

Commercial Paper and the Financial Crisis

From 1980 to 2007 the U.S. market for unsecured commercial paper grew rapidly. But that growth came to an end with the bailout of Bear Stearns and growing evidence of problems in the mortgage market. On September 15th, 2008, Lehman Brothers filed for bankruptcy. The following day the Reserve Primary Fund, a large money market fund, announced that it had incurred significant losses on \$785 million of its holdings of Lehman commercial paper and suspended redemptions for seven days. Over the following week investors withdrew \$285 billion from prime money market funds, or about 14% of total fund assets. Since money market funds held over 40% of the outstanding commercial paper, this led to considerable disruption in the market.

The run on money market funds was stemmed on September 19, when the U.S. Treasury announced a program to guarantee funds. Nonetheless, demand for commercial paper continued to fall away as money market funds and other investors became increasingly reluctant to purchase the paper. This had serious knock-on effects on corporations that depended on the commercial paper market to fund their working capital. Therefore, on October 7, the Federal Reserve stepped in and set up a special purpose vehicle to buy firms' commercial paper. The Fed's move had a nearly immediate impact with yields on high-grade overnight paper dropping by 74 basis points.

Despite the Fed's support, the commercial paper market remained sluggish. By July 2009 the amount of commercial paper outstanding had declined by over 40% and the spreads of 4-week paper against the Treasury bill rate had widened sharply, particularly for financial paper. At the same time, the difference in yields between high- and low-quality paper increased from a typical figure of about 20 basis points before the crisis to a peak of 615 basis points.

Asset-Backed Commercial Paper In 2007 asset-backed commercial paper (ABCP) made up about half of the \$2.16 trillion in commercial paper outstanding. Unlike corporate commercial paper which is generally a senior unsecured obligation, ABCP was secured by specific pools of supposedly high-grade assets and was therefore regarded as almost risk-free. The assets were usually held by a financial institution, which then sold them to a structured investment vehicle (SIV). The SIV raised the cash to buy the assets by selling ABCP to money market funds and other investors. This created a legal separation between the institution that wished to finance the assets and the SIV that issued the ABCP.

Many SIVs were set up by commercial banks to finance long-term mortgages, credit-card receivables and other high-yield investments.

In August 2007 American Home Mortgage declared bankruptcy, which led to its SIV, Broadhollow Funding, exercising an option to delay repaying its ABCP for up to 120 days. By September concerns about other SIVs had caused the ABCP market to dry up, and many SIVs were forced to liquidate their investments, at a substantial loss. From a peak of \$1.2 trillion in July 2007 total ABCP outstanding had fallen to \$470.7 billion by December 2009.

