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United Kingdom: Commercial Paper Facility[1]

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Yale Program on Financial Stability Case Study
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Abstract

In January 2009, following continued increases in commercial paper spreads, Her Majesty's Treasury authorized the Bank of England to begin purchasing commercial paper under the Asset Purchase Facility (APF) in order to maintain UK-based corporations' access to short-term financing. Under the Commercial Paper Facility (CPF), the Bank purchased commercial paper from both primary issuers and secondary holders at a rate that was favorable to issuers during the credit crunch but that would no longer be attractive once the markets recovered. By serving as a backstop, or market maker of last resort (MMLR), the Bank helped to restore liquidity to corporate credit markets. By February 2010, almost all issuers could find more favorable spreads in the market, and in November 2010, the Bank gave 12 months' notice of the facility's withdrawal. At peak utilization, the Bank purchased £2.4 billion of commercial paper in late April 2009.

Keywords: commercial paper, Bank of England, liquidity

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[1] This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering the responses to the global financial crisis that pertain to market liquidity.

Cases are available from the *Journal of Financial Crises* at https://elischolar.library.yale.edu/journal-of-financial-crises/.

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Commercial Paper Facility

At a Glance

Summary of Key Terms	
Purpose: To serve as a ready buyer for commercial paper, thereby restoring liquidity to corporate credit markets	
Announcement Date	January 19, 2009
Facility Opened	February 13, 2009
Facility Closed	November 15, 2011
Peak Utilization	£2.4 billion
Managed By	Bank of England, HM Treasury

Despite capital funding flowing to UK banks and the Bank of England's decision to cut the Bank Rate, or the interest rate that the Bank charges for overnight lending, to 0.5%, a corporate credit crunch was intensifying in early 2009. As a result, the Chancellor of the Exchequer of Her Majesty's Treasury authorized the Bank of England to begin purchasing private assets as part of an Asset Purchase Facility (APF). The ceiling for the APF was initially set at £50 billion and was subsequently increased by the Bank subject to the Treasury's approval. As part of the larger APF, the Bank established a Commercial Paper Facility (CPF), under which the Bank would readily purchase commercial paper from both primary issuers and secondary holders.

The framework for the APF was announced on January 19, 2009, and the CPF became operational on February 13, 2009. The program was managed by the Bank of England, but all losses were indemnified by the British government. As long as it met a set of broad criteria, any firm could theoretically access the facility. The Bank's intention was always to close the CPF once liquidity was restored to corporate credit markets. Given improvements in the markets throughout 2009 and 2010, the Bank announced in November 2010 that the CPF would be withdrawn in a year. Purchases of commercial paper through the facility peaked in late April 2009 at £2.4 billion.

Summary Evaluation

The CPF was a very small component of the larger APF. In addition, two months into the program, the Bank decided to fund the facility through the issuance of central bank reserves, or quantitative easing. As a result, it is challenging to isolate the effects of the CPF from these broader initiatives. Bank officials pointed to decreasing market spreads for commercial paper as well as a decline in usage of the facility by early 2010 as evidence that the CPF had been successful in restoring liquidity to the corporate credit markets.

Commercial Paper Facility: United Kingdom Context	
GDP (SAAR, Nominal GDP in LCU converted to USD)	$3,102.8 billion in 2007 $2,948.0 billion in 2008 *Source: Bloomberg*
GDP per capita (SAAR, Nominal GDP in LCU converted to USD)	$50,567 in 2007 $47,287 in 2008 *Source: Bloomberg*
Sovereign credit rating (5-year senior debt)	As of Q4 2007: Fitch: AAA Moody's: Aaa S&P: AAA As of Q4 2008: Fitch: AAA Moody's: Aaa S&P: AAA *Source: Bloomberg*
Size of banking system	$4,895.3 billion in total assets in 2007 $5,299.6 billion in total assets in 2008 *Source: Bloomberg*
Size of banking system as a percentage of GDP	157.8% in 2007 179.8% in 2008 *Source: Bloomberg*
Size of banking system as a percentage of financial system	Data not available for 2007/2008 *Source: World Bank Global Financial Development Database*
5-bank concentration of banking system	76.8% of total banking assets in 2007 79.1% of total banking assets in 2008 *Source: World Bank Global Financial Development Database*
Foreign involvement in banking system	14% of total banking assets in 2007 19% of total banking assets in 2008 *Source: World Bank Global Financial Development Database*
Government ownership of banking system	Data not available for 2007 1% of banks owned by the state in 2008

	Source: Call et al. "Bank Ownership – Trends and Implications"
Existence of deposit insurance	100% insurance on deposits up to $4,000; 90% on next $66,000 in 2007 100% insurance on deposits up to $93,000 after October 2008 *Source: World Bank Deposit Insurance Dataset, OECD*

I. Overview

Background

During the Global Financial Crisis (GFC), corporate credit markets froze up, as investors demanded liquidity premiums to offset increased risk. Prior to 2009, the British government provided substantial capital funding to UK banks. However, these efforts did little to increase liquidity in credit markets, as banks held on to funds to protect against future losses. This was evidenced by the fact that, in early 2009, spreads in the interbank market soared to 15 times their precrisis amounts (Dale 2010).

Throughout 2008 and early 2009, the Bank of England cut interest rates, eventually lowering the Bank Rate, or the interest rate that the Bank charges for overnight lending, to 0.5%. However, the Bank's Monetary Policy Committee (MPC) believed that these efforts were not enough to stimulate spending to reach the UK's 2% inflation target (Benford et al. 2009). In early 2009, commercial paper spreads remained at a level higher than any estimate consistent with the risks involved, and therefore, this market seemed to be a prime target for intervention so as to facilitate otherwise creditworthy firms in maintaining their access to short-term finance (Fisher 2010).

Program Description

In order to increase the availability of credit to UK corporate borrowers, in January 2009, the British government authorized the Bank of England to begin purchasing investment-grade sterling commercial paper as part of a new fund called the Asset Purchase Facility (APF) (BoE 2009e). The facility aimed to "increase the availability of corporate credit, in order to support the Bank of England's responsibilities for financial stability and monetary stability in the United Kingdom" (Darling 2009).

One piece of the APF was the Commercial Paper Facility (CPF), which allowed the Bank to purchase commercial paper either directly, through dealers in the primary market, or from certain counterparties in the secondary market. In order to be eligible, commercial paper had to be issued either by companies that made a "material contribution to economic activity in the United Kingdom" or by nonbank financial companies that significantly contributed to corporate financing in the UK (BoE 2009e). Interested issuers and counterparties had to apply to the Bank to determine eligibility. Commercial paper was deemed eligible if it was sterling-denominated, up to three-month maturity, and investment grade. The Bank purchased commercial paper at a spread to the overnight index swap (OIS) rate that was favorable at the time of the crisis but that would become increasingly unappealing to issuers as liquidity was restored to the market (Fisher 2010). For primary issuers, the spread was 75 basis points to 300 basis points, depending on the credit rating of the issuer. The spread for secondary holders was assessed similarly, and they were charged an additional 25-basis-point fee. Minimum amount for individual securities purchased through the facility was £1 million, and offer amounts had to be stated in increments of £0.1 million (BoE 2009e).

Originally, purchases of commercial paper were financed through the issuance of Treasury bills by the Debt Management Office. In March 2009, the MPC announced that asset purchases, including through the CPF, would be financed by central bank reserves as part of the Bank's quantitative easing program. This program aimed to stimulate spending, bringing inflation to target by injecting money into the economy through the purchase of public and private sector assets (BoE 2009f).

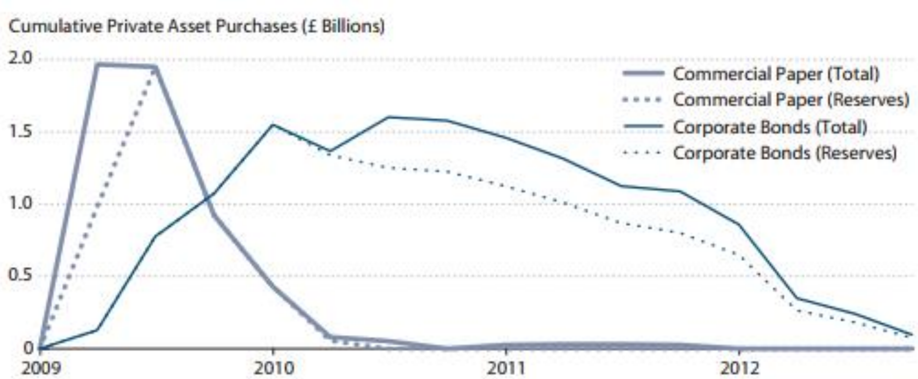
All of the commercial paper purchased through the facility was held off the Bank's balance sheet in the Bank of England Asset Purchase Facility Fund (BEAPFF). The fund was a wholly owned subsidiary of the Bank of England and was indemnified by the British government (Fisher 2010).

Rather than setting a specific timeline or target purchase amount for the CPF, the Bank of England designed the facility to last "for as long as the highly abnormal conditions in corporate credit markets that were impairing finance of real economic activity persisted" (BoE, n.d.-a). This decision reflected the Bank's desire to be a short-term market maker of last resort (MMLR), rather than a long-term source of corporate financing (Fisher 2010).

Outcomes

At peak utilization, the Bank purchased £2.4 billion of commercial paper in late April 2009 (Fisher 2010). Commercial paper comprised a small portion of the larger Asset Purchase Facility, which overwhelmingly purchased gilts (Fawley and Neely 2013). The majority of purchases through the CPF took place in early 2009, as depicted in Figure 1 below. The chart shows net purchases of private assets separated into commercial paper and corporate bonds. The solid lines show total net purchases; the dashed lines show net purchases funded by central bank reserve issuance.

Figure 1: Net Purchases of Private Assets



Source: BoE, n.d.-b; Fawley and Neely 2013.

For high-grade commercial paper, market spreads fell below spreads offered by the Commercial Paper Facility in August 2009. In February 2010, the Bank held only £300 million in commercial paper, which was attributed to a restored ability for issuers to find more favorable spreads in the market (Fisher 2010).

The Bank last made purchases under the facility in the second quarter of 2010 (see BoE, n.d.-b). In November 2010, the Bank gave a 12-month notice for the termination of the CPF, citing improvements in the corporate credit market. The facility was closed on November 15, 2011 (BoE, n.d.-a).

II. Key Design Decisions

1. The CPFF was launched to restore liquidity to the corporate credit markets.

In order to increase the availability of credit to UK corporate borrowers, in January 2009, the British government authorized the Bank of England to begin purchasing investment-grade sterling commercial paper as part of a new fund called the Asset Purchase Facility (BoE 2009e). The facility aimed to "increase the availability of corporate credit, in order to support the Bank of England's responsibilities for financial stability and monetary stability in the United Kingdom" (Darling 2009).

One piece of the APF was the Commercial Paper Facility, which allowed the Bank to purchase commercial paper either directly, through dealers in the primary market, or from certain counterparties in the secondary market (BoE 2009e).

2. The CPF was announced without a size limit and an end date.

CPF was a part of an APF, which had a ceiling initially set at £50 billion. However, for the CPF, rather than setting a specific timeline or target purchase amount, the Bank of England designed the facility to last "for as long as the highly abnormal conditions in corporate credit markets that were impairing finance of real economic activity persisted" (BoE 2009e).

3. The Bank received the Chancellor of the Exchequer's approval for the APF, which the CPF was launched under.

The government was to indemnify the Bank of England from any losses arising out of APF. Therefore, to launch the APF, the Bank of England received the Chancellor's approval because the taxpayers were taking on the risk from all APF facilities (Darling 2009).

4. The Bank consulted with the industry in the design of the CPF.

Before the operation of the CPF, a market notice announcing the program requested feedback from the industry. The request included invitation for detailed comments from all interested parties—existing and potential new issuers, investors, intermediaries, and infrastructure providers, including issuing and paying agents and ratings agencies (BoE 2009e).

5. The Bank purchased newly issued commercial paper from dealers in the primary market and from eligible counterparties in the secondary market.

All prospective counterparties were required to apply to the Bank via email to ascertain eligibility. If the Bank was able to confirm eligibility before 4:00 p.m., securities could be sold to the Bank the next business day. Once approved, offers to sell commercial paper to the CPF had to be submitted between the window of 10 a.m. and 12 p.m. Dealers acting as principles in the primary market had to provide details on the issuing entity and the nominal amount offered; counterparties in the secondary market had to provide the ISIN/ticker of the security, the money market yield on an amortized cost basis, the maturity date, and the nominal amount offered. Each individual security had to be at least £1 million, and offers had to be expressed in £0.1 million increments (BoE 2009e).[3]

By allowing both primary issuers and secondary market holders to participate in the facility, the Bank aimed to increase issuer and investor confidence by serving as a ready buyer. The Bank believed that this would give all banks and investors, not just those that participated in the facility, the confidence to resume normal lending, which would help to further restore liquidity to corporate debt markets (Benford et al. 2009).

6. The facility was specifically designed to help corporations making a material contribution to the UK economy.

In order to be eligible, commercial paper had to be issued by corporations that made a "material contribution to economic activity in the United Kingdom." This was defined as a company that was incorporated in the United Kingdom, was capable of issuing bonds, and had genuine business in the United Kingdom. In addition, commercial paper issued by nonbank financial companies was eligible as long as the issuer made significant contributions to corporate financing in the UK. Leveraged investment vehicles were not eligible for participation. The Bank also restricted purchases to sterling-denominated commercial paper (BoE 2009e).

7. Only investment-grade commercial paper was eligible for purchase under the facility.

In his letter authorizing the CPF, the Chancellor asked that the Bank, "be satisfied that there will be a viable private market demand for the types of assets that it buys when conditions in financial markets return to normal" (Darling 2009). To ensure this, Her Majesty's Treasury required that the Bank purchase only investment-grade assets that satisfied the following criteria:

1) A maturity of one week to three months if issued to the bank at issue via a dealer, or a residual maturity of three months or less if sold to the bank by a secondary market holder;

2) A minimum short-term credit rating of A-3/P-3/F-3 from at least one of S&P, Moody's, and Fitch; and

3) Issued directly into Crest, Euroclear, or Clearstream (BoE 2009e).

Asset-backed commercial paper was not eligible for sale into the Commercial Paper Facility (BoE 2009e).

If an issuer of the CP was downgraded below the minimum credit ratings, the CP was permitted to mature as normal, but the issuer was unable to access CPF again until it satisfied the required minimum credit ratings again (BoE 2009e).

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[3] Fisher 2010 indicates individual counterparty limits existed, but details have not been located.

8. Maturity and pricing were both determined in order to be attractive in stressed conditions but less attractive as conditions normalized.

As discussed below, the CPF was never intended to serve as a long-term corporate credit source. Only commercial paper with three-month maturity (when purchased directly) or with a residual maturity of no more than three months (when purchased from holders in the secondary market) was eligible for participation. Commercial paper was purchased "at spreads which were significantly below those in the market at the time, but which were significantly above those expected to prevail in normal conditions" (Fisher 2010). The spread to the maturity–matched OIS rate was determined based on the issuer's credit rating, and can be seen in Figure 2 below.

Figure 2: Commercial Paper Spreads by Credit Rating

	A1/P1/F1 or higher	A2/P2/F2	A3/P3/F3
Spread to maturity-matched OIS rate	75bp	125bp	300bp

Source: BoE 2009e.

The Bank purchased commercial paper from secondary holders at the lower of the price determined by the above method and the amortized cost from the issue price. In addition, counterparties on the secondary market were charged a 25-basis-point usage fee (BoE 2009e). This pricing mechanism was designed so that the CPF would be "self-liquidating," or less appealing as corporate credit markets improved (Fisher 2010).

9. The Bank sterilized the asset purchase program before March 2009 and after February 2010, but funded it through reserves for 11 months to support its quantitative easing program.

Initially, purchases of commercial paper were funded by Treasury bills issued by the Debt Management Office. Every purchase of private assets, including commercial paper, was financed through the issuance of short-term gilts, which did not affect the monetary supply. This was done to sterilize the operation, that is, to make sure that the purchases did not have an expansive impact on monetary policy. On February 17, 2009, shortly after the program was launched, the Bank's Monetary Policy Committee revised the scope of the program so that it could also support monetary policy. Starting on March 6, 2009, the Bank financed the CPF through creation of new central bank money as part of a broader quantitative easing program (Benford et al. 2009). Starting on February 4, 2010, the program was again funded by Treasury bills to maintain the level of central bank reserves (BoE 2010).

10. All assets were held off the balance sheet in the Bank of England Asset Purchase Facility Fund.

A wholly owned subsidiary company, called the Bank of England Asset Purchase Facility Fund, was specifically created by the Bank to purchase assets, including commercial paper. The Bank loaned money to BEAPFF to finance these purchases, but the source of funding depended on whether the Asset Purchase Facility, and CPF by extension, operated under the quantitative easing program, which it did between March 2009 and February 2010. In its authorization of the CPF, the Treasury agreed that all losses incurred by BEAPFF would be indemnified by the UK government (Darling 2009). The Bank did not consolidate the fund's assets and liabilities on its financial statements because, due to the indemnity, it had "no economic interests in its activities (BoE 2009a).

11. The facility was terminated once liquidity was restored to corporate markets.

The CPF was designed to operate as a short-term solution to the corporate credit crisis. The Bank agreed to regularly monitor market liquidity to assess the continued necessity of the facility. The Bank's intention was always to wind down the facility once the market rebounded, either as assets matured or through sales. As a result, it purchased only commercial paper for which it believed there would be a private market at such a time (King 2009).

III. Evaluation

The Bank of England's quarterly bulletin for markets and operations consistently reported that the CPF was a success. For the second quarter of 2009, the Bank observed that the issuance prices of CP in primary markets to non-APF investors suggested that spreads narrowed, particularly for lower-rated corporates, toward the rates at which the CPF offered to purchase CP. It concluded this showed some corporates benefited from issuing to other investors at these lower rates (BoE 2009b). During the third quarter of 2009, the Bank again observed the sterling primary market CP spreads narrowing further. The Bank suggested that this, combined with the fall in CPF net purchases and the increase in the total amount of sterling-denominated CP outstanding for UK corporate and nonbank financial firms, represented that some issuers found it more economic to issue to investors rather than use the CPF (BoE 2009c). In the last quarter of 2009, the Bank reported that quoted primary market CP spreads narrowed even further and remained below the spreads at which the CPF offered to purchase CP. This meant that some issuers found it more economic to issue to investors rather than use the CPF, and the Bank concluded that this facility successfully acted as a backstop following temporary reductions in market liquidity (BoE 2009d).

Fawley and Neely, in a comparative study of the quantitative easing programs of the Federal Reserve, Bank of England, European Central Bank, and Bank of Japan, argue that in the UK, "the presence of a market maker of last resort quickly restored market functioning and the price floor established by the purchase programs did not bind for long" (Fawley and Neely 2013). Additionally, Fisher emphasizes that although the program seemed small compared to other liquidity programs during the GFC, purchases peaked at £2.4 billion in late April 2009, which amounted to one-third of the sterling commercial paper market at the time (Fisher 2010).

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