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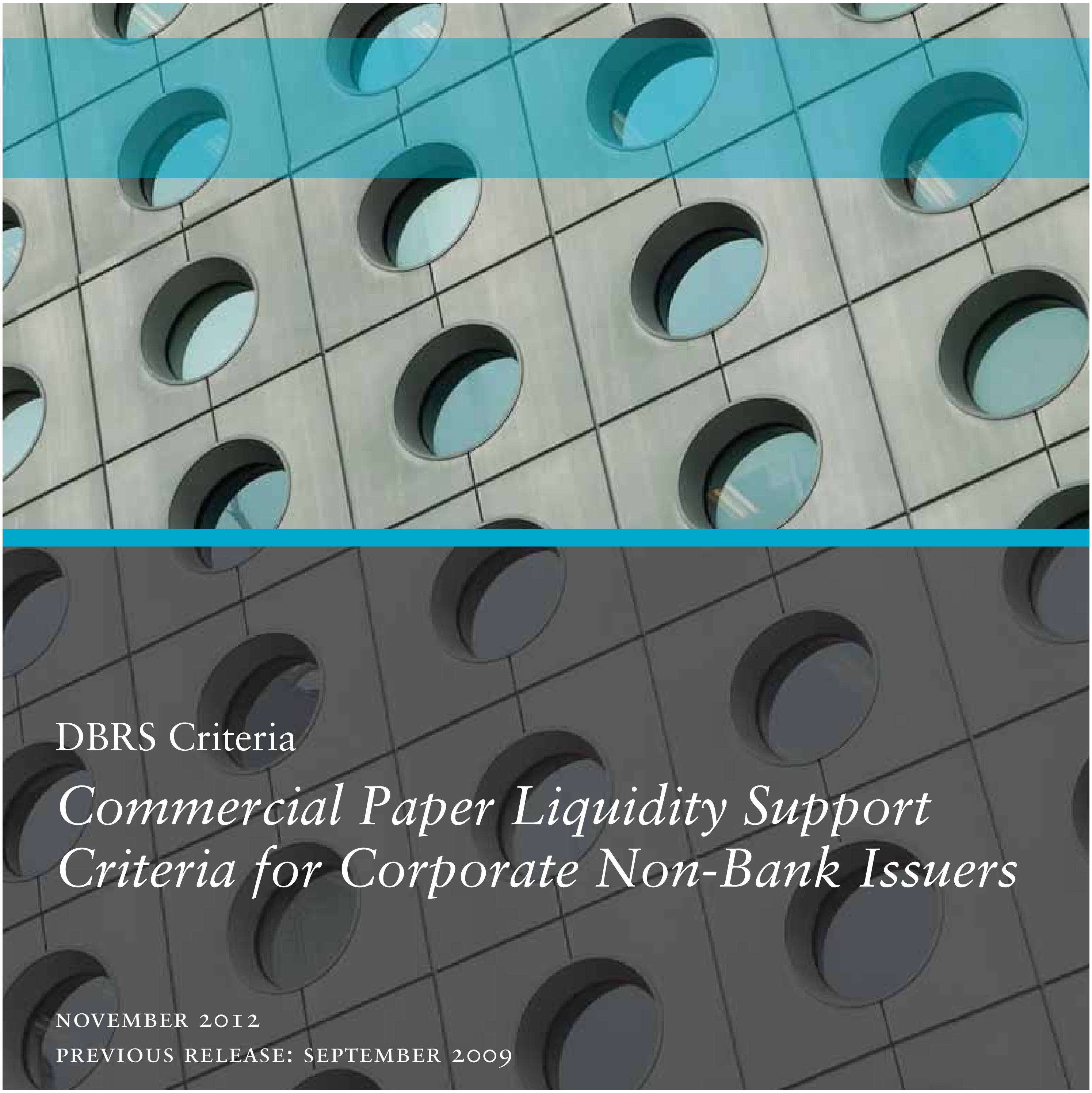
Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers

Dominion Bond Rating Service (DBRS)



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DBRS

Insight beyond the rating.

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DBRS Criteria: Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers

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Introduction

Commercial paper is typically issued by only highly rated corporate entities. DBRS commercial paper ratings are a reflection of the overall credit strength of the issuer, with particular focus on the shorter term as it fundamentally relates to an issuer's ability to fulfill its near-term obligations in a timely manner.

This criteria focuses on liquidity support for corporate non-bank issuers. For details on the DBRS approach to liquidity support where applicable in the Structured Finance area, refer to the *Legal Criteria for Canadian Structured Finance* methodology.

LIQUIDITY SUPPORT

Commercial paper markets are by nature confidence-sensitive and, while disruptions are infrequent, there is a very real risk that the normal orderly rolling of maturing paper may be prevented by exogenous market events or by matters more specific to the issuer. Such an occurrence could lead to an unexpected and sudden default. To address the risk of market disruptions, it is critical that all issuers have appropriate liquidity backup in place such that maturing commercial paper can be repaid in the event that there is an inability to roll or issue more commercial paper.

With few exceptions, the DBRS standard is that issuers should have 100% liquidity backup in place for their commercial paper programs. DBRS recognizes that there are a variety of liquidity backups that can be acceptable for this purpose, including cash and securities. In practice, however, there are several meaningful considerations that add complexity in terms of relying on backup in the form of cash and securities; as such, the vast majority of commercial paper issuers rely on bank lines for their commercial paper liquidity backup. As discussed herein, DBRS only gives consideration to bank lines that are committed for a term that extends beyond the maturity date of any outstanding commercial paper.

Regardless of the type of liquidity backup, it is important that it is structured in such a way that there is always coverage available for maturing commercial paper. In the case of bank lines, DBRS expects that same-day liquidity availability will equal or exceed the maximum amount of commercial paper that comes due on any day.

BANK LINES

Where bank lines are used for liquidity backup, DBRS generally expects issuers to maintain liquidity through a combination of unused capacity under committed bank facilities and any other acceptable liquidity sources, such that there is full liquidity support for outstanding commercial paper at any time. DBRS also expects that this liquidity support will include same-day availability equal to the maximum amount of commercial paper maturing on any day.

The committed bank facilities should extend to or beyond the maximum tenor of any outstanding commercial paper. Maturing facilities are expected to be extended in advance of the maturity date, so that coverage for outstanding commercial paper is not suddenly disrupted in these circumstances. DBRS gives very little credit for demand facilities or any other types of uncommitted bank lines.

While DBRS standards do not require that the full amount of bank lines be available for funding on a same-day basis, this is recognized as the most robust form of liquidity support. General purpose bank lines are far more prevalent in the market than those dedicated solely to commercial paper backup, and they are acceptable if managed appropriately. This would entail DBRS's satisfaction that there is the intent and ability to maintain full liquidity support and that the lines would be available at the necessary level when and if needed (i.e., bank facility usage (loans, letters of credit, etc.) and outstanding commercial paper balances will not exceed the maximum size of the bank facility).

Bank lines typically include a variety of covenants, representations, warranties and conditions precedent to drawdown that may impact an issuer's ability to access the facility. While these "bank funding outs" are generally issuer-specific rather than related to general market issues, overly punitive or restrictive conditions precedent to funding tied to the issuer will be viewed less favourably by DBRS. Because bank lines are in place primarily to deal with commercial paper issues caused by market disruptions, DBRS gives little credit to bank lines that allow the lender to refrain from advancing loans during general market disruptions.

THE BANKING GROUP

In assessing bank facilities as backup liquidity for commercial paper, DBRS considers the strength of the banks providing the backup facility. DBRS would generally expect a group of banks with average credit strength in the R-1 range if the issuer program were to achieve that rating. It may be acceptable to have some banks with a lower rating in the group, but the proportion would be expected to be relatively minor, and consideration would be given to the mix within the context of other issues such as the size of the program, other liquidity sources and the length and quality of the backup facilities themselves.

ALTERNATIVE LIQUIDITY SOURCES

While liquidity is mainly provided by bank lines, there may be other satisfactory forms of both external and internal sources which may vary from issuer to issuer. Potential options include cash, short-term investments, a close relationship with an associated issuer or parent, and government assistance or other third-party relationships. Any dependence on these sources of liquidity backup would require consideration of the nature of the issuer's business, the size of the program, the seasonality of borrowing needs and any upcoming maturity of longer-term debt obligations that must also be met by the issuer.

The complication in relying on these types of sources for liquidity backup is that it is imperative that they adequately provide cash in a known amount and in an immediate time frame. It is appropriate that there is a high burden of proof that these expectations can be met, and the onus is on the issuer to demonstrate this. For securities, they must be sold to receive cash and, as such, the speed of sale and any percentage reductions in asset value (i.e., "haircuts" for potential value fluctuations; see Appendix A for more information) would be considerations. Credit for securities would also likely necessitate specific classification, the assurance that no encumbrances were in existence and that the pool of "acceptable securities" would be limited to those with both very high ratings and very active secondary markets, such as highly rated sovereigns. In the case of cash, DBRS would typically request confirmation of the availability of cash for backup liquidity purposes and that it was located in a jurisdiction and location where it could be accessed on a timely basis.

When considering alternative liquidity sources, it should be noted that: (1) some situations may require additional conservatism if support were to be depended on in the context of same-day availability; (2) considerations vary with the strength of the issuer; and (3) giving credit for the availability of any liquidity source (bank lines or other) is always at the discretion of DBRS.

LIQUIDITY SUPPORT AND THE STRENGTH OF ISSUERS

In most cases, the size of total liquidity support should at least equal the size of the commercial paper program (see Appendix B for more information). As a general rule, there are virtually no exceptions to the standard for 100% liquidity support for programs rated R-1 (low) or lower and, notwithstanding the fact that certain stronger rated entities have more consistent access for refinancing at competitive terms with more alternatives, it is still relatively rare that even a strong borrower can operate with clearly qualified liquidity support of less than 100%. There may be circumstances where a gap is acceptable due to guarantees/support from other entities or where the issuer agrees to restrict the usage of its commercial paper program.

In the case of very highly rated entities, DBRS may also consider a liquidity support facility that is smaller than the size of the commercial paper program, recognizing positive factors such as the issuer's credit strength, stronger investor ties, funding diversification and access to capital markets. In general, these issuers have deeper and wider resources to adjust and deal with unforeseen liquidity issues, which often occur when markets are volatile. This occurs on a limited basis, however, and, with the exception of certain governments and pension funds (see below), it would be a rare occurrence for even an R-1 (middle) or an R-1 (high) issuer to have less than 75% liquidity support.

ISSUER STRENGTH

When discussing bank lines, it is important to remember that an issuer's rating reflects the overall strength of the issuer. While bank lines are expected to fulfill their support role when market disruptions occur, they are not established as legal guarantees to fund. Even the strongest and most diversified bank backup facility cannot improve the rating of an issuer. The latter requires an unconditional guarantee or a similar agreement that effectively transfers the debt obligation to a higher-rated supportive issuer. For this reason, the rating on an R-1 (low) issuer with bank lines of R-1 (middle) strength remains an R-1 (low) rating.

ISSUER RESPONSIBILITIES

Each issuer bears the responsibility to ensure that it has sufficient liquidity to meet all maturities as they come due and to take appropriate actions when there are indications of stress. In providing ratings, DBRS will review these plans to consider compliance and acceptability, but DBRS does not perform the role of auditor nor does it monitor issuers' commercial paper positions on a daily basis. As an example, consider the case where an issuer begins to experience stress in its commercial paper program in the form of higher pricing, reduced length of maturity and, perhaps, even loss of certain buyers. Should these changes be material, DBRS would expect that the issuer in question would take appropriate steps to ensure that there was no deterioration in the ability of liquidity backup to cover all commercial paper maturities. In a very negative situation, it may be necessary for the issuer to take actions such as selling securities or drawing down its bank lines to ensure that same-day coverage can be fully maintained.

RATINGS IMPACT

There will be cases where DBRS may provide a commercial paper rating when liquidity support is adequate but not as robust as desired for the rating that would normally correspond to the long-term evaluation of the company. In such cases, there is flexibility in the DBRS rating scales such that a commercial paper rating for an issuer can be lower than the long-term rating would normally dictate. For example, the DBRS policy with respect to ratings mapping denotes that, in most cases, an A (low) issuer would be able to obtain a rating of R-1 (low), but the policy does specifically provide for the ability to assign a lower rating, noting that this would occur if DBRS had meaningful concerns about either the liquidity support or liquidity strength of an issuer.

PARENT GUARANTEES

There are cases where a domestic borrower may issue based on a guarantee from a foreign parent. In such cases, liquidity backup may be based on resources of the parent and not the subsidiary, providing that all potential timing issues (such as different time zones, statutory holidays or the mechanics of moving funds cross-border on a same-day basis) are acceptably dealt with.

DBRS STANDARD

Issuers with commercial paper programs in more than one jurisdiction are expected to meet the DBRS requirements on a consolidated basis and provide same-day availability support to all maturities in all jurisdictions, regardless of the geographic location of the liquidity. In jurisdictions where a subsidiary issuer operates the commercial paper program and the commercial paper is not based on that issuer's stand-alone financials, the subsidiary issuer must have evidence of support from the parent issuer (an irrevocable, unconditional guarantee being most common) and show that there is same-day availability support, regardless of the geographic location of the liquidity.

REGIONAL GOVERNMENTS

DBRS requires municipal and regional governments to have access to liquidity support in an amount equal to 100% of any commercial paper issuance, usually in the form of unused but committed bank lines of credit, along with same-day availability and other requirements consistent with what is required for corporate credits. However, this requirement may be reduced in cases where a regional government demonstrates that it benefits from a significant, timely and reliable source of liquidity from a related government institution which has a clear mandate to provide such support (e.g., Bank of Canada in the case of Canadian provinces).

EXTENDABLE COMMERCIAL PAPER

It should be noted that in the case of extendible commercial notes (ECNs), the liquidity backup is essentially provided by the investor and, as such, DBRS does not require separate liquidity support for these programs. It should also be noted that, at this time, ECNs are no longer widely used in the markets and DBRS does not expect this to change in the foreseeable future.

SIZE OF COMMERCIAL PAPER AND SHORT-TERM DEBT PROGRAMS

Notwithstanding the presence of backup lines representing 100% of any authorized commercial paper program amount, DBRS may still have concerns with the size of an issuer's commercial paper program, as well as the amount of debt that is raised from any capital source that is short term in nature. Such concerns may include the following: (1) the availability of funding from bank backup facilities can, in certain cases, be restricted by breaches of financial covenants, material adverse change clauses, etc.; (2) issuers that borrow with a tenor that is too short in term relative to the usable life of its assets expose themselves to refinancing risk and interest rate risk; (3) short-term facilities can be drawn down quickly without notice to DBRS, which may cause total leverage to exceed an amount that is in excess of what is appropriate for the rating level; and (4) in rare cases, a commercial paper issuer may be so large as to test, on a routine basis, the liquidity of its local commercial paper market, even in the absence of any kind of market disruption. Other such issues may present themselves in specific situations.

In determining the maximum appropriate commercial paper program size and/or maximum appropriate short-term debt amount for an issuer, DBRS will review whatever factors DBRS deems to be relevant for the rating level. Such factors might include a forecast of liquidity needs and the availability of alternative sources of liquidity, including a commercial paper program or bank facilities from a related entity in another country, general access to the capital markets, the sources and stability of cash flow from operations, the potential for asset sales and so on.

APPENDIX A

PERCENTAGE REDUCTION IN ASSET VALUE

When securities are offered as part of liquidity support, DBRS will establish appropriate percentage reductions in asset values (i.e., haircuts) as recognition that the immediate sale of such securities may require the acceptance of a lower price, acknowledging that challenging market conditions may exist at the time of sale. In determining the degree of the haircut required, DBRS will consider the following factors:

- Credit strength and potential for change.
- Market liquidity in challenging markets.
- Restrictive elements, including encumbrances, immediate taxes and where the securities are held.
- An assessment of whether securities are clearly in excess of operating needs and are expected to remain so.
- Currency risk.
- The frequency of any maintenance test or contractual mark-to-market shore-ups in collateral value.
- The propensity for interest rate risk (including duration of the securities).

Even in the case of AAA-rated sovereign government securities that score well on all of the aforementioned considerations, DBRS would require some haircut, and, as a general rule, issuers with greater reliance on securities as part of their liquidity support package would also likely receive less credit (a higher haircut). For securities other than AAA-rated sovereigns, even if very highly rated, DBRS would be even more focused on the ability to sell quickly and what this would mean for pricing. In short, situations are treated on a case-by-case basis. The bar is high and securities that miss on any consideration in a meaningful way are, in many cases, simply viewed as ineligible to receive liquidity support credit.

APPENDIX B

LIQUIDITY REQUIREMENTS FOR CANADIAN PENSION FUNDS

By their nature, most pension funds in Canada have an exceptionally high degree of liquidity, with large bases of unencumbered high-quality securities that can be monetized through repurchase agreements or asset sales very quickly.

For these funds, DBRS defines "highly liquid assets" as unencumbered debt securities of any duration issued or guaranteed by sovereign governments rated AAA or R-1 (high). For Canadian pension funds, DBRS will also consider any debt issued or guaranteed by one of the Canadian provinces or Schedule 1 banks rated R-1 (high) for inclusion within the highly liquid asset definition. If DBRS does not rate a sovereign, it will still be acceptable for inclusion within the definition of highly liquid assets if the debt has been rated AAA (or the equivalent rating) by at least one publicly available Nationally Recognized Statistical Rating Organization or External Credit Assessment Institution. However, DBRS reserves the right not to rely on other agencies in this way if their risk opinions, methodologies or sector outlooks are meaningfully inconsistent with the views of DBRS.

- When a pension fund is a commercial paper issuer, DBRS will assess the need for bank line support on a case-by-case basis, by considering the following issues:
- The level of liquidity on the balance sheet relative to the size of the commercial paper program. As a general rule, the fair value of highly liquid assets should, at all times, be at least 1.5 times the size of the maximum authorized limit for the commercial paper program.
- The rating given to the pension fund (higher-rated entities generally have better ability to access the market in a stressed environment). In most cases, DBRS is only satisfied with relying on balance sheet liquidity for support when the rating of the pension fund in question is R-1 (high).
- Whether the commercial program is of such a large size that some bank line support would be prudent, notwithstanding the level of liquid assets maintained by the pension fund.
- Whether the issuing organization is aware of the importance of supporting its commercial paper program and is highly likely to access its sources of liquidity when needed.
- Whether the fair value of highly liquid assets on the issuer's balance sheet demonstrates high volatility.
- Whether there are any special circumstances that could add liquidity stress that should be taken into consideration, such as pension payment holidays or actuarial considerations.

Where there are concerns with any of these areas, DBRS standards may require the need of some bank line support as an alternative form of liquidity.

Insight beyond the rating.

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