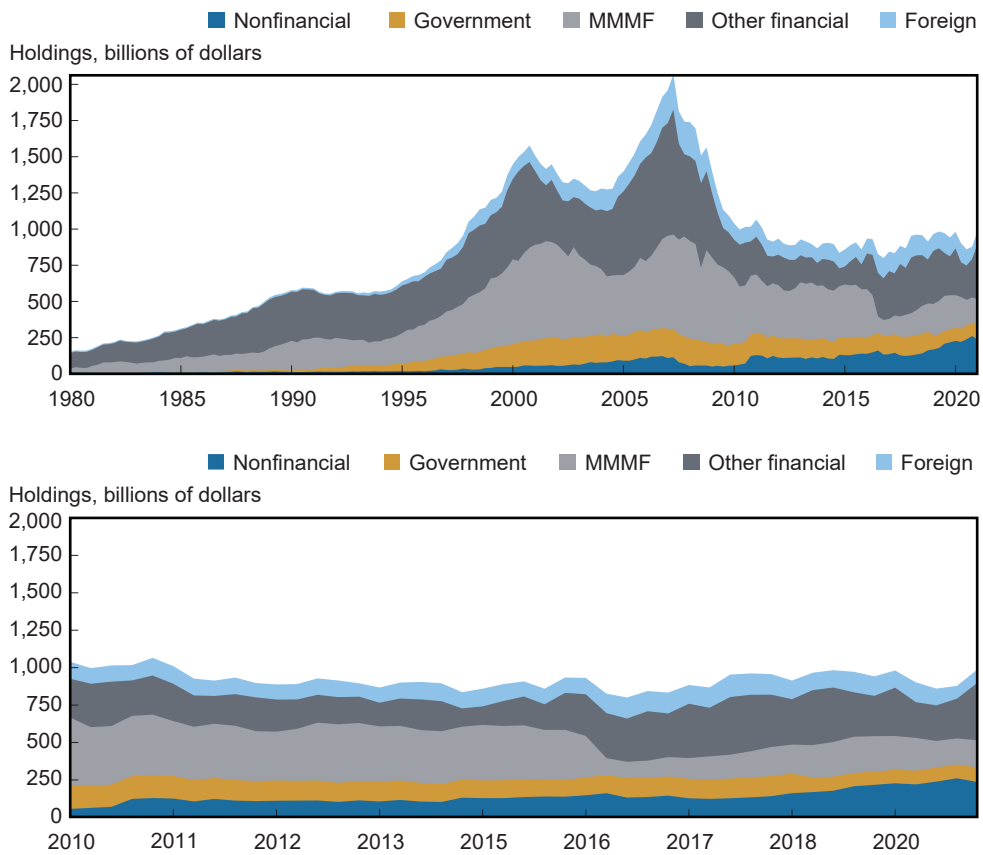


CHART 3
Commercial Paper Holdings by Institution Type

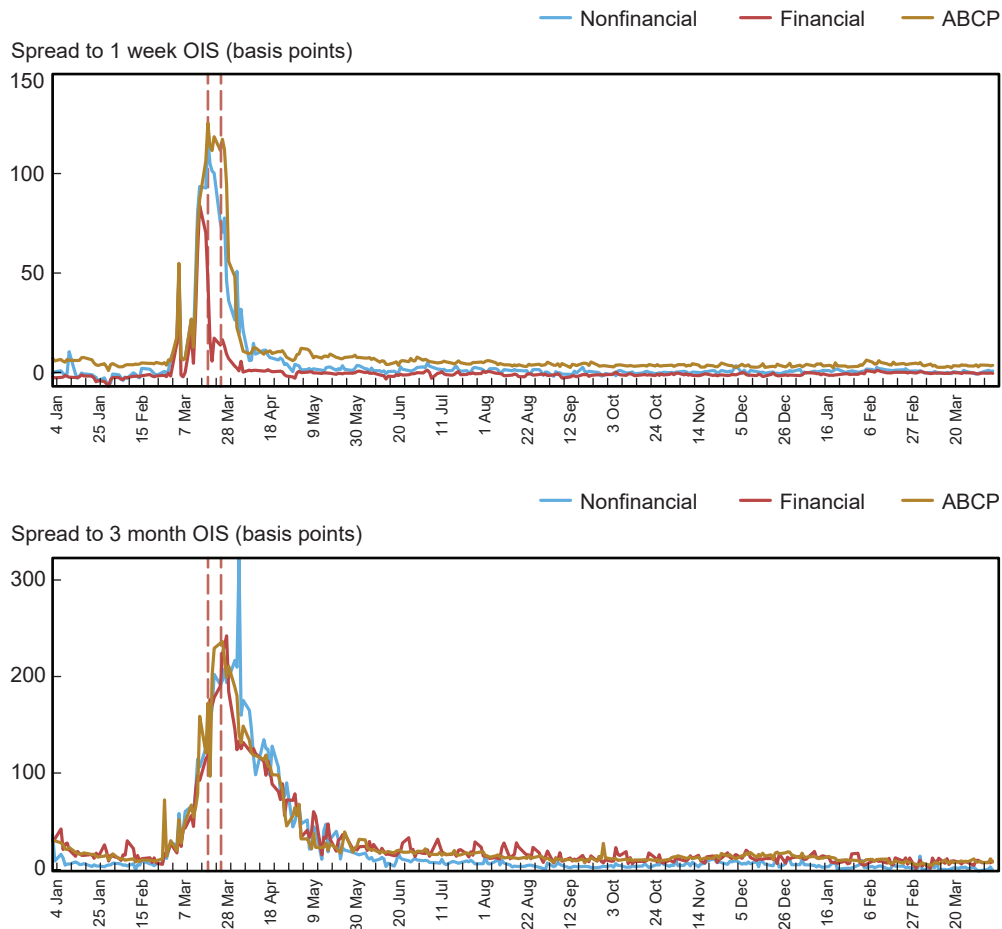


Source: Board of Governors of the Federal Reserve System, Statistical Release Z.1, “Financial Accounts of the United States: First Quarter 2021, Table L.209.”

1.2 Lenders in the Commercial Paper Market

Historically, money market mutual funds (MMMFs) have been the largest single investor in the CP market. One of the biggest changes to the CP investor base came in response to changing MMMF regulation. In 2010, the Securities and Exchange Commission (SEC) first amended Rule 2a-7 to require prime MMMFs to invest in even higher-quality assets with shorter maturities. In 2014, in a further attempt to make the industry more resilient to financial shocks, the SEC approved a new set of rules for prime and muni MMMFs. These rules, which came into effect in October 2016, imposed floating net asset values (NAVs), fund management gates, and the possibility of redemption fees. There was a corresponding shift in assets from prime funds to government funds (see Cipriani and La Spada [2017] for more details), and a decrease in the share of CP outstanding held by MMMFs. Chart 3 characterizes the commercial paper market from the perspective of the investors.

CHART 4
Spreads on A1/P1 Paper Rose Sharply at the Beginning of March 2020



Source: Depository Trust and Clearing Corporation.

Notes: An issuer is designated A1/P1 if its short-term rating is A1/P1/F1 according to at least one major rating agency. If the issuer is rated by multiple rating agencies, the issuer must receive a short-term rating of A1/P1/F1 from at least two agencies. The two vertical red lines correspond to March 17 and March 23.

Since that one-time fall, the share of CP held by MMMFs gradually increased, and holdings by other institutions have been mostly stable since the financial crisis.

1.3 Commercial Paper Market Stress in 2020

Chart 4 plots the recent time series of the spread to the matched-maturity overnight index swap (OIS) for commercial paper issued by A1/P1/F1 nonfinancial, financial, and ABCP issuers. At the beginning of March, spreads on this most highly rated paper increased sharply, particularly for longer maturity commercial paper. In contrast to the GFC, the increase in

spreads was particularly high for nonfinancial issuers. As in past episodes of dysfunction in these markets, a combination of liquidity risk and jump to default risk was manifested, reflecting concerns about the underlying credit quality of issuers based on their potential exposure to ramifications of the COVID-19 pandemic.

Nonfinancial three-month paper spreads to three-month OIS averaged 18 basis points in 2019 and typically were below spreads for financial paper and ABCP. By March 17, 2020, spreads had increased tenfold, subsequently peaking above 300 basis points by the end of March. Anecdotally, concerns were raised about the difficulty of longer-term CP issuance, although no fall in issuance is visible in the data. Such concerns are consistent with the decline in the amount of CP outstanding that began in March 2020, as can be seen in Chart 2.

2. CPFF DESIGN AND OPERATION

The design and operation of the original version of the CPFF is described in detail in Section 3 of Adrian, Kimbrough, and Marchioni (2011). The authors highlight that the effectiveness of the facility as a liquidity backstop was due to its simplicity in usage, compliance with existing market conventions, accessibility to a large cross section of the commercial paper market, minimization of credit risk taken by the Reserve Bank, carefully calibrated pricing, and quick implementation.

The 2020 version of the CPFF (CPFF 2020) sought to capitalize on the previous CPFF by drawing on the legal, trading, investment, custodial, administrative, and risk management blueprints from the prior experience.

2.1 2020 Organization

The design and operation of CPFF 2020 were generally similar to that of the original GFC-era facility.

As in the 2008 program, CPFF 2020 operated through a dedicated funding vehicle—CP Funding Facility II LLC (CPFF II LLC)—that was established solely to purchase eligible three-month commercial paper from eligible issuers, providing a sufficiently long maturity for borrowers to avoid continuous rollover risk. Eligible issuers were highly rated U.S. entities, including nonfinancial corporations, banks, state and local governments, and ABCP programs. CPFF II LLC obtained loans from the Federal Reserve Bank of New York to fund its commercial paper purchases and pledged its assets, including the purchased commercial paper, as collateral to secure any loans.

Also as in the 2008 program, CPFF 2020 operated through existing market structures. Issuers sold paper to the facility through commercial paper dealers, who served as agents between the New York Fed and the commercial paper issuers, drawing on the dealers' existing relationships with the hundreds of issuers in the commercial paper market and their experience underwriting, placing, and making markets in this market. Trade execution was conducted electronically on a platform commonly used for the primary issuance of commercial paper, with straight-through processing requiring little manual intervention. A daily purchase operation with same-day settlement assured issuers that the CPFF could meet any unexpected liquidity need.

Pricing of the facility was again set as a spread to the three-month OIS rate, although the 2020 facility was set at a narrower spread of 110 basis points for top-tier paper and a spread of 200 basis points for tier-two paper (discussed more below). In addition, as in the 2008 facility, issuers paid an upfront registration fee of 10 basis points.

Once again, the New York Fed secured the services of experienced market participants to build the infrastructure needed to run the facility. These included the services of Pacific Investment Management Company, LLC (PIMCO), which served as CPFF II LLC's transaction agent and investment manager, and State Street Bank & Trust Company (State Street), which served as the custodian and accounting administrator. Transactions all cleared through the market's standard clearing mechanisms through the Depository Trust and Clearing Corporation.

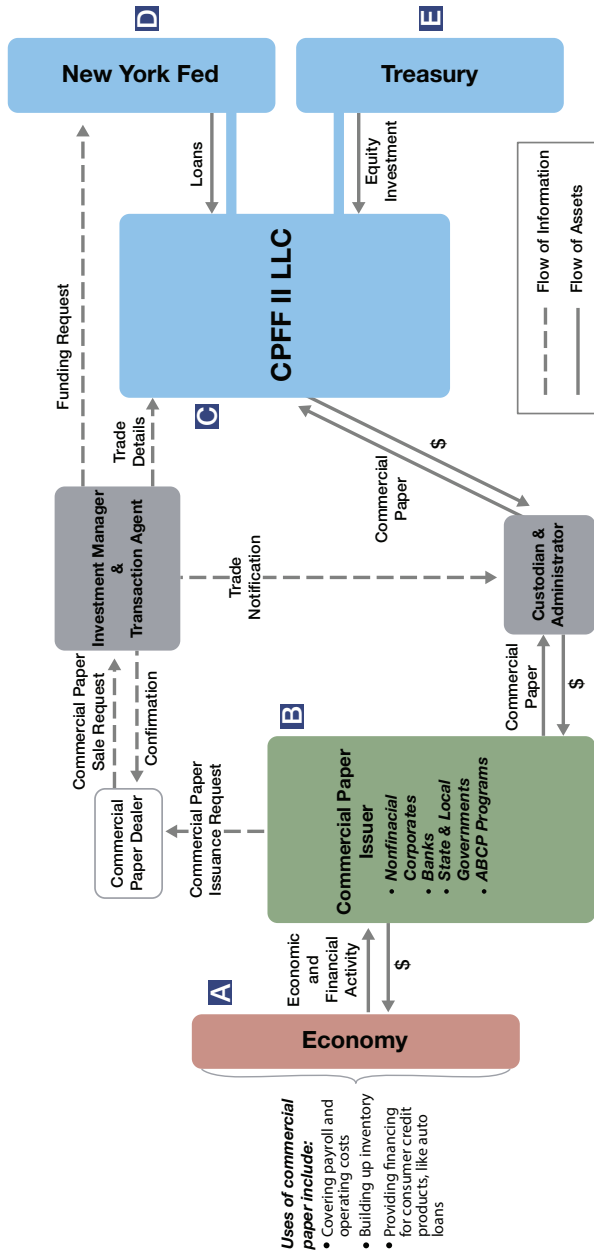
The key players in the transaction and flow of funds are explained further in Exhibit 1.⁴

2.2 Differences from the 2008 Facility

Although the overall design and structure of the CPFF 2020 replicated that of the original program, CPFF 2020 operated with several distinct differences, which reflected in part the unprecedented uncertainty and potentially broad impact of the pandemic, initiatives to expand participation and diversification in Federal Reserve programs, and clearer risk-sharing arrangements with the U.S. Treasury. Some of the key differences follow.⁵

- **Downgrade exception:** To minimize the credit risk offered by a backstop facility, the Federal Reserve generally limited purchases to top-tier commercial paper, rated A1/P1/F1 or higher, consistent with 2a-7 fund conventions. Recognizing the uncertainty and concerns about market dynamics as the pandemic spread in the United States, the Fed added a limited-use exception for issuers that met the top-tier eligibility requirement when the facility was announced. These were subsequently downgraded to no lower than A2/P2/F2. Such downgraded issuers would be allowed to make a one-time sale to the facility, effectively allowing them to roll maturing paper with the facility while they worked to secure alternative funding sources. Additional support for corporate bond issuers that were rated investment grade as of March 23 was provided by the Corporate Credit Facilities, which became active later in 2020.
- **Municipal commercial paper:** State and local governments and related entities faced a severe tightening in market conditions because of pandemic-induced uncertainty about revenues and strains on expenditures. On March 23, 2020, to facilitate the flow of credit to municipalities, municipal commercial paper was added as eligible for CPFF purchases, at the same time that the Money Market Liquidity Fund (MMLF) was expanded to accept a wider range of municipal instruments for secondary market purchases. Both actions provided support before the Federal Reserve and Treasury Department announced in early April the establishment of a \$500 billion Municipal Liquidity Facility to support state and local governments more directly.
- **Pricing structure:** While the 2008 version of the program offered different spreads for the prices at which the facility would buy unsecured versus asset-backed commercial paper (and considered a credit surcharge for paper that did not carry a government guarantee), CPFF 2020 offered to purchase both unsecured and asset-backed commercial paper at the same price. The initial terms and conditions stated that the price of Tier 1 paper would be the three-month OIS rate plus 200 basis points, which was equal to the all-in pricing offered in the 2008 program. Downgraded paper would be subject to a

EXHIBIT 1
Schematic of Key Linkages in the CPFF



Key Entities

- A. Commercial paper is a short-term IOU used to finance a wide range of economic activity, supplying funding for the operational needs of businesses and municipalities. Commercial paper can help firms cover payroll and other operating costs, build up inventories, and provide financing for assets like auto loans.
- B. Issuers of commercial paper can register to sell their paper to the CP Funding Facility II LLC (CPFF II LLC). Eligible issuers are highly rated U.S. entities, including nonfinancial corporations, banks, state and local governments, and asset-backed commercial paper (ABCP) programs.
- C. The CPFF II LLC is a dedicated funding vehicle established solely to implement the CPFF by purchasing eligible commercial paper from eligible issuers.
- D. The New York Fed manages the CPFF II LLC and makes loans to fund its commercial paper purchases. It has retained vendors to assist in managing the CPFF II LLC's activities (Investment Manager & Transaction Agent), and to serve as custodian and administrator of the CPFF II LLC's assets (Custodian & Administrator).
- E. The U.S. Treasury has made an equity investment in the CPFF II LLC to help absorb potential losses.

higher price. The spread on the Tier 1 price was subsequently lowered to 110 basis points (and the spread for Tier 2 paper was set at 200 basis points), in order to be more consistent with pricing offered for other facilities active at the same time and in consideration of prevailing market conditions.

- **Equity capital:** The U.S. Treasury, using the Exchange Stabilization Fund, provided a \$10 billion equity investment in the CPFF II LLC. While the original CPFF did not have formalized credit protection, ensuring this arrangement at inception helped to secure the facility to the Federal Reserve’s satisfaction—a requirement for all 13(3) lending—and reinforced cooperation between the Federal Reserve and Treasury in addressing the urgent needs of this crisis. The size of the equity investment for the facility was calibrated based on historical A1/P1/F1 extreme downgrade probabilities.⁶ This equity was in addition to the 10 basis point registration fee that issuers paid upfront, which, together with any earnings, would absorb potential credit losses.
- **Expanded ratings agencies:** CPFF 2020, like the 2008 version, was launched with program terms that would accept credit ratings only from Fitch Ratings, Inc., Moody’s Investors Service, Inc., and S&P Global Ratings. On May 26, 2020, the Federal Reserve expanded the set of nationally recognized statistical rating organizations (NRSROs) whose ratings would be accepted in determining the eligibility of commercial paper—adding DBRS, Inc., Kroll Bond Rating Agency, Inc., and only with respect to insurance companies, A.M. Best Rating Services, Inc.—to the extent the issuer also had a qualifying rating from one of the original three NRSROs.
- **Expanded counterparties:** Finally, while both versions of the CPFF were launched with a structure that relied on primary dealers as the intermediaries between issuers and the facility, on July 23, 2020, the Federal Reserve launched an initiative to broaden the set of broker dealers who would be eligible to transact with the CPFF. This initiative was expected to increase the operational capacity of the facility while supporting equal opportunity for and diversity in the operation of the facility. Between September 9, 2020, and February 4, 2021, seven nonprimary commercial paper dealers who met designated eligibility requirements (including size restrictions, transaction capabilities, financial conditions, compliance controls, and equal opportunity and diversity efforts), were added to the program as CPFF dealers.

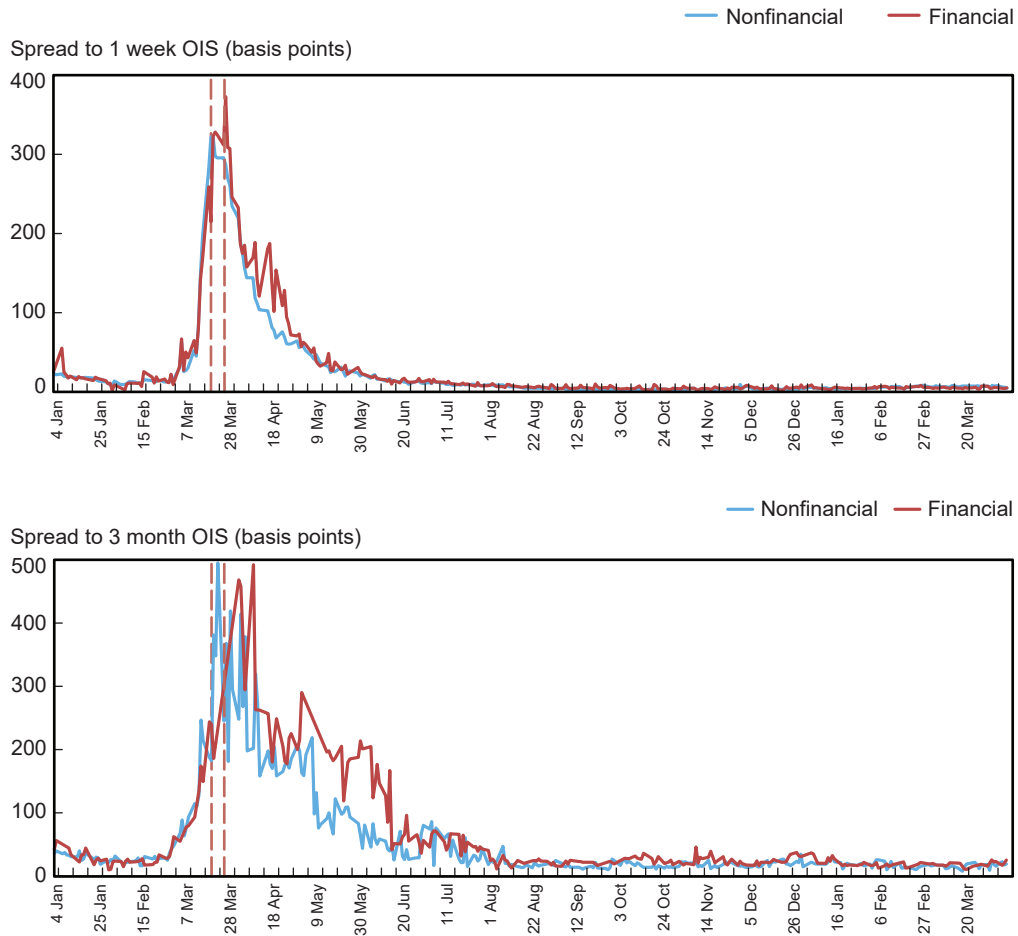
Other terms of the program, including issuer capacity limits and registration provisions, were the same as those of the 2008 program. Counterparty risk management also functioned essentially the same, with penalty pricing associated with lending rates analogous to setting haircuts on a nonrecourse loan.

3. IMPACT OF THE FACILITY

As shown in Chart 4, for the shortest maturity issuances, spreads to one-week OIS on one-week A1/P1 paper started declining immediately upon announcement of the facility on March 17: The spread on nonfinancial commercial paper declined from 117 basis points on March 17 to 11 basis points on April 14 (when the facility commenced purchases), and the spread on financial commercial paper declined from 46 basis points on March 17 to 1 basis point on April 14. The

CHART 5

A2/P2 Market Functioning Also Improves after CPFF Announcement



Source: Depository Trust and Clearing Corporation.

Notes: An issuer is designated A2/P2 if its short-term rating is A2/P2/F2 according to at least one major rating agency. If the issuer is rated by multiple rating agencies, the issuer must receive a short-term rating of A2/P2/F2 from at least two agencies. The two vertical red lines correspond to March 17 and March 23.

response of spreads on longer maturity commercial paper continued to rise after the facility announcement, with the spreads to three-month OIS on three-month A1/P1 nonfinancial commercial paper peaking at 322 basis points on April 1, before declining to 125 basis points by April 14. Similarly, the spreads to three-month OIS on three-month A1/P1 financial commercial paper started to decline on March 26 from 242 basis points to 98 basis points on April 14.

While the facility only accepted commercial paper from issuers rated A1/P1 as of the facility announcement date, by stabilizing the A1/P1 market, the facility has had a positive impact on market functioning and liquidity for lower-rated issuers as well. Chart 5 shows spreads to maturity-matched OIS for A2/P2 commercial paper.

As with the A1/P1 market, the shortest maturity spreads reacted almost immediately: The spread on nonfinancial commercial paper declined from 322 basis points on March 17 to 93 basis points on April 14, and the spread on financial commercial paper declined from its peak of 373 basis points on March 24 to 187 basis points on April 14. The reaction of longer maturity spreads was less pronounced, with a modest 50-basis-point decline in the spread on nonfinancial three-month paper over the period from March 17 to April 14. Indeed, the bottom panel of Chart 5 shows that the spreads on three-month A2/P2 paper only went back to pre-pandemic levels toward the end of the summer of 2020. Thus, although the CPFF announcement helped to ameliorate stresses throughout the commercial paper market, the response of securities not eligible for direct purchases was more muted.

Inspecting the A1/P1 nonfinancial issuers in greater detail, we can examine whether market pricing for issuers in industries more likely to be directly affected by the COVID epidemic—such as airlines, department stores, restaurants, and hotels—has evolved in the same way as for issuers less likely to be directly affected. In particular, we group issuers into “most affected” and “less affected” based on the declines in payroll employment between January and April 2020 at the three-digit NAICs industry level, with the issuers most affected defined as those in industries that declined by 15 percent or more. Chart 6 shows that, although spreads on one-week paper have declined for both sets of issuers since the facility announcement, the initial decline in spreads for more directly affected issuers was more modest. It was not until the economic outlook improved during the summer of 2020 that the spreads on the issuers most affected caught up to the spreads on the issuers less affected. Indeed, toward the end of 2020, spreads on the issuers most affected were below those of the issuers less affected. However, as can be seen in the bottom panel of Chart 6, issuance by the issuers most affected has remained sluggish, while issuance by the issuers less affected has surpassed pre-pandemic levels.

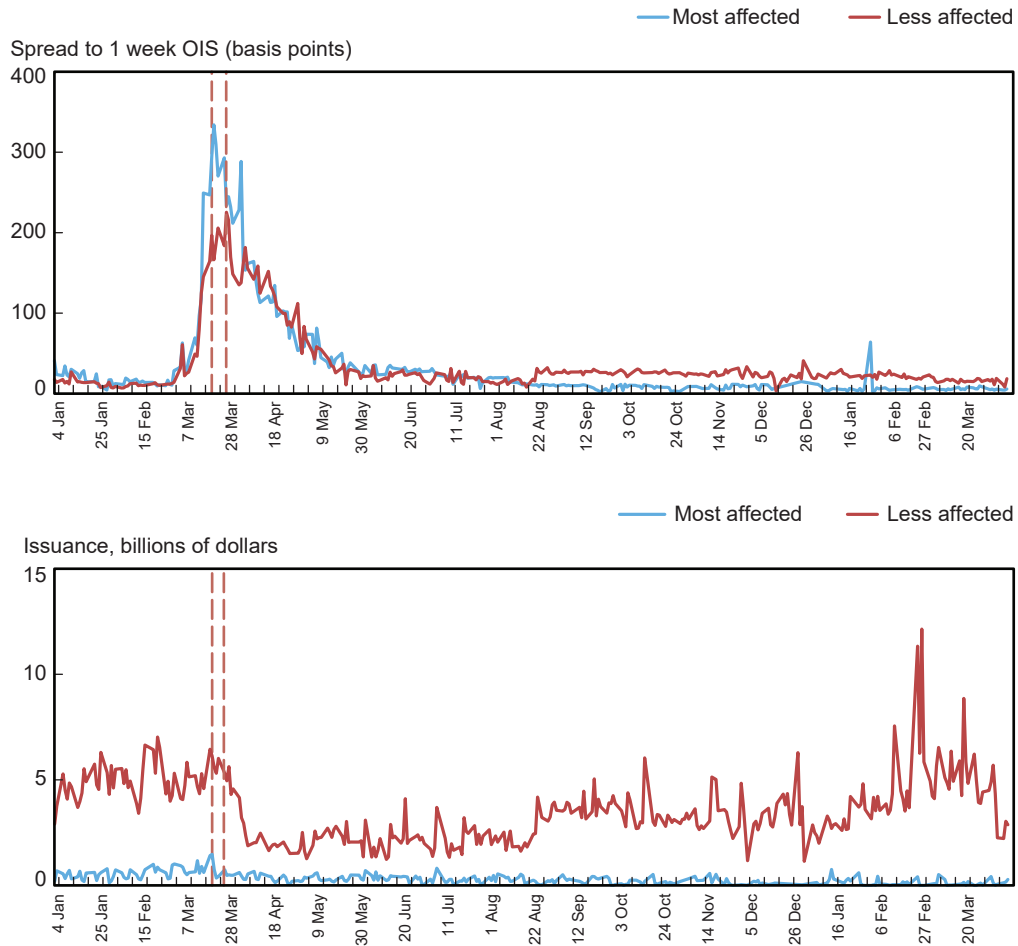
4. LESSONS LEARNED

Three main lessons were learned from the CPFF 2020: different crises require different actions, facility design needs to evolve with the market and the crisis, and experience speeds response.

First, considering the nature of the crisis, the 2008 dislocations in the commercial paper markets were driven by the financial sector, while the 2020 market dislocations were seen more at nonfinancial corporations. In addition, issuance in this market had moved away from ABCP. Therefore, CPFF 2020’s design did not differentiate between financial and nonfinancial issuers in pricing or other terms. In both episodes, the establishment of a backstop facility was effective in restoring normal market functioning.

Second, specific terms and conditions need to reflect the particulars of the given economic environment. Design elements that were substantially similar to those of the original program were adapted to the new situation (as discussed in the previous section, including a downgrade exception and the inclusion of muni issuers), and other elements that remained the same elicited different reactions (for example, some reactions from market participants about registration fees, which had the same structure as before, faced more resistance this time than last). Moreover, in considering the appropriate pricing and amount of required equity, the Fed had to weigh the high credit quality and rare historical defaults of the market against the

CHART 6
Spreads on One-Week Paper Decline for Different Types of Nonfinancial Issuers



Source: Depository Trust and Clearing Corporation.

Notes: The two vertical red lines correspond to March 17 and March 23. The issuers most affected are those in industries with a decline in payroll employment of 15 percent or more between January and April 2020.

specific circumstances under which the facility might be needed. However, ensuring pricing such that usage would naturally decline as conditions normalize is a key design feature.

The third lesson learned is the importance of operational readiness in setting up the facility and the importance of a quick and comprehensive response. It was much easier to revive a prior facility than to build one from scratch. The task of setting up CPFF 2020 was eased by the ability to make use of structure and implementation lessons from the 2008 CPFF. This is particularly important because the speed with which the Federal Reserve was able to announce the MMLF, CPFF, PDCF, along with the reduction in the policy rate and the primary credit rate all supported critical access to credit to support employment.

Usage of CPFF 2020 was much lower than in 2008, with a maximum outstanding of the original CPFF at nearly \$350 billion and the maximum outstanding of CPFF 2020 at \$4.3 billion. However, facility usage is not a measure of its success, and this too is an important lesson: Just because a facility is not used in scale doesn't mean that the facility was not useful. The existence of a backstop is sufficient to prevent runs from happening, ensuring access to funding to pay employees or other liquidity needs. The relatively low usage reflects the quicker speed of the market recovery in 2020 relative to 2008-09, as well as differences in market structure over the past decade, the differing nature of the two crises, and differences in banks' high levels of capital and their ability to provide back-up credit. The rapid recovery in markets and relatively low usage reflected the importance of this timely response and the availability of backstops in times of uncertainty. CPFF 2020 was one of numerous large-scale actions announced by the Federal Reserve to support the flow of credit to households and businesses during the pandemic—initially with facilities directed at short-term markets that had been used in the past, and then new credit programs that supported other critical segments of the market and the economy.

5. CONCLUSION

The sudden deterioration in commercial paper markets in March 2020 was similar to that of the financial crisis, and CPFF 2020 made available similar liquidity of last resort to this critical funding market, allowing the market to resume activity with relatively little usage of the facility. This reinforces the idea that a facility need not be used to be successful. One key difference was in the extent of the dislocations at financial as compared with nonfinancial corporations. Another difference was the aggressiveness and comprehensiveness of the policy response: Complementary programs were launched at the start of the crisis, and then subsequent to the CPFF announcement, the Federal Reserve announced additional corporate credit interventions targeting corporate bonds and municipal debt. It is hard to know to what extent those facilities contributed to the success of CPFF 2020.

With the CPFF 2020, the Fed has acted as a liquidity provider of last resort for the second time in commercial paper markets. Without changes to the ecosystem of money markets, it seems likely that this role will continue to be required when very large shocks affect financial markets and have the potential to amplify declines in economic activity.

NOTES

Acknowledgments: The authors thank Mark Carlson, Raymond Check, Dina Marchioni, and an anonymous referee for substantial comments and contributions. Some sections of this article are based on Liberty Street Economics blog posts published in 2020. Dorinda Ma and Rajesh Rao provided research assistance.

¹The Federal Reserve also announced the Primary Dealer Credit facility on March 17, 2020, as well as supervisory guidance on the use of capital and liquidity buffers for banks. For a comprehensive list of the Federal Reserve's actions in response to the pandemic, see Board of Governors of the Federal Reserve System, "Coronavirus Disease 2019 (COVID-19)," <https://www.federalreserve.gov/covid-19.htm>. They are also described in Clarida, Duygan-Bump, and Scotti (2021) as well as in this special issue.

²An exception to this is asset-backed commercial paper, which played a large role in the 2008 financial crisis.

³Note, however, that since one-day paper, by definition, matures within a day, there is very little amount outstanding of one-day commercial paper, as reflected in the thin blue area in the bottom panel of Chart 2.

⁴The exhibit is a stylized diagram that does not include several other players in the full end-to-end clearing and settlement process.

⁵For a comprehensive overview of terms and conditions, frequently asked questions, announcements, agreements, and operational details relating to the CPFF, see Federal Reserve Bank of New York, "Commercial Paper Funding Facility," <https://www.newyorkfed.org/markets/commercial-paper-funding-facility>.

⁶Specifically, the historical worst-case frequency of downgrade to nonprime within one year. Note that, historically, no A1/P1/F1 paper has defaulted.

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FEDERAL RESERVE BANK OF NEW YORK
ECONOMIC POLICY REVIEW

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