COMMERCIAL PAPER

commercial paper
A form of financing consisting of short-term, unsecured promissory notes issued by firms with a high credit standing.

Commercial paper is a form of financing that consists of short-term, unsecured promissory notes issued by firms with a high credit standing. Generally, only large firms of unquestionable financial soundness are able to issue commercial paper. Most commercial paper issues have maturities ranging from 3 to 270 days. Although there is no set denomination, such financing is generally issued in multiples of $100,000 or more. A large portion of the commercial paper today is issued by finance companies; manufacturing firms account for a smaller portion of this type of financing. Businesses often purchase commercial paper, which they hold as marketable securities, to provide an interest-earning reserve of liquidity. For further information on recent use of commercial paper, see the *Focus on Practice* box.

Interest on Commercial Paper

Commercial paper is sold at a discount from its *par,* or *face, value.* The size of the discount and the length of time to maturity determine the interest paid by the

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focus on PRACTICE

The Ebb and Flow of Commercial Paper

in practice The difficult economic and credit environment in the post–September 11 era, combined with historically low interest rates and a deep desire by corporate issuers to reduce exposure to refinancing risk, had a depressing effect on commercial paper volumes from 2001 through 2003. According to the Federal Reserve, U.S. nonfinancial commercial paper, for example, declined 68 percent over the 3-year period, from $315.8 billion outstanding at the beginning of 2001 to $101.4 billion by December 2003. In addition to lower volume, credit quality of commercial paper declined over the same period, with the ratio of downgrades outpacing upgrades 17 to 1 in 2002.

In 2004, signs emerged that the volume and rating contraction in commercial paper was finally coming to an end. The most encouraging of these was the pickup in economic growth, which spurs the need for short-term debt to finance corporate working capital. Although commercial paper is typically used to fund working capital, it is often boosted by a sudden surge of borrowing activity for other strategic activities—mergers and acquisitions and long-term capital investments, among others. According to Federal Reserve Board data, at the end of July 2004, total U.S. commercial paper outstanding was $1.33 trillion.

By 2006, commercial paper surged to $1.98 trillion—an increase of 21.5 percent over 2005 levels. However, after peaking at $2.22 trillion, the tide changed in response to the credit crisis that began in August 2007. According to Federal Reserve data, as of October 1, 2008, the commercial paper market had contracted to $1.6 trillion, a reduction of nearly 28 percent, and new issues virtually dried up for several weeks. With much of the commercial paper outstanding at the start of the credit crisis coming up for renewal, the Federal Reserve began operating the Commercial Paper Funding Facility (CPFF) on October 27, 2008. The CPFF was intended to provide a liquidity backstop to U.S. issuers of commercial paper and, thereby, increase the availability of credit in short-term capital markets. CPFF allowed for the Federal Reserve Bank of New York to finance the purchase of highly rated unsecured and asset-backed commercial paper from eligible issuers.

Even with the CPFF up and running, companies that were worried about their ability to roll over their outstanding commercial paper every few weeks turned to long-term debt to meet their liquidity needs. Merrill Lynch & Co. and Bloomberg data showed that, to manage short-tem liability risk, companies were paying as much as $75 million in additional annual interest to swap long-term debt for $1 billion of 30-day commercial paper.

With the recession in the rearview mirror and short-term credit markets working again, the CPFF was closed on February 1, 2010. As of mid-2010, the U.S. commercial paper market appeared to be hitting bottom at around $1.06 trillion and showing signs of recovering.

▶ *What factors contribute to an expansion of the commercial paper market? What factors cause a contraction in the commercial paper market?*