COMMERCIAL PAPER AN INSTRUMENT OF LOW COST BORROWING

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Abstract :

Due to intense competition , instable market conditions, instable market conditions , Indian companies are trying to work on low cost model and for that trying to find the cheaper sources of funds to meet their short term capital requirement at cheap interest rate . Commercial paper is one of the such instrument. In this paper author has tried to give an analysis by taking different example and tried to make the people to understand how commercial papers are a low cost source of capital as compared to others.

Key words: Commercial papers, source of fund, short term borrowing,

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Introduction:

Commercial paper came in to existence in Jan 1990, on the recommendation of Mr. N. Vaghul, who has given recommendation in his report on Jan 1987, on the development of money market and its instruments. With the introduction of commercial paper , RBI has enabled both , the corporate borrowers , who are highly rated but want to diversify their short term borrowing sources and to the investors by providing them an additional new instrument to invest for short term i.e. is minimum 7 days but not beyond 1 year for an amount not less than 5 lakh. In order to protect the interest of investors the commercial paper issuer need to have some eligibility criteria and also if eligible they must have minimum P-2 rating by CRISIL or equivalent rating agency. A eligible corporate is one whose net tangible is not be less than 4 crore as per latest audited balance sheet , its working capital limit should be sanctioned by banks or FIs and also any financial bank and institution must classify the borrowal account of the company as a standard asset. In order to issue commercial paper every issuers needs to appoint IPA i.e. Issuing and Paying Agent and only a scheduled bank can be a IPA and also issuers has to disclose its financial position to the prospective investor as per current market conditions. As all over the world technology is advancing and most importantly in financial sector ,same is happening in Commercial Paper market , where now for investors Cp's are available in both dematerialized and physical form.

Growth of commercial paper market: Commercial paper was launched in Jan 1990 during the time of crisis and government of India had adopted new economic policy in 1991 due to country's bad financial position. So initial two years the commercial paper market in India was very minimal in both volume and intensity. Up to may 1997 there was a continuous up and down in this market and after that a continuous growth has been witnessed. From March 1994 to October 1994 a sharp decline has been observed due to withdrawal of standby facility , rise in discount rate and a shrink in short run surplus funds with banks. But in the period Oct 94 to March 95 it has again risen from INR 75 cr. to 495 cr. due to fresh issues of commercial papers. Again by the end of march 1996, CP market fall down and next year revived back because of fall in discount rate and also now all companies are allowed to issue CP up to 100% of their MPBF (Maximum Permissible Banking Finance). After that amount in CP is increasing continuously and one of the important factor is that more than 80% of CP amount is subscribed by commercial banks only. Table 1 shows the growth in CP market

Table 1 : Growth in CP market 2003-04 to 2011-12 (9 years)

Year	Amount (in crore)	No. of Issues
2003-04	8,744	418
2004-05	10,270	374
2005-06	8,337	333
2006-07	13,095	473
2007-08	37,260	852
2008-09	51,666	1013
2009-10	98,673	1431
2010-11	181,639	2842
2011-12 (as on 23/02/12)	264,281	3896
	673,965	11,632

Though from table one growth in CP market is very much clear from the continuous increase in the outstanding amount, but this market can grow further but some hindrance needs to be removed further. In CP market still we don't have any reliable benchmark available and also issue procedure of CP in physical term is very time consuming as all corporate needs to arrange stamping on the certificate as it is to be given to the investors. More over there is not only difference in stamp duty rates between banks and non –banks, but also inter- state disparities in the stamp duty is exit.

Literature Review: There are two major techniques for explicit interest rate forecast:-1) Correlation with economy, usually based on an "informal" non statistical approach. 2) An analysis of the outlook for the sources and uses of funds Flow of fund –statistics in interest rate forecast is very much useful. (Freund W/ and E. Zinbarg). Ghosh & Pradhan (2009) try to understand the determinants of WADR (weighted average discount rate) and how these determinants have affected their movement over the past 5 years after adjusting for seasonal fluctuation. The real and financial variables considered for the study were: - Index of industrial production (IIP), Amount of CP issued, Cut-off yield 364 days treasury bill, Call/Notice money, Sensex, Indian Rupees – US Dollar exchange rate & bank credit. Covitz & Downing (2002) explain the relationship between short term and long term yield spreads. Short term spreads cannot be explained by insolvency model because of large spread. Many a times short and long term spreads are negatively correlated. Their explanation for observed risk spreads rests on a distinction between the fixed and liquid assets of a firm. After the bankruptcy of Lehman Brothers' on Sep.15, 2008 commercial paper market experienced considerable strain, as redemption demands accelerated, especially in money mutual funds and as a result investors were not purchasing commercial papers, so to support the orderly functioning of the commercial paper the Federal Reserve announced the creation of the Commercial Paper Funding Facility (CPFF) (Adrin Tobis, Kimbrough Karim and Marchioni Dina). Gao & Yun± (2009) points out that the collapse of Lehman brothers was followed by a virtual closing of the CPs market, followed by which a number of firms drew excessively on their remaining lines of credit out of fear that weakened banks would reduce their loan commitments. Aggregate CP borrowing declined 15% after the collapse of Lehman brothers, but the effect was concentrated among firms with high default risk. High risk borrowers that were negatively impacted by the decline in the CP market after Lehman's default substituted CP with lines of credit. Low risk borrowers remained as they were. M. S. Rao & K. R. Pillai depicts the behavior of rate of return and risks associated with commercial paper against the backdrop of the global financial crisis. A remarkable finding of the study is that as the Indian outstanding commercial paper market increases considerably, the US market experiences a sizeable decrease.

Low cost source of capital : An example to show how commercial papers helps the companies to raise the short term funds at cheaper cost compared to the debts from banks which in turn results into reduced cost of capital and helps them to increase their profitability margin.

Call market money rates and minimum lending rates

YEAR	Call money market rates	Minimum Lending rates prescribed by RBI
1999-2000	8.87	----
2000-01	9.15	12-12.50
2001-02	7.16	11-12
2002-03	5.89	11-12
2003-04	4.62	10.75-11.50
2004-05	4.65	10.25-11
2005-06	5.60	10.25-10.75
2006-07	7.22	12.25-12.50
2007-08	6.07	12.25-12.75
2008-09	7.67	11.50-12.50
2009-10	3.39	11-12
2010-11	4.51	8.25-9.50
2011-12	4.8	9.50-10.75

Source – RBI

In the year 2009 commercial Papers worth Rs 500Cr for a period of 87 days have been issued by Sail at a coupon rate of 3.39 and they have saved a huge amount of money on interest.

Option 1: lending from banks

Rate of interest = 11%

Amount raised = Rs500cr

Duration = 87days

Interest = (500*0.11*87)/365 = 13.10Cr

Option 2: commercial paper

Interest paid = (500*.0339*87)/365 = 4.04Cr

Difference in the interest paid = 13.10-4.04 = 9.05Cr

Note – here simple interest is used to simplify the calculation.

Interpretation – the use of commercial paper acts as a cheaper source of fund compared to the lending from banks. Hence SAIL was able to lower its cost of capital and was able to save around 9Cr.

Consider a hypothetical example. XYZ Ltd. Wants to raise 1000Cr in the financial year 2008-09 for a maturity period of 90days issued at the call market money rates prevailing in the economy.

Option 1: lending from banks

Rate of interest = 11.50%

Amount raised = Rs1000cr

Duration = 90days

Interest = (1000*0.1150*90)/365 = 28.35Cr

Option 2: commercial paper

Interest paid = (1000*.0767*90)/365 = 18.91Cr

Difference in the interest paid = 28.35-18.91 = 9.43Cr

Above data shows that call money market rates are quite less than lending rates prescribed by RBI and main reason is that any bank cannot lend the capital to any corporate below the minimum lending rate. So when ever any company with good credibility needs a huge money for short period it always prefer commercial papers as can save huge interest.

Conclusion: As commercial paper s are for short term financial need, so companies can take advantage of short term interest fluctuation in the market as it has an exit option. It provides a continuous source of funds while giving the opportunity to earn a safe and good amount on ideal funds of companies for short run.

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