Article Title: ARCHIVE | Criteria | Corporates | General: Standard & Poor's Revises Its Approach For Backup Of Commercial Paper Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by the article titled "2008 Corporate Criteria: Commercial Paper," published April 15, 2008.) Standard & Poor's has established new criteria for analyzing the liquidity of corporates that issue confidence-sensitive paper, such as commercial paper and short-term notes. (Finance company and structured-vehicle commercial paper criteria are not affected.) Under the new criteria, companies will have greater flexibility with respect to the amount of bank back-up facilities they maintain--if they are prepared to match their maturities carefully with available liquidity. The basic idea is that these firms--if and when they lose access to the commercial paper market--should have sufficient liquidity to cover the paper coming due during the time they would require to arrange additional funding. How long might that take? A key assumption is that firms of higher credit quality will have an easier task arranging financing quickly. Accordingly, companies currently rated 'A-1+' or 'A-1' are presumed to remain reasonably good credits--even if they should experience a liquidity problem--and would be able to arrange funding within 30 days. For companies that are currently rated only 'A-2', the presumed period is longer--90 days; as weaker credits, they would find it more difficult to arrange financing. For 'A-3' rated companies, the standard for coverage will remain 100% of outstanding confidence-sensitive obligations. Until Now Ever since the Penn Central bankruptcy roiled the commercial paper market and some companies found themselves excluded from issuing new commercial paper, Standard & Poor's has deemed it prudent for companies that issue commercial paper to make arrangements in advance for alternative sources of liquidity. This alternative, "back-up" liquidity would protect them from defaulting were they unable to roll over their maturing paper with new notes--due to a shrinkage in the overall commercial paper market or some cloud over the particular company that might make commercial paper investors nervous. The standard coverage has been 100% of confidence-sensitive paper outstanding (which includes euro commercial paper, master notes, and short-term notes as well as conventional commercial paper in the U.S. market) for all but the very strongest credits (those rated 'A-1+', which could provide 50%-75% coverage). This level of backup has provided a sense of security to commercial paper investors--even though back-up facilities are not a guarantee that liquidity will, in the end, be available. (For example, a company could be denied funds if its banks invoked "material adverse change" clauses. Alternatively, a company in trouble might draw down its credit line to fund other cash needs, leaving less than full coverage of commercial paper outstandings, or issue paper beyond the expiration date of its lines.) Similarly, commercial paper dealers have been eager for rating agencies to set high standards for coverage, in the belief that this reduced their own risk--since investors might expect the dealer to step in and provide liquidity were an issuer unable to pay off its commercial paper. Thus, Standard & Poor's 100% back-up liquidity criteria have contributed to the vibrancy of the commercial paper market. From a credit perspective, there would be nothing wrong with maintaining this status quo, which works quite well. Indeed, Standard & Poor's would encourage companies to maintain a robust level of alternative liquidity as "insurance" against the unknown. However, companies that issue commercial paper have questioned whether it is appropriate from a credit perspective to request that everyone carry such a high level of "insurance," given the degree of risk that is involved. Since back-up facilities are costly, firms have a legitimate reason to question what the appropriate level of backup is. More specifically, companies want to know if providing less than the standard 100% backup would lead to a change in their Standard & Poor's rating. If they were to choose lesser coverage, at what point would the added risk translate into a lower rating? Another impetus for Standard & Poor's to take a fresh look at back-up criteria is the introduction of innovative forms of backup--such as capital-market puts or commitments from structured entities--and new types of notes--such as extendible notes. Companies are keen to utilize these new products to diversify their sources of alternative liquidity and also to reduce their reliance on the commercial banking sector. Recent Innovations Last year, companies began issuing extendible commercial notes (ECNs), a Goldman Sachs product. Since ECNs can be extended if the issuer cannot sell new paper, they are said to have "built-in backup." On the other hand, there is a real risk that a company--in a crisis--would dip into its bank back-up facilities to avoid the stigma of extension. Since the company's backup for conventional commercial paper could also be used for its ECNs, issuers of unbacked ECNs do not really conform to the standard of 100% backup. It is because of this risk that Standard & Poor's has limited ECN issuance to 20% of the extant backup. In effect, then, for commercial paper issuers that also issue ECNs, the 100% back-up liquidity standard has been reduced to a potential 80%. Moreover, with the advent of ECNs, back-up criteria have shifted from merely setting percentages of outstandings that need to be covered to also considering how a company might manage to remain solvent after utilizing the back-up arrangement to repay or extend its maturing commercial paper. The extension of an ECN merely provides the company a breather; the company must still procure new funding to pay off the note. The extended note represents a hard maturity, as opposed to the expiry of a bank facility, which would be renewed in a normal lending relationship. Similarly, backup provided by recently innovated structured vehicles and capital market contracts would pay off the outstanding commercial paper--but leave the company still facing hard maturities. For example, one commitment vehicle requires the company to repay the funding entity in as little as three months. The common analytical element for determining how long a breather is required when the back-up facility provides only a temporary respite--and how much backup is needed in the first place--is the pragmatic question: How much time might a company need to arrange more permanent funding? New Criteria The new criteria, just like the old, take into account 1) the likelihood of the event--of a given issuer's ever losing access to funding in the commercial paper market--and 2) the time frame presumed necessary to arrange alternate funding should the company lose access. Current credit quality is the key factor with regard to both. A higher-rated entity is less likely to encounter business reverses of significance and--in the event of a general contraction of the commercial paper market--the higher-rated credit would be less likely to lose investors. In fact, higher-rated firms could actually be net beneficiaries of a flight to quality. The new criteria, however, focus explicitly on a company's maturity schedule. This differentiates between companies that are rolling over all their commercial paper in just a few days and those that have a cushion by virtue of having placed longer-dated paper. Accordingly, the guidelines are as follows: 'A-1+' provides for 30 days of upcoming maturing paper on a rolling basis. 'A-1' provides for 30 days of upcoming maturing paper on a rolling basis. 'A-2' provides for 90 days of upcoming maturing paper on a rolling basis. 'A-3' provides for all paper outstanding on a rolling basis. It is critical to consider the upcoming maturities on a daily rolling basis--rather than to rely on averages--because borrowing patterns vary as companies finance peak needs or occasionally bunch maturities. The backup always needs to cover the peaks--as they fall within the number of days to be covered. Any company that proposes to adopt the new guidelines to reduce its back-up requirements has to establish a system to match maturities carefully with available backup. The company should first match the first few days of maturities with excess cash or funding facilities that provide for immediate availability. For example, a bank back-up facility that requires two-day notification to draw down won't be of any use in repaying paper maturing in the interim. The same would hold true if a company were relying on a bank facility in Germany--and differences in time zones or bank holidays prevented immediate availability. Obviously, a bank facility in the U.S. would be equally lacking with respect to maturing euro commercial paper. This exercise, then, will focus on the maximum amount that could mature in any three- to four-day period. (This is not a change of criteria: All issuers--even if they have 100% backup--are expected to provide for similar immediate availability to cover a few days of maturing paper.) Next, the company would match the maximum amount of paper maturing in the upcoming 30- to 90-day periods (depending on its rating) with back-up liquidity that includes excess cash, bank lines, capital market commitments, and so forth. This exercise has to be performed daily on a rolling basis. The maturities to be matched include commercial paper, euro commercial paper, master notes, and short-term notes, as well as current maturities of long-term debt and medium-term notes that the company is planning to refinance with commercial paper or short-term notes. A company paring its backup to these new guideline levels could not issue ECNs without backup, since that would degrade its coverage below what is deemed the minimum levels. The tenor of any back-up facility with a hard maturity needs to be at least 90 days--regardless of rating levels--inasmuch as the company would already have lost access to the commercial paper market in the scenario of relevance. Some Questions Could the new criteria add system risk? Perhaps, but Standard & Poor's would not consider the added risk to be significant. It should be understood that a Standard & Poor's credit rating is an opinion on a specific issuer's or issue's credit risk. System risk, if any, falls within the purview of policymakers, not ratings services. If there is less "insurance" in the system, there might well be a company--that might otherwise have pulled through a liquidity crisis--that defaults. The criteria, however, are designed to keep such outcomes few and far between. The small number of potentially adverse outcomes does not justify requiring every company to pay for a level of risk avoidance that may be above that needed as a credit matter. How do investors feel about the new approach? Not surprisingly, investor feedback indicates some disappointment over the potential for their losing their 100% backup "security blanket." It is not yet clear if this disappointment will translate into a reluctance to buy paper with different levels of backup. How will the new levels of coverage be kept under surveillance? Surveillance is still an open question. The obvious solution is self-monitoring by the issuers. Standard & Poor's is also considering some form of compliance certification. When will these new policies go into effect? Companies will want to give a lot of thought to what level of coverage works for them. It could be a mistake for them to try to play it too close--especially if their operating cash flow is at all variable. Moreover, matching maturities may involve some complexities for issuers. Accordingly, it would make sense for companies that want to modify their commercial paper coverage to conduct a trial over a several-month period prior to making a change. Implementation, then, will not occur for at least several months. Investors and dealers should have sufficient time to digest the potential for companies adopting different back-up policies and to make any adjustments to their own procedures that might have to accompany such changes.