Shyamala Gopinath: Issues in strengthening commercial paper market

Address by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at a seminar on “Issues in strengthening commercial paper market”, organised by the Bombay Chamber of Commerce and Industry and Fixed Income, Money Market & Derivatives Association, Mumbai, 17 January 2005.

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I am happy to be with you today in this seminar on “Issues in Strengthening Commercial Paper Market”. I am sure the seminar will bring out issues, which would be useful in further strengthening the CP market.

It is worth noting that during late the 1980s, call/notice market was virtually the only segment in Indian money market. Today, we have a variety of new instruments e.g., CD, CP, Treasury bills, repo and CBLO catering to the varied needs of market participants.

What has been the genesis of the CP market in market in India? How far has it come about? What are the outstanding issues? Let me share with you some of my thoughts on some of these issues.

Genesis

India initiated reforms in the money market way back in 1987. 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 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 then formally introduced in the market on January 1, 1990. We, thus, have a nearly 15-year history of this market.

At the time of introduction, only top rated corporates with tangible net worth of not less than Rs. 10 crore were allowed to issue CP with maturity between 3-6 months from the date of issue. Further, issuance of the CP had to be carved out of the working capital (fund based) limit and it was also stipulated that CP could be issued in multiples of Rs. 25 lakh and the amount to be invested by a single investor should not be less than Rs 1 crore.

These guidelines had been reviewed from time to time. However, major changes were effected last in October 2000, when the organic link of issuance of CP in relation to working capital (fund based) limit was severed and *CP was allowed to be issued as a “stand alone” product*. At present, CP issuers should have minimum credit rating P2 or its equivalent and CP can be issued in denomination of Rs. 5 lakh or multiple thereof. CP can be issued in dematerialised form and non-bank entities including corporates may provide guarantee for CP issue subject to some prudential guidelines.

Recent trends in CP market

As you are aware, 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. 577 crore as at the end of the year 1992-93 (Annex I). Following various relaxations in the terms and conditions for issue of CP *viz*., eligibility criteria, denomination of CP, quantum of CP that can be issued against maximum permissible bank finance (MBPF) and maturity of CP during the following years coupled with decline in discount rates, CP issuances gathered momentum thereafter and reached Rs. 7,224 crore by end-March 2002.

The market experienced some sluggishness during January-October 2003. However, issuances of CP have increased in recent period following increasing investment interests seen from mutual funds and cost effectiveness in issuances of CP. Accordingly, the outstanding amount of CP increased substantially from the level of Rs. 9,131 crore in March 2004 to Rs. 12,107 crore by December 2004. This is the highest ever level achieved by the CP market since its inception.

Issuers' profile in CP market has changed remarkably in recent period. 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 86 per cent in 2000-01 declined progressively to 34 per cent in 2004-05 so far. This was not only on account of enhanced efficiency in their operations, but also due to larger internal accruals and better cash management. Corporates raise funds at comparable rates from banks without incurring any additional cost towards stamp duty, demat costs, fees for IPA etc. associated with the launching of CP.

The share of Leasing and Finance Companies (LFC) has started showing markedly increasing trend from only 13 per cent in 2000-01 to as much as 38 percent during 2003-04. Further, for the first time since the introduction of CP in 1990, in the current financial year up to December 2004, the share of Lasing and Finance Companies at 54 per cent is more than the share of manufacturing companies at 34 per cent.

The shares of FIs have also increased dramatically from an average of only one percent during 2001-02 to 18 percent during 2003-04 before declining to 12 per cent during 2004-05 so far.

Regarding ratings, although issuers with credit rating of P2 of CRISIL or equivalent can raise resources through CP, in effect, the CP issuance is dominated by the prime-rated companies i.e., companies having credit rating of P1+ or its equivalent. Even then, there has been some decline in the share of CPs issued by prime-rated companies. During 2001-02, as much as about 93 per cent of CP amount issued were by prime-rated companies, which declined to 87 per cent during 2004-05 so far. Correspondingly, the share of medium-rated companies increased from 7 per cent to 13 per cent over this period. This could be largely on account of search for higher return by investors in an environment of substantial improvement in liquidity in the economy.

As you are aware, as a part of the eligibility criteria, the minimum tangible net worth of the corporate was reduced from the initial level of Rs. 10 crore to Rs. 4 crore in October 1993. However, corporates having tangible net worth of up to Rs.10 crore do not account for even 1 per cent of the total CP issuance. The market is, however, dominated by corporates having tangible net worth of Rs. 50 crore and above, which accounted for more than 93 per cent of the total CP amount issued during 2002-03 and 2003-04. Their share has, however, declined to 88 per cent during 2004-05 so far.

In this backdrop, let me now turn to some of the recent steps taken by the Reserve Bank to strengthen the CP Market.

Recent steps taken by RBI to further develop the market

As you know, in order to further develop the CP market, we had placed a Status Paper on CP market in India on the RBI website on July 7, 2004 for inviting comments/suggestions from market participants. Subsequently, the issues were discussed with market participants as also in the Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets. Accordingly, in the mid-term Review of the Annual Policy Statement for the year 2004-05, the following three recommendations were accepted viz.,

(i) reduction in minimum maturity period from 15 days to 7 days;

(ii) reporting of issuance of CP on the Negotiated Dealing System (NDS) platform by the end of the day; and

(iii) constitution of a group comprising market participants to rationalize and standardise, wherever possible, various aspects of processing, settlement and documentation of CP issuance with a view to achieving the settlement at least on T+1 basis.

In this regard, I would like to inform you that the minimum maturity period has since been reduced to 7 days with effect from October 26, 2004. Further, necessary software development has been taken up for reporting of CP on NDS platform. We expect it to be ready by early this year. As regards the constitution of the Group to rationalize and standardise the various market practices with a view to achieving the settlement at least on T+1 basis, the Group has been set up under the chairmanship of Shri C.E.S. Azariah, Chief General Manager, State Bank of India within FIMMDA. I am told the Group is expected to submit the report soon.

The other recommendations made in the Status paper are as follows:

- *Rating:* The Status Paper 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. In this context, it may be noted that the CP market is generally accessible only to companies with high credit quality as only such companies can find buyers for their commercial paper. This is evidenced from the fact that prime rated companies (i.e., P1+ or equivalent) constituted about 87 per cent of the total amount of CP issued during 2004-05 so far as indicated above. Therefore, investors in the market appear to require commercial paper to have virtually no default risk. It may, however, be noted that we continue to maintain P2 or its equivalent as the minimum credit rating required for issue of CP.
- *Asset backed commercial paper:* The Status Report recommended introduction of ABCP for further deepening the CP market. Asset-backed commercial paper is fundamentally different from traditional commercial paper. It is essentially a pass through security typically with accounts receivable and other current assets as the backing asset that is being passed through just as an asset backed mortgage security with mortgages payments being passed through. In a way, asset-backed issuers securitise a portfolio of cash generating assets funded by liabilities including CP. This process may enable smaller firms even with higher risks to access the CP market. Traditionally, banks use ABCP as a liquidity management instrument. This is under examination of RBI.
- *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, the Status Paper proposed to make reporting all CP deals mandatory, in line with the same for call/notice money deals, on the NDS platform so that benchmarking becomes more appropriate in the economy. I am happy to indicate that the necessary software for reporting of CP on NDS platform is being developed. This would further enhance transparency in the market.

Concluding observations

In conclusion, I may say that the adequate growth of CP market in India is immensely important because it not only provides investors an avenue to invest in short-term quality papers, issuers also get an opportunity to fund themselves for working capital purposes from diversified sources including the banking sector.

I sincerely appreciate BCCI and FIMMDA for taking the initiative in organising this seminar, where, I am sure that the participants would take this opportunity to discuss in detail the various issues pertaining to strengthening the CP market. The Reserve Bank would welcome suggestions for further development of CP market.

Annex I
Commercial paper:* outstanding amount and range of discount

As on 31 March of	Total outstanding (Rs crore)	Range of discount (per cent)[@]
1993	577	15.76-16.00
1994	3,264	11.01-12.00
1995	604	14.00-15.00
1996	76	20.15[#]
1997	646	11.25-12.25
1998	1,500	14.22-15.50

1999	4,770	10.05-11.50
2000	5,663	10.00-12.00
2001	5,846	8.75-11.25
2002	7,224	7.41-10.25
2003	5,749	6.00-7.75
2004	9,131	4.70-6.50
December 2004	12,107	5.10-7.10

* Issued at face value by companies. @ Range of typical effective discount rate per annum during the fortnight. # All transactions contracted at this rate.

Source: RBI, *Handbook of Statistics on the Indian Economy, 2003-04*.