Report of The Internal Group to Review the Guidelines Relating to Commercial Paper

Monetary Policy Department
Reserve Bank of India
Mumbai

March 2000

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RESERVE BANK OF INDIA
CENTRAL OFFICE
MONETARY POLICY DEPARTMENT
SHAHID BHAGAT SINGH ROAD
MUMBAI-400 001

'¥¸ú㏄¸¢ㅁ›¸ : 266 16 02
TELEPHONE :

·¸¸£ : "RESERVBANK"
TELEGRAMS :

㏄¸¢Æ¬¸ : 265 1685
FAX : 269 3204

March 18, 2000

Dr. Y.V. Reddy,
Deputy Governor,
Reserve Bank of India,
Mumbai-400 001

Dear Sir,

Internal Group to Review the Guidelines
<u>Relating to Commercial Paper</u>

We submit herewith the Report of the captioned Group.

Yours faithfully,

(Asha P. Kannan)
Convenor

J. Chitra
(Chitra Chandramouliswaran)
Member

(V. B. Angadi)
Member

(Rajan Goyal)
Member

(T. K. Kuruvilla)
Member

(Mohindar Kumar)
Member

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Report of the Internal Group to Review the Guidelines Relating to Commercial Paper

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As desired by Deputy Governor (Dr. Y.V. Reddy) in the Second Meeting of the Technical Advisory Committee on Money and Government Securities Markets, it was decided to constitute an Internal Group to Review the Guidelines Relating to Commercial Paper in the light of the developments in the Commercial Paper (CP) market. Accordingly, a Group comprising of the following members drawn from the concerned departments was formed :

(i)	Smt. Asha P. Kannan, Director, MPD	Member & Convenor
(ii)	Smt. Chitra Chandramouliswaran, General Manager, DBOD	Member
(iii)	Dr. V.B. Angadi, Director, DBS, FID	Member
(iv)	Shri Rajan Goyal, Assistant Adviser, MPD	Member
(v)	Shri T.K. Kuruvilla, Assistant General Manager, IECD	Member
(vi)	Shri Mohindar Kumar, Assistant General Manager, DNBS	Member

2. The Group held five meetings. The Group also held discussions/consultations with a cross section of market participants, viz., banks, corporates, depository, Credit Rating Agency, Self Regulatory Organisation (SRO) and industry association (list attached) to get a feedback on the operation of CP market in India. The Group also had the benefit of the views expressed by the members of the Technical Advisory Committee on Money and Government Securities Market on the draft of this Report.

3. The Internal Group in its First Meeting held in October 1999 decided to, inter alia, examine the following issues :

(i) Review the growth and operation of CP market in India.

(ii) Examine policy related, legal and structural factors inhibiting faster and healthy growth of the CP market.

(iii) Analyse the reasons for secondary market for CP not developing.

(iv) Discuss the role of CP in meeting the short-term funds requirement of borrowers in the context of withdrawing the prescription of Maximum Permissible Bank Finance (MPBF).

(v) Examine the usefulness of CP for All India Financial Institutions, in the context of introduction of ALM and risk management systems.

(vi) In the light of evolution of CP market in India and international experience identify the scope for modifications in the extant guidelines and recommend measures which need to be taken for developing an efficient and liquid CP market.

Genesis of CP market in India

4. CP is an unsecured money market instrument issued in the form of a promissory note and transferable by endorsement and delivery. Commercial Paper was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings as also to

provide an additional instrument to investors. Issue of CP is governed by the Non-banking Companies (Acceptance of deposits through Commercial Paper) Directions 1989. Acceptance of funds through issue of CP has been exempted from the provisions of Section 58A of the Companies Act 1956 and brought within the overall purview of the Directions issued by the Reserve Bank of India under Section 45K of the RBI Act, 1934. Under these Directions, CP can be issued only for raising working capital finance. The aggregate amount to be raised by issuance of CP cannot exceed the working capital (fund-based) limit sanctioned by bank/s to an issuer company and to the extent of CP issued, a corresponding reduction has to be made in the working capital limit. It was felt that with the introduction of CP, funds flowing through the inter-corporate deposit market would shift to the CP market. The eligibility conditions prescribed for issue of CP have been amended from time to time and the present guidelines are set out in Annexure I. Initially only corporates were permitted to issue CP. Subsequently, primary dealers (PDs) were permitted to issue CP in September 1996 and satellite dealers (SDs) in June 1998.

Growth of the CP Market

5. CP market in India has witnessed sharp ups and downs. Since its inception in 1990 and until the end of the financial year 1992-93, the activity in the CP market in India was minimal and volumes were very small. The amount outstanding at the end of the year 1992-93 rose to Rs.578 crore from Rs.86 crore as at the end of financial year 1989-90. Following the various relaxations in the terms and conditions for issue of CP (viz., eligibility criteria, denomination of CP, quantum of CP, etc.) and decline in discount rates, CP market witnessed a strong growth thereafter. During 1993-94, on an average around Rs.460 crore was mobilised through CP in a fortnight and the outstanding CP amount as at the end of March 1994 was 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 shrinking 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 Rs.2,660 crore and stood at Rs.604 crore at end-March 1995. There was a further decline in the volume of CP to Rs.76 crore by end-March 1996. 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 MPBF, there was a revival in the CP market and outstanding amount of CP touched Rs.646 crore by the end of March 1997.

6. CP issuance 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 amount outstanding at the end of March 1998 was Rs.1,500 crore, end-March 1999 was Rs.4,770 crore and at end-January 2000 was Rs.7,814 crore. The unprecedented and steep rise in CP issuance in the last two years has been on account of the following factors :

(a) In October 1997, the stipulation that the request for restoration of working capital (fund based) credit limit (on repayment of Commercial Paper) should be considered by banks on the lines of enhancement of limit was withdrawn and banks were given the freedom to decide the manner of restoration of the working capital limit.

(b) There had been sluggishness in the off-take of non-food credit during this period and banks therefore, deployed their resources in short-term instruments.

(c) Highly rated blue chip corporates have been issuing CP as an effective instrument for reducing the funding cost of their working capital during periods when money market interest rates have ruled low.

7. Investors in CP have been banks, financial institutions and to some extent other corporates. Except for the period when demand for bank credit had been very high (such as 1995-96), an overwhelming proportion (more than 80 per cent) of CP amount has been subscribed to by commercial banks only.

Factors Hampering Growth of CP Market

8. Some of the factors which have hampered active growth of CP market in India are as follows :

(i) The linking of CP to working capital limits. Market participants have suggested that CP should be made a "stand alone" product.

(ii) At present, for issuance of CP approval or NOC is required from the Financing Banking Company. This NOC/approval is valid for a period of two weeks from the date of its issuance. Furthermore, rating for the issuance of CP has to be current and not more than 2 months old. Market participants perceive these stipulations as impediments to the development of CP market.

(iii) The difference in stamp duty rates as between banks and other entities has created operational difficulties. There is at present, inter-state disparities as also investor-wise differences in stamp duty rates. Further, there is tenor-wise slab structure of stamp duty as given below :

Tenor	**Rate for**	
	Banks	**Non-banks**
Upto 90 days	**0.05**	**0.125**
91 - 180 days	**0.15**	**0.375**
181 - 364 days	**0.20**	**0.50**

Secondary market transactions in CP, however, do not attract any stamp duty. This divergence in stamp duty for banks and non-banks has created some distortions in the market and also encouraged some mal-practices. All primary issues of CP are almost exclusively subscribed to by banks and non-banks buy CP from banks in the secondary market. Further, CP issues with maturity of less than 90 days are generally not preferred.

(iv) Procedure to issue CP in physical form is quite cumbersome. The concerned corporates have to arrange for stamping of all the certificates, which is time consuming. Furthermore, copies of all the documents have to be given to all the investors along with the CP certificate.

(v) No reliable bench mark is available in the market for pricing CP.

International Experience

9. The features of CP market in the USA, UK and Japan are given in the Annexure II. The major features of CP in some countries are given in the Statement.

Recommendations of the Group

10. Based on the detailed deliberations of the Group and discussions held with market participants, the Group arrived at the following recommendations/suggestions for the healthy development of CP market :

(i) Who can issue CP?

11. At present only highly rated corporates, primary dealers and satellite dealers are permitted to issue commercial paper. The Group felt that financial institutions may also be permitted to raise resources by way of CP within the

overall umbrella limit fixed (by RBI) for raising resources by select All India Financial Institutions (FIs), for the following reasons:

(a) This may facilitate level playing field among all the financial institutions, as at present only those financial institutions which are set up under Companies Act can raise resources through inter-corporate deposits (ICDs). Further, it may help in reducing the dependence of some FIs on the ICD market.

(b) It would be an additional instrument to raise short-term resources.

(c) It would help the FIs in asset-liability and risk management.

12. The Group recognises that the permission to FIs to issue CP would, however, be subject to the existence of enabling provisions in their respective statutes. Since, financial institutions which are non-banking company are already exempted from the provisions of Section 58A of the Companies Act for issue of CP, only other FIs which are in the nature of statutory corporations, may have to be brought under the overall purview of directions issued by RBI under Section 45K of RBI Act, 1934, in consultation with the Central Government.

(ii) <u>Mode of Issuing CP and Ceiling on CP Issuance</u>

13. At present, CP issued by any company is carved out of its working capital fund based limit extended by its bank. Accordingly, the working capital limit of the corporates are correspondingly reduced, once the CP are issued. This is to ensure that corporates overall access to funds by means of bank credit and CP does not exceed the working capital limit fixed by the banks. To enforce the above policy prescriptions, corporates have to follow a set procedure whereby they have to submit a formal proposal to the bank together with a certificate issued by a credit rating agency, obtain NOC from the lead bank and ensure that private placement of issue is complete within a fortnight from the date of issue of NOC. While, these procedural requirements ensure that corporates access to short-term funds remain within the working capital limit fixed by the banks, the

adherence to this procedure which is time consuming, cumbersome and rigid and does not allow corporates intending to issue CP, to take advantage of favourable interest rate scenario. To overcome these limitations of the present system, the Group felt that there is a need for delinking CP from working capital limit and making it a 'stand-alone'[*] product. Delinking CP from working capital limit and making it a 'stand alone' product may give an impetus for further development of the CP market. However, delinking of CP from working capital limit would require suitable changes in the eligibility criteria for issuance of CP.

14. The Group discussed the implications of making CP a 'stand-alone' product. It was recognised that while making CP a 'stand-alone' product would certainly help in streamlining and simplifying the procedure for CP issuance, being a stand-alone product, it may also result in over-dependence of corporates on short-term funds. To avoid such a situation, the need for placing a ceiling on CP issuance was discussed.

15. In this connection, the various alternatives for placing a cap on CP issuance such as linking it to current assets, net owned funds and working capital gap were debated. The Group further discussed whether the issuers of CP should be categorised on the basis of their business activities and different ceilings (percentage/multiples of NOF) could be fixed for different issuers based on the nature of their business activity or uniform ceiling should be prescribed for all issuers. It was felt that given the diverse nature of business activities of issuers, it would not be possible to prescribe any uniform ceiling on the amount of CP which corporates can raise. There is, therefore, a need to prescribe a ceiling on the amount of CP which any company can raise.

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[*] The word 'Stand-alone' in this Report means not linked to working capital (fund based) limit.

16. The Group further discussed issues like who should be vested with the responsibility of fixing the ceiling on the amount of CP which any company can raise and how it should be fixed and who would monitor the ceiling. In this connection, it was felt that the credit rating agencies (CRA) could play a more important role. At present, companies have to obtain a specific minimum credit rating for issuing CP from any of the CRA specified by the RBI. For prescribing a rating for the instrument, CRA carries out an in-depth analysis of business activities and financial parameters of the company. The rating prescribed by the CRA are valid for the quantum and period for which the resources are raised. Larger the amount a company intends to raise through CP, lower would be its credit rating for CP. The Group recommends that RBI may continue to prescribe a minimum credit rating for issuance of CP. The prescription of minimum rating by RBI would provide an automatic mechanism for placing a cap on the amount of CP which any corporate can raise. Thus, the limits for CP issuance would emerge from the minimum credit rating stipulated by the RBI and the actual rating given by the CRA based on its assessment. The CRA has to take on the responsibility of monitoring that the limits of CP issuance are strictly adhered to by the corporate.

17. Incidentally, in USA the rating agencies rate the short-term borrowing programme of a company based, inter alia, on the debt-equity structure of the company, which in turn acts as a cap on the various types of liability products which the company can raise (including CP).

(iii) <u>Stand-by Facility From Banks</u>

18. Under the existing arrangements, the working capital (fund-based) limit of the company issuing CP is correspondingly reduced by the financing banking company, once the CP is issued. On payment of the CP, banks are permitted to restore the working capital limit. Thus, the present mode of CP issuance extends an implicit line of credit to the issuers of CP for retiring the CP at the time of maturity. In the light of the Group's recommendation to make CP a 'stand-alone' product, a question which arises is whether or not stand-by line of

credit needs to be provided by banks to issuers of CP for meeting the liability of CP on maturity. It may be argued that if corporates are given the flexibility of issuing CP as a 'stand-alone' product, they should try to mobilise funds on the basis of their own financial strength and stand-by line of credit need not be provided to them by banks. However, as CP is essentially a short-term money market instrument, at times even well rated corporates may face some temporary mismatches in their funds position both due to internal and external factors, which may make it difficult for them to retire the CP on maturity. Any occurrences of default in repayment by companies may erode investors confidence in CP market. Furthermore, as mentioned earlier in this report, following the withdrawal of the stand-by facility for CP in October 1994, there was a sharp decline in funds raised through CP and the market almost came to a stand still. The market started picking up in April 1997, only after banks were given freedom to restore the working capital limit of the concerned corporate to the level which existed prior to issue of CP. Incidentally, internationally (USA and Japan) stand-by line of credit is provided by banks, and availability of stand-by line of credit is mandatory for obtaining credit rating for issuance of CP.

19. It is, therefore, suggested that in the interest of healthy development of CP market, banks may be allowed to offer stand-by line of credit for issuance of CP. The Group, further recommends that banks' decision whether to offer or not to offer a stand-by line of credit should entirely depend upon their own commercial judgement and should be with the prior approval of their Board. This may also form part of the single/group borrower limits fixed by the RBI. It is further recommended that the banks should have discretion to decide both the quantum of stand-by line of credit, as also the fee to be charged on the same. In this connection, for the sake of symmetrical treatment as to the investor and the issuer, the Group also recommends that stand-by line of credit need not be made mandatory for purpose of credit rating. Companies with large net owned funds and which can generate large internal surpluses may not require line of credit.

(iv) Role of Banks

20. In the proposed scheme, wherein CP issue would be delinked from working capital limit, corporates would no longer be required to obtain NOC from banks for issuance of CP. As a result, role of banks in the CP market would undergo a substantive change, but they would, however, continue to perform crucial functions in the following areas :

- Banks would be free to offer stand-by line of credit for CP issuance depending upon their commercial judgement and with the prior approval of their Board. Banks would have the discretion to decide both the quantum of stand-by line of credit as also the fee to be charged on the same. The stand-by line of credit provided by banks would also form part of the single/group borrower limit fixed by RBI.

- Banks can also act as Issuing and Paying Agent (IPA) for the issuance of CP. However, in view of the recently observed irregularities in the CP market, the Group felt that role of IPA should be clearly laid down and they should play a more responsible role.

- Though CP issuance would be outside the working capital limit extended by commercial banks, banks would, nevertheless have to take cognizance of the amount of CP issued by corporates while assessing/determining working capital (fund based) limits of corporates. This would help in ensuring that corporates do not over depend on short-term resources.

(v) Role of Credit Rating Agencies (CRAs)

21. In the proposed scenario wherein CP becomes a 'stand alone' product with limits for CP issuance emerging from the minimum rating stipulated by RBI and actual rating given by CRA, they (credit rating agencies) would be required

to play a more important and responsible role. Accordingly, the Group recommends the following responsibilities for the CRAs :

- ❖ While assigning the rating for issuance of CP by corporates, CRAs should make an assessment of the overall short-term funds requirements (including the working capital limits sanctioned by banks) of the corporates.

- ❖ CRAs should monitor the CP limits of corporates and any instance of non-adherence of CP limit by corporates has to be reported by them to the RBI immediately. CRAs should also consider the impact of irregularities and notify the reduction, if any, on the level of credit rating, for public information.
- ❖ Corporates should advise the RBI the limit for issuing CP and the amount of CP actually issued through the credit rating agency within 3 days from the date of completion of issue.
- ❖ Code of ethics prescribed by SEBI for CRAs for undertaking rating of capital market instruments should also be made applicable to them (CRAs) for rating CP.

As CRAs require prior permission or accredition from RBI for rating CP, the aforementioned requirements can form a part of the accredition letter issued to CRAs.

(vi) Role of Corporates/Issuers

22. With the delinking of issuance of CP from working capital limit and other proposed changes, the procedure for CP issuance would become less cumbersome and corporates would get more flexibility. At the same time, corporates/issuers need to be impressed upon that all the guidelines/procedures laid down for CP issuance are strictly adhered to. In this context, the Group recommends the following responsibilities for corporates/issuers :

- ❖ The guidelines and procedures laid down for CP issuance have to be strictly followed by them.

- In the absence of direct monitoring of CP issues by commercial banks, the Group felt that disclosure norms for CP issuance may be introduced, despite the fact that the CP is a privately placed instrument. Disclosure norms may include a summary of the balance sheet for the past two years, the amount of CP outstanding, the outstanding bank borrowings, the maximum and minimum amount of bank borrowings, together with CP borrowings, the purpose of utilisation of funds, the availability of stand-by facility with the commercial banks, the name of the banker, the level of credit rating, the track record of servicing the CP borrowings and other debts over the last four quarters.

23. The Group also recommends that any violation of the procedures and guidelines by corporate/issuer of CP should attract penal action by way of debarring the concerned issuer from issuing CP for say next one year or so. Punitive action taken against any CP issuer should also be notified to CRAs and banks for appropriate action at their end. Such a punitive measure would ensure that corporates do not misuse the flexibility given to them.

(vii) <u>Role of Issuing and Paying Agents (IPAs)</u>

24. At present, RBI has not laid down any specific guidelines regarding the procedure to be followed by IPAs. Indian Banks' Association (IBA) was entrusted with the task of specifying documentation details for CP, including the IPAs. IBA guidelines gives flexibility to banks in the matter of adopting the documentation. Thus, there is at present no standardised documentation for CP which is followed by all market participant and no set procedures for IPA. The Group deliberated on the role which IPAs should be assigned. Presently, IPA has to obtain and verify a series of documents from the issuers, viz., copy of IPA agreement, copy of board resolution, copy of credit rating given by CRA, NOC of lead bank and copy of specimen signatures. Copies of all these documents

verified by the IPA are then given to the investor by the issuer, along with the CP certificate. The Group recommends the following responsibilities for IPAs :

- ❖ IPAs should be made responsible for verifying these documents (other than NOC from lead bank which will no longer be required) and for issuing a certificate to the effect that the documents are in order. Accordingly, investors in CP need be provided with only a copy of agreement with IPA and certificate from IPA stating that documents are in order along with CP (only copy of IPA agreement and IPA certificate need be given if CP is in demat form). This is expected to not only make the procedure for issuance of CP less cumbersome, but would also ensure that there is no recurrence of irregularities in issuance of CP as were observed in the case of Bombay Dyeing.
- ❖ These original documents verified by the IPA should also be held in the custody of IPA.
- ❖ Make payment of matured CP.

25. While these are only some of the roles of IPA, the Group recommends that as there are no standard procedures for IPAs, some Self Regulatory Organisation (SRO) may be entrusted with the task of evolving standardised procedures to be followed by IPA, specifying safeguards to be followed in the matter of documentation, etc. The Group also recommends that after the SRO evolves the documentation procedures for IPAs, in the event of any violation of guidelines/procedures by IPA, punitive measures may be considered.

(viii) <u>Types of CP</u>

26 With a view to providing flexibility as also to enable both issuers as well as investors to take advantage of interest rate movements, the Group recommends that corporates/FIs/PDs/SDs may be permitted to issue floating rate CP. Further, CP with call/put option exercisable after 15 days may also be permitted.

(ix) Demat Form

27. At present, commercial paper are issued in a physical form as a promissory note which is transferable by endorsement and delivery. This requires physical movement of the paper from seller to the buyer, everytime the paper is sold. The present procedure is very cumbersome and it also leaves scope for fraudulent encashment. Furthermore, the need to physically transfer the paper hampers the scope for the development of secondary market and restricts it to major centres only.

28. To overcome the above inhibiting factors, the Group felt that CP should be issued in demat form. In this connection, the Group explored the feasibility of issuing CP in demat form and held informal discussion with NSDL officials. Operationally, issuance of CP in demat form is feasible as SEBI under Depositories Act, 1996 permit commercial paper to be admitted to the depositories. A tentative scheme of demat procedure for CP is given in Chart 1 and procedure for dematerialisation of physical CP certificates is given in Chart 2. However, before CP can be permitted in demat form, the feasibility of the same needs to be examined from the legal point of view, as demat changes the character of the instrument. In demat form, transfer cannot be effected through endorsement and delivery.

(x) Validity of Rating

29. At present, the rating for the issuance of CP given by CRA is valid for a period of two months only. The Group recommends that rating agency may be given the discretion regarding the validity period, i.e., it can be either more or less than two months depending upon the rating agencies perception about the strength of the company/institution. CRA at the time of rating can indicate clearly the date when the rating is due for review.

(xi) Eligibility for Repo

30. If CP is permitted to be issued and held in demat form, then such CP issues may also be made an eligible security for undertaking Repo as this may enhance the liquidity of the product.

(xii) Underwriting/Co-acceptance

31. At present, issuers of CP are not permitted to have the issue of CP underwritten or co-accepted in any manner. The Group felt that there are advantages in permitting underwriting of CP as it will help in developing the CP market. This facility would provide comfort of assured funds required by the company. However, the Group felt that this issue needs to be examined in detail in the context of introduction of CP with Revolving Underwriting Facility (RUF) in India.

(xiii) Stamp Duty

32. As inter-state and investor-wise differences in the stamp duty rates have created distortions thereby hampering the growth CP market, the Group recommends that the matter may be taken up with the Government of India to prescribe uniform rate of stamp duty for all types of investors and across the states.

(xiv) Data Reporting

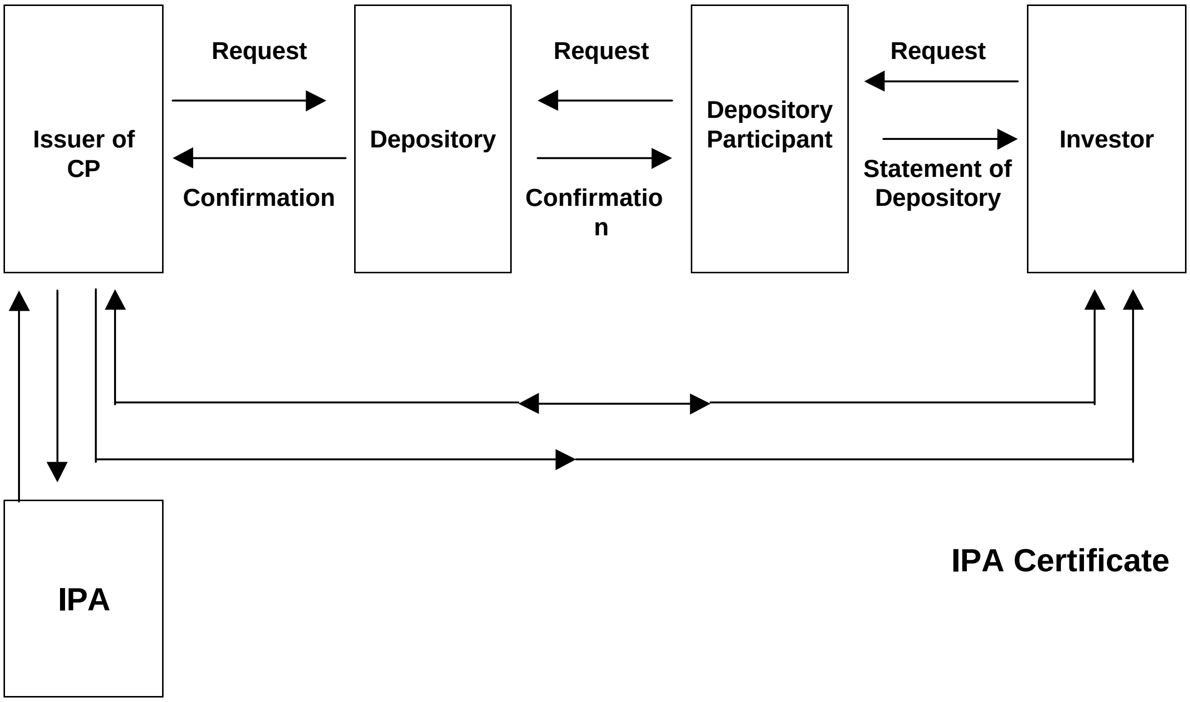
33. At present, lead banks are forwarding data furnished by the corporates, relating to CP issued during the fortnight to IECD, RBI. In the context of the recommendations by the Group to make CP a 'stand-alone' product, the question which arises is how to ensure flow of data/information on CP to RBI. RBI requires above data/information for reviewing the developments in money market and for the purpose of monetary policy formulation. In this regard, it is felt that issuers of CP may be required to furnish the data to RBI, through credit rating agency in place of the financing banks at present.

(xv) Benchmark for Pricing CP

34. The issue regarding non-availability of benchmark for pricing CP was discussed. The Group felt that the issue of absence of a benchmark rate should be considered in the context of money market as a whole. The various measures taken by the RBI in the recent years like removal of reserve requirements on inter-bank liabilities, deregulation of interest rates, introduction of ALM and risk management systems and introduction of FRAs/IRS for creating a conducive environment for emergence of a transparent and widely accepted Rupee benchmark rate for the money market were discussed. The Group is of the view that the RBI can only create necessary conditions for developing a benchmark which should basically emerge on its own in the market. It was also felt that once ALM and risk management systems are fully in place, a Rupee yield curve will emerge, which can serve as a benchmark for the pricing of various money market products.

Chart - 1

Demat Procedure For CP - Tentative Scheme

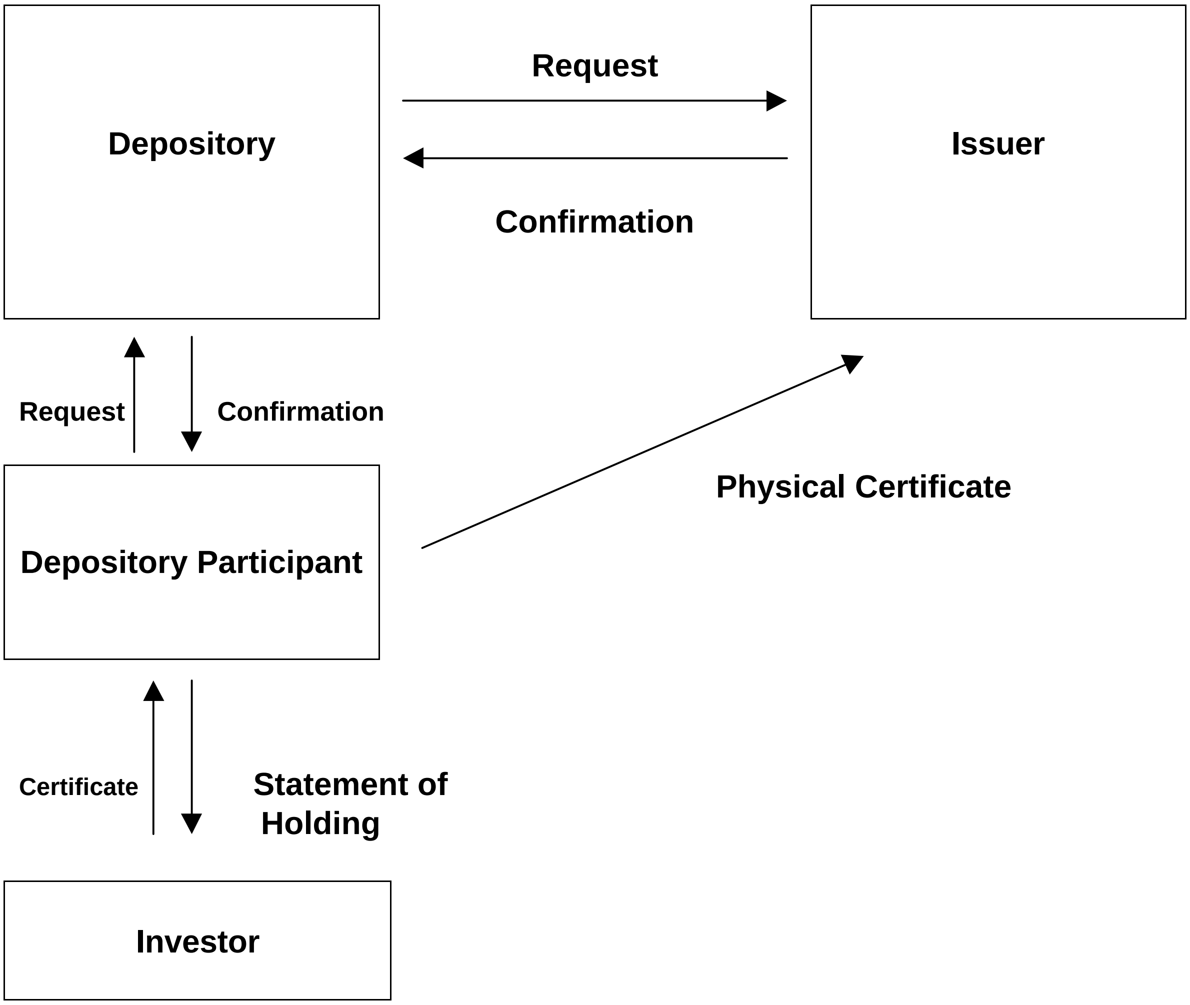


Steps :

1. After the deal is struck between issuer and investor, deal confirmations are exchanged.
2. Issuer enter into agreement with IPA.
3. IPA verify all the documents and issue certificates to that effect.
4. Issuer send IPA certificates to Investor.
5. Issuer request depository to credit the CP to the investor's account.
6. Investor request depository through depository participant for the credit of CP.
7. Depository matches the request from issuer and depository participant and give credit to the investor and send confirmation to issuer and depository participant.
8. Depository participant give statement of account to investor.

Chart - 2

Dematerialisation of Physical CP Certificates



Steps :

1. Investor surrender physical certificates to Depository Participant (DP).

2. DP make request for dematerialisation to depository which in turn request the issuer for the same.

3. Issuer confirm to depository certificate may demateralised and receive physical certificate from DP.

4. DP gives statement of holding to investor.

ANNEXURE I

Features of Commercial Paper

Extant major features of CP in India are as follows :

Eligibility for issuance of CP

Presently, companies, which satisfy the following requirements, shall be eligible to issue commercial paper :

- The tangible net worth of the company is not less than Rupees four crore
- Working capital (fund-based) limit of the company is not less than four crore
- The minimum credit rating of the company shall be P-2 from CRISIL or equivalent from other Rating agencies

The borrowal account of the company is classified as a Standard Asset.

Besides companies, Primary Dealers (PDs) and Satellite Dealers are also permitted to issue CP.

Period of CP

CP can be issued for maturities between 15 days to less than one year.

Denomination and minimum size of CP

CP can be issued in multiples of Rs.5 lakh. Minimum amount to be invested by single investor - Rs.25 lakh (face value).

Secondary market transaction may be for Rs.5 lakh or multiples thereof.

Ceiling on amount of issue

The aggregate amount to be raised by way of CP shall not exceed the working capital (fund-based) limit sanctioned by bank/s to an issuer company.

Mode of Issue

The commercial paper is in the form of usance promissory note negotiable by endorsement and delivery and issued at discount to face value.

Eligible Investors

CP can be issued to individuals, banks, companies, other corporate bodies registered in India and unincorporated bodies. However, CP issued to NRIs will not transferable and will be on a non-repatriable basis.

Procedure for Issue of CP

The company which proposes to issue CP has to submit its proposal to the financing banking company along with a certificate issued by Credit Rating Agency. The financing banking company, after satisfying that the issuing company fulfils the eligibility criteria takes the proposal on record. The issuing company thereafter makes arrangements for privately placing the issue and has to ensure that it shall completes the issue of CP with in the period of two weeks. Once the CP is issued, the financing banking company makes arrangements for reducing the working capital fund based limit to the extent of the amount of CP issued. The issuing company has to advise the RBI through its financing company the amount of CP actually issued with three days from the date of completion of the issue.

Prohibition against underwriting or co-acceptance

No company shall have the issue of CP under written or co-accepted.

ANNEXURE II

Commercial Paper - International Experience

A. Commercial Paper In U.S.A.

Commercial paper is a short-term unsecured promissory note issued by corporations and foreign governments. Because of the advantages of commercial paper for both investors and issuers, commercial paper has become one of America's most important debt markets. Commercial paper outstanding grew at an annual rate of 14 per cent from 1970 to 1991.

Characteristics of Commercial Paper

The Securities Act of 1933 requires that securities offered to the public be registered with the Securities and Exchange Commission. Registration requires extensive public disclosure, including issuing a prospectus on the offering, and is a time-consuming and expensive process. Most commercial paper is issued under Section 3(a)(3) of the 1933 Act which exempts from registration requirements short-term securities as long as they have certain characteristics. The exemption requirements have been a factor shaping the characteristics of the commercial paper market.

One requirement for exemption is that the maturity of commercial paper must be less than 270 days. In practice, most commercial paper has a maturity of between 5 and 45 days, with 30-35 days being the average maturity. Many issuers continuously roll over their commercial paper, financing a more-or-less constant amount of their assets using commercial paper. Continuous rollover of notes does not violate the nine-month maturity limit as long as the rollover is not automatic but is at the discretion of the issuer and the dealer. Many issuers will adjust the maturity of commercial paper to suit the requirements of an investor.

A second requirement for exemption is that notes must be of a type not ordinarily purchased by the general public. In practice, the denomination of commercial paper is large: minimum denominations are usually $100,000, although face amounts as low as $10,000 are available from some issuers. Because most investors are institutions, typical face amounts are in multiples of $1 million. Issuers will usually sell an investor the specific amount of commercial paper needed.

A third requirement for exemption is that proceeds from commercial paper issues be used to finance "current transactions", which include the funding of operating expenses and the funding of 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 requirement broadly, approving a variety of short-term uses of commercial paper proceeds. Proceeds are not traced directly from issue to use, so firms are required to show only that they have a sufficient "current transaction" capacity to justify the size of the commercial paper program (for example, a particular level of receivables or inventory). Firms are allowed to finance constructions as long as the commercial paper financing is temporary and to be paid off shortly after completion of construction with long-term funding through a bond issue, bank loan, or internally generated cash flow.

Like Treasury bills, commercial paper is typically a discount security: the investor purchases notes at less than face value and receives the face value at maturity. The difference between the purchase price and the face value, called the discount, is the interest received on the investment. Occasionally, investors request that paper be issued as an interest-bearing note. The investor pays the face value and, at maturity, receives the face value and accrued interest. All commercial paper interest rates are quoted on a discount basis.

Until the 1980s, most commercial paper was issued in physical form in which the obligation of the issuer to pay the face amount at maturity is recorded by printed certificates that are issued to the investor in exchange for funds. The certificates are held, usually by a safekeeping agent hired by the investor, until presented for payment at maturity. The exchanges of funds for commercial paper first at issuance and then at redemption, called "settling" of the transaction, occur in one day. On the day the commercial paper is issued and sold, the investor receives and pays for the notes and the issuer receives the proceeds. On the day of maturity, the investor presents the notes and receives payment. Commercial banks, in their role as issuing, paying, and clearing agents, facilitate the settling of commercial paper by carrying out the exchanges between issuer, investor, and dealer required to transfer commercial paper for funds.

An increasing amount of commercial paper is being issued in book-entry form in which the physical commercial paper certificates are replaced by entries in computerized accounts. Book-entry systems will eventually completely replace the physical printing and delivery of notes. The Depository Trust Company (DTC), a clearing co-operative operated by member banks, began plans in September 1990 to convert most commercial paper transactions to book-entry form. By May 1992, more than 40 per cent of commercial paper was issued through the DTC in book-entry form.

The advantages of a paperless system are significant. The fees and costs associated with the book-entry system will, in the long run, be significantly less than under the physical delivery system. The expense of delivering and verifying certificates and the risks of messengers failing to deliver certificates on time will be eliminated. The problem of daylight overdrafts, which arise form non-synchronous issuing and redeeming of commercial paper, will be reduced since all transactions between an issuing agent and a paying agent will be settled with a single end-of-day wire transaction.

Placement and Role of the Dealer

Most firms place their paper through dealers who, acting as principals, purchase commercial paper 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 paper. There are approximately 125 direct issuers, most of which are finance companies or bank holding companies. These issuers sell significant amounts of commercial paper on a continuous basis.

The largest commercial paper dealers are still the investment banks, including Merrill Lynch, Goldman Sachs, and Shearson Lehman. Commercial bank holding companies with large commercial paper dealer subsidiaries include Bankers Trust, CitiCorp, Bank America, and J.P. Morgan. 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, which makes it difficult to assemble blocks of paper large enough to facilitate secondary trading. Partly it reflects the short maturity of the paper: investors know how long they want to invest cash and, barring some unforeseen cash need, hold commercial paper to maturity. Dealers will sometimes purchase paper from issuers of investors, hold the paper in inventory and subsequently trade it. Bids for commercial paper of the largest issuers are available through brokers.

Ratings

Since 1970, when the Penn Central Transportation Co. defaulted with $82 million of commercial paper outstanding, almost all commercial paper has carried ratings from one or more rating agency. Rating agencies rely on a wide variety of information in assessing the default risk of an issuer. The analysis is largely based on the firm's historical and projected operating results and its financial structure. Relevant characteristics include size (both absolute and compared to competitors), profitability (including the level and variation of profits), and leverage.

Backup Liquidity

Commercial paper issuers maintain access to funds that can be used to pay off all or some of their maturing commercial paper and other short-term debt. These funds are either in the form of their own cash reserves or bank lines of credit. Rating agencies require evidence of short-term liquidity and will not issue a commercial paper rating without it. The highest-rated issuers can maintain liquidity backup of as little as 50 per cent of commercial paper 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 commercial paper rating, they will 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 commercial paper if the issuer cannot. 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 commercial paper market is the backing of commercial paper with assets. The risk of most commercial paper 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 receivable. Asset-backed paper is one way smaller, riskier firms can access the commercial paper market.

Asset-backed commercial paper is issued by a company, called a special purpose entity, which purchases receivables from one firm or a group of firms and finances the purchase with funds raised in the commercial paper 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 commercial paper it issues is isolated from the risk of the firm or firms which originated the receivables.

Swaps

A factor in the growth of the commercial paper market during the 1980s has been the rapid growth in the market for interest rate swaps. Interest rate swaps are one of a variety of relatively new instruments that have significantly increased the financing options of commercial paper issuers. Swaps provide issuers with flexibility to rapidly restructure their liabilities, to raise funds at reduced costs, and to hedge risks arising from short-term financing programs.

B. Commercial Paper In United Kingdom

The London Money Markets

The powers conferred on the Treasury by the Banking Act 1979 to remove specified transactions from the definition of deposit-taking within that Act were used to allow corporate issues of sterling short-term debt, subject to certain requirements designed to provide investor protection. These requirements are as follows :

(i) The issuing company should be listed on the International Stock Exchange and have net assets of £50 million or more, or be the wholly-owned subsidiary, and issue under the guarantee, of such a company.

(ii) Issues should have an original maturity of between 7 and 364 days.

(iii) Issues should be in denominations of £500,000 or £1 million (the minimum was subsequently reduced to £100,000), and

(iv) Issues must carry a statement that the issuer or its guaranteeing parent is in compliance with the International Stock Exchange Listing Rules.

For statistical purposes, issuers are asked to notify the Bank, at the commencement or extension of any programme, of the total amount of paper they propose to issue under that programme, and to provide monthly returns of the amount of sterling commercial paper outstanding and of issues and redemptions made since the previous return.

C. CP Market in Japan

Commercial Paper (CP) is an unsecured promissory note which business corporations issue in open market to raise short-term funds. The domestic CP market was established in November 1987 as Japan's newest open market. Its minimum issue unit was set at ¥100 million, and the issue term was 1-6 months at the time, but it was revised to 2 weeks to 9 months in December 1988. Interest-bearing is based on discount method. At the time of issue, nine backup lines are required, or nine guarantees by financial institutions are needed. The amount of the backup line is dependent on the judgement of rating agencies.

Initially, eligibility standards for unsecured ordinary corporate bonds were applied to CP issuing companies, but CP rating standards were introduced in December 1988 (original standards remained at this time). Stamp duty was imposed on CP, which is a promissory note. Originally, a graduated tax rate corresponding to face amount was applied as in the case of ordinary bills, but in response to the request from issues, stamp duty was changed into a fixed tax rate of ¥5,000 in 1990 (CP is not subject to withholding tax and securities transaction tax).

Meanwhile, in addition to the above measures to improve CP marketability, arbitrage between large-lot time deposit was activated. The CP issue balance increased rapidly, and stood at ¥14 trillion in May 1990, a little over two years since the start of the market.

STATEMENT

International Comparison : Framework of CP Market

	Japan	United States	Europe	United Kingdom
Face Amount	¥ 100 million or more	Usually $100,000 or more	Usually $100,000 or more	£100,000 or more
Term	2 weeks to 9 months	Within 270 days	7 days to 1 year	7 days to 5 years
Issuing Mode	Indirect	Indirect and Direct	Indirect	Indirect and Direct
Issuing Companies	1 Companies which obtained CP ratings of the highest A_1 or the equivalent. 2. Among companies with CP ratings of the second highest A_2 or the equivalent, those with net assets of ¥33 billion or more. Provided that only securities finance companies and securities companies are approved among finance related companies.	No special restrictions	No special restrictions	Listed companies with net assets of £25 million or more or their 100% subsidiaries
Ratings	Required from 2 or more companies	Required from 2 or more companies	Not Required	Not Required
Backup Line	In principle, required	In principle, required	Not Required	Not Required
Secondary Market	"Gensaki" transactions are active	Almost not-existent	It exists	Almost not-existent