Commercial Paper Today

Key Takeaways

- Commercial paper (CP) is a short-term, unsecured promissory note issued primarily by corporations to meet working capital, receivables financing and other short-term funding needs. Maturities generally range from 1 to 270 days.

- Governments may use commercial paper as part of a diversified investment portfolio to provide competitive yields and diversification, but CP carries greater credit and liquidity risk than U.S. Treasury and U.S. government agency or GSE obligations.

- Commercial paper should not be evaluated solely on the basis of its credit rating. Investors should also evaluate the financial condition of the issuer, the structure of the CP program, liquidity support, credit enhancements, maturity and market conditions.

- GFOA recommends that governments choosing to invest in CP limit purchases to first-tier short-term credit ratings from two NRSROs, such as A-1, P-1 or F-1 or better.

- Governments should determine whether CP is permitted under applicable state law and their investment policy and whether they have the expertise and resources necessary to evaluate and monitor CP.

- A government should continually determine whether the incremental yield from CP justifies its additional credit and liquidity risk.

- **For Illinois public entities, commercial paper is only one part of the corporate-credit investment universe. Illinois law separately permits qualifying longer-term corporate obligations with maturities of more than 270 days but less than 10 years, subject to statutory credit, issuer-size, concentration and portfolio limits.**

What Is Commercial Paper?

Commercial paper is a short-term, unsecured promissory note issued by corporations, including financial and non-financial companies. It is commonly used to finance working capital, receivables and other short-term obligations.

Because commercial paper generally has a maturity of 270 days or less, it is exempt from registration with the Securities and Exchange Commission under federal securities law.

Unlike U.S. Treasury or U.S. government agency or GSE obligations (government sponsored enterprises), commercial paper represents an obligation of the issuing entity and therefore carries issuer credit risk.

Commercial paper can also carry liquidity and rollover risk. An investor that intends to hold CP to maturity may nevertheless face difficulties if market conditions deteriorate or an issuer experiences financial stress and liquidity dries.

Why Do Governments Invest in Commercial Paper?

Governments may include commercial paper in their investment portfolios because it can provide:

- Competitive yields relative to other short-term investments;
- Diversification among issuers and sectors; and
- Additional investment opportunities for funds that are not immediately required for operating purposes.

The additional yield available from CP, however, should always be evaluated against the additional credit and liquidity risks associated with the security.

GFOA cautions that governments should determine whether the incremental yield associated with CP justifies those additional risks.

Illinois Public Entities: Commercial Paper and Corporate Credit

For Illinois public entities, it is important to distinguish **commercial paper and other short-term corporate obligations** from the broader category of **corporate obligations** authorized under the Illinois Public Funds Investment Act.

Under 30 ILCS 235/2(a)(4), Illinois public agencies may invest in qualifying short-term obligations of corporations organized in the United States with assets exceeding $500 million when the obligations are rated at the time of purchase in one of the three highest classifications established by at least two standard rating services and mature no later than 270 days from the date of purchase. Purchases may not exceed 10% of the corporation’s outstanding obligations, and no more than one-third of the public agency’s funds may be invested in short-term corporate obligations under this paragraph.

For Illinois investors, this is the statutory framework that generally encompasses **commercial paper**.

The Important Distinction: Corporate Credit Is Broader Than Commercial Paper

Illinois law also contains a separate provision, 30 ILCS 235/2(a)(4.5), authorizing investment in qualifying obligations of corporations organized in the United States with assets exceeding $500 million that mature **more than 270 days but less than 10 years** from the date of purchase.

These longer-term corporate obligations must:

- Be rated at the time of purchase in one of the three highest classifications established by at least two standard rating services;
- Mature more than 270 days but less than 10 years from the date of purchase;
- Represent no more than 10% of the corporation's outstanding obligations purchased by the public agency; and
- Be subject to the statutory limitation that no more than one-third of the public agency's funds may be invested in obligations under this corporate-obligation provision.

This distinction is important.

Commercial paper did not become a 10-year investment.

Rather, Illinois law provides **two separate corporate-investment categories**:

Investment Category	Illinois Statutory Maturity	Credit Standard
Short-term corporate obligations / commercial paper	**270 days or less**	One of the 3 highest classifications from at least 2 rating services
Longer-term corporate obligations	**More than 270 days but less than 10 years**	One of the 3 highest classifications from at least 2 rating services

The Illinois Public Funds Investment Act therefore gives qualifying Illinois public entities access to a broader corporate-credit universe than commercial paper alone.

Understanding Commercial Paper Risk

Credit Risk

Commercial paper is unsecured debt. The investor therefore relies on the creditworthiness of the issuer and, where applicable, the strength of the program's credit support.

Credit quality can change quickly. A highly rated issuer or CP program can experience a downgrade or other adverse development that affects the market value and liquidity of its outstanding paper.

For this reason, investors should conduct ongoing credit analysis rather than relying solely on an initial credit rating.

Liquidity Risk

Commercial paper is generally less liquid than U.S. Treasury and U.S. government agency or GSE obligations.

Although a secondary market exists, market liquidity can deteriorate rapidly during issuer-specific or broader market disruptions. An investor that needs to sell CP before maturity may not be able to do so at an attractive price—or may not be able to sell it at all.

Rollover Risk

Commercial paper programs frequently rely on the continued issuance of new CP to refinance maturing obligations.

During periods of market stress, an issuer may be unable to refinance maturing CP.

Liquidity facilities, such as bank lines of credit, may provide support, but investors should evaluate the amount, terms, availability and reliability of that support rather than assuming that the existence of a facility eliminates rollover risk.

Types of Commercial Paper

Commercial paper is available in several structures. Government investors should understand the differences before purchasing a security.

Traditional Commercial Paper

Traditional CP is generally an unsecured obligation of a corporate issuer. The creditworthiness and financial condition of the issuing company are therefore central considerations.

Asset-Backed Commercial Paper

Asset-backed commercial paper (ABCP) is issued through a conduit or special-purpose vehicle and is supported by specified assets and their cash flows.

ABCP programs can be structured as:

- Multi-seller programs, in which assets from multiple sellers and industries support the program; or
- Single-seller programs, in which the assets of one entity support the program.

The structure, underlying assets, liquidity support, credit enhancement and concentration characteristics of an ABCP program should be evaluated before investment.

Extendible or Structured Notes

Certain commercial paper structures include provisions that can extend the maturity of the security under specified circumstances.

Government investors should understand the circumstances under which an extension can occur and determine whether the resulting maturity and liquidity characteristics are appropriate for the portfolio.

Structured Investment Vehicles

Structured investment vehicles (SIVs) and other highly structured CP programs can involve complex assets, funding arrangements and valuation considerations.

Because of their complexity, government investors should carefully evaluate whether they have the expertise and resources necessary to understand and monitor such investments before including them in a portfolio.

Credit Ratings

Nationally Recognized Statistical Rating Organizations (NRSROs) routinely assign short-term credit ratings to commercial paper programs and monitor their credit quality.

However, a credit rating should be viewed as one component of the investment analysis—not a substitute for independent due diligence.

Consistent with the GFOA advisory, governments choosing to invest directly in commercial paper should limit purchases to first-tier short-term credit ratings from two NRSROs, such as:

- A-1 or better;
- P-1 or better; or
- F-1 or better.

Government investors should also monitor ratings and rating outlooks on a frequent basis and establish procedures for responding to a downgrade or other material deterioration in credit quality.

Illinois Credit-Rating Requirements

Illinois law establishes its own statutory credit-quality requirements for corporate obligations.

For both the short-term corporate obligations authorized under Section 2(a)(4) and the longer-term corporate obligations authorized under Section 2(a)(4.5), the security must be rated at the time of purchase in one of the **three highest classifications established by at least two standard rating services**.

Accordingly, an Illinois public entity should look at **both** the statutory requirement and its own investment policy before purchasing corporate credit.

An investment may satisfy the Illinois statute but still be ineligible under the entity's investment policy if the policy establishes more restrictive requirements.

Implications for Investors of Public Funds

Before investing in commercial paper or other corporate credit, a government should address four fundamental questions.

1. Is the Investment Permitted?

The government should verify that the security is permitted under applicable state law, local ordinances and its investment policy.

For Illinois public entities, this means distinguishing between:

- Short-term corporate obligations maturing no later than 270 days; and
- Qualifying corporate obligations maturing more than 270 days but less than 10 years.

Investment staff should understand any applicable maturity, credit-quality, concentration or other statutory and policy limitations.

2. Does the Government Have the Necessary Expertise?

Commercial paper and corporate credit require ongoing analysis of credit quality, market conditions, issuer fundamentals, security structures and liquidity.

GFOA recommends that governments determine whether they have the expertise to understand, evaluate and monitor commercial paper before including it in a diversified investment portfolio.

The same principle applies to longer-term corporate credit—and arguably with even greater importance as maturities lengthen and market-value sensitivity increases.

Governments that do not have the necessary expertise may choose not to invest directly in corporate securities or may obtain exposure through an appropriately managed investment fund or investment adviser.

3. Does the Additional Yield Justify the Additional Risk?

Commercial paper and corporate bonds should not be purchased simply because they offer a higher yield.

Government investors should continually evaluate whether the incremental yield compensates the portfolio for the additional credit, liquidity, market and, where applicable, duration risk associated with the investment.

The longer the maturity, the greater the potential for market value to fluctuate before maturity.

4. Is the Investment Appropriate for the Particular Fund?

Even when an investment is legally authorized, the investment should be evaluated against the purpose and expected cash-flow needs of the particular fund.

Operating funds, capital-project funds, reserve funds and longer-term funds may have very different liquidity requirements.

An investment appropriate for one fund may not be appropriate for another.

GFOA-Consistent Practices for Investing in Commercial Paper

Government investors choosing to use commercial paper should consider the following practices:

1. Conduct ongoing credit analysis.

Periodically review financial information for issuers of traditional CP and, where applicable, monthly or quarterly reports for ABCP programs.

2. Diversify.

Establish appropriate diversification by issuer, industry sector and type of commercial paper.

3. Establish a portfolio limit.

Set a maximum percentage of the portfolio that may be invested in commercial paper.

4. Establish issuer and sector limits.

Limit the amount of CP purchased from any one issuer, industry or type of CP.

5. Use shorter maturities.

Favor maturities that reflect the more active portion of the CP market and reduce the opportunity for material deterioration in credit quality before maturity.

6. Monitor market and industry conditions.

Consider restricting investments in sectors or industries experiencing significant turmoil, volatility or major regulatory or technological changes.

7. Understand the structure.

Distinguish among traditional corporate CP, ABCP, multi-seller and single-seller programs, and extendible or structured CP.

8. Require strong credit quality.

Limit investments to first-tier short-term credit ratings from two NRSROs, such as A-1, P-1 or F-1 or better.

9. Evaluate liquidity support and credit enhancement.

Review bank lines of credit, guarantees, insurance and other forms of support, including their amount, terms, conditions and reliability.

10. Maintain security-level information.

Keep current information regarding each CP program or issue held in the portfolio.

11. Monitor ratings and outlooks frequently.

Establish procedures for identifying and responding to ratings changes, negative outlooks and other material credit developments.

12. Use a pre-approved list.

Maintain a short list of CP programs that investment staff are authorized to purchase and review that list frequently.

These practices are consistent with the risk-management framework outlined in GFOA's advisory, *Using Commercial Paper in Investment Portfolios*.

Corporate Credit Beyond Commercial Paper

For Illinois public entities, the same disciplined approach should be applied when considering longer-term corporate obligations.

A longer maturity can provide additional yield and diversification, but it can also introduce greater exposure to:

- Changes in interest rates;
- Credit-spread widening;
- Deterioration in issuer credit quality;
- Reduced secondary-market liquidity; and
- Greater potential market-value volatility.

Accordingly, an investment policy that permits longer-term corporate obligations should consider establishing guidelines beyond the statutory minimums.

These may include:

- Maximum maturity;
- Maximum percentage of the portfolio;

- Maximum exposure to any one issuer;
- Industry or sector limits;
- Minimum credit ratings;
- Requirements for ongoing credit review;
- Liquidity requirements;
- Procedures following a downgrade; and
- Appropriate benchmarks and performance measures.

The Illinois Public Funds Investment Act specifically requires public agencies to operate under a written investment policy. The policy must include authorized investments, a standard of care, investment guidelines, diversification provisions and periodic review of the portfolio's effectiveness in meeting the agency's needs for safety, liquidity, rate of return and diversification.

The statute therefore establishes the legal framework, while the investment policy provides the **practical guardrails** for implementing that authority.

Commercial Paper and Portfolio Safety

For public funds, commercial paper should be considered within the broader hierarchy of safety, liquidity and yield.

U.S. Treasury and U.S. government agency or GSE obligations generally provide greater liquidity and lower credit risk than commercial paper. CP may provide additional yield, but that yield comes with additional risk.

Accordingly, a prudent government investor should consider:

Safety → Liquidity → Yield

Commercial Paper Through an Investment Fund

Governments that do not have the staff, expertise or resources to conduct individual commercial paper analysis may obtain CP exposure through a professionally managed investment fund or investment adviser.

A professionally managed portfolio can provide diversification, ongoing credit monitoring, security selection and portfolio management.

The government should nevertheless ensure that the fund's investment strategy, eligible securities, credit-quality standards, maturity limits and risk controls are consistent with applicable law and its investment policy.

For Illinois public entities, the same review should be applied when considering a fund that provides exposure to corporate credit. The entity should understand exactly what securities the fund may hold, the fund's maturity and duration parameters, credit-quality standards, liquidity provisions and concentration limits.

Conclusion

Commercial paper can be a useful component of a diversified public investment portfolio when it is permitted by law and policy and when the government has the expertise and procedures necessary to manage its risks.

For Illinois public entities, the investment conversation is broader than commercial paper alone. Illinois law permits qualifying corporate obligations across a range of maturities, including short-term obligations maturing within 270 days and longer-term corporate obligations maturing more than 270 days but less than 10 years.

The fundamental question is not simply whether commercial paper or corporate credit offers an attractive yield.

Rather, government investors should determine:

Is it authorized by our investment policy?

Does it fit the liquidity needs of the fund?

Do we understand the risks?

And does the additional yield adequately compensate the portfolio for those risks?

A disciplined corporate-credit program should emphasize:

High Credit Quality • Diversification • Appropriate Maturities • Liquidity • Ongoing Monitoring

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