

CHAPTER

17

COMMERCIAL PAPER

INTRODUCTION

All commercial organisations borrow short term funds from banks for working capital until they generate funds through sales. The working capital loans are based on the prime lending rates (PLR) of banks. The most credit-worthy borrower gets funds at the PLR, while for borrowers considered a higher risk, there is a mark-up over the PLR.

During the 1980s, a wave of financial liberalisation and innovation in financial instruments swept across the world. A basic feature of these innovations was towards securitisation *i.e.*, raising money direct from the investors in the form of negotiable securities as a substitute for bank credit. The corporate borrower found it cheaper to borrow directly from public by way of short term paper. Commercial paper is a new instrument used for financing working capital requirements of corporate enterprises.

Commercial Paper (CP) was introduced as a money market instrument in January 1990 with a view to enabling corporates to diversify their sourcing of short-term borrowing as well as of providing investors with an additional instrument for investment. It was made broad-based with the lowering of the minimum issue size to ₹ 5 lakh and the widening in the maturity period from 91 days-6 months to 15 days 1 year in July 2000 to make it compatible with instruments of comparable maturities.

COMMERCIAL PAPER

Commercial Paper (CP) is issued in the form of a promissory note sold directly by the issuers to investors, or else placed by the borrowers through agents such as merchant banks and security houses. When it is issued by corporate borrowers directly to investors in the money market and by the process of securitisation, the intermediation of the bank is obviated.

CP was introduced in the Indian financial market by the Reserve Bank of India on January 1, 1990 in pursuance of recommendations of the Working Group on Money Market under the Chairmanship of Shri N. Vaghul, in 1987 in order to enable highly rated non-bank corporate

borrowers to diversify their sources of short-term borrowings and provide an additional instrument to investors. RBI guidelines make CP an element of the credit limit sanctioned to be availed from alternative sources.

The recommendations of the Vaghul Working Group on introduction of commercial paper in Indian money market are as follows:

1. There is need to have limited introduction of commercial paper. It should be carefully planned and the eligibility criteria for the issuer should be sufficiently rigorous to ensure that the commercial paper market develops on healthy lines.
2. Initially, access to the commercial paper market should be restricted to rated companies having a networth of ` 5 crore and above, with good dividend payment record.
3. The commercial paper market should function within the overall discipline of CAS. The RBI would have to administer the entry on the market, the amount to each issue and the total quantum that can be raised in a year.
4. No restriction be placed on the participants in the commercial paper market except by way of minimum size of the note. The size of any single issue should not be less than ` 1 crore and the size of each lot should not be less than ` 5 lakh.
5. Commercial paper should be excluded from the stipulations on unsecured advances in the case of banks.
6. Commercial paper would not be tied to any specific transaction and the maturity period may be 7 days and above but not exceeding six months, backed up if necessary by a revolving underwriting facility of less than three years.
7. The issuing company should have a net worth of not less than ` 5 crore, a debt equity ratio of not more than 1.5, a current ratio of more than 1.33, a debt servicing ratio closer to 2, and be listed on the stock exchange.
8. The interest rate on commercial paper would be market dominated and the paper could be issued at a discount to face value or could be interest bearing.
9. Commercial paper should not be subject to stamp duty at the time of issue as well as at the time of transfer by endorsement and delivery.

CPs differ from other short-term money market instruments such as Commercial Bills in that they are not tied to any specific transactions and that they are an obligation to the issuer only, whereas Commercial Bills are obligation of both the drawer and accepting party/bank.

Features of Commercial Paper

The main features of commercial paper are:

- Commercial Paper (CP) is a debt instrument issued by an organisation to raise short-term funds to meet current expenditure needs.
- CP is a money market instrument comprising unsecured promissory note with a fixed maturity.

- CP is negotiable by endorsement and delivery. The investor can resell the CPs.
- CP is issued at a discount on the face value as may be determined by the issuing company.
- CP is not tied to any specific transactions.
- CP is issued directly by a company to investors or through banks/merchant banks.
- CP bears a certificate from the banker verifying the signatures of the expectants.
- The issuer promises to pay the buyer some fixed amount on some future period but pledge no assets, only his liquidity and established earning power, to guarantee that promise.
- The Reserve Bank of India frames the regulations pertaining to CPs.

The Need for CP

CP was issued to enable highly rated corporate borrowers diversify their source of short-term borrowing, as also to provide an additional instrument to investors:

Advantages of CP

The advantage is that by issuing CPs, Corporates can raise funds at even below the PLR of banks. Further, inter-corporate deposit market would shift to the regulated CP market. Other advantages of CPs are:

1. Simplicity
2. Flexibility
3. Diversification
4. Transparency
5. High returns
6. Easy to raise funds
7. Securitisation

Validity of CP

CP can be issued by the companies for maturities between 3 months and less than one year from the date of issue. CPs are issued at a discount on face value, *i.e.*, no interest will be specified in the instrument and the discount will be freely determined by the market forces of demand and supply. The minimum tenor has been brought down to seven days (by October 2004) in stages.

Who can Issue CP?

Any company in the private or public sector or non-banking company, etc., satisfying the following criteria can issue CPs:

- (i) Minimum tangible net worth of ₹ 4 crore and minimum current ratio of 1.33:1 as per latest audited balance sheet. However, during 2005-06, around 92 per cent of CP were issued by the corporates having net worth of more than ₹ 50 crore.
- (ii) Eligibility for a working capital (fund based) limit (MPBF) of not less than ₹ 4 crore.
- (iii) The shares of the company should be listed in one or more stock exchanges (this condition does not apply to Public Sector Companies).
- (iv) Companies desirous of issuing CPs should get themselves rated by either CRISIL or ICRA. The CRISIL rating should not be below P2 (High safety). The minimum rating from ICRA should be A2 (High safety). Moreover, these ratings should not be more than 2 years old.
- (v) The Health Code assigned by the bankers to the issuing company should be No. 1.

Who can Invest?

Any person, banks, company, other registered and incorporated bodies as well as unincorporated bodies, Non-Resident Indians are eligible to invest in CPs. Usually, banks, large corporate bodies and public sector units with investible funds participate actively in the CP market.

Minimum Size of Issue and Denominations

CPs should be issued of a minimum amount of ₹ 25 lakh and in multiples of ₹ 5 lakh. The minimum size of individual issue has also been reduced to ₹ 5 lakh with a view to aligning with other money market instruments.

Ceiling on Size of Issue

Aggregate CP issue should not exceed 75 per cent of the eligible working capital (fund based) limit.

Transferability

CPs are freely transferable by endorsement and delivery.

Underwriting

No banking company can underwrite or co-accept the issue of CP in any manner. Commercial banks can however, provide standby facility for redemption of CPs on the maturity date.

Cost/Expenses Connected with the Issue of CP

- (i) CPs attract stamp duty (0.20 per cent) as with any usance promissory note.
- (ii) CPs are issued through a merchant banker, therefore the merchant banker's fee is leviable.

- (iii) For establishing standby credit, fee may be required to be paid to the merchant banker.
- (iv) The rating agency charges/fees for assigning the ratings.
- (v) Discount on the face value as determined by the issuing company.
- (vi) Other administrative expenses.

Mode of Issue and Payment of CP

Investment in CP will have to be made through crossed account payee cheques to the account of issuing company with the bank. On maturity, the holder of the CP shall present the CP or payment to the issuing company.

Each CP issue is to be recorded by the lending banker or the lead bank in the case of consortium advances. The entire approved amount, either in one lump sum or in instalments should be raised within two weeks from the date of clearance by the bank.

Effect on Working Capital Limit

Working Capital fund based limit of the issuing company should be simultaneously reduced on issue of CP. The limit of CP issuance was first carved out of the maximum permissible bank finance (MPBF) limit and subsequently only to its cash credit portion. 'Stand by' facility of the restoration of cash credit limit and guaranteeing funds to the issuer on maturity of the paper was with-drawn. As the reduction in the cash credit portion of then MPBF impeded the development of the CP market, CP was delinked from the cash credit limit in October 1997. It was converted into a 'stand alone' product from October 2000, so as to enable the issuers of the services sector to meet short-term working capital requirements.

Advantages to Issuers

- (i) Short-term funds could be tapped at low cost. CP offers an attractive alternative for companies to raise funds relatively cheaply.

There is reported to be a rush to the CP market due to large interest differentials available in the sluggish money market. Corporates have been offering typically a yield in the range of 10.25 to 12.50 per cent for a cp with a maturity period of more than 3 months in consonance with other money market segments.

- (ii) CP facility is unsecured.
- (iii) Once a CP is issued/raised, the cost remains constant throughout the period. On the other hand, interest rates on bank loan could change at short notice.
- (iv) CPs are more stable and assured than bank finance.
- (v) CPs do not attract the conditionalities which are normally imposed by banks.

Disadvantages

- (i) The money is available for a fixed period. Further, there is no possibility of pre-payment before maturity.

- (ii) The need to get a good credit rating from an approved agency does make all but the blue-chip companies ineligible for a CP issue.
- (iii) When a CP matures for payment, the issuing company is not automatically entitled to bank finance to that extent but has to have a stand by credit facility with the bank.

Advantages to Banks

- (i) The bank would be able to earn the following income out of CP issues:
 - (a) as issuers and paying agent's fees (0.50 per cent)
 - (b) standby fee of 1 per cent
- (ii) banks may find in CPs an avenue for deployment of short-term surplus funds. With the prevailing easy liquidity position and the low returns from call money markets it has now become lucrative for banks to subscribe to CP.
- (iii) Strict income recognition norms have also made it imperative for the commercial banks to increasingly go for low risk assets like CP to maximise their profit.

Disadvantages

The dawn of CPs has had an immediate and, according to some quarters, dampening effect on the working and profitability of banks. The intermediation of banks between a pool of savers on the one hand and the community of credit users on the other would no longer be required and the process of disintermediation has already set in.

- (i) Since CPs are issued by first-class companies who enjoy top credit rating with the banks, these companies reduce the bank borrowing by resorting to CPs and the income earning potential of the banks from a very safe lending avenue diminishes.
- (ii) In times of easy money conditions, banks might even be forced to invest in CPs of their own clients thereby getting a far lower income.

Credit Rating

Since CP is an unsecured debt under the current stage of development of the Indian money market, it is desirable to have all CP issues rated by a recognised credit rating agency.

Today, there are already three credit Rating Agencies operating in the country. They are:

- (i) CRISIL (the Credit Rating Information Services of India Ltd.), promoted by ICICI.
- (ii) ICRA (Investment Information and Credit Rating Agency of India Ltd.) promoted by the Industrial Finance Corporation of India.
- (iii) CARE (Credit Analysis and Research), recently promoted by the Industrial Development Bank of India.

Secondary Market

Development of CP market depends on an active secondary market. The secondary market is provided by the Discount and Finance House of India Ltd. (DFHI). Set up by Reserve Bank of India jointly with public sector banks and all-India financial institution in April, 1988.

Future Prospects

The emergence of CP market in India is an integral part of the process of financial liberalisation. The creation of CP market has been aimed at broadening the borrowing and investment system and in general, improving financial efficiency. With the rapid liberalisation of Financial sector in India, Commercial Paper is expected to play a wider role in the financial market. This is also evident from the fact that in the years 2002-2007, the CP market has seen a quantum jump. During the current financial year so far, outstanding amount of CPs issued showed a sharp increase from ₹ 577.25 crore as on March 31, 1993 to ₹ 8,268 crore as at end March 2003 and further to ₹ 21,314 crore at end March, 2007.

<i>Activity in CPs</i>	
<i>Year</i>	<i>Outstanding Amount (₹ crore)</i>
1993-94	2,280
1995-96	442
1997-98	2,806
1998-99	4,514
1999-00	7,014
2000-01	6,751
2001-02	7,927
2002-03	8,268
2003-04	7,835
2004-05	11,723
2005-06	17,285
2006-07	21,314

<i>Commercial Paper – Major Issuers</i>			
<i>Category of Issuer</i>	<i>(Amount in ₹ crore)</i>		
	<i>End of</i>		
	<i>March-05</i>	<i>March-06</i>	<i>March-07</i>
1	2	3	4
Leasing and Finance	8,479	9,400	12,419
	(59.6)	(73.9)	(70.2)
Manufacturing	2,881	1,982	2,574
	(20.2)	(15.6)	(15.6)
Financial Institutions	2,875	1,336	2,515
	(20.2)	(10.5)	(14.2)
Total	14,235	12,718	17,688
	(100)	(100)	(100)

Note: Figures in parentheses are percentage share to the total.

CONCLUSION

The Indian CP market is driven by swings in bank liquidity. Banks prefer investing in CPs, especially in times of easy liquidity as they can park funds at interest rates higher than call rates and at the same time avoid higher transaction costs associated with bank loans. The effective discount rate of CP usually lies between representative money market rate and the bank lending rate. On the other hand, companies are able to raise funds through CPs at a lower rate than the lending rates of banks under easy liquidity conditions. The amount of CPs outstanding increased significantly from ₹ 577 crore in March 1993 to a high of ₹ 21,314 crore in March 2007 accompanied by a decline in the average discount rate from 15.9 per cent to 10.5-12.5 per cent during this period. As the call rates firmed up, the average discount rate touched a peak of 20.2 per cent in April 1996 with the concomitant decline in outstanding amount to ₹ 71 crore. The subsequent easing of liquidity conditions and institution of a series of reforms including dematerialisation of issuance's and alignment of minimum maturity period boosted the CP market taking the outstanding amount to ₹ 21,314 crore at end March, 2007.

The WADR, which had risen to 8.59 per cent at end-March 2006, softened by mid-May 2006, CP rates have been firming up somewhat since mid-August in tandem with the increase in money market rates. Corporates have been offering typically a yield in the range of 10.25 to 12.50 per cent for a CP with a maturity period of more than 3 months in consonance with other money market segments. Leasing and finance companies remained the predominant issues of CP. The share of issuances by financial institutions recorded an increase during 2006-07. As on April 15, 2007, the WADR of CP stood at 10.5 per cent.

SELF ASSESSMENT QUESTIONS

- (1) Analyse the special features of commercial papers.
- (2) Discuss the advantages and disadvantages of commercial papers.