# Buyer Beware: Four Tips on Navigating the Government's Commercial Paper Funding Facility (CPFF)

**EXECUTIVE SUMMARY:**

***Tip No. 1: In a market that lacks liquidity, CPFF means liquidity.***

***Tip No. 2: When a firm can no longer access CPFF, liquidity may deteriorate rather rapidly.***

***Tip No. 3: Despite the appearance to the contrary, not all CPFF-eligible issuers are the same.***

***Tip No. 4: CPFF eligibility and credit ratings are derived from an issuer's fundamental credit quality, not the other way around. Fundamental credit research remains the key.***

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Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

## Embrace the CPFF

**But Beware of the American Express Blues**

Of the several government programs introduced since the collapse of Lehman Brothers last fall, the Commercial Paper Funding Facility (CPFF) has played a very important role in restoring money market liquidity and lowering short-term credit rates. Since October 27 of last year, when the program was introduced, until January 14, 2009, the three-month commercial paper (CP) rate declined from 2.83% to 1.02%, the lowest level in the current cycle, according to Bloomberg data. The rate currently stands at 1.27%. The program's success is also evidenced by more private investors' interest in the CP market. For example, about 85% of the U.S. CP volume was purchased by the CPFF at the onset of the program but the program's $83 million CP purchase represented just 0.13% of the $62.50 billion new purchases for that week ending January 14th, 2009.

***Tip No. 1: In a market that lacks liquidity, CPFF means liquidity.***

Although we remain wary of unsecured corporate CP issuers, we understand that some more adventurous cash investors are interested in programs supported by the CPFF because of the Fed liquidity backstop. This brings up the topic of the American Express "Blues."

The criteria for CP issuers to participate in the CPFF is rather broad: all U.S. based issuers with top-tier short-term credit ratings, namely A-1 from S&P, P-1 from Moody's, or F1 from Fitch, may issue three-month CP to the program. An obvious question from our perspective would be: what happens to a name that is downgraded below this threshold and thus is no longer eligible for the CPFF liquidity? As far as we can tell no one has the answer; but if recent history offers any guidance, the prognosis is not good! American Express is one such issuer facing that predicament right now.

Traditionally associated with luxury and prestige, "The Card" fell on hard times recently as its aggressive strategy of growing its *Blue* credit card portfolio backfired and credit losses soared. To make matters worse, both of the firm's main funding channels, unsecured CP and credit card securitizations, were essentially shut down during the credit crisis. Although the CPFF literally extended Amex's life expectancy since late last year, rapidly deteriorating consumer delinquencies eventually led to both Moody's and S&P placing the firm's A-1/P-1 on reviews for downgrade. This means that Amex may be ejected from the CPFF in a matter of weeks. If that happens, the firm's days as a solvent investment grade company may be numbered.

***Tip No. 2: When a firm can no longer access CPFF, liquidity may deteriorate rather rapidly.***

American Express is not alone. We can count at least a dozen CP issuers that lost their A-1/P-1/F1 designations and their access to the program since October 2008. This list includes some of the most well known names such as Allstate, Harley-Davidson, and the Hartford. At least 30 more are also at risk of losing CPFF access due to their negative ratings "CreditWatch" status.

In a somewhat perverse way, the credit rating agencies that were widely criticized for helping to create the financial mess have become the *de facto* gatekeepers for a number government programs, the CPFF included. Thanks to this gate-keeping function, whether a firm qualifies for such programs may mean the difference of life or death for many firms. Fair or not, issuers and investors must play the hands being dealt. So, how do we as investors cope with it?

As we've pointed out in earlier communications, the short-term ratings do not provide the same level of granularity as that offered by the long-term ratings. The so-called Tier 1 ratings category encompasses a wide spectrum of credit worthiness that does not adequately address the gradual decline of an issuer's credit quality. For example, securities rated Aaa, Aa1, Aa2, Aa3, A1, A2 and A3 by Moody's would all generally receive a P-1 rating. Investors who focus on the rating alone would have missed some of the warning signals as an issuer comes down the credit "staircase."

***Tip No. 3: Despite the appearance to the contrary, not all CPFF-eligible issuers are the same.***

Let us expand on this point a bit further. The Federal Reserved started the CPFF in hopes of providing "last resort" liquidity to eligible issuers so that private investors would be more willing to purchase the same names. As our earlier statistics show, the strategy has worked well in bringing back private investors. However, investors would be mistaken in believing that because the Federal Reserve is buying certain CP names, it is somehow signaling that the issuer is of good credit quality. There is no qualitative assessment on the part of the Fed to determine credit eligibility other than the ratings factor.

In other words, investors still need to do their homework to determine whether issuers may eventually lose their short-term ratings, and thus lose access to the Federal Reserve backstop. At a minimum, one should gravitate towards the more highly rated names in the AA or AAA (if any are left) rating categories rather than the A-rated names with much less leeway before they may be kicked out of the CPFF.

It's important to recognize that ratings changes are not made in a vacuum. Faced with the same economic challenges, diversified issuers with little cash needs such as Johnson & Johnson (JNJ) and Procter & Gamble (PG) should be less likely to see their short-term ratings downgraded than financial and cyclical issuers such as American Express, Caterpillar and John Deere. This comparison also is consistent with the ratings agencies awarding JNJ and PG much higher long-term ratings than those given to the latter, even though all currently maintain Tier 1 status.

***Tip No. 4: CPFF eligibility and credit ratings are derived from an issuer's fundamental credit quality, not the other way around. Fundamental credit research remains the key.***

Originally scheduled to expire in April of 2009, the CPFF has been extended to October 30th of this year. Rumor has it that the return of market liquidity and the introduction of subsequent government programs have caused the Fed to consider winding it down by the expiration date. While some investors take comfort in a CP issuer having the flexibility to tap CPFF for liquidity, the fundamental credit landscape remains very challenging for Corporate America.

This leads us to believe that downside risk to liquidity remains substantial. Despite the perceived benefit, we would not consider CPFF as an unfettered stamp of approval to purchase names that may be susceptible to global economic downturns.

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