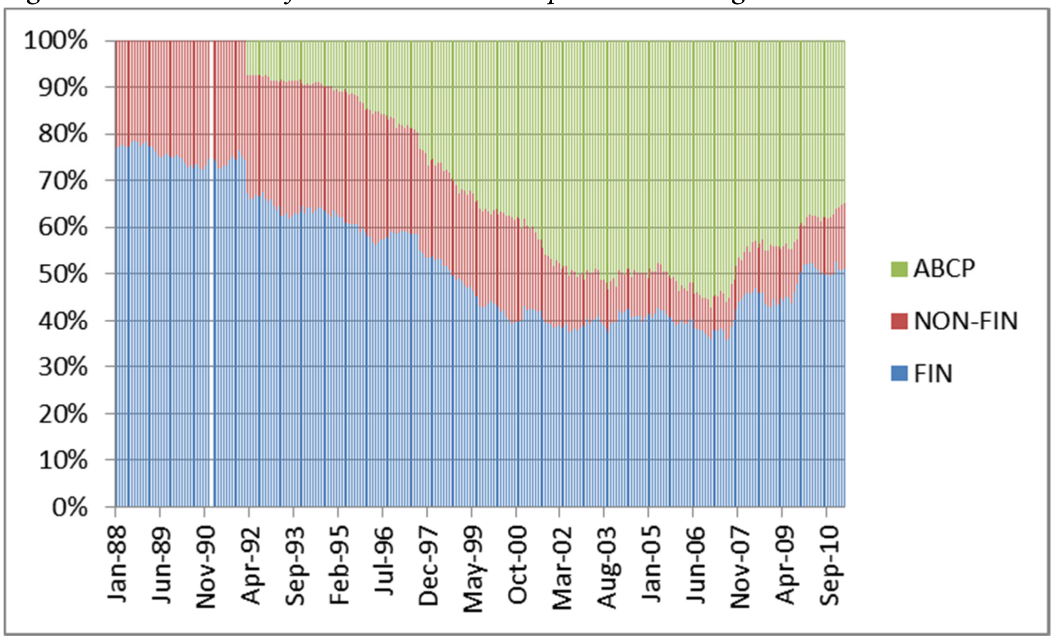
c. Asset Collateral: In typical multi-seller programs, banks facilitate borrowing by organizing "sellers" of loans and receivables into asset pools. The identities of the sellers and the ultimate borrowers are anonymous to ABCP investors, which makes analysis of collateral quality challenging. Investors must rely on the expertise and impartiality of the administrator, a subsidiary of the parent, for collateral performance. In the case of CCP, the sellers are wholly owned subsidiaries of the parent. A third-party bank acts as an agent for the investors by monitoring underlying repo collateral, which may mitigate some of the conflict of interest concerns.

Similarities to Repo-Backed ABCP: We think CCP resembles repo-backed ABCP conduits in that it has an issuer/co-issuer structure, uses repos as asset collateral, and does not have liquidity facilities. However, in our opinion these similarities do not in themselves turn CCP into ABCP. This is because the parent remains legally obligated to pay liabilities where the repo-backed ABCP issuer is a third-party SPV entering into repo agreements with multiple financial firms.

Buyer Beware – Where to Look

We stress again that this paper is not intended as a credit opinion on one CP program, but rather, as a new security structure, CCP fascinates us with its potential to replace ABCP as the next major structured funding vehicle for major financial firms.

Figure 2: Distribution of U.S. Commercial Paper Outstanding 1988-2011



Source: Federal Reserve's CP outstanding statistics via Bloomberg.

Figure 2 is a snapshot of the U.S. CP market makeup since 1988, when the Federal Reserve broke out market statistics into financial and non-financial sectors. The period from the early 1990s through 2008 was marketed by the steady growth of ABCP outstanding and the decline of non-financial CP. The reversing trend since 2008, in the backdrop of declining overall CP outstanding, is expected to continue due to more stringent regulatory requirements and reduced bank appetite for funding clients' assets with ABCP.

Does the new structure have the potential to carry the banner left by its aging ABCP sibling? Will money market funds continue to buy the new notes as more come to market? Can the new structure attract investors who otherwise would not or could not conduct term repos with the same broker-dealers? With these questions in mind, we advise investors to look at the following areas of concern before they jump on the bandwagon:

a. Issuer Credit: We cannot stress enough that the first line of defense is the issuer's standalone credit strength. In addition, one should keep an eye on the issuer's funding mix of CCP and other channels. Alarms should go off if an issuer lacks a diversified funding lineup and leans heavily on the CCP structure.

b. Quality and Terms of Asset Collateral: When investors must look beyond an issuer's standalone credit for comfort, they need to assess the credit quality of securities held in the repo collateral account. The maturity structure of these securities is also important because of the lack of a liquidity facility. The transparency of eligible securities and investors' access to asset collateral information become more critical.

c. Legal and Operational Considerations: As with most structured investments, CCP involves a number of legal entities and uses a number of outside vendors to perform specific functions on its behalf. Investors should exercise caution in assessing their legal protection, the competence of the vendors involved, and the recourses or indemnifications available should certain parties fail to fulfill their obligations.

d. Potential Regulatory Interference: Since large financial institutions are expected to be the early adopters and major issuers of CCP, regulatory uncertainty remains a major credit consideration. Because CCP investors are one step removed from repo transactions, their claims against the collateral may be challenged if a regulator seizes assets of a failing financial institution. The Dodd-Frank Wall Street Reform Act and the Basel III Accord on bank capitalization, among others, may significantly reshape how new CCP programs are structured and how investors are protected.

Conclusions

It is said that financial innovation is Wall Street's middle name. New regulatory changes in money market funds and tri-party repo markets provided logical explanations for the introduction of collateralized commercial paper, although other factors also may be at play. We are interested in the new CCP structure due to its potential in transforming illiquid term repos held by money market funds into seemingly liquid corporate commercial paper. We are interested in its capacity in housing financial obligations previously provided by ABCP conduits. We are interested in the potential risk in funding long-term assets (repo collateral) with short-term obligations (commercial paper). We are also concerned with broker-dealers' over-reliance on a new security type not previously proven to sustain a market disruption.

While uncertainties remain, we think CCP differs materially from multi-seller ABCP programs, but resembles more closely the repo-backed conduits. Acknowledging the added collateral protection at the individual issuers' level, we are nonetheless mindful of the potential for systemic risk if CCP overwhelms other forms of dealer financing. Investors should carefully evaluate any and all new asset types according to their objectives of safety, liquidity and yield in their separately managed portfolios or in the money market funds they own.

[1] Refer to the program's private placement memorandum (PPM) dated November 19, 2010, available at its CP dealers Barclays Capital, J.P. Morgan, or RBC Capital Markets.

[2] According to postings to Hub.com by one of the CCP dealers JPMorgan at https://bonds.jpmorgan.com/stfi/mmTierCPProgram.jsp?applicationID=9999&orderBy=9999

[3] Information on JPMorgan's CCP development was confirmed by the firm's employees doing business with Capital Advisors. Information on other dealers' interest came to us from third-party channels and is unconfirmed.

[4] Refer to the SEC file number 17 CFR Parts 270 and 274. http://www.sec.gov/rules/final/2010/ic-29132.pdf.

[5] Refer to the program's private placement memorandum (PPM) dated November 19, 2010, available at its CP dealers Barclays Capital, J.P. Morgan, or RBC Capital Markets.

[6] Interested readers may find more resources on covered bonds at www.coveredbondinvestor.com.

[7] Refer to proposals from the New York Federal Reserve Bank Task Force on tri-party repos http://www.newyorkfed.org/tripartyrepo/

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