Demystifying Asset-Backed Commercial Paper:
Opportunities, Risks and Practical Considerations

EXECUTIVE SUMMARY:

ABCP can be a good investment choice in large corporate treasury accounts due to the depth, liquidity, flexibility, and yield potential of the asset class.

ABCP gained popularity recently because increased event risk of corporate names resulted in concern about unsecured commercial paper.

A potential investor of ABCP should carefully review the strength of the sponsor bank, external support, program type, and asset collateral quality prior to investing.

The wide range of risks among different programs requires specialized credit knowledge and regular asset collateral monitoring to minimize risk.

INTRODUCTION

Created in the mid-1980s, asset-backed commercial paper (ABCP) trailed its term asset-backed securities (ABS) cousin in acceptance by fixed income investors, especially corporate cash managers. The stigma against ABCP started to change in the new millennium, when event risk of corporate names caused the unsecured commercial paper market to shrink dramatically.

Meanwhile, the increased demand by institutional investors for ABCP resulted in the proliferation of innovative ABCP structures that made it more difficult for buyers to discern the risks associated with newer programs. Many corporate cash investment policies still take a conservative stance on ABCP as eligible securities, even though well over half of the high-grade commercial paper market is ABCP.

Without delving too much into technical details, we will provide a brief introduction to ABCP, highlight some of the common advantages and risks of the traditional programs, and provide a practical guide for ABCP risk assessment. We believe ABCP are legitimate investment vehicles in large corporate treasury accounts due to the depth, liquidity, flexibility, and yield potential of the market. We also think that the wide range of risks among programs requires dedicated credit expertise and regular asset collateral monitoring when investing in ABCP.

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ABCP PRIMER

ABCP is a type of short-term money market instrument issued at a discount and maturing at face amount. Unlike corporate commercial paper, which is a borrower's unsecured promissory note to investors, a pool of financial assets such as trade and credit card receivables provides the collateral to secure ABCP until maturity, at which time the proceeds from the collateral repay investors.

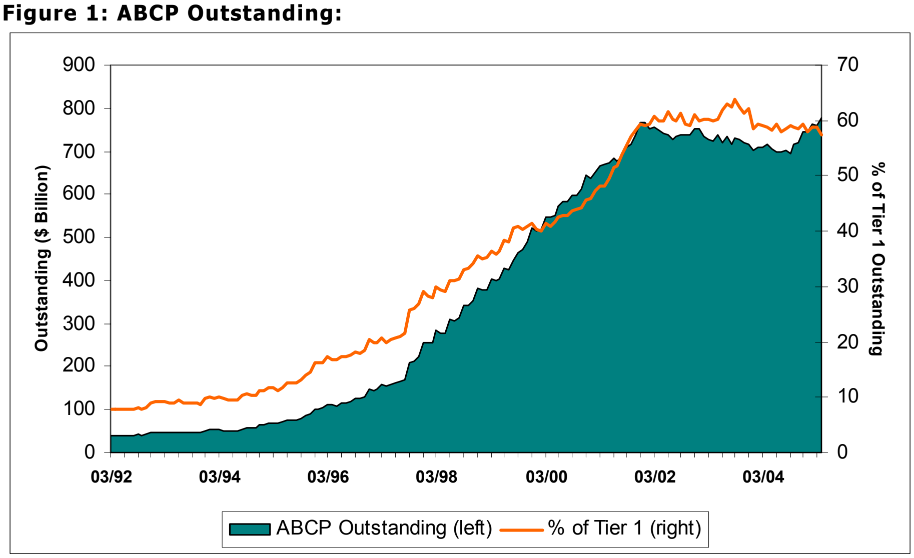
The development of ABCP paralleled that of the ABS market. In the early 1980s, several US banks started to offer ABCP as another short-term funding channel for their corporate clients. Acting as program administrators, they earned a modest fee by helping their clients borrow from investors directly using trade receivables as collateral and thereby reduced their own balance sheet leverage. The arrangement also allowed corporate borrowers to treat ABCP as off-balance-sheet financing. This stong bond between an ABCP program and its sponsor bank has been largely carried forward to this day.

Today, ABCP is an effective and efficient way of financing all types of receivables and many other predictable cash flows, with an aggregate market size of over $700 billion. One difference from the traditional corporate commercial paper in that the borrowing is secured. In addition, the legal issuer is a "bankruptcy-remote special purpose entity", called the ABCP "conduit", which purchases receivables from the corporate borrower in a "true sale without recourse", thereby isolating investors from corporate bankruptcies.

MARKET OVERVIEW

Over the past two decades, the ABCP market grew dramatically in size and sophistication. Many different types of ABCP exist today with varied credit, liquidity and interest rate risk characteristics. Investment in ABCP is usually made through managed accounts, as the time and expertise required in ongoing analysis and credit surveillance of ABCP programs can be substantial.

Figure 1: ABCP Outstanding:

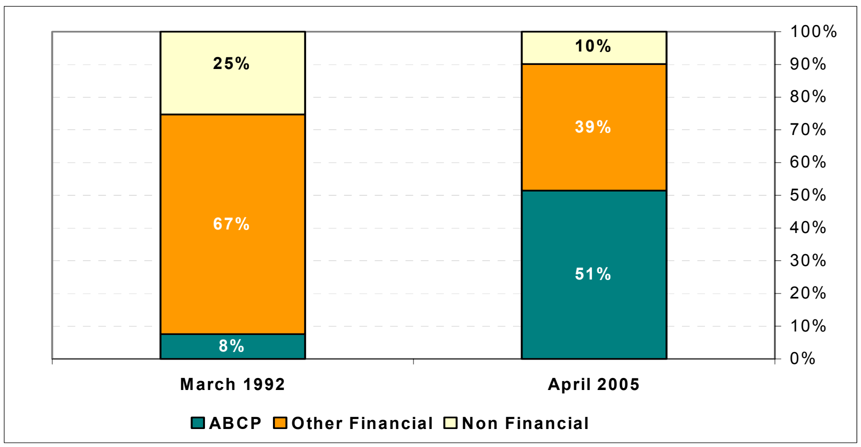


Source: Federal Reserve website Statistics: Releases and Historical Data

According to Federal Reserve data, the ABCP market grew close to 20 times from $40 billion in 1992 to $779 billion in April 2005 as indicated in Figure 1. During this period, its percentage in the overall investment grade CP market also grew substantially. Since June 2001, when ABCP outstanding surpassed traditional corporate Tier 1 (top ratings of A-1/P-1) CP outstanding, it has been close to 60% of all Tier 1 commercial paper outstanding. It currently stands at 57.5% of overall Tier 1 CP outstanding as of April 2005.

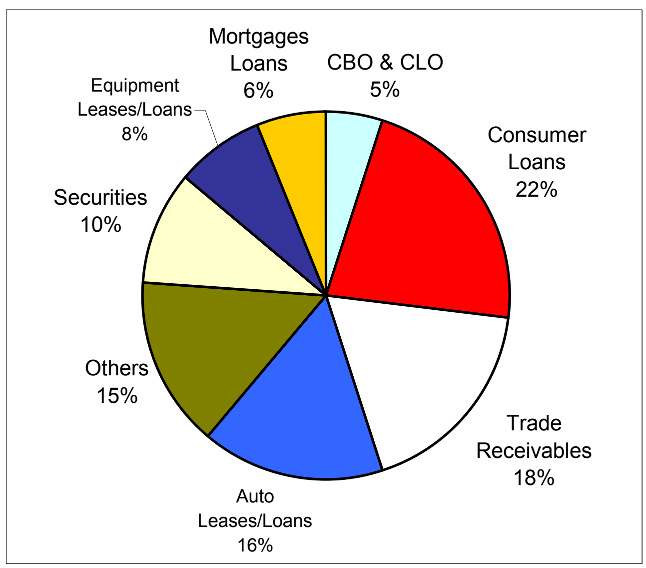
As Figure 2 shows, the makeup of the commercial paper market has changed dramatically. Of all CPs (including those rated A-2/P-2 and lower) outstanding in March 1992, the ratio of traditional corporate CP to ABCP was roughly 11 to 1. Recently, the market is about equally divided between unsecured corporate CP and the secured ABCP.

Figure 2: Comparison of All Commercial Paper Outstanding:



Source: Federal Reserve website Statistics: Releases and Historical Data

Figure 3: Outstanding of Asset Types in ABCP Multiseller Programs (9/04):



Source: 2004 Review and 2005 Outlook: Asset-Backed Commercial Paper, Moody's Investors Service.

During this period, the market has also evolved from primarily a bank-run receivables-backed CP market to one that serves a wide variety of needs, including temporary warehousing of receivables prior to long-term securitization, investing for credit and interest rate arbitrage profit, providing leverage to mutual funds, and so on. Addtionally, some ABCP programs have extended their maturity limits and issue notes beyond the traditional 270-day maximum maturity.

Figure 3 provides a snapshot of the types of asset collateral in ABCP programs as of September 2004. The many different collateral types, funding purposes, and issuance types should serve as a reminder that credit quality range within ABCP can be as vibrant as that among corporate issuers. The approval process for ABCP should go beyond simply relying on the A-1/P-1 short-term ratings.

IS ABCP APPROPRIATE FOR CORPORATE CASH PORTFOLIOS?

With sufficient understanding of the underlying credit risk, the inclusion of ABCP in a corporate cash portfolio may enhance potential yield while reducing portfolio risk. Examples of the benefits of ABCP include:

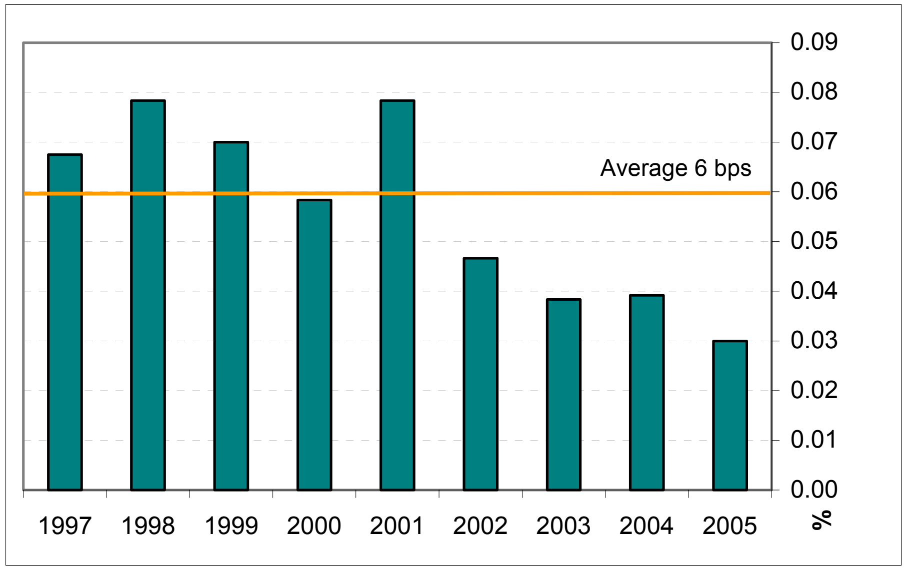
Better Risk Diversification: ABCP offers investors a wider selection of commercial paper programs with less risk correlation to other investment types, such as corporate and agency securities. The large number of ABCP programs may help to reduce issuer and asset concentration risk, and the inclusion of ABCP in investment policies may allow short-term investors to better comply with diversification requirements.

Reduced Idiosyncratic Credit Risk: Part of the recent popularity of ABCP stems from investors' wariness of issuer-specific event risk in corporate names. Since the late 1990s, many investors have been exposed to unsecured investment-grade securities that lost their A-1/P-1 status in a short period of time. Secured ABCP programs, on the other hand, have portfolios of assets that dramatically eliminate credit risk to individual borrowers, thereby reducing exposure to issuer-specific credit risk.

Attractive Yield: In their early days, ABCP programs generally offered competitive yields relative to unsecured corporate CP. Due to its complexity and the need for extensive research, ABCP usually rewards investors with 2 to 20 basis points in extra yield. Today, ABCP spreads over traditional CP continue to be a prime motivator for investors.

In comparing the yields of 90-day ABCP rated A-1+/P-1/F1+ against similarly rated non-asset backed commercial paper yields, we found the yield advantage to be 6 basis points on average between 1997 and 2005. As Figure 4 indicates, the yield spread has compressed now that ABCP has been increasingly accepted as viable investment. During the 1997-2005 period, the yield advantage varied between 25 basis points in October 1998 to 1 basis point in December 2002. When corporate event risk is high, the yield advantage has tended to become less as some investors find ABCP more favorable than corporate CP on a credit-risk basis.

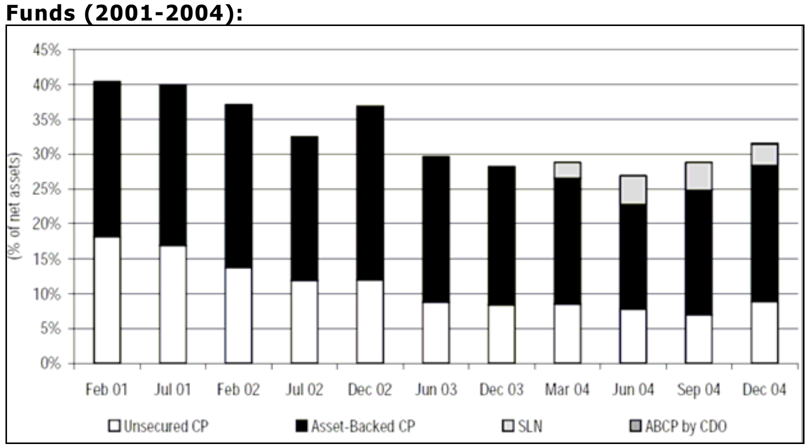
Figure 4: 90-Day ABCP Yield over Corporate CP (A-1+/P-1/F1+):



Source: Bloomberg ABCP and Directly Placed CP Indices

Increased Investor Acceptance: ABCP became a mainstream money market vehicle in the late 1990s, when the corporate CP market shrank in size and the A-2/P-2 market became dormant due to default concerns. Institutional investors also increasingly participated in ABCPs because of their rating stability.

Figure 5: CP Holdings as Percentage of the 15 Largest Prime Money Market Funds (2001-2004):



Source: 2004 Review: Portfolio Activities of Large Prime Institutional Money Market Funds, Moody's Investors Service, March 2005.

Figure 5 provides data from surveys conducted by Moody's of the 15 largest prime institutional money market funds, a group that represents the mainstream of sophisticated short-term investors. The graph indicates consistent use of ABCP and declining use of unsecured CP in prime money market funds. The study shows that, over the survey period, the large prime institutional funds held roughly 31% of assets in commercial paper, of which 20% was in ABCP.

RISK CONSIDERATIONS OF ABCP

While ABCP may provide some risk mitigation in an investment portfolio, it may carry other risks associated with securitized debt.

Structural Risk: Unlike a traditional corporate issuer, whose business and financial risks are relatively easy to understand and analyze, the creditworthiness of an ABCP program is affected by its status as a special purpose entity, which involves risks due to multiple parties and complex legal arrangements. For example, even though voluntary bankruptcy of the issuer is prohibited, some language may be subject to interpretation by a local court of law. Also, because the structure is difficult to understand, the program may be more prone to abuse or fraud by any number of involved parties.

Credit Risk: The Credit risk of an ABCP program addresses the likelihood that collateral in the program will suffer losses and ultimately not be fully collectible. ABCP credit risk comes primarily from two groups: the corporations who use ABCP as funding vehicles, called the “sellers”, and the parties who owe cash to the sellers, called the “obligors” (see Figure 1 in the Appendix). The credit strength and diversification of these two groups will have direct impact on an ABCP program’s credit quality.

In order to mitigate the credit risk of individual sellers and obligors, ABCP programs frequently use banks to provide support, or “credit enhancement”, to offset the initial losses due to seller or obligor defaults. The choice of a credit enhancement bank and the amount of the support are, therefore, major credit risk factors.

Liquidity Risk: The liquidity risk of ABCP is the danger that collections from collateral assets may not arrive in time to provide funds to repay maturing balances. An ABCP program usually uses a bank or a group of banks to provide 100% standby liquidity guarantees for that purpose. The credit quality of the banks and the terms of the liquidity contacts are important factors to consider when evaluating an ABCP program. In addition, the bid-ask spread of ABCP in the secondary market can be wider than corporate commercial paper, which indicates lower liquidity.

Operational Risk: The operational risk stems from the complex administrative tasks performed by the sponsor bank. The bank personnel is responsible for the purchases and collections of collateral assets, making payments to ABCP investors, coordinating among all parties to an ABCP program (see Figure 1 in the Appendix), ensuring proper documentation, performing due diligence, and so on. Since this risk is difficult to assess by an outsider, investors should consider the credit strength of the sponsor bank, its history and experience in ABCP administration, and the program's relevance to the bank's economic interest as some of key operational risk measures.

UNTANGLING THE ABCP WEB FOR CASH INVESTORS

The proliferation of ABCP programs and their increasingly complicated structures can intimidate even the most seasoned corporate cash investors. Here we provide a practical guide of evaluating ABCP program risks for the novice ABCP investor. Bear in mind that some of the complicated subjects have been oversimplified for illustrative purposes.

Strength of Program Administrators: ABCP programs are bankruptcy-remote, special-purpose entities that exist only in legal documents. The starting point in the selection process should be the sponsor bank, or the "program administrator". Since asset collateral essentially represents the sponsor bank's loans labeled with a different legal title, the credit quality of an ABCP is closely associated with that of the program administrator. Absent other credit considerations, investors should refrain from purchasing ABCP administered by banks that they would not invest in directly.

Types of External Support: In the early days of ABCP, some sponsor banks promised to fully and directly guarantee the full and timely payment of maturing ABCP. A handful of these "fully-supported" programs still exist today. Large foreign banks that wish to establish a foothold in the US CP market may also offer fully-supported programs. In these cases, investors generally view the program as part of the bank's own debt.

The vast majority of the market today are "partially-supported" programs, in that a bank, or a group of banks, agrees to bear a portion of the credit risk, with the rest absorbed by investors. The partial credit support, called "credit enhancement", ranges from 6% to 12% of potential losses due to deterioration in the collateral portfolio. Investors should evaluate both the credit quality of the supporting banks and the percentage of credit support to determine the credit risk of a certain program.

Types of Programs: Of all the ABCP programs outstanding, more than half are traditional, partially-supported "multiseller" programs. In a multiseller program, the sponsor bank combines collateral assets from several sellers who deal with a multitude of obligors in a wide variety of industries, offering ABCP investors instant risk diversification. Multiseller programs backed by trade and credit card receivables are generally easier to understand and less risky than other types.

"Single-seller" programs are backed by assets sold by one company, such as automobile loans from GM or Ford. They tend to expose investors to the credit and operational risks of the issuing company, diminishing the risk diversification benefit of ABCP. Even though single-seller ABCP programs may have higher credit ratings than the seller due to bank credit support, the homogenous asset collateral exposes investors to company-specific risks that should be evaluated carefully.

Investors should be skeptical of "arbitrage" programs, which were established to take profit from spread differentials in fixed income securities. Program managers use the proceeds from low-cost, short-term ABCP to fund the purchases of higher yielding, longer-term marketable securities. Arbitrage programs are generally "non-core" businesses to the sponsor banks, as they are not tied to lending relationships, and are less likely to be salvaged by the bank in times of distress. Unfortunately, this is also the type of ABCP that has experienced the most growth recently and has been aggressively marketed to CP investors. Unless well aware of the program manager's investment expertise and risk management capabilities, novice ABCP investors should generally avoid arbitrage ABCP programs.

Collateral Asset Quality: In many cases, a program administrator offers similar programs with different collateral asset qualities. For example, one may allow below investment grade obligors, another may contain non-US assets, and so on. Investors should distinguish the different programs by their collateral asset quality and establish a tolerance threshold prior to investing. It is a good practice to monitor industry diversification, percentage of below investment grade obligors, and exposure to non-US assets on an on-going basis. The data quality of periodic portfolio performance statistics provided by the program administrators should be a relevant investment selection consideration.

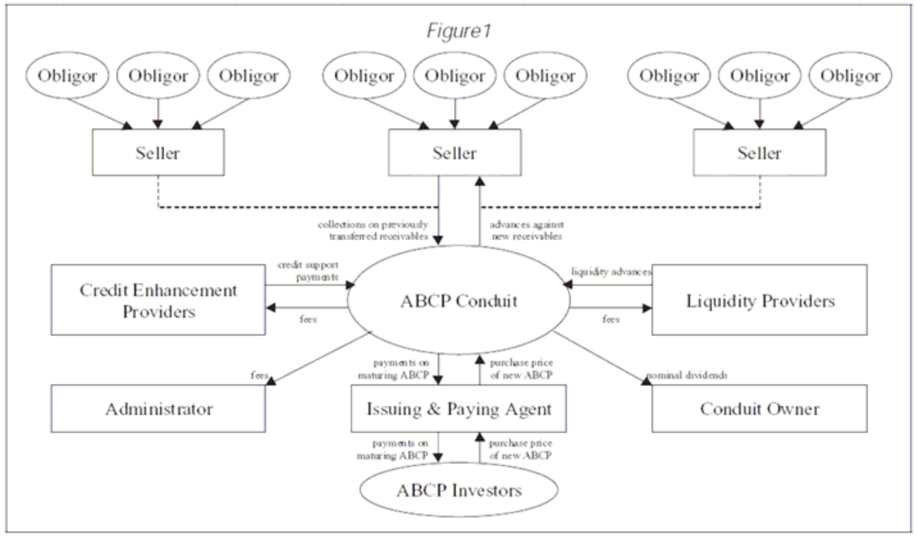
CONCLUSION:

ABCP are appropriate investment vehicles in large corporate treasury accounts due to market depth, liquidity, flexibility, and yield potential. The wide range of risks that exist among programs require dedicated credit expertise and regular asset collateral monitoring.

While the complexity of various programs may be intimidating, corporate cash investors may benefit from selecting some of the more traditional, conservative, and higher quality ABCP names for their portfolios. Specifically, investors may be well served by investing in traditional, mutliseller, receivables-backed programs associated with banks with strong credit ratings and track records of ABCP expertise.

APPENDIX:

Figure 1: Major Components of an ABCP Conduit:



Sources: Moody's Investors Service

Figure 2: Largest ABCP Programs:
(As of December 2004)

	Program Name	Administrator	Outstanding	Support	Program Type
1	Grampian Funding LLC	HBOS Treasury Services plc	21,468	Partial	Sec. Arbitrage
2	Sheffield Receivables Corporation	Barclays Bank PLC	15,676	Partial	Multiseller
3	DAKOTA CP Notes Program	Citibank (South Dakota), N.A.	15,000	Partial	Single-Seller
4	Edison Asset Securitization LLC	General Electric Capital Corp.	13,789	Partial	Multiseller
5	Atlantis One Funding Corporation	Rabobank Nederland	13,333	Partial	Multiseller
6	Park Granada LLC	Countrywide Home Loans Inc.	13,273	Partial	Single-Seller
7	FCAR Owner Trust	Ford Motor Credit Company	12,985	Partial	Single-Seller
8	Scaldis Capital LLC	Fortis Bank S.A./N.V.	12,299	Partial	Hybrid
9	Amstel Funding Corporation	ABN AMRO Bank N.V.	11,109	Partial	Sec. Arbitrage
10	Falcon Asset Securitization Corp.	JPMorgan Chase Bank	10,480	Partial	Multiseller
11	Jupiter Securitization Corp.	JPMorgan Chase Bank	10,302	Partial	Multiseller
12	CAFCO, LLC	Citibank, N.A.	9,850	Partial	Multiseller
13	CRC Funding LLC	Citibank, N.A.	9,798	Partial	Multiseller
14	New Center Asset Trust	GMAC	9,667	Partial	Single-Seller
15	Ranger Funding Company LLC	Bank of America, N.A.	9,609	Partial	Multiseller
16	Barton Capital LLC	Société Générale	8,753	Partial	Multiseller
17	Amsterdam Funding Corporation	ABN AMRO Bank N.V.	8,339	Partial	Multiseller
18	Preferred Receivables Funding Corp.	JPMorgan Chase Bank	8,164	Partial	Multiseller
19	Clipper Receivables LLC	State Street Global Markets LLC	7,836	Partial	Multiseller
20	Chesham Finance LLC	QSR Management Limited	7,090	Full	Other

Sources: Moody's Investors Service

Figure 3: Largest Program Administrators ($mm): (as of December 2004)

	Administrator	Outstanding
1	Citibank N.A.	68,638
2	JPMorgan Chase	48,667
3	Bank of America, N.A.	34,171
4	ABN AMRO	33,912
5	Halifax Bank of Scotland	22,236
6	Rabobank Nederland	21,778
7	Barclays Bank PLC	21,736
8	Danske Bank	20,220
9	Ford Motor Credit Company	19,985
10	WestLB AG	16,025
11	Société Générale	16,023
12	The Liberty Hampshire Co.	15,213
13	Dresdner Bank AG	14,865
14	General Electric Capital Corp.	14,431
15	Countrywide Home Loans Inc.	13,273
16	Bayerische Landesbank	12,854
17	Fortis Bank	12,299
18	Royal Bank of Canada	10,292

Sources: Moody's Investors Service