Status Paper on Commercial Paper (CP) Market in India

Pursuant to the recommendations of the Committee to Review the Working of the Monetary System (Chairman: Professor Sukhamoy Chakravarty) [1985] and the Working Group on the Money Market (Chairman: Shri N. Vaghul) [1987], a number of measures were taken by the RBI to widen and deepen the money market through institution building and instrument development. Accordingly, introduction of Commercial Paper (CP) as a money market instrument was announced in the Governor's statement on Monetary and Credit Policy in March 1989. It was, however, formally introduced in the market on January 1, 1990.

This paper is organised into three sections. Section I reviews the evolution in the characteristics of CP as a money market instrument in India over the years against a cross-country perspective while Section II discusses the trend and the broad features of this market. In this context, it may be noted that while summary data are presented from 1989-90 onwards, detailed data are available from April 2000 onwards. The market microstructure and various issues/ suggestions for further development of CP market are reviewed in Section III. The cross-country experiences of the CP market in select major developed economies viz., USA, UK and France are given in Annex I.

Section I

Characteristics of CP Market in India vis-à-vis Other Major CP Markets in the World

1. ***Issuers***

Initially, only highly rated corporate borrowers were allowed to issue CP to diversify their short-term borrowings. Primary Dealers (PDs) were allowed in this market, subject to fulfilling the eligibility criteria, on April 15, 1997. Thereafter, all-India financial institutions (FIs) that have been permitted to raise short-term resources under umbrella limit fixed by RBI were permitted to issue CP since October 10, 2000 (Annex II).

Internationally, there is no restriction on issuers in UK. In USA, both financial and non-financial issuers are allowed to issue CP. In France, CPs are mainly issued by investment firms, public companies, community institutions and international organisations of which France is a member.

2. ***Maturity Period***

Initially, corporates were permitted to issue CP with a maturity between a minimum of three months and a maximum of upto six months from the date of issue. Since October 18, 1993, the maximum maturity period of CP was increased to less than one year. Subsequently, the minimum maturity period had been reduced from time to time and since May 25, 1998, it was reduced to 15 days. Presently, CP can be issued for maturity period between a minimum of 15 days and a maximum upto one year from the date of issue.

As against this, in USA, there is no prescription of minimum and maximum maturity period of CP but for practical matter, it is limited upto 270 days. However, 1-day to 7-day CPs are very popular of which 1-day CP constitutes the substantial component of the CP market. In UK also, there is no restriction but in France, initial maturity ranges from 1 day to upto 1 year.

3. ***Credit Ratings***

All eligible participants are required to obtain credit rating for issuance of CP from either the Credit Rating Information Services of India Ltd. (CRISIL) or such other credit rating agency (CRA) as approved by the Securities and Exchange Board of India (SEBI) from time to time for the purpose. Initially, the minimum credit rating was stipulated at $P1^+$ of CRISIL. It was softened to P1 of CRISIL or such equivalent rating by other agencies on April 24, 1990 and further to P2 of CRISIL or its equivalent on May 13, 1992. As of now, the minimum credit rating shall be P2 of CRISIL or its equivalent.

In UK, France and USA, rating is not compulsory. However, in US, CPs should generally have the rating of A1/P1 (the highest category) for generating investor interest.

4. Limits and the Amount of Issue of CP

The entry criteria for issuance of CP have been relaxed considerably over the years. In 1990, a corporate was eligible to issue CP provided the tangible net worth of the company, as per the latest audited balance sheet, was not less than Rs.10 crore. This was reduced to Rs.5 crore on April 24, 1990 and further to Rs.4 crore on October 18, 1993. Also, initially, issuance of CP had to be carved out of the working capital (fund based) limit. Accordingly, in 1990, a company could issue CP upto 20 per cent of its working capital (fund based) limit which was stipulated to be not less than Rs.25 crore. Thereafter, while the working capital limit had been reduced progressively to enable more corporates to issue CP, the amount to be carved out of the working capital limit for issuance of CP was also increased over the years for facilitating the growth of this market. Accordingly, while the working capital (fund based) limit was reduced to "not less than Rs.4" crore on October 18, 1993, the amount of CP that could be issued out of the working capital was also raised upto 100 per cent of the companies' working capital limit of Rs.20 crore or more since June 20, 1996.

The organic link of issuance of CP in relation to working capital (fund based) limit was severed on October 10, 2000 when CP was allowed to be issued as a "stand alone" product. The aggregate amount of CP from an issuer, however, has to be within the limit as approved by its Board of Directors or the quantum indicated by the credit rating agency for the specified rating, whichever is lower. Banks and FIs, however, have the flexibility to fix working capital limits duly taking into account the resource pattern of companies' financing needs including CPs. An FI can issue CP within the overall umbrella limit fixed by the RBI i.e., issue of CP together with other instruments viz., term money borrowings, term deposits, certificates of deposit and inter-corporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

In USA and UK, there is no limit on the amount of CP that the entities may issue.

5. Denomination

At the time of introduction, with effect from January 1, 1990, it was stipulated that CP may be issued in multiple of Rs.25 lakh and the amount to be invested by a single investor should not to be less than Rs.1 crore (face value). Subsequently, on April 24, 1990, the minimum denomination was reduced to Rs.10 lakh and amount to be invested by a single investor was also reduced to Rs.50 lakh. At present, CP can be issued in denominations of Rs.5 lakh or multiple thereof and amount invested by a single investor should not be less than Rs.5 lakh (face value).

Internationally, in USA, there is no required minimum size of issue. However, it is usually issued in minimum denomination of $1,00,000. In France, the minimum amount stands at EUR 1,50,000 and in UK, it stands at EUR 40,000.

6. Investors in the CP Market

Initially, it was stipulated that CP can be issued to and held by individuals, banks, companies, other corporate bodies registered or incorporated in India and unincorporated bodies. CP may be issued to a non-resident Indian (NRI) on a non-repatriation basis and that those CPs shall not be transferable. Also, Foreign Institutional Investors (FIIs) were added as eligible investors in CP market in October 2000. However, investment by FIIs would be within the limits set for their investments by SEBI.

In USA, investors include money market mutual funds, banks, insurance companies and pension funds.

7. Stamp Duty

The stamp duty on issuance of CP is governed by the Indian Stamp Act and is under the purview of the Central Government. Stamp duty has been revised recently effective March 1, 2004. While the level of stamp duty has been scaled down substantially across various maturities, the rates as applicable to non-bank entities are five times higher than those applicable to banks.

Structure of Stamp Duty

(Effective from March 1, 2004)

(In per cent)

Period	Banks		Non-Banks	
	Past	Present	Past	Present
I. Upto 3 months	0.05	0.012	0.125	0.06
II. Above 3 months upto 6 months	0.10	0.024	0.250	0.12
III. Above 6 months upto 9 months	0.15	0.036	0.375	0.18
IV. Above 9 months upto 12 months	0.20	0.05	0.500	0.25
V. Above 12 months	0.40	0.10	1.00	0.5

Internationally, no stamp duty applicable on CP issuances in USA, UK and France.

8. Dematerialisation

With effect from June 30, 2001, banks, FIs and PDs have been encouraged to make fresh investments and hold CP only in dematerialised form. Outstanding investments in scrip form in the books of banks, FIs and PDs were to be converted into dematerialised form by October 31, 2001.

Internationally, in USA and France, CPs are issued in dematerialized form. In UK, fully dematerialized system does not exist though by market convention, Euro CP is issued in the form of an immobilized global certificate lodged with a central depository e.g., Euroclear/Clearstream.

9. Issuing and Paying Agent (IPA)

Only a scheduled commercial bank can act as an IPA for issuance of CP. IPA verifies all original certificates viz., credit rating certificates, letter of offer and the Board authorizing issue of CP. IPA holds custody of original of credit support document if it is in the form of standby assistant/backstop facility with relevant declarations and confirms the documents are in order. Also, it obtains a declaration from the issuer that the amount proposed to be raised is within the ceiling mentioned by the credit rating agency or approved by the Board whichever is lower, further stating the amount of CP issued and subscribed so far on strength of the credit rating under reference. After authentication of the entire CP document, IPA issues 'IPA certificate' to all subscribers of CP in primary market and then reports the issue to RBI.

10. Standby Facility

Initially, in 1989, underwriting or co-acceptance of CP issues was prohibited but the CP issuer had the option to avail of a stand-by facility for an amount not exceeding the amount of issue for meeting the liability of commercial paper on maturity. Also, it was stipulated that where stand-by facility had been arranged for, CP issuer could fall back on the working capital (fund-based) limit with a bank (as CP was to be carved out of working capital at that time) if there is no roll-over of commercial paper. However, 1993, it was noticed that bankers were providing stand-by facility in a manner which amounted to extending a guarantee for redemption of commercial paper. Therefore, banks were advised to ensure that the stand-by arrangement provided to the issuer of a commercial paper was strictly in accordance with the guidelines prescribed.

In 1994, the guidelines for issuance of CP were modified and it was indicated that as CP issue was to be carved out of the cash credit limits, the repayment of CP was assured enabling the issuer to automatically draw on the cash credit limits in case there was no roll over. However, with CP being an unsecured paper, it was decided to delink the repayment of CP out of the cash credit limits and accordingly, the facility of the stand-by arrangement was abolished effective October 17, 1994. This was to impart a measure of independence to CP as a money market instrument, rating of which would reflect the intrinsic strength of the CP issuer. This issue was revisited in October 2000. In view of CP being declared as a 'stand alone' product, it was indicated that it was not obligatory for banks/FIs to provide stand-by facility but they were given the flexibility to provide credit enhancement facility within the prudential norms and subject to specific approval of their Boards.

In this context, the review of cross-country experiences shows that rating agency insists on issuers of CPs to have in place back-up liquidity lines with banks upto a stipulated percentage of the amount of CPs outstanding at any particular point of time. This is not only to assure investors that the issuers have access to sufficient liquidity and they would be repaid when the refinancing of outstanding CPs is not possible but also to ensure that there is no systemic disruption in CP market in the event of default of any large CP issuer. In some markets like USA, Revolving Underwriting Facility (RUF) - a revolving line of credit (LOC) - is also popular. The RUF provides an assured commitment of funds from banks to the CP issuers for fairly a longer period of time. As a result, the issuing companies are enabled to raise longer-term resources taking advantage of at the same time the shorter-term interest rate.

Considering all these issues, it is suggested that in order to further preserve the integrity of the CP market as also to generate further investment interest in this instrument, we should encourage issuers to use back-up credit lines from banks/FIs at least to the extent of 20 per cent of their outstanding CP issuance at any particular point of time.

In this connection, it may be noted that banks and FIs already have the flexibility to provide for a CP issue, credit enhancement by way of stand-by assistance/credit, back-stop facility etc. based on their commercial judgment, subject to prudential norms as applicable and with specific approval of their Boards.

11. Non-bank Entity Issuing Guarantee

Non-bank entities including corporates may provide unconditional and irrevocable guarantee for credit enhancement for CP issue, effective April 30, 2003, provided the issuer fulfils the eligibility criteria prescribed for issuance of CP, the guarantor has a credit rating at least one notch higher than the issuer given by an approved credit rating agency and the offer document for CP properly discloses the net worth of the guarantor company, the names of the companies to which the guarantor has issued similar guarantees, the extent of the guarantees offered by the guarantor company, and the conditions under which the guarantee will be invoked.

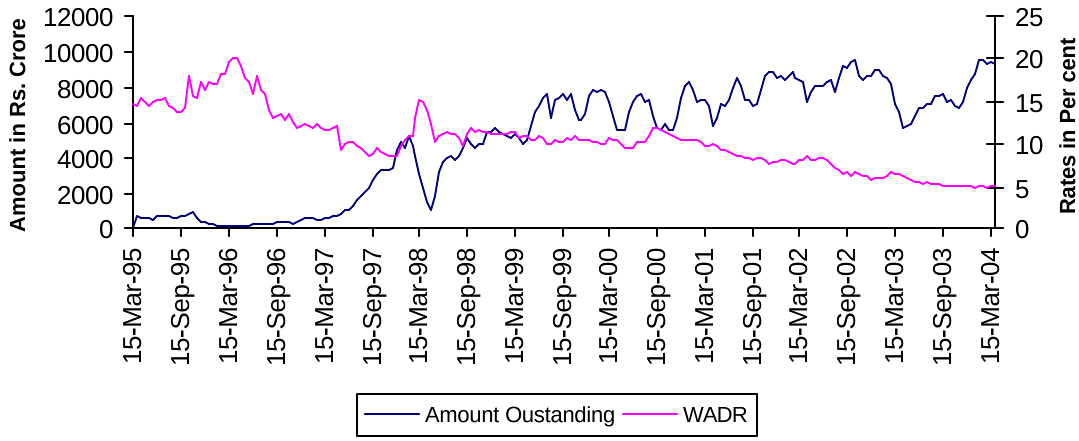
Section II

Trends in the Commercial Paper Market

The amount of CP issued during any particular point of time generally depends on underlying liquidity i.e., higher the liquidity, higher would be the issuances of CP. Initially, the CP amount outstanding rose from Rs.86 crore as at the end of financial year 1989-90 to Rs.578 crore as at the end of the year 1992-93. Following various relaxations in the terms and conditions for issue of CP viz., eligibility criteria, denomination of CP, quantum of CP and maturity of CP during 1992 and 1993 and decline in discount rates, CP market witnessed a strong growth thereafter. During 1993-94, on average, around Rs.460 crore was mobilised through CP in a fortnight and the outstanding CP amount as at the end of March 1994 stood at Rs.3,264 crore. However, following the withdrawal of the stand-by facility for CP in October 1994, coupled with rising discount rates and a shrinkage of short-term surplus funds with banks, there was a sharp decline in the amount raised through CP. During the period from October 1994 to March 1995, fresh issues of CP ranged between Rs.75 - 495 crore during various fortnights. The outstanding amount of CP declined sharply by as much as Rs.2,660 crore to only Rs.604 crore at end-March 1995. It declined further to Rs.76 crore by end-March 1996 on account of continuation of tight liquidity conditions in the economy. However, with the fall in the discount rates, coupled with further relaxations such as permission to company to issue CP upto 100 per cent of maximum permissible bank finance (MPBF), there was a modest revival in the CP market and outstanding amount of CP touched Rs.646 crore by the end of March 1997. CP issuances gathered momentum thereafter and witnessed a pronounced increase since May 1997. During the year 1997-98, fortnightly issue of CP ranged between Rs.83 -1,880 crore and average amount of CP outstanding stood at Rs.2,806 crore. It went up further to Rs.4,514 crore during 1998-99. Subsequently, CP market witnessed a consistent growth to reach, on average, an outstanding amount of Rs.8,202 crore during 2002-03. The market experienced some sluggishness during January-October 2003 apparently on account of surge in sub-PLR lending to top rated corporates thereby obviating the need for them to issue CP in the wake of huge improvement in liquidity. However, thereafter, CP started increasing reaching an outstanding amount of Rs.9,131 crore in end-March 2004 (Chart 1). Issuances of CP have increased in recent period following large investment interests seen from mutual funds on account of SEBI's guidelines on investments in non-SLR debt securities and cost effectiveness in issuances of CP vis-à-vis bonds and fixed deposits. Reduction in stamp duty on CP since March 1, 2004 has further boosted its issuances.

Though there is enough liquidity in the system but the CP market is adversely affected on account of sub-PLR lending, external commercial borrowing by top rated corporates and generation of substantial amount of internal of funds for meeting their credit demand.

Chart 1: Outstanding Amount and Weighted Average Discount Rate

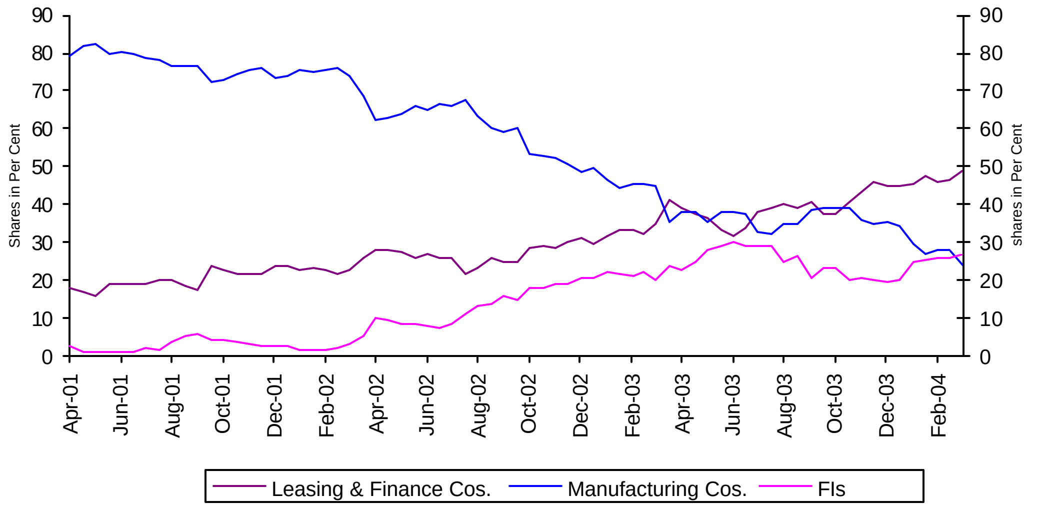


Note: During March 15, 1995 - September 3, 1999, CP rates are middle rates of typical effective discount rates.

2. Trends in CP issuance by Manufacturing, Leasing and Finance Companies and Financial Institutions

Issuers' profile in CP market has changed remarkably in recent period. It has been found that the shares of manufacturing companies in aggregate amount of CP outstanding have gone down substantially over a period of time whereas those of leasing and finance companies and the financial institutions have started showing an increasing trend. The share of manufacturing companies which stood as high as at 82 per cent in end-April 2001 declined to an average of 56 per cent during 2002-03 and further to 34 per cent during the following year. This was not only on account of enhanced efficiency in their operations, but also larger internal accruals and better cash management. Introduction of sub-PLR lending has also enabled corporates to raise funds at comparable rates from banks without incurring any additional costs towards stamp duty, demat costs, fees for IPA etc. associated with the launching of CP. Further, easier access to external commercial borrowing has also helped some of these tops rated companies to borrow cheaper funds instead of relying essentially on domestic sources. The share of Leasing and Finance Companies (LFC) has started showing markedly increasing trend from 17 per cent in end-April 2001 to an average of 29 per cent in 2002-03 and further to as much as 41 percent during 2003-04. The shares of FIs have also increased dramatically from an average of only 3 percent during 2001-02 to 25 percent during 2003-04 (Chart 2). The recent RBI guidelines on investment in non-SLR scurrilities for banks exempting CP from the purview of such guidelines have also enabled FIs to raise more resources through CP in recent period thereby increasing its share.

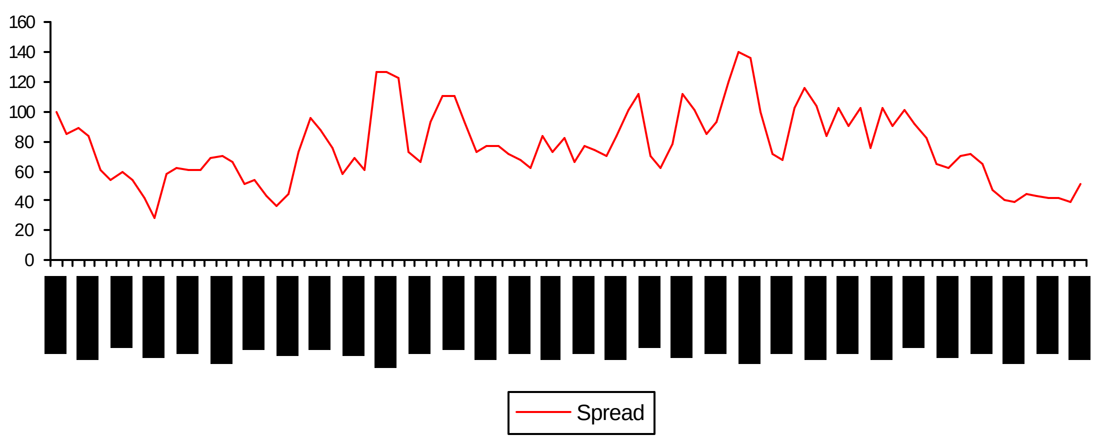
Chart 2: Shares of Manufacturing, Leasing & Finance Companies and Financial Institutions



3. *Trends of Spread between Prime Rated and Medium Rated Companies.*

The spread (3-period moving average) of Weighted Average Discount Rate (WADR) between the prime rated and medium rated companies which had widened to 221 basis points by July 2001 from 90 basis points in end-April 2000, narrowed to 35 basis points by end-November 2003, with some fluctuations in between (Chart 3). The lowering of spread in recent period largely reflects the substantial improvement in liquidity in the economy.

Chart 3: Spread between Prime Rated and Medium Rated Companies



Section III

Market Microstructure: Issues and Suggestions

In order to strengthen market microstructure and improve efficiency, it is instructive to know the current market practices based on the discussions with select market participants.

1. *Settlement of CP*

It has been found that settlement of CP i.e., crediting of dematted CP securities to investors vis-à-vis payment of funds to issuer of CP takes place in two days. The processes involved are payment of stamp duty across the counter, submission of relevant documents to the IPA, uploading of required information to the depository for seeking ISIN for the issuances of CP and finally, crediting the appropriate securities to the investor against payment of funds to the CP issuer.

In major CP markets in the world viz., USA, France and UK, majority of these processes are done on straight-through-processing (STP) basis for which settlement takes place generally on T+ 0 DVP I basis. This is also essential because majority of CPs are issued for 1 day in these markets. In these three markets, stamp duty is also not required. In India, it is possible to reduce the settlement time to at least T+1 basis following full scale operationalistion of the real-time gross settlement (RTGS) system for which the transfer of funds would be faster. Also, uploading of information to depository is already done on STP basis. Now, if it is possible to achieve/strengthen the electronification of submission of relevant documents to IPA, settlement of CP could be completed at least within T+1 basis. However, the endeavour should be to achieve T+0 settlement for CP. This would be possible if stamp duty is phased out or paid seamlessly.

During the course of both issuances of CP and redemption of CP, it has often been the experience that IPA has to provide intra-day liquidity (IDL) to both the investors and issuers at two different stages. At the time of issuance, investors present pay orders/bankers' cheques to the IPA which are presented to high value clearing for which funds are actually available only in the evening. However, IPA affords credit of securities to investors and pays the issuers of CP in the morning resulting in an extension of IDL to investors during the course of the day till IPA's account is credited towards the end of the day. If such pay order/banker's cheque is returned unpaid, IDL may get crystallized into an overnight exposure. The reverse process takes place on redemption. Such intra-day exposure is, however, expected to be resolved once RTGS system stabilises fully for which real-time funding would be enabled.

2. Stamp Duty

Primary issuances of CP attract stamp duty as indicated earlier. Stamp duty has been reduced substantially by the Central Government effective March 1, 2004. However, disparity continues to exist in that that banks as investors pay only one-fifth of what non-bank entities pay for subscribing to CP.

This has given rise to distortions in the market in the sense that issuers in their effort to economise on stamp duty, generally sell their CPs initially to banks who in turn offload them to actual non-bank investors, mostly mutual funds in recent period. This roundabout process not only creates delay in searching the bank who could agree to undertake this type of job (external auditors some time view it as an inappropriate transactions), direct selling to non-bank entities places additional cost to the CP issuer. Further, there could be a situation whereby a bank could be accused of conniving with the issuers of CP to save on stamp duty.

The structure of stamp duty is also affecting the maturity period of CP as, say, there is a tendency to issue CP for period upto 90 days rather than for a lesser period as marginal cost of issuing CP from the point of stamp duty is same for period upto 90 days. Further, the sheer physical process through which stamp duty is to be paid across the counter also delays the settlement process of CP.

For all these reasons, it is suggested that stamp duty should be phased out completely. In fact, in that eventuality, the Government of India is not expected to incur much additional revenue losses because majority of CPs are otherwise being issued through banks only where stamp duty has been reduced substantially effective March 1, 2004. However, if it is not feasible to phase out stamp duty, it is proposed that at least we may request the Government to bring down the stamp duty as applicable to non-banks to the level of banks to ensure a level playing field.

3. Rating

As indicated under Section I, the minimum credit rating has been scaled down from $P1^{+}$ to P1 and further to P2 of CRISIL or its equivalent by May 1992. It has been continuing at that level since then. In major international markets, rating is not compulsory though issuers get themselves rated. Since CP market in India is now fairly matured and investors are essentially institutional in nature, it is proposed that minimum credit rating may be brought down to P3 of CRISIL or its equivalent to provide wider choices to both issuers and investors. Incidentally, P3 is the lowest level among the investment grades.

4. Maturity Period of CP

At present, maturity period of CP ranges from 15 days to one year. In USA and France - the two major markets of CP, much of the CPs are issued with overnight maturity. This is possible because settlement of CP takes place on the same day (i.e., at T+0 basis) and stamp duty is not required. In India, with full fledged operationalisation of RTGS, it would be possible to issue CP on T+1 basis. In that case, the minimum maturity period of CP could be reduced to at least 7 days. However, given the stamp duty structure, there would be incentive on the part of issuers to issue in the region of 90-day CP to minimise the cost (as stamp duty is same for period upto 90 days). Therefore, with complete phasing out of stamp duty and full fledged RTGS system in place, maturity period of CP could be reduced to even 1 day. However, considering the present situation, it is proposed that minimum maturity period of CP could be reduced from 15 days to 7 days.

Operationally, there is one more issue. As per the extant guidelines, multiple CPs issued on different dates within the stipulated period of two weeks under one tranche must mature on the same date. This poses operational problems and therefore, it is suggested that RBI should only insist that the maturity period of CPs does not exceed one year from the date of issuance.

5. Asset Backed Commercial Paper

In USA, asset backed commercial paper (ABCP) is reportedly the largest component of the CP market. It is issued by a company which purchases receivables from one firm or a group of firms and finances the purchase with funds raised in the commercial paper market. In other words, asset-backed issuers securitise a portfolio of cash generating assets funded by liabilities including CP. The sole business activity of the special company is the purchase and finance of the receivables so that risk of the company and the CP it issues is isolated from the risk of the firm or firms which originated the receivables. With asset-backed paper, the paper's risk is instead tied directly to the creditworthiness of specific financial assets, usually some form of receivables. Asset-backed paper is one way whereby smaller, riskier firms can access the CP market. The advantages of asset-backed securities may lead to large, lower-risk CP issuers to also participate in asset-backed CP programmes. Traditionally, banks have used ABCP as a device to put their current asset credits off their balance sheets and yet provide liquidity support to their clients.

It is suggested that in India, we should permit introduction of ABCP for further deepening the CP market.

6. Reference Rate

At present, issuers decide on the discount rates of their CPs taking into account the Reuters/Telerate CP reference rate as well as the supply-demand forces prevailing in the market.

In this context, in order to improve transparency and strengthen efficiency, it is proposed that we may make it mandatory to report all CP deals, in line with the same for call/notice money deals, on the NDS platform within 15 minutes of undertaking the transactions so that benchmarking becomes more appropriate in the economy.

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Annex-I

International Experiences

A. U.S.A.

Background

The US commercial paper (USCP) market originated in the 1960s and experienced a drammatic growth in the second half of the 1990s. The development of the US CP market can be traced largely to the late 70s and early 80s, a period of high and volatile interest rates, which led households and businesses to shift assets from bank deposits with regulated interest rates to alternative types of assets offering market-determined rates. This demand was met in partly by issuance of commercial papers. As a result, the share of commercial papers in the short-term liabilities of non-financial corporations, in particular, rose from less than 5 per cent at the end of the 60s to around 15 per cent one decade later.

Characteristics

The Securities Act of 1933 requires that securities offered to the public be registered with the Securities and Exchange Commission (SEC). Most commercial papers (CP) are issued under Section 3(a)(3) of the 1933 Act which exempts short-term securities from registration requirements as long as they have certain characteristics.

The maturity of CP must be less than 270 days. In practice, 1 to 7-day CPs, particularly 1-day CP, constitute the substantial component of the total CP market. This is because CPs are used as funding tool and as a cash management tool. Many issuers continuously roll over their CP, financing a more-or-less constant amount of their assets using CP.

One requirement for exemption is that proceeds from CP issues be used to finance "current transactions", which include the funding of operating expenses, and current assets such as receivables and inventories. Proceeds cannot be used to finance fixed assets, such as plant and equipment, on a permanent basis. The SEC has generally interpreted the current transaction requirements broadly, approving a variety of short-term uses of CP proceeds.

The denomination of CP is large: minimum denominations are usually $100,000 (about Rs.44 lakh at current exchange rate), although face value amounts to as low as $10,000 are available from some issuers. Because most investors are institutions, typical face value are in multiples of $1 million. Like Treasury bills, CP is typically a discount security.

Until the 1980s, most CP were issued in physical form. However, CP is now being issued in book-entry form and settlement typically takes place on the same day.

Most firms place their paper through dealers who, acting as principals, purchase CP from issuers and resell it to the public. Most dealers are subsidiaries of investment banks or commercial bank holding companies. A select group of very large, active issuers, called direct issuers, employ their own sales forces to distribute their CP. Demand for commercial paper in the US originated largely from the investors and businesses for assets offering market-determined rates of return, at a time when interest rates paid on bank deposits were regulated. Large holders of US commercial paper include non-financial corporations, life insurance companies as well as private and government pension funds. Some foreign investment and commercial bank holding companies have also become significant dealers.

The secondary market in commercial paper is small. Partly, the lack of a secondary market reflects the heterogeneous characteristics of commercial paper and partly it reflects the shorter maturity of the paper: The possibility to trade commercial paper on a secondary market does not seem to have been crucial to the rise in demand for commercial papers in the US, nor indeed in other major CP markets. Commercial paper is typically purchased at maturities that fulfill the requirements of investors. If investors need to liquidate their assets, it is standard for the dealers or issuers to purchase them back (though a put option is not a standard feature of USCP).

Ratings

Although USCP need not be rated, in practice it tends to be rated by one or more rating agencies to attract investor demand. Most USCP are rated in the highest category.

Backup Liquidity

CP issuers maintain access to funds that can be used to pay off all or some of their maturing CP and other short-term debt. These funds are either in the form of their own cash reserves or lines of credit from banks. Rating agencies require evidence of short-term liquidity and generally would not issue a CP rating without it. The highest-rated issuers can maintain liquidity backup of as little as 50 per cent of CP outstanding, but firms with less than a high A1-P1 rating generally have to maintain 100 per cent backup.

Credit Enhancements

While backup lines of credit are needed to obtain a CP rating, they do not raise the rating above the underlying creditworthiness of the issuer. Issuers can significantly increase the rating of their paper, however, by using one of a variety of credit enhancements which lower default risk by arranging for an alternative party to retire the CP. These credit enhancements differ from backup lines of credit in that they provide a guarantee of support which cannot be withdrawn. Some smaller and riskier firms, which normally would find the commercial paper market unreceptive, access the commercial paper market using these enhancements.

Asset-Backed Commercial Paper

A relatively new innovation in the CP market is the backing of CP with assets. The risk of most CP depends on the entire firm's operating and financial risk. With asset-backed paper, the paper's risk is instead tied directly to the creditworthiness of specific financial assets, usually some form of receivables. Asset-backed paper is one way by which smaller, riskier firms can access the CP market. The sole business activity of the special company is the purchase and finance of the receivables so the risk of the company and the CP it issues is isolated from the risk of the firm or firms which originated the receivables.

B. United Kingdom

Background

The euro commercial paper (ECP) market emerged in the early 1980s as an offshoot of underwritten Note Issuance Facilities (NIFs) and was characterized by US dollar-based uncommitted programmes with a small group of intermediaries acting as dealers for each programme. ECP did not comply with SEC exemptions in the USA and could not, therefore, be sold to US investors. Since then, the ECP market has developed into a multi-currency short-term market, which largely absorbed the sterling domestic market.

Characteristic

London-based dealers distribute ECP around the world in contrast to most other major CP markets that are largely focused on domestic issuers and investors. The ECP market is international in terms of issuers, investors and currencies. English law governs most ECP programmes.

Ratings of ECP are purely a matter of market convention and are not required by UK regulation. There is no VAT/stamp duty neither is withholding tax on interest for ECP with a maturity period of less than 365 days.

By convention, ECP takes the form of an immobilized global certificate lodged with a central depository e.g., Euroclear or clearstream. No fully demat system exists in the UK.

C. <u>France</u>

Background

The French CP market is part of the larger "TCN" (*Titres de Creances Negociables)* market created in 1985. The size of the broad French TCN market, which includes certificates of deposit, commercial paper and medium term notes, was EUR 305 billion in August 2002.

The French commercial paper market is one of the major domestic CP markets in the euro area representing about 50 per cent of the European market. The outstanding amount in the French market for corporate issuers (issued in all currencies by domestic and non-domestic issuers) stabilized around EUR 73 billion between the end of June and the end of August 2002.

Characteristics

CP must have a fixed maturity date, an initial maturity of at lest one day and upto one year and a unit value equivalent to at least EUR 150,000. French CP is issued in particular by investment firms, companies making pubic offerings (resident or non-resident) with at least two year of activity, public companies and community institutions and international organizations of which France is the member. According to the New Economic Regulations came into effect on May 15, 2001, local public authorities are also authorised to issue CP and Medium Term Notes (MTN). Dematerialisation has become compulsory since July 26, 1991. CP can be issued as a fixed rate, floating rate or index-linked paper.

Ratings

The rating is not compulsory. However, rating may be obtained from a rating agency expressly mentioned in the list established by the French Ministry of Economy and Finance. Bank of France may also grant issuers a rating.

Trading

Placing and trading is open to any authorised credit institution or investment firm. CP is not listed at stock exchange and buy-back is possible by issuers. Transactions must be reported to Banque de France.

Taxation

No withholding tax is applied on CP.

Annex-II

Chronology of Development of CP in India

As On	Tangible Net Worth	Working Capital	Aggr. Amt. Of CP Issue	Maturity	Denomination	Minimum CP issued per Investors	Mode of Issuance	Rating	Stamp Duty
January 1990	Rs.10 crore	Rs.25 crore	20 per cent of Working Capital (fund based limit)	3 to 6 months	Multiple of Rs.25 lakh	Rs.1 crore	Physical Form	P1+	Primary issue is 0.25 per cent for all investor, with confessional rate 0.05 per cent for banks.
April 24, 1990	Rs.5 crore	Rs.15 crore	20 per cent of Working Capital (fund based limit)	3 to 6 months	Rs.10 lakhs	Rs.50 lakhs	Physical Form	P1	
May 30, 1991	Rs.5 crore	Rs. 10 crore	30 per cent of working Capital (fund based limit)	3 to 6 months	Multiple of Rs.5 lakhs	Rs.25 lakhs	Physical Form	P1	
May 13, 1992	Rs.5 crore	Rs.5 crore	75 per cent (fund based limit)	3 to 6 months	Multiple of Rs.5 lakhs	Rs.25 lakhs	Physical Form	P2	
October 18, 1993	Rs.4 crore	Rs.4 crore	75 per cent (fund based limit)	3 to less than one year	Multiple of Rs.5 lakhs	Rs.25 lakhs	Physical Form	P2	
November 4, 1996	Rs.4 crore	-	As sanctioned by Bank	3 to less than one year	Multiple of Rs.5 lakhs	Rs.25 lakhs	Physical Form	P2	
April 15, 1997	Rs.4 crore	-	As sanctioned by Bank	1 months to less than one year	Multiple of Rs.5 lakhs	Rs.25 lakhs	Physical Form	P2	
May 25, 1998	Rs.4 crore	-	As sanctioned by Bank	15 days to 365 days	Multiple of Rs.5 lakhs	Rs.25 lakhs	Physical Form	P2	
October 10, 2000	Rs.4 crore		CP can be issued as "Stand alone" product	15 days to 365 days	Multiple of Rs.5 lakhs	Rs.25 lakhs		P2	
April 30, 2001	Rs.4 crore	-	CP can be issued as "Stand alone" product	15 days to 365 days	Multiple of Rs.5 lakhs		Dematerialised form (June 2001)	P2	
November 4, 1996			As sanctioned by Bank						

Reason:

- After introduction of the ‘loan system’, the amount of commercial paper is required to be carved out of the ‘cash credit component’ of the WC limit. In view of the further reduction in the ‘cash credit component’, it is decided that the amount of commercial paper that can be issued will not henceforth be restricted to the cash credit component.

ANNEX III

Commercial Paper: A Comparative Position

Countries	USA	United Kingdom	France	India
Legal Basis	Securities Act	English common Law	1. French Financial and Monetary Code 2. Decree and CRBF Regulation	1. Non-banking (Acceptance of deposit through CP) Direction 1989 2. Section 45K of RBI Act, 1934
Maturity Period	No minimum and Maximum period but in effect ranges from 1 day to 270 days.	Less than 365 days	Between one day and upto one year	15 days and upto 1 year
Denomination	No required Minimum Denomination but market practice of $1,00,000	EUR 40, 000	A unit value equivalent at least EUR 1,50,000	Denominations of Rs.5 lakh or multiple thereof. Amount invested by a single investor should not be less than Rs.5 lakh (face value).
Issuers	Both Financial and non-financial corporation	No restriction	Investment firms, companies making public offer, EIG, public companies, community institutions and international organisation of which France is member.	Corporates, primary dealers (PDs) and FIs.
Rating	Tough not compulsory, in practice A-1/P1	Rating not compulsory, purely driven by market convention	Rating is not compulsory	P2 of CRISIL or its equivalent from other rating agencies
Investors	Money market mutual funds, banks, financial corporations, securities dealers and private and govt. pension funds	Institutional	Institutional	Individuals, banks companies, other corporate bodies registered or incorporated in India and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs).
Innovation	Asset Backed Commercial Paper	Euro Commercial Paper, NIF, Revolving Underwriting Facilities	Medium Term Notes	-
Trading	Buy back possible	No buy back	Placing and trading open to authorised credit institution or investment firm. Buy back is possible through central depository	No buy back

Settlement	Issued in book entry form & same day settlement	No central Securities depository. Market practice is to clear ECP transactions through Euroclear or clearstream.	Same day settlement	Generally T+2 basis
Dematerialisation	DTC	No demat, immobilised global certificate with a central depository	Dematerialisation is compulsory since 1993	Dematerialisation since June 2001
Taxation and Stamp Duty	Only Income Tax on the interest and capital gain tax as sales, no other faxes.	No withholding tax and no stamp duty for CP upto 365 days. For non-residents for CP above 365 days with holding tax applicable	Withholding Tax	Stamp duty applicable as per maturity.