

Asset-backed commercial paper (ABCP) is a short-term liability with a maturity of up to 270 days. As we saw in Chapter 7, commercial paper (CP) can be issued only by the most creditworthy borrowers and is widely perceived as a low-risk asset that trades easily in financial markets. While CP typically is not collateralized, ABCP is a special form of collateralized CP that allows financial institutions to borrow at low cost in order to create assets that form the collateral. While ABCP existed even before the 1990s, it played a special role in the housing boom of recent years and in the subsequent financial crisis.

ABCP and Bank Balance Sheets. Banks typically wish to earn the fees for originating loans (mortgages, consumer loans, and the like), while avoiding the cost of holding the loans directly. For the past two decades, some large banks created firms to hold the loans that they made off of their own balance sheets. These firms issue debt into financial markets, including ABCP, to finance the holdings. Banks sometimes provided guarantees for the ABCP to reduce the default risk and lower the cost of issuance. This off-balance-sheet approach is one of a number of practices that banks have used to boost leverage and take risks at a lower cost than government rules otherwise permit (see the Chapter 3 module: Shadow Banking).

ABCP and the Housing Bubble. As we have already seen in other modules for Chapter 7, the housing bubble prompted a surge in subprime mortgage lending. Rather than selling the mortgages or mortgage-backed securities directly into financial markets, some large banks moved them to firms off the banks' balance sheets and financed these *shadow banks* by issuing commercial paper. The result was an unprecedented increase in the volume of outstanding ABCP from 2005 until the financial crisis hit in mid-2007 (see Figure 1).

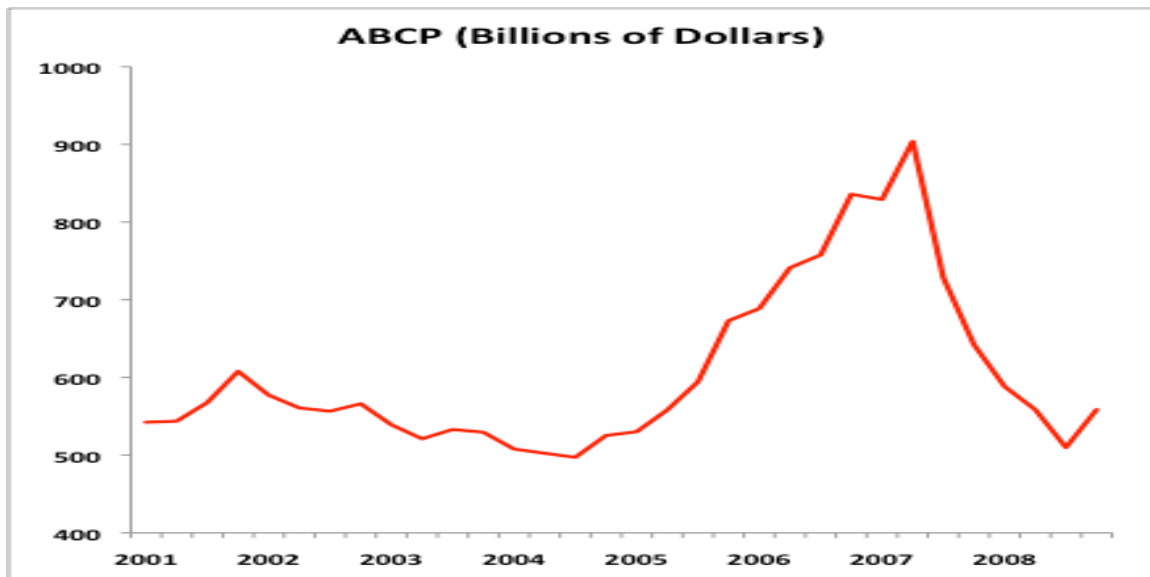
The mismatch between the long-term maturity of the assets (mortgages) and the short-term maturity of the liabilities (ABCP) posed a dangerous, underappreciated threat to the financial safety of the ABCP issuers. As it turned out, the risk was that the shadow banks created to hold assets would not be able to issue new liabilities when the ABCP matures – that is, they faced *rollover* risk. If they were also unable to sell the long-term assets easily, these off-balance-sheet firms would then fail. Fueling both the rollover and asset sale risks, ABCP issuers had become complacent about the assets that they acquired: in their *search for yield*, they helped bid up the price of risky mortgage securities beyond sustainable levels (see the Chapter 4 module: The Search for Yield).

ABCP and the Financial Crisis. ABCP rollover risk was a key trigger at an early stage of the financial crisis. When the value of subprime mortgages became highly uncertain in the summer of 2007, purchasers of ABCP grew anxious that the assets backing their commercial paper could plunge in value. Because they had erroneously viewed ABCP as a very low-risk security, the sudden awareness of risk prompted a virtual halt to ABCP purchases and trading in ABCP dried up. The

crunch is visible in Figure 1, which shows a plunge in outstanding ABCP volume beginning in the third quarter of 2007 that continued for a year.

Firms that had borrowed by issuing ABCP faced an immediate threat to their survival. Uncertainty about the value of subprime mortgages made their assets difficult to sell, and concerns about their safety made it impossible to borrow in open markets. As their ABCP matured and could not be rolled over, some of the firms failed outright. In other cases, banks chose to rescue the shadow banks that they had created, in order to limit legal risks and reputational damage. As a result, the banks faced heightened liquidity needs and pressures to sell assets precisely when the cost of liquidity had surged and asset prices were plunging. In effect, the risk that some banks believed had been shifted off balance sheet returned at the worst possible time – in the midst of a crisis.

Figure 1. Asset-Backed Commercial Paper (Billions of Dollars), 2001-08



Source: Federal Reserve Board.