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DBRS Criteria: Commercial Paper Liquidity Support for Non-Bank Issuers

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Introduction

DBRS commercial paper (CP) ratings reflect the overall credit strength of the issuer, with particular focus on the issuer’s ability to fulfill its near-term obligations in a timely manner.

CP markets are by nature confidence-sensitive and, while disruptions are infrequent, there is a risk that the normal orderly refinancing of maturing CP may be prevented by exogenous market events or by matters that are specific to the issuer. Such a failure to refinance could lead to a default. To address this risk, it is critical that all issuers have appropriate liquidity backup in place such that maturing CP can be repaid from alternative sources in the event that the Issuer’s access to refinancing in the CP market has been impaired.

This criteria applies to non-bank issuers. The main section of this criteria applies to corporates, including finance companies. CP liquidity support requirements for Canadian pension plans are discussed in Appendix A and CP liquidity support for municipal and regional governments are discussed in Appendix B.

REQUIRED AMOUNT OF LIQUIDITY SUPPORT – CORPORATE ISSUERS
DBRS expects corporate CP issuers to have 100% liquidity backup in place for their CP programs, although in certain cases issuers rated R-1 (mid) or higher may have as low as 75% CP liquidity support provided that the issuer benefits from exceptional liquidity, very low debt levels and/or other such factors. This minimum required percentage liquidity support is typically calculated against the total CP program.

While the vast majority of CP issuers rely on committed bank lines for their CP liquidity backup, DBRS recognizes that there are a variety of liquidity backup options that can be acceptable for this purpose, including cash and marketable securities, provided they are committed to the purpose of CP liquidity backup (see Appendix C). Regardless of the type of liquidity backup, there must be sufficient same day availability to permit the refinancing of maturing CP in a timely manner.

BANK LINES
Where committed bank lines are used for CP liquidity backup purposes, DBRS expects issuers to maintain unused capacity under committed bank facilities equal to the required amount of liquidity as discussed above. DBRS also expects that this liquidity support will include same-day availability equal to the maximum amount of commercial paper maturing on any day.

Committed bank facilities must extend to or beyond the maximum tenor of any outstanding CP. Maturing bank facilities are expected to be extended well in advance of the maturity date of the facility so that coverage for outstanding CP is not suddenly disrupted. DBRS gives no credit for demand facilities or any other types of uncommitted bank lines.

General purpose bank lines are far more prevalent in the market than those dedicated solely to CP backup, and are acceptable if managed appropriately. DBRS must be satisfied that the issuer has the intention of and the ability to maintain the required amount of liquidity support and that the lines would be available at the necessary level when and if needed (i.e., bank facility usage (loans, letters of credit, etc.) combined with outstanding CP balances will not exceed the maximum size of the bank facility).

Bank lines typically include a variety of covenants, representations, warranties and conditions precedent to drawdown that may impact an issuer’s ability to access the facility. While these conditions precedent to funding are generally issuer-specific rather than related to general market issues, overly punitive or restrictive funding restrictions tied to the issuer are viewed less favourably by DBRS. Consequently, DBRS gives no credit to bank lines that allow the lender to refrain from advancing loans during general market disruptions.


QUALITY OF THE BANKING GROUP
In assessing the suitability of bank facilities as backup liquidity for commercial paper, DBRS considers the strength of the banks providing the backup facility. DBRS expects the group of banks to have average credit strength in the R-1 range for the issuer’s CP program to achieve that rating. It may be acceptable to have some banks with a rating that is lower than the R-1 range in the banking group; however, the proportion would have to be relatively minor. Consideration would be given to the mix of banks within the context of other issues such as the size of the CP program, the tenor and quality of the backup facilities and other liquidity sources.

ISSUER RATING IS NOT A FUNCTION OF THE QUALITY OF THE BANK GROUP
It is important to remember that an issuer’s rating reflects the overall strength of the issuer and not the quality of the bank group. While bank lines are expected to fulfill their support role when market disruptions occur, they are not absolute commitments to provide funding. Even the strongest and most diversified committed bank backup facility cannot improve the rating of an issuer. For this reason, the CP rating of an R-1 (low) issuer with bank lines of R-1 (middle) strength remains R-1 (low).

ALTERNATIVE LIQUIDITY SOURCES
While liquidity is provided by committed bank lines in the vast majority of cases, there may be other satisfactory forms of both external and internal liquidity sources which may vary from issuer to issuer. One such option is the pledging of cash or marketable securities (per Appendix A).

ISSUER RESPONSIBILITIES
Each issuer bears the responsibility of ensuring that it has sufficient liquidity to meet all CP maturities as they come due and to take appropriate actions when there are indications of stress. In providing ratings, DBRS will review these contingency plans to evaluate compliance and acceptability, but DBRS does not perform the role of auditor.

As an example, suppose an issuer experiences material stress in its CP program in the form of higher pricing, reduced access to longer term CP maturities and perhaps, even the loss of certain buyers. DBRS expects that the issuer would take appropriate steps to ensure that there was no deterioration in the ability of liquidity backup to cover all CP maturities. In a very negative situation, it may be necessary for the issuer to take actions such as selling marketable securities or drawing down its bank lines to ensure that same-day coverage can be fully maintained.

RATINGS IMPACT OF INSUFFICIENT CP LIQUIDITY SUPPORT
There can be cases where DBRS may provide a CP rating in which liquidity support is adequate but not as robust as required for the rating that would normally correspond to the long-term rating of the company. In such cases, there is flexibility in the DBRS rating scales such that a CP rating for an issuer can be lower than the long-term rating would normally dictate. For example, the DBRS policy with respect to ratings mapping (see Short-Term and Long-Term Rating Relationships) specifies that, in most cases, an A (low) issuer would achieve a CP rating of R-1 (low). However, the policy specifically provides for the ability to assign a lower-than-standard CP rating if DBRS has concerns about either the liquidity support or liquidity strength of an issuer at the standard mapping level.

GUARANTEES FROM A FOREIGN PARENT
Domestic borrowers sometimes issue CP based on a guarantee from a foreign parent. In such cases, liquidity backup may be based on resources of the parent and not the subsidiary, providing that all potential timing issues (such as different time zones, statutory holidays or the mechanics of moving funds cross-border on a same-day basis) are dealt with acceptably.
Issuers with CP programs in more than one jurisdiction are expected to meet the DBRS requirements on a consolidated basis and provide same-day availability support to all maturities in all jurisdictions, regardless of the location of the liquidity. In jurisdictions where a subsidiary issuer manages the CP program and the rating of the CP is not based on the subsidiary issuer’s credit quality, the subsidiary issuer must have evidence of support from the parent (an irrevocable, unconditional guarantee being most common) and demonstrate that there is sufficient same-day availability support.

EXTENDIBLE COMMERCIAL PAPER
Liquidity backup for extendible commercial notes (ECNs) is essentially provided by the investor and DBRS does not require separate liquidity support for these programs. Note, however, that ECNs are no longer widely issued.

SIZE OF COMMERCIAL PAPER AND SHORT-TERM DEBT PROGRAMS
Notwithstanding the presence of the required amount of liquidity as discussed herein, DBRS may still have concerns with the size of an issuer’s CP program, as well as the amount of debt that is raised from any capital source that is short term in nature. Such concerns may include the following: (1) the availability of funding from bank backup facilities can, in certain cases, be restricted by breaches of financial covenants, material adverse change clauses, etc.; (2) an issuer that borrows with a tenor that is too short in term relative to the usable life of its assets exposes itself to refinancing risk and interest rate risk; (3) short-term facilities can be drawn down quickly without notice to DBRS, which may cause total leverage to exceed an amount that is appropriate for the rating level; and (4) in rare cases, a CP program may be so large as to test the liquidity of its local CP market, even in the absence of any kind of market disruption.

In determining the appropriate maximum CP program size and/or maximum appropriate short-term debt amount outstanding for an issuer, DBRS will review a number of factors that DBRS deems to be relevant for the rating level. Such factors might include a forecast of liquidity needs and the availability of alternative sources of liquidity, including a CP program or bank facilities from a related entity in another country, general access to the capital markets, the sources and stability of cash flow from operations and the potential for asset sales.
APPENDIX A

LIQUIDITY REQUIREMENTS FOR CP PROGRAMS OF CANADIAN PENSION FUNDS

By their nature, most pension funds in Canada have an exceptionally high degree of liquidity, with large bases of unencumbered high-quality securities that can be monetized through repurchase agreements or asset sales very quickly.

For these funds, DBRS defines “highly liquid assets” as unencumbered debt securities of any duration issued or guaranteed by sovereign governments rated AAA or R-1 (high). For Canadian pension funds, DBRS will also consider any debt issued or guaranteed by one of the Canadian provinces or Schedule 1 banks rated R-1 (high) for inclusion within the highly liquid asset definition. If DBRS does not rate a sovereign, it will still be acceptable for inclusion within the definition of highly liquid assets if the debt has been rated AAA (or the equivalent rating) by at least one publicly available Nationally Recognized Statistical Rating Organization or External Credit Assessment Institution. However, DBRS reserves the right not to rely on other agencies in this way if their risk opinions, methodologies or sector outlooks are meaningfully inconsistent with the views of DBRS.

When a pension fund is a commercial paper issuer, DBRS will assess the need for bank line support on a case-by-case basis, by considering the following issues:

(1) The level of liquidity on the balance sheet relative to the size of the commercial paper program. As a general rule, the fair value of highly liquid assets should, at all times, be at least 1.5 times the size of the maximum authorized limit for the commercial paper program.

(2) The rating given to the pension fund (higher-rated entities generally have better ability to access the market in a stressed environment). In most cases, DBRS is only satisfied with relying on balance sheet liquidity for support when the rating of the pension fund in question is R-1 (high).

(3) Whether the commercial program is of such a large size that some bank line support would be prudent, notwithstanding the level of liquid assets maintained by the pension fund.

(4) Whether the issuing organization is aware of the importance of supporting its commercial paper program and is highly likely to access its sources of liquidity when needed.

(5) Whether the fair value of highly liquid assets on the issuer’s balance sheet demonstrates high volatility.

(6) Whether there are any special circumstances that could add liquidity stress that should be taken into consideration, such as pension payment holidays or actuarial considerations.

Where there are concerns with any of these areas, DBRS standards may require the need of some bank line support as an alternative form of liquidity.
APPENDIX B

CP LIQUIDITY SUPPORT FOR MUNICIPAL AND REGIONAL GOVERNMENTS
DBRS requires municipal and regional governments to have access to liquidity support in an amount equal to 100% of any CP issuance, usually in the form of unused but committed bank lines of credit, along with same-day availability and other requirements consistent with requirements for corporate CP issuers. However, this requirement may be reduced in cases where a regional government demonstrates that it benefits from a significant, timely and reliable source of liquidity from a related government institution which has a clear mandate to provide such support (e.g., Bank of Canada in the case of Canadian provinces).

APPENDIX C

CASH AND MARKETABLE SECURITIES AS CP BACKUP LIQUIDITY
While committed bank CP backup facilities with same day availability will be, in the vast majority of cases, the expected source of liquidity support for CP issuers, DBRS may be willing to consider other sources of liquidity such as cash and marketable securities that have been pledged as security to the trustee for the sole purpose of refinancing CP that cannot be rolled over for any reason. DBRS would expect to see in such situations: (1) marketable securities with an excess of value that is consistent with (a) the expected price volatility of the particular asset class of marketable securities being pledged, and (b) the frequency of any mark to market calculation or “topping up” mechanism; (2) satisfactory control over the securities by the trustee such that the trustee maintains priority in the securities over any other security party; (3) appropriate perfection of the security interest in the marketable securities in accordance with the laws of the applicable jurisdiction; and (4) whatever other requirements DBRS considers appropriate given the facts at the time.