The European Commercial Paper Market Reimagined
An ICMA Workshop

Summary note
November 4, 2020

Executive summary

- Objectives of the workshop were (i) to look back on how the European Commercial Paper market performed during the peak of the COVID-19 crisis, and (ii) to identify possible initiatives, whether market-based or regulatory, that could help develop the market.
- For the most part, European Money Market Funds performed well during the crisis. Despite a rotation out of Money Funds, very few LVNAV funds saw their cash buffers drop below 30%.
- Banks were unable or unwilling to show secondary market bids for CP, including their own paper. This was partly a balance sheet issue, but also a liquidity issue, as banks anticipated drawdowns through RCFs.
- For many corporate issuers, the CP market was effectively shut through March. The only demand was for very short maturities and the most liquid names.
- Notably, the market still had not normalized, which is exemplified by the very high cash levels being held in MMFs (45-55%).
- The ICSDs played an important role in facilitating speedy access to the market for new CP issuers following central bank interventions.
- In the US the Federal Reserve supported the CP market effectively through both the CCPF and MMLF programs. The latter helped restore a bid to the secondary market by supporting dealers with balance sheet relief.
- In the UK, the BoE's CCFF programme was viewed as a being an efficient and effective response, providing issuers with confidence that they could source funding.
- In comparison, the extension of the ECB's PEPP to include ECP was largely viewed as too slow, limited in its scope, and largely ineffective.
- Trading platforms, and the digitalization of the market, are welcomed market developments supporting increased efficiencies, improving transparency, and reducing operational risk. However, it is not clear that they create liquidity.
- All market stakeholders believe that greater transparency in the ECP market would be beneficial.
- The development of a repo market for ECP would help in improving liquidity. The inability to price ECP independently is the main obstacle.
- There is a need to review Money Market Fund Regulation to reduce procyclical risks, particularly the linkage between liquidity buffers and gates and swings, how liquidity buffers are used, and the possibility of using MMF units as collateral.
- There is good interest in a cross-industry group developing proposals that could help support the development of the European CP market and in engaging with regulators and policy makers, in particular the ECB.

Notes from the workshop

The workshop was held under Chatham House Rules

Opening remarks

The objective of the workshop is twofold. Firstly, to look back on how the European Commercial Paper market performed during the peak of the COVID-19 crisis, from the perspectives of different stakeholders, in particular identifying potential lessons learned. Secondly, looking forward, to identify possible initiatives, whether market-based or regulatory, that could help develop the market, providing greater efficiencies, liquidity, and resilience. It would seem unlikely that the workshop would provide all the answers, but it could be viewed as the first step in bringing the market ecosystem together to discuss ways to support market development and possible engagement with the regulators and policy makers.

Part 1: Lessons learned from the COVID-19 turmoil

The money market fund perspective

It was an interesting time as an investor back in March, and the events are very well documented and understood. There was a big risk-off move and a significant rotation in the US out of Prime Funds of around $140bn, and a massive inflow into Government Funds of around $600bn. In contrast, Europe did not see quite as strong a movement. In terms of European LVNAV funds we saw a drop of around 16% in AUM in the two weeks in March. Much of this was in USD, as the activity of many USD investors in Europe is driven by their US based headquarters and decision markers. There was a fear that if US Prime Funds fell below their 30% weekly liquid asset threshold then liquidity fees or redemption gates would be imposed.[1] That worry also acted as a big motivator for investors in Europe as well. However, following Federal Reserve intervention, the market quickly stabilized and we have seen continued interest in both Prime/LVNAV and Government money funds. In Europe LVNAV AUM is back to pre-March levels, and in the US, despite some closures of Prime Funds, AUMs have also recovered to early 2020 levels. So, a bumpy ride, but money market funds performed the way they are supposed to perform. In the US we saw sponsors stepping in to support funds over the two weeks prior to the Fed intervention, while in Europe LVNAV Funds performed as expected, with no fees or gates being imposed, and by and large the 30% weekly liquid asset thresholds held, and very few funds breached it and then only for a very short period of time. So overall, an encouraging experience, but one that nonetheless required the intervention of the Fed to stabilize markets more broadly.

It is correct that very few LVNAV funds dipped below the 30% threshold, which raises an interesting question as those cash buffers are meant to be counter-cyclical, but instead became a floor and may have prompted pro-cyclical behaviour when combined with fees and gates and mark-to-market triggers (‘first mover advantage’). The question for the participants is whether these (and other) aspects of the regulation caused that, which is something to think about in the next session. In terms of VNAV funds,

[1] It is important to note that some funds that have links between gates and fees and funds with their buffers, and others that do not (such as standard VNAVs); in the case of the former those buffers were not used, and in the case of the latter they were.

outflows were also relatively modest in Europe and the UK, which is also highlighted in the Central Bank of Ireland report.[2]

An additional point is that irrespective of the investor flows, the way the market behaved with respect to liquidity raising reflected the lack of underlying market liquidity, which is an important area to focus our attention as we move to the second session. Due to the fact that dealers struggled to take risk on their books, money funds, regardless of their view, were forced to bias their liquidity buffers higher given that there was no market liquidity. So, it will be important to explore ways in which to improve secondary market liquidity for CP. For example, we saw a lot of central bank support across a range of asset classes, but not for financial CP, which was a big part of the problem.

The dealer perspective

March and April can be described by a rapid change in investor preference which had impacts on market liquidity. In mid-March, in the US, we saw what has been described as a 'dash for cash', however this is better characterized as a dash for liquidity. Investors who had previously been quite happy to roll three-month maturities, were suddenly looking to roll for one, two, or three weeks, or even not to roll at all and instead looking to trade into more liquid names, specifically SSA, government securities, or large Tier 1 corporate issuers. This was not a credit flight to quality, but more a flight to liquidity. There were many situations where investors asked for bids back on longer-dated paper, however in mid-march dealers were coming up to quarter-end which further complicated the ability of the dealer community to provide liquidity for investors. It quickly became clear that the first bid for any investor's paper was likely to be the best bid and pricing became very volatile with prices gapping wider, particularly as issuers themselves were looking for funding to meet month-end requirements. This led to pricing dislocations both across maturities and credit.

Banks that are also active issuers were looking to raise liquidity in anticipation of revolving credit facility (RCF) drawdowns from issuers who, as a result of COVID-19, might need incremental liquidity. Some banks paid up for liquidity, others declined to chase the market, either in the form of shorter maturities or higher costs, and some banks were able to provide bids to buy back paper. As we got further into March, central bank activity was critical in restoring confidence to the market as much as providing liquidity, specifically the Bank of England CCFF programme which provided liquidity to investment grade borrowers in sterling. In step, the ECB announced the PEPP programme and additional TLTROs. These programmes helped to reduce the need for banks to issue commercial paper. Meanwhile in the US the Fed dusted off the CPFF and MMLF programs, which also boosted confidence as well as providing liquidity for money funds.

As we moved into the next quarter, it was also helpful that funds that had anticipated the very large outflows had not experienced quite as dramatic a move as expected, meaning liquidity provisions were adequate to cover withdrawals. And by late April/early May, those fund outflows turned around to become net inflows. It was also helpful that the term market reopened and corporate issuers were able to source term funding at attractive rates.

[2] The persisting effect of the pandemic on Money Market Funds and money markets, CBI, 2020

In contrast the SSA community enjoyed good liquidity and continued to issue during the turmoil, and outstandings actually increased as investors sought the most liquid issuers and programs.

One of the reasons why investors moved into SSAs was the fact that there were no bids in the market for corporates, and dealers and brokers who are normally relied upon to provide a price simply were not there. It was not a question of price, in some cases there was no bid at any level, even in their own paper. This is very concerning when banks cannot bod for paper that they are happy issuing, suggesting that something needs to be done. Whether this requires changes to capital or liquidity ratios with respect to CP, but there should not be a situation where banks are unable to buy their own paper.

The issuer perspective: non-financial

With respect to what worked and what did not work, it is fair to say that the market did not work in the sense that we were trying to secure CP funding and, especially in March, that became difficult. We could have placed some paper for very short maturities, such as a week or so, but anything beyond that was extremely difficult. From our perspective we were looking for certainty of funding to meet our seasonal cash flow requirements, but that certainty was not there. This was the case for all of March and most of April. By late April/early May the situation got better but by then we had covered everything we needed via the US CP market, which came back much quicker and more strongly than we saw in the ECP market. With regards conditions in different currencies, we primarily borrow in USD and Euro, but given the difficulties we signaled to investors that we were open to issue ECP in different currencies, including GBP, JPY, CHF, but there was no interest.

Central bank intervention

In terms of central bank intervention, while this is workshop is ECP focused, the Fed's intervention was very important in restoring confidence to the US market. And while we were not able to benefit directly, as our US program is not eligible for Fed purchases, we did benefit from the positive knock-on effect of the market coming back quickly, and during April we were able to secure all of our financing needs through the US market. Unfortunately, we did not see that same speed in Europe. With respect to the ECB programme, it took some time before we got all the details, and then the structure was not really catered to certain segments of the ECP market, specifically the German CP market, mainly due to corporate CP programs usually utilizing classical global notes, not being listed, or not issued under a STEP label. So, for the German market, the ECB purchase programme was not really there, but on the positive side, the Bank of England programme was very clear, very pragmatic, and relatively unbureaucratic. Eventually the ECP market came back, including for Germany, but how much of this was due to the indirect knock-on effect of the ECB's programme or with German CP programs being revamped to be ECB eligible is difficult to say. In terms of lessons learned, many German corporate issuers have now updated their programs to be ECB eligible, which will be helpful in case of a future, similar event, and will mean not having to rely on the Bank of England or, indirectly, the Fed.

Two additional points. The ECB intervention was welcomed and helped in improving liquidity, however faster intervention would have been better. When the market became blocked, we had to find alternative sources of financing to meet our funding profile. That meant that once the central bank intervention came, we had already committed and could not take advantage of the ECB's programme. Secondly, in terms of pricing, it was very difficult for dealers to provide issuers with price guidance, and also levels were extremely volatile day-to-day. This is very normal, but as an investor it is a deterrent to locking-in a particular yield.

We have two CP programs, one in the US and one in Europe. We are frequent issuers in the US but not Europe. However, we were looking to ramp up our European program to meet some significant short-term funding requirements. Unfortunately, this was in March when we needed the ECP market to be there, so clearly this was disappointing. It probably made it more difficult that we were not rolling over any paper, as we had no outstandings at the time, but the market was effectively shut to us for around one month. In the US, where we already had outstandings, we remained able to print. Some days we had to pay up, so we targeted shorter maturities, but there was always a market. So, we were quite shocked that there was no liquidity for us at all in the ECP market, and the significant disconnect between what we were able to do in the US and Europe. We do not think it was a credit issue, but more the fact that in Europe we are not seen as a liquid issuer.

In terms of central bank intervention, from the investor perspective, what we witnessed in the US is quite different to what we saw in Europe in that we saw a 'no bid' situation there as well, until the MLLF was rolled-out. So, on March 17 we could not get a bid, but on March 18 we were getting calls from our dealers saying that they would bid for any amount of paper we wanted. What we heard from the US sell-sides that the most important feature of the Fed's intervention was making the purchases of their own paper balance sheet neutral, allowing them to become the cornerstone of the market again. In contrast, we did not see this in Europe, hence we had much more stressed markets, which the issuers have described. Another important difference is that the program in the US included both financial and non-financial issuers, whereas the ECB's programme did not include financial CP, even though this is the larger part of the market. So, the European programme was less comprehensive and did not help dealers from a capital perspective, and accordingly the market remained stressed for much longer.

The BoE's CCFF had a very defined set up, targeting issuers who needed liquidity quickly. There was also a process whereby dealers could approach corporates who may not even have CP programs, and relatively quickly they could be approved, which gave them comfort that they could source liquidity if needed. However, the way the PEPP functioned required dealers to show offers to the ECB in eligible paper, which they may or may not have lifted, creating less certainty for issuers.

We used the BoE's programme and it was very efficient, pragmatic, and worked well.

With the PEPP there was a hope that even with purchases limited to non-financial CP, this would help clear dealers' balance sheets allowing them room to bid for financial names, but that did not happen. Trying to find out what the ECB was happy to bid on was a very stressful process for the dealers, and even when the ECB did show bids these were not reflective of where the market was pricing at that point. Ultimately dealers were not willing to take losses on their positions, so instead the result was that they held onto inventory, did not clear their books, and were unable to help investors when they needed bids on noneligible paper.

When we looked across our funds, we saw that very little CP actually qualified for the PEPP.

The percentage of eligible paper in our portfolio was also very small, and it was not always clear what exactly might qualify.

Similarly, we were not able to utilize the PEPP at all. Additionally, it was frustrating for US domiciled UCITS that did not qualify for the MMLF. While they benefited from the knock-on effects as secondary market liquidity in the US improved, it still felt as if a section of the market fell between the cracks.

The infrastructure perspective

It is perhaps not obvious to most people what the role of the ICSD was during all of this, as they are very much behind the scenes, but as a key infrastructure they played a fairly significant role, particularly in supporting the various COVID-19 funding facility packages for ECP. The first interaction was linked to the BoE CCFF, announced on March 17. We started to receive requests two days later from the appointed issuing agents of various organizations interested in leveraging the facility and who wanted to ensure that they could issue paper through the ICSD model. Many of these corporate issuers were not familiar with the ECP borrowing procedure, and the process in place for the eligibility review of a program to start drawing down on the facility is document heavy. Given the pressure on time, it was necessary to come up with a light version of the program acceptance process, which was established through working with one of the major capital markets law firms. Instead of having a fully documented info memo along with the agency agreement, the deed of covenant, and the global certificate, the process was streamlined dropping the need for the info memo, working on the basis of a copy of the master global note, a copy of the executed agency agreement between the issuer and their appointed agent, and the deed of covenant to show legal certainty on the borrowing. The view was that throwing more people at reviewing documents was not the right approach and that to help facilitate the anticipated volumes the solution was to come up with a simpler documentation process, compliant with ICMA standards, but that would allow issuers and their legal counsels to react quickly. So far, 215 new ECP programs were set up specifically to leverage the CCFF. These facilities are still being used: the BoE published data last week showing £195mm of purchases, with a total of outstanding purchases net of redemptions of just over £15bn. The total approved is up to £83bn. So, it is a facility that worked well.

As to the PEPP facility, we saw very little interest from borrowers. If you compare the CCFF volumes and PEPP related volumes, it was night and day.

Part 2: The European CP market reimagined

Recap

Recapping in order to put forward a problem statement, firstly it is fair to say that the short-end markets froze with banks unwilling to buy back their CP, money market funds not investing in new CP issuance other than for very short-term, very liquid paper, with the exception of US money market funds, outflows from Euros and Sterling, whether CNAV, VNAV, or LVNAV, were much more modest than in the GFC being roughly in the range of 10-15% at the worst point. This should have been easily manageable given that the LVNAV funds have a 30% liquidity buffer and VNAV funds have a 15% cash buffer. But in the case of the LVNAV funds, this high buffer could not be used to meet redemptions and effectively became a floor given the link to gates and fees and the inability to sell paper.

Central Bank intervention was helpful in the case of the BoE, but not so much in the case of the ECB, even indirectly. The redemptions seen in Euros were mostly either due to corporates needing liquidity for cash flow management, or pension funds managing margin calls, so it could be argued that ECB intervention did help indirectly to some extent, but there was little direct support to money market funds. It would also seem that markets are still not functioning properly given the money market fund cash buffers remain high indicating continued caution and the possibility for renewed market stress.

One point not discussed so far is that the CP market in Europe is fairly opaque, particularly in contrast to the US, and this workshop is in many ways a recognition that information on how the market is performing is not widely available. Another important point is the differences in experiences between the US and Europe.

This session focuses on what needs to be done to improve market efficiency, to the benefit of the issuers, but also the investors. How do we improve liquidity? How do we improve the availability of market data? How do we make the market more efficient?

The comments so far have highlighted the linkages between the various stakeholders in the money markets, so with that in mind there is unlikely to be any silver bullet, but maybe a range of different actions. For example, what could be done with prudential regulation to allow banks to continue to fulfill their cornerstone role as market-makers, both in good times and bad times? For instance, why were banks reluctant to dip into their counter-cyclical capital buffers? Perhaps regulators could provide guidance for banks on this issue. Another suggestion is that high quality CP could be balance sheet neutral for banks to hold, or is HQLA eligible, either permanently or in times of stress.

On the market structure side, how do we evolve the CP market functioning in light of the fact that compared with equity and fixed income markets there has been very little development over the past decade? How do we increase the efficiency of the market? And finally, where do we see issues with the Money Market Find Regulation? This has been successful in the sense that funds are investing in shorter-term, higher quality paper, but there are clearly issues as well.

Dealer regulation and initiatives

With respect to dealer capacity, the challenge for banks in the crisis when bidding back paper was not so much a credit issue but a liquidity issue. Banks were trying to protect their own liquidity and to be prepared for any potential outflows from RCF drawdowns. A quick fix could be to enhance the ability for banks to finance CP and CD positions externally via repo. Clients are reluctant to take a portfolio of CP into a repo structure as there is usually no daily mark and there are challenges with valuing the assets. There are vendor initiatives to provide CP pricing, which would help. Having access to repo funding would certainly help the capacity of dealers to provide more liquidity.

The ability to fund CP via repo would probably bring a lot more participants into the market. Clients that invest in repo, but do not traditionally invest in CP are interested in the product, and like the rates, but the challenge is how do they price it and can they pledge this as collateral to their prime broker? But this could be transformative for the market and increase liquidity. In the US, dealers do fund positions through repo. But in Europe, this is trapped collateral.

The biggest challenge is the regulation with respect to buying back paper from a treasury perspective and the impact on liquidity. Also, as mentioned, with the prospect of RCF drawdowns, and the relative uncertainty, buying back paper was probably not the most prudent thing to do at that time. In times of stress prudential regulators need to be quicker in allowing banks to buy back paper with penalty. Also, a more developed secondary market for CP would help. If dealers had to prove liquidity in CP by either trading or repo-in secondary positions, this would vastly improve overall liquidity.

Central Bank collateral eligibility for CP would help, but it is more a case of pricing. In the US the Fed produces generic curves that can be used to price CP. Something similar in Europe would be the difference.

Market structure

Would all-to-all trading, straight-through-processing, broader distribution channels, and operational risk mitigation and capital cost reduction due to shorter settlement cycles have made a difference in the crisis?

Same-day settlement works for Euro, but it becomes more complicated when this is being hedged with a currency swap.

Electronification of the market is definitely an improvement and will help the market to develop, particularly in a negative rate environment where investing in CP becomes an alternative to bank deposits. But infrastructure is not only the settlement of paper, but also about information as to who is willing to place and who is willing to buy. Essentially, we need a market place. If issuers can post their interests on the same platform this will make it easier for investors to engage with the marker.

Creating a repo market for CP could be difficult as there are a lot of operational errors with CP. Processes and platforms that eliminate these errors will assist in this respect.

How much of an issue is market transparency? What is available? At what price? And what has printed?

Total transparency on CP is difficult, as issuers and dealers do not necessarily want to show their prices to competitors.

In Europe we have two traditions, the French system which is regulated and the ECP market. The benefit of the French system (the 'NEU market') is that there is a degree of transparency, such as outstanding volumes. By contrast, there is limited transparency in the ECP market. So, when it comes to Central Bank support it is not surprising that they will look to markets they know. This is a benefit of transparency.

Full transparency of pricing and prints would be in keeping with other markets. In the past, issuers have had issues with this, to avoid funding levels being revealed, but if you compare this with the Yankee CD market, which has full transparency, you see a much better functioning market.

Not sure if it would have made a difference, but increased transparency, improved efficiency, and shorter settlement cycles would be welcomed.

CP platforms are reliant on the issuer to put all their interest on one platform. Does this improve liquidity? If they put their orders across different platforms, they run the risk of over-issuance.

While platforms bring efficiencies, it is not clear that they necessarily bring liquidity, particularly when we look at the issues back in March.

All-to-all functionality is interesting and could be useful day-to-day. But in the crisis, when everybody was looking for a bid, this probably would not have made a difference.

Money Market Funds

The focus so far has very much been on the liquidity supply side, but there is also the question of what can be done to ease the pressure on money market funds. There are a few considerations here.

Firstly, as mentioned earlier, the linkage between the liquid asset requirement and gates and fees. This warrants looking at again and how, from an investor perspective, this is driving behaviour and a drive to get out of the fund.

The second consideration is related to the wider issue of liquidity buffers and perhaps regulatory guidance on how to use these buffers across the industry in a more harmonized context.

Thirdly, to ease pressure on Money Market Funds, similar to the repo point made earlier, to what extent can units in Money Funds be used as collateral in the derivatives space, so reducing the pressure to generate cash to post as margin.

Finally, how, as a group, do we take all of these recommendations discussed today and present them to regulators as a package in a way that they find appealing and that they will effectively address the problems we saw in March under similar circumstances?

Next steps

Is there value is us writing up a note of the workshop and then thinking about how to engage with regulators on the various recommendations?

And is there value in proposing an ECB Contact Group for short-term markets that includes not only the dealers, but also the busy-side, including MMFs, PFICs, etc., as well as the issuers?

In the case of engaging with the ECB, the experience was very different to that described by others earlier. However, it is quite a fragmented engagement as corporate CP purchases are spread across the different NCBs, with some extremely efficient and helpful and others less so. But the process did take a long time to get up and running, and also it was clear that the NCB dealers were bond traders and not so familiar with ECP, what was eligible and what was not. Another challenge was inherent in some of the ECP programs, where the issuer may be domiciled in one country, but the guarantor is in another, and so it was difficult to find the correct NCB.

But the ECB would probably be very interested to hear the feedback from participants today, and an approach from a group such as this would likely be taken extremely positively.

If agreed, ICMA will write up a note of the discussions, along with an overview of some of the recommendations. This will be with a view to meeting again to discuss and think of ways forward, and possibly reaching out to the ECB and other regulatory bodies.

[Participants were largely favourable.]

Possible proposals for further consideration

- Favourable capital/liquidity treatment of CP for banks to support secondary market liquidity.
- The development of a repo market for CP.
- Ongoing development of trading platforms and digitalization.
- Greater market transparency.
- Reviewing the linkages between liquidity buffers in MMFs with gates and fees.
- Harmonized regulatory guidance on the use of MMF liquidity buffers.
- Eligibility of MMF units as collateral.

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