Government Finance Officers Association

Recommended Practice

Use of Commercial Paper (2001 and 2007) (CASH)

Background. Commercial paper is a short-term, unsecured promissory note issued by corporations for working capital, for general cash flow, and for financing receivables. Commercial paper has maturities ranging anywhere from 1 to 270 days. By federal law, commercial paper issues are exempt from registration with the U.S. Securities and Exchange Commission. Nationally recognized statistical rating organizations (NRSROs) routinely rate commercial paper and regularly review the strength of the credit quality. Commercial paper may be sold directly to investors by the issuing company (direct issued) or by the underwriting brokerage firm (dealer placed). Commercial paper is used by many government entities as a short-term investment for funds not immediately required, and to provide diversification and competitive rates of return. Typically, governments purchase commercial paper with a buy and hold until maturity strategy; however, there is a secondary market that can be utilized for sales prior to maturity. State statutes vary as to the extent or ability of governments to utilize commercial paper.

Recommendation. The Government Finance Officers Association (GFOA) recommends that if commercial paper is used as part of an investment program of state and local governments, government investors are highly encouraged to develop policies and procedures to appropriately manage the risk of such investments.

To protect public funds invested in commercial paper, government investors should consider practices such as:

- diversification by industry sector or type
- limitation on percentage of portfolio comprised of commercial paper
- limitation on percentage of commercial paper issued by any one issuer, industry, or type
- limitation of investments to shorter maturities reflecting the most active part of the commercial paper market and providing the least opportunity for credit quality changes
- recognizing different types of commercial paper, such as corporate promissory notes, asset-backed paper, funding paper, or extendible paper (also called liquidity notes or structured notes) and determining the appropriateness of each for the government's portfolio
- limitation to first tier short-term credit ratings by two NRSROs (for example, A-1, P-1, F-1 or better)
- evaluation of underlying credit enhancements such as bank lines of credit or insurance in addition to the dual credit ratings
- maintenance of information on each commercial paper issue in the portfolio
- monitoring of ratings and rating outlook analyses

References

- GFOA Sample Investment Policy, 2003.
- *Investing Public Funds*, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- *An Elected Official's Guide to Investing*, M. Corinne Larson, GFOA, 1996.

Approved by the GFOA's Executive Board on March 2, 2007.