Commercial Paper

Meaning of Commercial Paper

Commercial paper is a commonly used type of unsecured, short-term debt instrument issued by corporations, typically used for the financing of payroll, accounts payable and inventories, and meeting other short-term liabilities. Maturities on commercial paper typically last several days, and rarely range longer than 270 days. Commercial paper is usually issued at a discount from face value and reflects prevailing market interest rates.

The introduction of Commercial Paper in India was considered the beginning of financial reforms in India. Post liberalization the Indian government introduced many short-term instruments to tackle the various financial needs and situations of financial crisis one of which was Commercial papers.

Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in Commercial Papers. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time.

Commercial Papers emerged as a source of short-term finance in India in the early nineties. As we discussed, Primary Dealers (PDs) and the All-India Financial Institutions (FIs) issue commercial papers which is an unsecured promissory note to raise funds for a short period of 90 days to 364 days.

The money raised by the commercial paper is generally very large. It is generally issued by one firm to another business firms, insurance companies, pension funds and banks. Its regulation comes under the purview of the Reserve Bank of India (RBI). As the RBI does not want to risk the funds, only the firms having good credit rating can issue the commercial paper.

Features of Commercial Paper

Few distinct features are:

- It is a short-term money market tool including a promissory note and a set maturity.
- It acts as an evidence certificate of unsecured debt.
- It is subscribed at a discount rate and can be issued in an interest-bearing application.
- The issuer guarantees the buyer to pay a fixed amount in future in terms of liquid cash and no assets.
- A company can directly issue the paper to investors or it can be done through banks/dealer banks.

Types of Commercial Paper

According to security, there are two types of commercial papers

- **Unsecured Commercial Papers –** These are traditional papers and allotted without any security.
- **Secured Commercial Papers –** It is also known as Asset-Backed Commercial Papers (ABCP) and assured by other financial assets.

Advantages of commercial papers

(i) It is quick and cost effective way of raising working capital.

(ii) Best way to the company to take the advantage of short term interest fluctuations in the market

(iii) It provides the exit option to the investors to quit the investment.

(iv) They are cheaper than a bank loan.

(v) As commercial papers are required to be rated, good rating reduces the cost of capital for the company.

(vi) It is unsecured and thus does not create any liens on assets of the company.

(vii) It has a wide range of maturity.

(viii) It is exempt from federal SEC and State securities registration requirements.

Disadvantages of commercial papers

(i) It is available only to a few selected blue chip and profitable companies.

(ii) By issuing commercial paper, the credit available from the banks may get reduced.

(iii) Issue of commercial paper is very closely regulated by the RBI guidelines.

Certificate of Deposit

Certificate of deposit (CD) is a money market instrument issued by a bank to raise funds from the secondary money market. It is issued for a specific period for a fixed amount of money with a fixed rate of interest. It is an arrangement between the depositor of money and the bank.

CD is issued in dematerialized form. The amount deposited for cannot be withdrawn till the maturity period, if it is withdrawn during the tenure of deposit then early withdrawal penalty needs to be paid. On maturity, principal amount and the interest on the same will be available for withdrawal, the depositor needs to decide the action on the matured amount.

- The Certificate of Deposit (CD) is an agreement between the depositor and the bank where a predetermined amount of money is fixed for a specific time period
- Issued by the Federal Deposit Insurance Corporation (FDIC) and regulated by the Reserve Bank of India, the CD is a promissory note, the interest on which is paid by the bank

A certificate of deposit (CD) is a time deposit, a financial product commonly sold by banks, thrift institutions, and credit unions. CDs differ from savings accounts in that the CD has a specific, fixed term (often one, three, or six months, or one to five years) and usually, a fixed interest rate. The bank expects CD to be held until maturity, at which time they can be withdrawn and interest paid.

Features of Certificate of Deposit

Before you invest in a certificate of deposit, it is necessary that you are entirely aware of what this money market instrument is all about-

- **Eligibility:** Not all institutions or banks are allowed to issue Certificates of Deposit and not every individual or organization can purchase one. There are certain conditions laid down by the RBI that allow the purchase of CDs

- **Maturity Period:** A Certificate of Deposit issued by the commercial banks can have a maturity period ranging from 7 days to 1 year. For financial institutions, it ranges from 1 year to 3 years

- **Minimum investment amount:** A CD can be issued to a single issuer for a minimum of Rs.1 Lakh and its multiples

- **Transferability:** Certificates that are available in Demat forms must be transferred according to the guidelines followed by Demat securities. While dematerialised/electronic certificates can be transferred by endorsement or delivery

- **Non-availability of loan:** Since these instruments do not have any lock-in period, banks do not grant loans against them. In fact, banks cannot even buy back certificates of deposit before maturity

- **Discount offered:** Certificate of deposit is issued at a discounted rate on the face value. Moreover, banks and financial institutions can also issue CDs on a floating rate basis

Advantages of CD-icate of Deposit (CD)

- Risk is less in CD compared to other money market instruments like stocks, bonds, etc as the money deposited is safe with the banker.

- CD offer better returns for the amount deposited than the traditional deposit schemes.

- Post maturity options are given to the depositor to use their funds like rollover of the CD into a new CD, transfer the funds to another account at that bank or withdraw the maturity money and it can be transferred to another bank account or cheque can be received for the money.

Disadvantages of CD

- It is not a liquid asset as the funds are blocked for a fixed duration and any withdrawal of deposit before the maturity period is possible only if the early withdrawal penalty is paid.
- Its returns are less than stocks, bonds, etc over a period of time.
- Interest rate is fixed and does not vary according to inflation/ market scenario, and it does not give effect to changes in the interest rates during the tenure.

Conclusion

CD is one of the safe and high return investment. If the depositor has good money, and the same is not required for any use in near future then the same can be invested in CD as it yields higher interest than the traditional bank deposits, and it is safer compared to the other money market instruments. The blocked money can also be withdrawn on payment of penalty.

Banks issue CD only when the incoming of deposits in the bank is getting reduced whereas there is a high demand for loans and credits. CDs cost the bank more than the traditional deposits so, it is issued only when there are liquidity issues in the market.

Who should Invest in a Certificate of Deposit

As per the guidelines by RBI, the following can invest in a certificate of deposit-

- Ordinary individuals
- Corporations
- Banks
- Financial institutions
- Mutual fund associations
- NRIs (they are not allowed to repatriate on maturity)