Management of Fixed Income Securities
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Module No # 06
Lecture No # 29
Short –Term Corporate Bond Markets

Good morning, so in previous class we discussed about the government securities market particularly the how these securities are issued, what are those different types of instruments which are available and we discussed about the government securities market with respect to India as well as U.S. to make a comparative analysis we have considered one market from the emerging economy and another market from the developed economy. Today's discussion will be based on corporate bond market. So, we will discuss about short-term bond market, then we can move towards the long-term bond market.

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So, the concepts, what we are going to cover in today's session that will be who are those players who are playing the significant role in the corporate bond market. And particularly as we know that the most important instrument which is traded in the corporate bond market that is commercial paper. We will be concentrating more on that commercial paper, because the commercial papers are traded both in the developed economy and as well as the emerging economy like India.

So, like our government securities market discussion will be again discussing about the commercial paper market in India and the commercial paper market in U.S.

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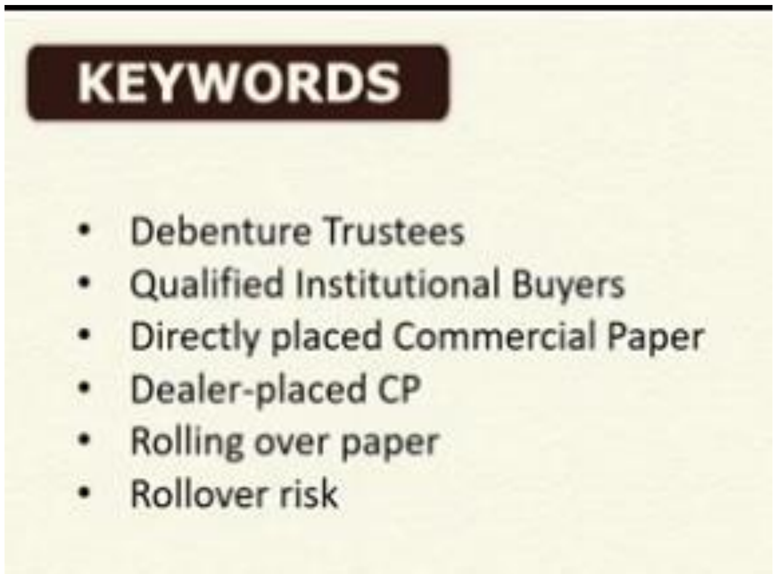

So, you will come across certain keywords what basically over the sessions will be using that is debenture trustees, qualified institutional buyers, directly placed commercial paper, dealer placed commercial paper, rolling over paper, rollover risk and all kinds of things. So, these are the some of the keywords basically will get to know that whenever we are going to discuss about the short-term securities market with respect to an emerging economy and as well as the developed economy.

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So, whenever you talk about the corporate bond market you see that like your government securities market, we have certain players who are playing basically the significant role in this particular segment and who are those players. Obviously from the investment point of view we have the issuers and we have the investors. So, who are those issuers and who are those investors. You see if you look at the major players in the corporate bond market in India who basically issues these commercial papers mostly the companies are basically issuing these commercial papers right. And the non-banking financial companies they are also issuing these commercial papers. Banks are not that kind of role they play in terms of these but if you see that mostly the commercial papers issued by the companies.

Then we have the debenture trustees there is another player who basically play the role in that case, these are basically secures any issue of debentures by corporate entities for the benefit of the debenture investors. As you know that the debentures are not secured instruments, so in that case there are certain development debenture trustees, who are basically approved by or the registered with securities exchange board of India (SEBI) they basically play in this particular context.

So, another player we have the qualified institutional buyers and whenever you talk about the qualified institutional buyers, they are basically the institutional and high net worth individuals. Who are basically allowed to private placement market that is a part of this corporate bond market or we can say part of the primary market of the corporate bonds. You see these players whatever we are talking about these players basically related to the aggregate bond market it includes the short-term and long-term bond.

The companies are issuing the commercial papers, debenture and all and the banks are issuing the certificate of deposits and all these things, so that also you should keep in the mind. So, whenever you talk about the qualified institutional buyers, who are those qualified institutional buyers? The qualified institutional buyers are like commercial banks, insurance companies, mutual funds, state industrial development corporation, pension funds and provident funds.

But the whenever you talk about the pension funds or provident funds, they should have a minimum corpus of rupees 25 crores and the foreign institutional investors are the portfolio investors who have registered with securities and exchange board of India that is SEBI. And also, some venture capital funds which are also registered with SEBI, largely these are basically considered as a qualified institutional buyer in the bond market or in the financial market.

Apart from these players these are the major players, apart from these players we have some retail individual investors or we can say that retail investors, the small investors. The small investors also can invest in the corporate bond market and they can apply for the investment of the worth 2 lakhs or less. There is a certain limit for that but the small investors also are eligible to invest in this particular market, but their total investment amount is limited.

And already what I told you that whenever you talk about the short-term corporate bond market largely the commercial paper is the major short-term debt instrument, which are traded in the corporate bond market in India and as well as also in the U.S market. So, the commercial papers are the most used instrument in this particular segment.

So largely our discussion will be based upon the different aspects like the features of commercial papers and what is the market for the commercial papers, how the commercial papers are traded in the market, who can issue the commercial papers; all those things basically you will get to know in this particular session.

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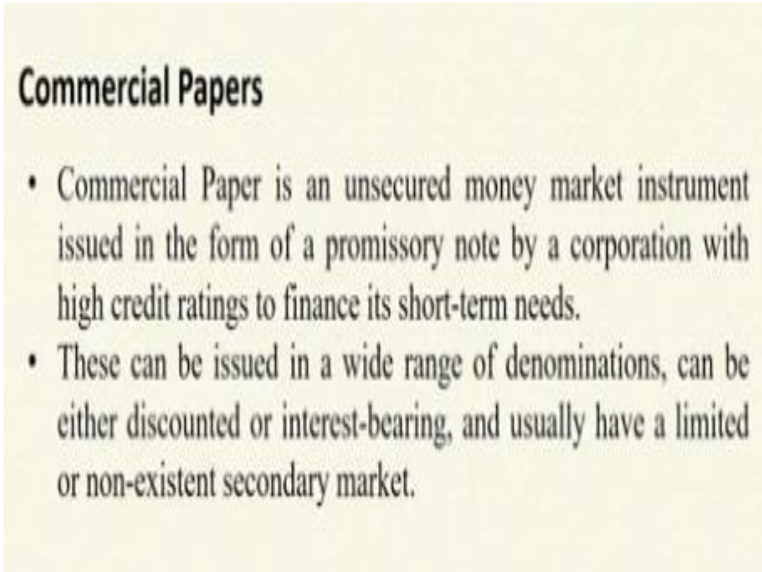

So, whenever you talk about the commercial papers, what exactly the commercial paper is? Commercial paper is also an unsecured instrument, it is an unsecured instrument it is not backed by any kind of assets. So, if you formally define this commercial paper, the commercial paper basically is an unsecured money market instrument why we call it the money market instrument because it is a short-term instrument, which is issued in the form of a promissory note by a corporation with high credit ratings to finance its short-term needs. Whenever companies need the short-term financing or they required short-term money for their operational activities they can take the help of the commercial papers to raise the money. So, they can issue the commercial papers to raise the money to fulfill their short-term requirements.

So, these instruments are issued in a wide range of denominations, it can be either discounted or interest bearing. But if you look at the aggregate market in India you will not find a very developed secondary market for this mostly the commercial papers are available in the primary market. So, whenever the company needs a short-term financing, they can go and issue these commercial papers and accordingly their financing requirements can be fulfilled.

So that actually you have to keep in the mind, we do not have a very mature or developed market in terms of a secondary market with respect to these commercial papers. So, this is the way the commercial paper is defined.

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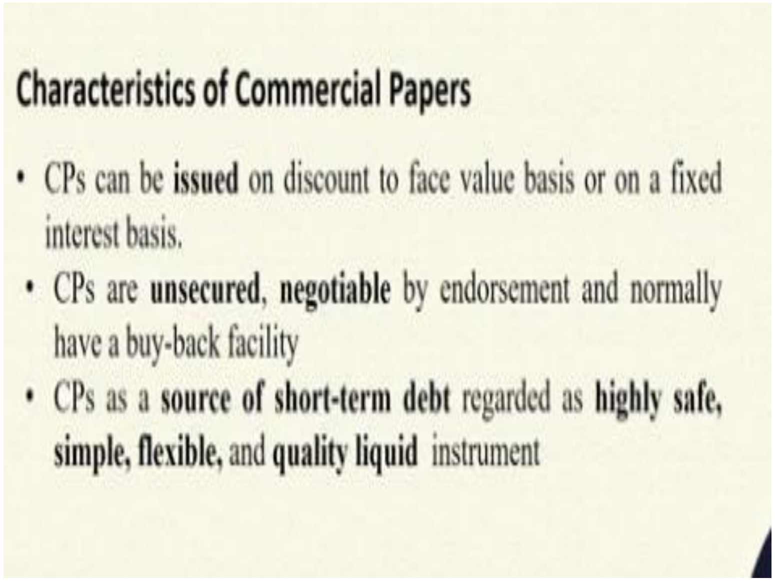

Then we will see that what are those characteristics of the commercial paper or we can say that the features of the commercial paper. Already we have discussed that the commercial papers can be issued on a discount to the face value basis or it can also issue on a fixed interest basis. So, both the options are available with respect to the commercial paper. So, these are basically unsecured, negotiable and normally have a buyback facility if the issuer wants, they can buyback those particular commercial papers from the investors.

And this is a short-term debt financing, this is a major source of short-term debt for the companies and it is regarded as a highly safe, simple, flexible and quality liquid instrument. Because it is the term to maturity of this instruments are quite small or it is a completely short-term instrument then the liquidity of this particular instruments is also relatively higher. So, these are also considered as a safe instrument and highly liquid instrument, that is what basically the basic feature of the commercial papers.

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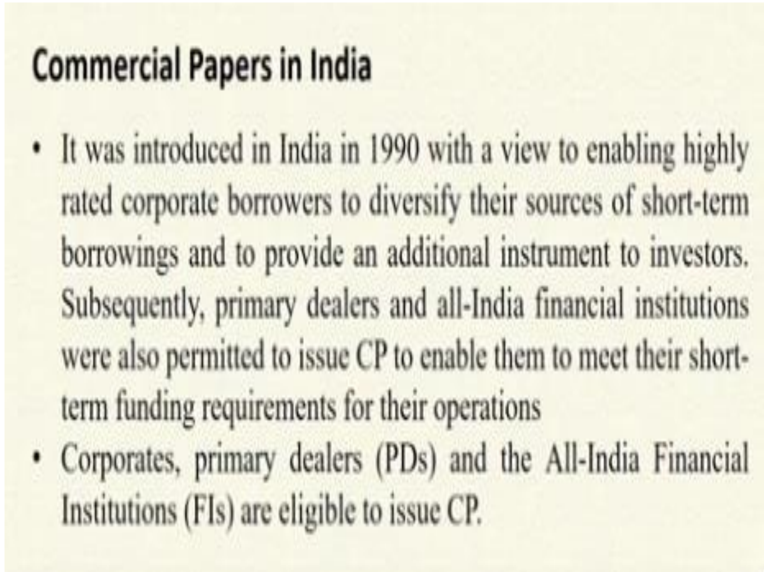

Then if you see that or if you look at the Indian market, if you little bit go towards the history or historical development of the emergence of these commercial papers market in India. It was introduced in 1990 with an objective of increasing the short-term financing for the corporates or to fulfill the short-term requirements of the corporates. So that's why it is a who can issue this whenever we take the case that it is a safe instrument it should be issued by the highly rated corporate borrowers and the basic objective is to diversify the sources of short-term borrowings.

And also, it will provide an additional instrument to the investors. The investors having the short-term horizon period they can always rely upon this commercial paper as a part of their investment alternatives. So subsequently the primary dealers and all India financial institutions some specific institutions they are also permitted to issue the commercial paper to meet their short-term funding requirements for their operations.

So that's, why they got the permission from the regulatory authority they can also use the commercial paper as a source of financing for them. So that's why in general what we can say the companies or the corporates, primary dealers and the all-India financial institutions are eligible to issue the commercial paper in Indian market.

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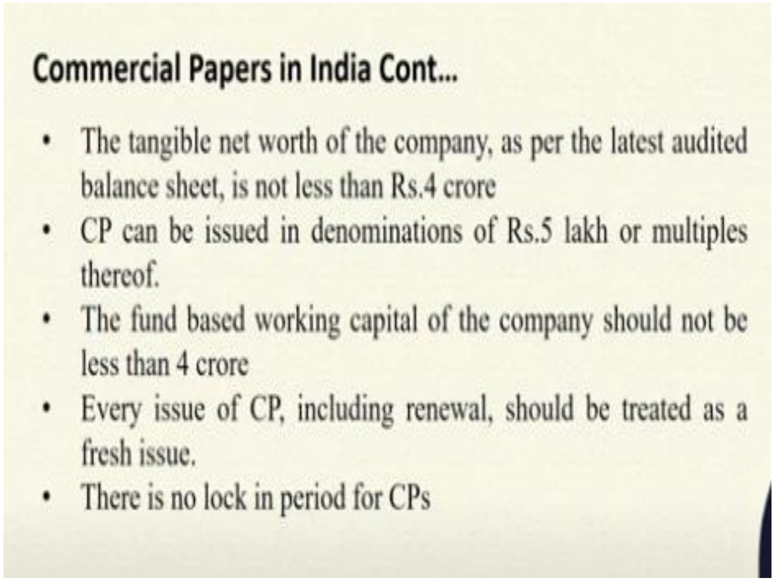
Commercial Papers in India Cont...

- The tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs.4 crore
- CP can be issued in denominations of Rs.5 lakh or multiples thereof.
- The fund based working capital of the company should not be less than 4 crore
- Every issue of CP, including renewal, should be treated as a fresh issue.
- There is no lock in period for CPs

Then if you see that who can issue these commercial papers, because all the companies are not eligible to issue the commercial papers in the market. So, in the beginning we have discussed that only the companies with high credit rating which are highly rated those companies are eligible to issue the commercial papers. But with that we have certain restrictions certain kind of criteria the companies have to fulfill whenever they will be issuing the commercial papers in the market.

Who are those or what are those conditions first of all the tangible net worth of the company as for the latest audited balance sheet should not be less than 4 crores. The tangible net worth of the company should not be less than 4 crores as per the audited balance sheet that is number one condition. And number 2 the commercial papers can be issued in the denomination of 5 lakhs or the multiple of that, so the commercial papers denominations are always reflected with a value of rupees 5 lakhs or the multiple of the 5 lakhs.

And the working capital the fund based working capital of the company should not be also less than 4 crores. So, these are all basically the regulatory requirements for the company have to fulfill whenever they will be eligible to issue the commercial papers in the market. So, every issue of commercial papers including the renewal should be treated as a fresh issue.

Even if somebody is renewing the issuance of the commercial paper that issue will be considered as a fresh issue and there is no lock-in period for the commercial papers. Lock-in period concept is not involved with respect to the commercial papers which are issued in the market.

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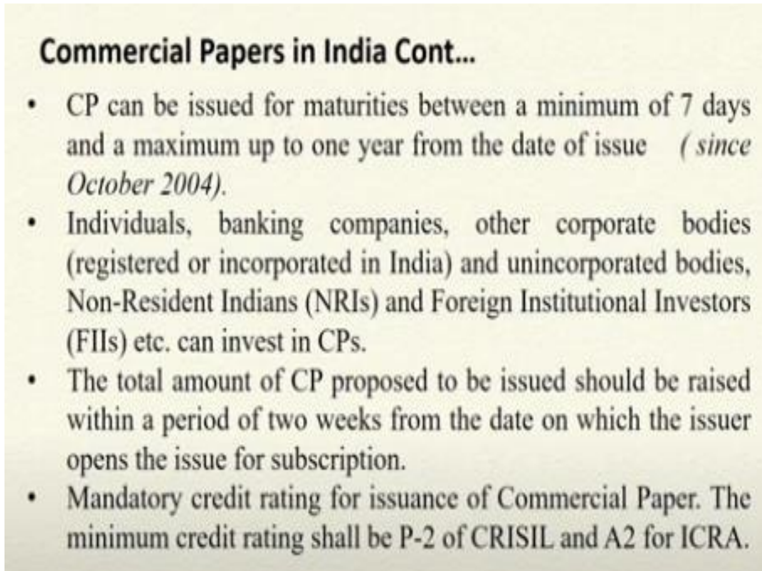

So, then the CP what is the maturity period of the commercial papers. In India the commercial papers can be issued for a maturity between the minimum period of 7 days and the maximum up to 1 year from the date of issue. This is applicable since October 2004, this particular regulation is implemented since October 2004, the minimum maturity period is 7 days and maximum it can go up to 1 year.

And already we have discussed who can invest, we have discussed about who can issue, now we are discussing who can invest. The individuals, banking companies, other companies or other corporate bodies or we can say that nonresident Indians, foreign institutional investors all can invest in the CP market. The CP market is open to all type of players who are actively participating in the financial market.

So, whenever the particular issue is or particular commercial papers are issued, the total amount of commercial paper which are the companies proposing to be issued should be raised within a period of 2 weeks from the date on which the issuer opens this issue for this subscription. Whenever the company has thought of raising that particular issue that total amount what they are proposing that should be issued within a period of 2 weeks that is the regulatory norm they have to follow.

And the mandatory credit rating for the issuance of the commercial paper if you look at it should be P-2 for the CRISIL and A-2 for the ICRA. Already we have discussed about the credit rating concept. So, the companies which have this kind of rating they are basically eligible to issue the commercial paper in the Indian market.

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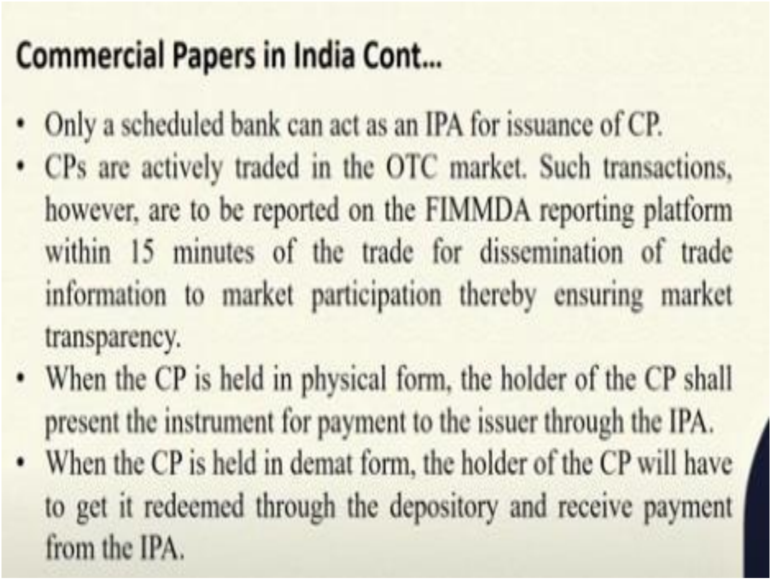

So, then we will see that what is the basic operational modality of the issuance of the commercial paper. So, here we have a concept of the IPA and the IPA basically plays a significant role in this particular context. And who can become this IPA, only a scheduled bank can act as an IPA for the insurance of the commercial property. And commercial papers are actively traded in the OTC market that is the over-the-counter market.

But these transactions; has to be reported in FIMMDA platform within the 15 minutes of the trade and what is the objective of the reporting that trading issues in the FIMMDA platform to disseminate the trade information to market participants. And once the information is disseminated to all the market participants then we can assume that the transparency in the market is going to be increasing.

But when the CP is held in a physical form the commercial paper shall present the instrument for the payment to the issuer through the IPA. And when the commercial paper is held in the demat form the holder of the commercial paper will have to get redeemed through the depository and receive payments from the IPA. So, IPA is the basically the intermediary organization or the playing a mediating role between the issuer and the investors, so that is what basically what you have to keep in the mind then.

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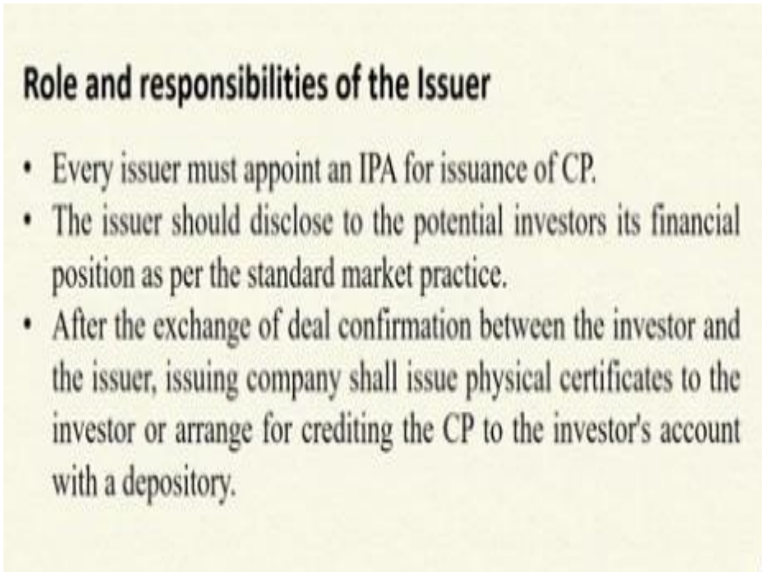

What is the responsibility of this work? Whenever any company is issuing the commercial paper what are those responsibility they should fulfill whenever they are issuing this commercial paper. The first of all every issuer should appoint an IPA, so generally the banks are acting as the IPA. And this is the basic objective of the issuer to disclose to all the financial information to all the potential investors. The investors should know all the financial details about the company; this is the standard practice what basically they have to follow.

So, all those data which are pertaining to this balance sheet or the cash flow statement of the company that has to be disseminated to all those investors, potential investors, who are inclined to invest in this particular market. So, after the exchange of the deal confirmation between the investor and the issuer, the issuing company can issue the certificate to the investor or arrange for crediting this commercial paper to the investors account with a depository.

So once this confirmation is done, the deal confirmation is completed. So, then this particular credit process will go on and the commercial papers can be credited to their account. And that thing will be done through the IPA's.

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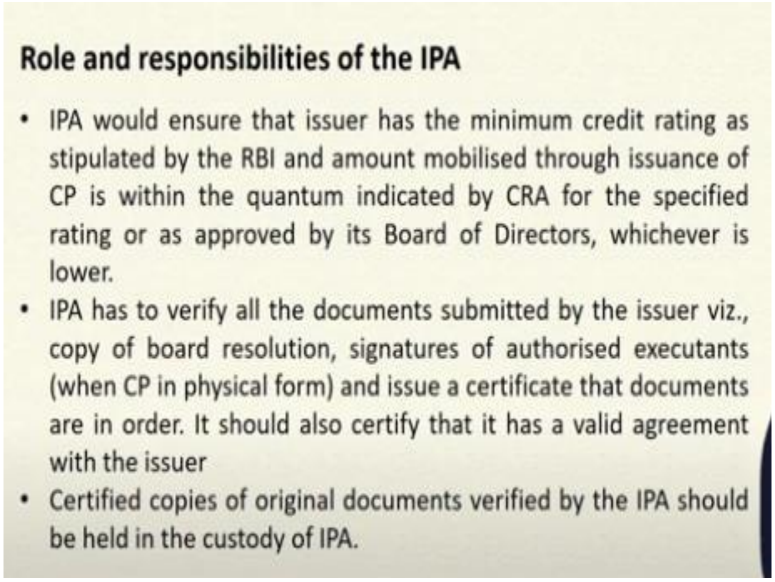

Then what is the responsibility of the IPA; The IPA should ensure that the issuer has the minimum credit rating as stipulated by the RBI. That means just now we have discussed that the companies who are eligible to issue this commercial paper they should have a minimum credit rating or above. So, it is the job of the IPA should ensure that the company has the adequate credit rating from the credit rating agency and they are eligible to issue these commercial papers.

And also, they should ensure that they are also eligible to mobilize this much amount of the fund through this issuance of the commercial papers. And the amount which is mobilized through the issuance of the commercial paper that should be within the quantum indicated by the credit rating agency for the specified rating or it should be approved by the board of directors of this particular company whichever is the lower that thing should be checked upon by this IPA.

So that is the basic role of the IPA to ensure that the particular company is within this particular state regulated regulatory limit to issue these particular commercial papers in the market. Another job is the IPA has to verify all the documents submitted by the issuer like the copy of the board resolution, signatures of the authorized executives, who are basically authorized to sign in that particular document and issue a certificate the documents are in order.

And it should also certify that this company has a valid agreement with the issuer. And the certified copies of the original documents also should be verified by the IPA and it should be in the custody of the IPA only. So, all those necessary things basically IPA has to check. That means the investor does not have to worry to check all those documents of the companies who are issuing these particular commercial papers.

This is the job of the IPA to ensure that all those requirements are fulfilled by the companies for issuance of these particular commercial papers. So, the IPA role is basically to give a confidence to the investor and as well as checking the regulatory norms for this issuance of the commercial papers in the market. So once those things are basically done then the investor has the confidence to invest in that type of commercial papers, who are basically issued by these corporates who are eligible to issue this particular instrument.

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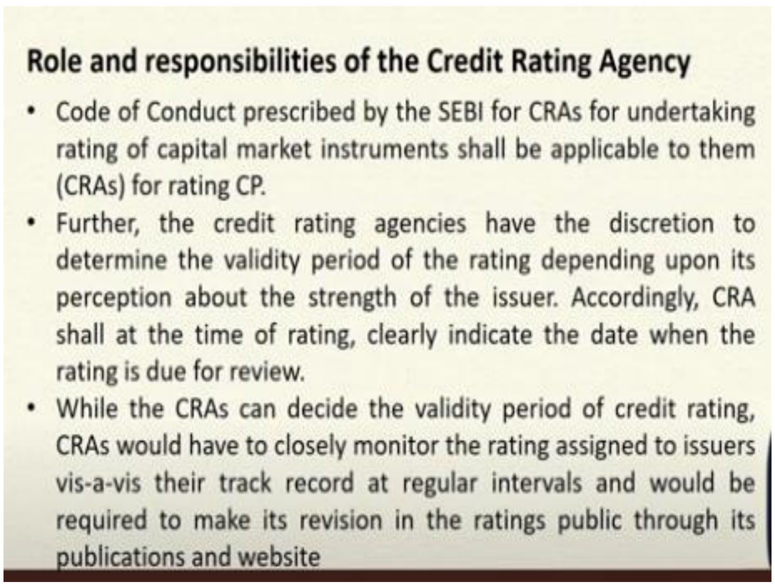

So, then the credit rating agency what they should do as per the SEBI for the credit rating agencies, they have to always go for rating this commercial papers. So, they have to undertake the rating of the capital market instrument which will be applicable to them for rating the CP. And the credit rating agencies also have the discrimination to determine the validity period of the rating. One rating is given maybe one company is using that rating for this issue.

But whether this particular rating is valid or not that also has to be checked out in a particular period. And accordingly, the credit rating agency sell at the time of rating clearly indicate that the date when the rating is due for the review. Because once the rating is given the rating is not basically permanent, so we have to see that whether the rating is valid or not.

So, the credit trading agencies can decide the validity period of the credit rating and the rating agencies would have to closely monitor the ratings which are assigned to these issuers their track record as at regular intervals. And they would be required to make its revision in the rating through its publication and the website that actually they have to keep in the mind.

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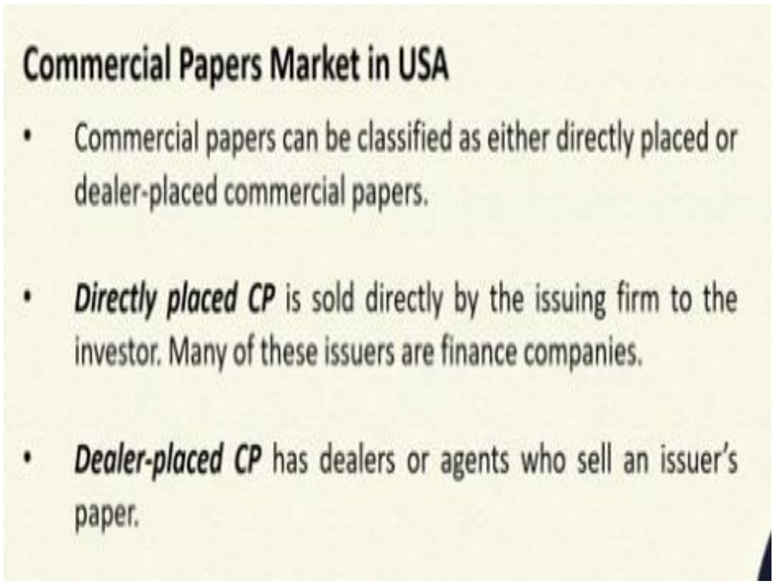

Now come to the commercial papers market in U.S, if you see that the commercial papers in the market in U.S can be classified in 2 types either they are directly placed or they can be placed through the dealer. That is so we have a directly placed market and we have a dealer placed commercial papers; so directly place CP is sold directly by the issuing firm to the investors and many of the issuers are basically the finance companies in U.S.

If you are talking about the dealer placed CP here the dealers or the agents who sell the issuer's paper on behalf of the issuers the dealers basically are selling that particular commercial papers in the market.

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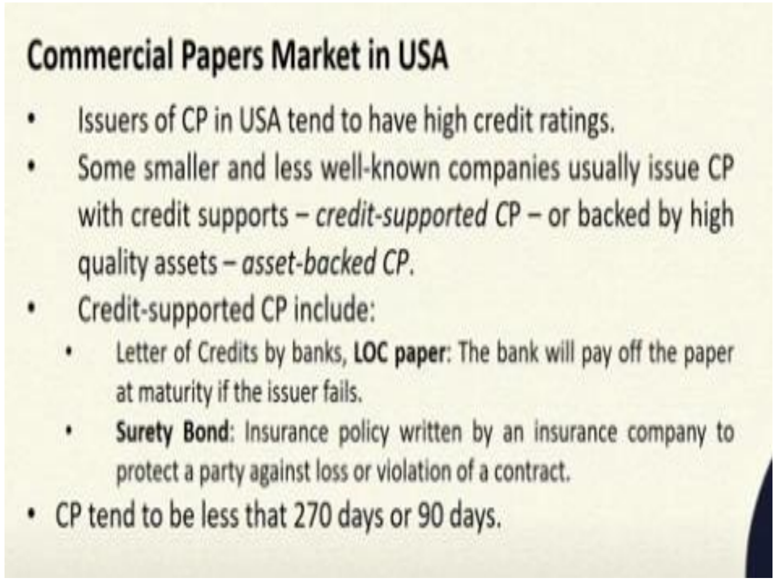

So again, credit rating also comes into the picture. The issuers of the commercial paper in U.S tend to have high credit ratings and there are some smaller and less known companies usually issues CP with credit supports. They are eligible to issue the commercial purpose through credit supports that is called the credit supported commercial papers. Or they should be backed by high quality assets that are called the asset backed commercial paper.

Even if in Indian context it is unsecured instrument but in U.S if it is backed by certain high-quality asset then some of the small companies can also issue the commercial papers. And the credit supported commercial purpose if you talk about either they should have a letter of credit by the banks that is called the LOC paper that means the bank will pay off the paper at maturity if the issuer fails. The bank has given the guarantee that if the issuers fails then that particular papers cash flow will be paid off by them.

And also, it can be credit supported through the surety bond, the insurance policy basically which is written by the insurance company to protect a party against the loss or the violation of the contract. So that also can play the role in this particular context. So, the CPs which are issued in U.S they are basically maturity period if you talk about then there tend to be less than 270 days or the 90 days. So, the period basically is different varies between the Indian market and the U.S market.

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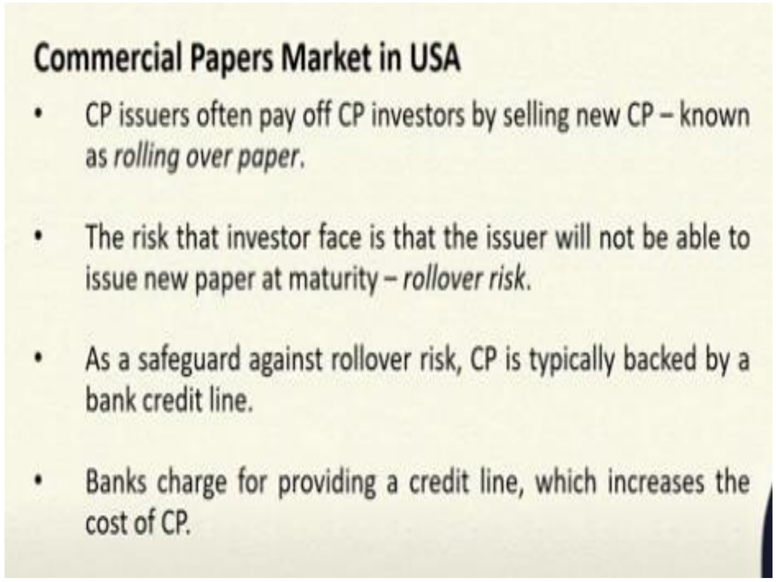

So, the commercial paper market if you look at the CP's basically who are the issuer, they often pay off the commercial paper investors by selling the new CP, which is called the rolling over paper. And the risk what the investors face is that the issuer will not be able to issue the new paper at the maturity that is called the rollover risk. If this particular concept works then the rollover risk basically comes into the picture.

So as a safeguard against the rollover risk the commercial paper is typically backed by a bank credit line. Banks basically charge for a for providing this credit line which increases the cost of the commercial paper. So, if it is backed by a bank credit line then to provide those services the bank basically charges certain money. So that's why it will increase the cost of the commercial papers in the market.

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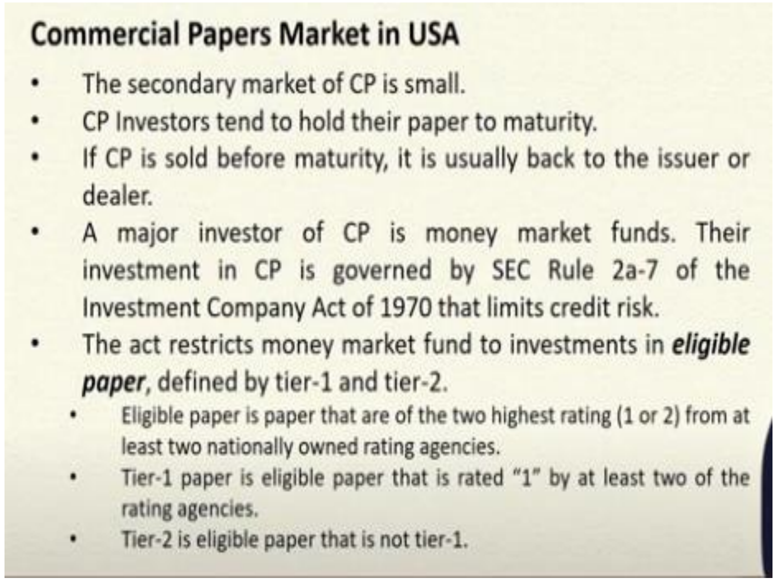

So, the secondary market in U.S also is quite small in terms of the commercial papers and the commercial paper investors generally tend to hold their paper to the maturity. So, if this CP is sold before the maturity, then it is usually back to the issuer or the dealer, the buyback concept what basically we have discussed before.

So, a major investor of CP is the money market funds in U.S. Their investment in the commercial paper generally governed by their SEC rule 2a-7 of the Investment Company Act of 1970 that basically limits the credit risk, this is basically for your information point of view. And this act basically restricts the money market fund to investments in eligible paper defined by tier 1 and tier 2.

So, the eligible paper is what it is the papers which are basically 2 highest credit rating 1or 2 from at least 2 nationally owned rating agencies. And the tier 1 paper is eligible paper, that is rated 1 by at least 2 of the rating agencies and tier 2 is eligible paper that is not tier 1. That is the way basically the particular regulations are defined in the U.S market.

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So, there are certain factors which are affecting the commercial paper market development in both the emerging and always as well as developed economy. One is credit quality of the issuer, the liquidity of the market and what are those alternative sources which are available to finance the short-term requirements of the companies and whether there is any proper adequate financial market infrastructure is there for the development or for issuance of the commercial paper and the working capital limits fixed by the banks for these particular companies. Because if they want to finance their short-term requirements, they can do it through the bank financing. So instead of that if they will go for this one of the commercial papers that will depend upon what is the limit the bank has fixed for them. So, these are the different factors which are affecting the commercial paper market development in the different economies.

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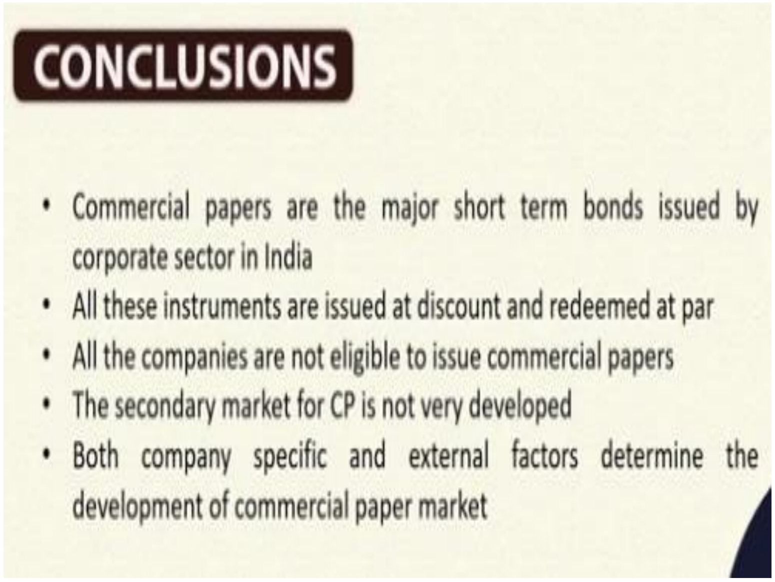

So, what basically we have discussed here the commercial papers are the short-term bonds issued by the corporate sector. All these most of the commercial papers are issued in the discount and redeemed at par. And all the companies are not eligible to issue the commercial papers they should fulfill certain requirements for that. The secondary market for the CP is not very developed. And both company specific and external factors generally determine the development of the commercial paper market across the globe. So, these are the overall things what basically we have discussed in today's class.

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So, these are the references what you can go through for the detailed discussion on this.

Thank you.