

## Asset-Backed Commercial Paper: A Primer

### ABCP Delivers Several Benefits to Cash Investors, Enhanced Diversification and Attractive Yields Chief among Them

*With diversification benefits, flexible terms, transparency, and a historic yield advantage relative to other cash investments, asset-backed commercial paper (ABCP) has been a sound addition to cash portfolios. In the Q&A below, Frank Gianatasio, a senior fixed income analyst at BofA Global Capital Management, describes the mechanics and potential benefits of ABCP.*

#### Q. First, what is ABCP?

**A.** ABCP is a short-term, senior-secured debt instrument collateralized by a variety of asset classes, such as credit card receivables, student loan payments and auto loan receivables. In the case of a specific ABCP credit, the investor's interest payments emanate from the pool of assets backing the credit, e.g., borrowers' monthly credit card payments. When the debt matures — typically between 30 and 270 days — the investor receives a principal payment that is funded either from the collection of the credit's assets, from the issuance of new ABCP or by accessing the credit's liquidity facility, a key feature of ABCP. Typically the liquidity facilities are structured to equal — if not exceed — the size of the ABCP program.

#### Q. How is ABCP created?

**A.** The issuance of ABCP begins with the seller of the security's underlying assets, e.g., a bank that wants to sell its credit card receivables or the financing arm of a car company that wishes to sell its auto loan receivables. The seller sells its receivables — “the assets” — to a Special Purpose Vehicle (SPV), which is set up by a “sponsor” (a bank or other financial institution) to issue ABCP. The SPV also is known as the “conduit” because it is responsible for collecting and disbursing funds generated by the receivables to the ABCP credit's investors. During the life of the investment, the sponsor is responsible for monitoring developments that could affect the performance and credit quality of the assets in the SPV, e.g. increased loan

delinquencies. As noted above, the sponsor's role is to ensure that ABCP investors receive their interest payments and their principal repayment when the credit matures.

ABCP carries strong credit ratings issued by Moody's Investors Service and/or other ratings agencies because of their short maturities and because the sponsors themselves generally have very high credit ratings. All of the ABCP programs purchased by BofA Global Capital Management are sponsored by institutions that have been vetted by our financial institutions group. Thorough analysis of the strength of the sponsor is very important because the sponsor typically provides significant program-level credit enhancement and liquidity facilities that are designed to protect investors from potential credit losses and to provide liquidity in the event of a market disruption.

#### Q. What advantages does ABCP present relative to other cash investments?

**A.** One major advantage is the diversification benefit, which accrues, to a large extent, from the risk profile of ABCP. First of all, ABCP investors are exposed primarily to the risks inherent in the underlying asset pools rather than the credit risk of a single financial institution or other issuer. Those underlying asset portfolios are well diversified. An ABCP issue may be backed by several distinct asset classes from a variety of sellers. This compares to standard commercial paper (CP) issued by a bank or other corporate entity, in which the investor is exposed to the risk of a downgrade of the issuer's debt or to an outright default by

Diversification does not ensure a profit or guarantee against loss.

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| NOT FDIC INSURED | May Lose Value    |
| NOT BANK ISSUED  | No Bank Guarantee |

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that issuer. The fact that ABCP is issued by the SPV helps insulate investors from the sponsor’s other balance sheet risk. Therefore, in the event of a sponsor’s bankruptcy, ABCP investors are not “in line” with other creditors. Again, ABCP risk is secured by the underlying assets of the conduit, and investors have claim to those assets.

**Q. How does ABCP’s yield compare to that of commercial paper?**

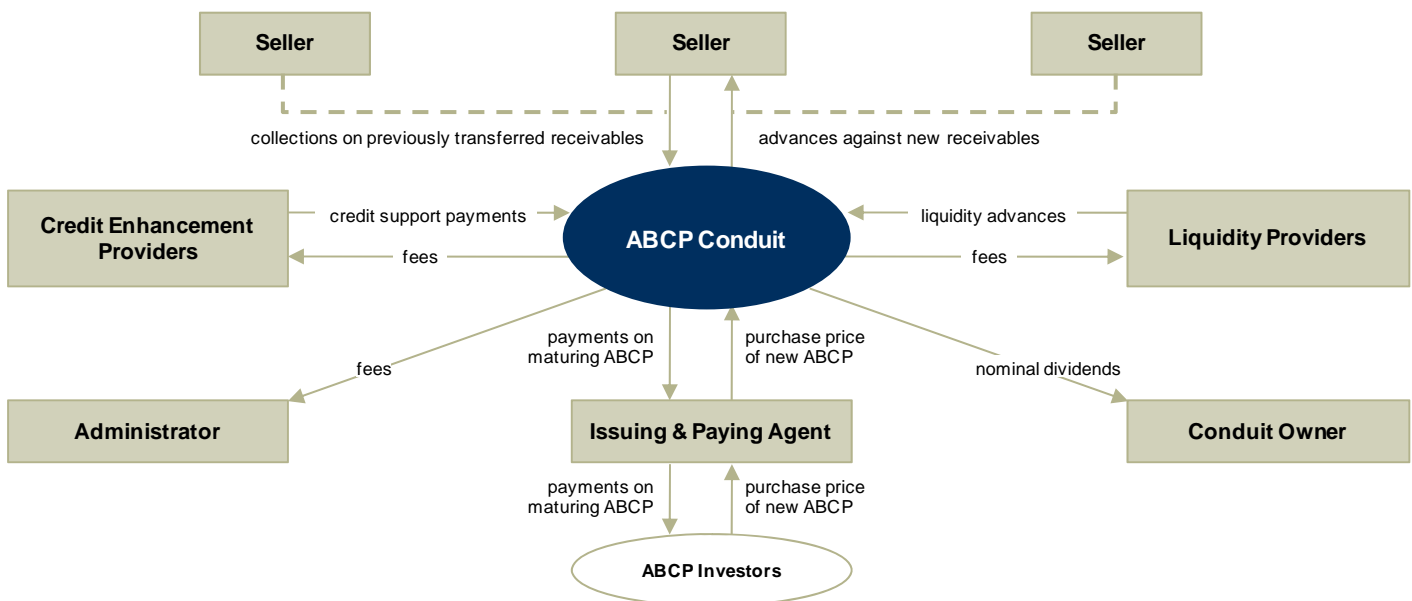
**A.** Historically ABCP yields have been higher than unsecured CP yields. This is somewhat counter-intuitive, as investors in ABCP earn more for taking a secured risk than a CP investor earns for taking an unsecured risk. The reason for that is that compared to CP, ABCP is understood and followed by a smaller group of investors. Some investment firms may not be sufficiently staffed or have the expertise necessary to analyze ABCP programs. The smaller buyer base means ABCP must offer a yield premium to attract investors. Money market funds can benefit from this slight pick-up in yield.

**Q. We saw during the global financial crisis that liquidity can dry up very quickly during a market disruption. How large and liquid is the ABCP market?**

**A.** As of January 28, 2011 there was \$383.0 billion<sup>1</sup> in ABCP outstanding, which accounts for approximately 35% of all commercial paper issuance in the U.S. Liquidity in the ABCP market is very robust. We know the market is broadly supported by many large institutional cash investors that are consistent buyers of ABCP, and there are at least two to three dealers on each ABCP program. In addition, every ABCP program is structured with at least 100% liquidity support so in the event of a market disruption, the liquidity facility can and would be drawn upon to repay maturing ABCP on a timely basis.

<sup>1</sup> Source: Morgan Stanley, “Morgan Stanley Short-Term Credit Weekly Update,” January 28, 2011.

**Generic ABCP Conduit Structure**



Source: Moody's, "The Fundamentals of Asset-Backed Commercial Paper," February 3, 2003

**Q. Many cash investors became more conservative in the wake of the global financial crisis. How did ABCP perform during the crisis?**

**A.** The traditional ABCP market functioned quite well during the crisis. Although issuance volumes declined significantly from the peak in 2006 (see chart on page 4), many ABCP issuers continued to access the ABCP market, albeit mostly on an overnight basis. Additionally, several government-sponsored programs such as the Commercial Paper Funding Facility (“CPFF”) and Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (“AMLF”) helped ensure that liquidity was available to issuers and investors and reflected the importance of ABCP to issuers and investors alike.

Many of the problems that occurred during the financial crisis can be attributed to Structured Investment Vehicles (“SIVs”) and extendible CP programs. There are significant structural differences between traditional ABCP programs and SIVs/extendible programs, the major one being the embedded liquidity support available to ABCP investors during market disruptions. Traditional ABCP programs are structured with liquidity support provided by highly rated financial institutions. That liquidity support is equal to at least 100% of the program size. If there is a market disruption and an ABCP issuer cannot issue new ABCP to generate funds necessary to meet payments on maturing issues, the liquidity facility provides that funding.

SIV and extendible CP investors did not enjoy the benefits of a traditional liquidity facility. Liquidity for SIV investors was generated primarily by selling the underlying assets, which, in a distressed market environment, resulted in proceeds that were not sufficient to repay all maturing SIV notes. Similarly, extendible CP programs did not have traditional liquidity facilities. Instead, liquidity was generated by extending the maturity of the notes for a year or longer. Because of the structural deficiencies within SIVs and extendible CP programs, both products are virtually nonexistent today, but the traditional ABCP market continues to be an important piece of the U.S. commercial paper market.

**Q. How do you decide which ABCP programs are appropriate for BofA Global Capital Management’s cash portfolios?**

**A.** When assessing the appropriateness of a given ABCP program for a portfolio, we consider:

- the quality and experience of the sponsor
- the performance of the underlying assets and accompanying credit enhancements
- the soundness of the legal structure

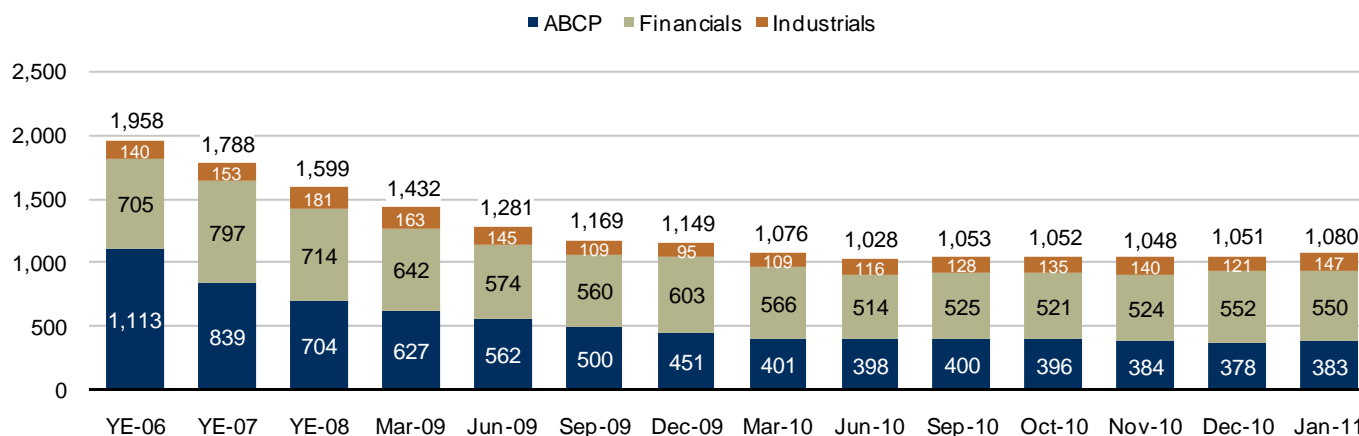
With regard to sponsor analysis, we work very closely with our financial institutions analysts to identify any sponsor-related issues that could cause us to avoid a given ABCP program. The rating on the ABCP program is highly correlated to the rating of the sponsor, so if our financial institutions analysts believe a sponsor’s short-term debt rating could be downgraded to the tier-II level, we will immediately recommend suspension of the related ABCP program.

After reviewing the sponsor, we evaluate the performance of an ABCP program’s underlying assets at the pool level on an ongoing basis. Monthly data is analyzed rigorously for any deterioration in key performance metrics, including delinquency, default, dilution, deal triggers and credit enhancement. If we see significant deterioration in one or more pools, we contact the sponsor to discuss our concerns and ascertain the actions the sponsor will be taking to address the situation.

The final piece of the review process is the analysis of the legal structure. We closely review the underlying conduit documents, looking especially closely at the issuer structure (single-issuer versus purchasing companies and any related loan agreements, bankruptcy remoteness, etc.), credit enhancement structure, liquidity structure, security interest, stop issuance/wind-down events, hedging agreements and the like.

## U.S. Commercial Paper Outstanding

## All Issuers (\$Billions)



Source: Morgan Stanley, "Morgan Stanley Short-Term Credit Weekly Update," January 28, 2011

**Q. You mentioned credit enhancements as a feature of ABCP that you vet as part of your evaluation. How do credit enhancements work?**

**A.** ABCP programs typically benefit from two levels of credit enhancement that work to protect investors against asset deterioration. Pool-specific credit enhancement, which is required by the rating agencies and structured into each underlying asset pool, is the first level of protection against asset deterioration and is typically sized to cover a multiple of historical losses. Pool-specific enhancement can take many forms, including subordination, reserve fund, excess spread or third-party guarantee, but one of the most common is overcollateralization. Simply put, overcollateralization means that the value of the assets exceeds the value of the liabilities issued to fund the assets, thereby creating a cushion that protects investors against potential asset losses. For example, a finance company may sell \$100 of assets to the conduit, but ABCP issued to fund those assets may only be \$80. The unfunded portion (\$20) is held by the finance company and would absorb the first \$20 of losses. Program-wide credit enhancement, usually provided by the bank sponsor, affords additional support for the program and would primarily be used to absorb losses in excess of the

pool-level credit enhancement for any transaction.

Program-wide enhancement is typically provided by the conduit sponsor in the form of a letter of credit or cash collateral account and is generally sized between 5% and 10% of ABCP outstanding. We believe that the amount of enhancement in these structures is robust and provides significant protection for investors.

**Q. In highlighting the advantages of ABCP over other cash investments, you mentioned the diversification benefits and the historical yield advantage. Are there any other reasons to include ABCP in a cash portfolio?**

**A.** For the managers of cash portfolios, the flexibility inherent in ABCP is an important benefit. ABCP is typically issued with maturities ranging from overnight to 270 days. This flexibility allows portfolio managers to customize their exposures to fit their overall portfolio construction strategy. Another important benefit is transparency. Unlike the holders of unsecured investments, ABCP investors can clearly see the assets they own within the conduit. Investors receive detailed monthly reporting that allows them to track portfolio performance and identify risks in a timely manner.

**Q. Given the potential benefits ABCP can provide, do you suggest that cash investors include it in their portfolios?**

**A.** We believe clients for whom ABCP is appropriate should consider adding it to their portfolios. We believe that the ABCP market will continue to play an important role in the cash investment management business for years to come. ABCP is an important source of funding for banks and their clients, and ABCP investors benefit from a diversified, high-quality, secured investment option that typically offers a yield pickup relative to the yield offered by unsecured CP.

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Director  
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Frank Gianatasio is a director, senior credit research analyst, portfolio manager and trader at BofA Global Capital Management. Mr. Gianatasio focuses on securitized products, including asset-backed commercial paper (ABCP) and term asset-backed securities. He has more than 14 years of experience analyzing, managing, structuring and trading securitized products across asset classes and rating categories. Mr. Gianatasio joined a former affiliate of Bank of America in 2008 and has been a member of the investment community since 1996.

Prior to joining Bank of America, Mr. Gianatasio worked at State Street Global Advisors (SSgA) where he was responsible for mortgage-, asset- and commercial mortgage-backed analysis across various total return and index funds, and was the lead portfolio manager for the firm's asset-backed securities collateralized debt obligation (ABS CDO) business. Previously, he was a senior research analyst for SSgA's cash and securities lending businesses, where he focused on quantitative and qualitative credit analysis of ABCP, mortgage-, asset- and commercial mortgage-backed securities. Prior to that, Mr. Gianatasio was with FleetBoston Robertson Stephens, Inc. in the company's asset securitization group, where he structured various esoteric asset securitization transactions. Before that, he was a senior asset-backed and future flow analyst at Fitch, Inc.

Mr. Gianatasio earned a B.S. in finance from Bentley College and an M.B.A. from the F.W. Olin Graduate School of Business at Babson College. He is a member of the Boston Security Analysts' Society and the CFA Institute. In addition, he holds the Chartered Financial Analyst designation.

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