

Course: PGDFM

Paper II

Topic: Commercial Paper

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What is 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.

Understanding Commercial Paper

Commercial paper was first introduced over 150 years ago when New York merchants began to sell their short-term obligations to dealers that acted as middlemen in order to free up capital to cover near term obligations. These dealers would thus purchase the notes at a discount from their par value and then pass them on to banks or other investors. The borrower would subsequently repay the investor an amount equal to the par value of the note.

Commercial paper is not usually backed by any form of collateral, making it a form of unsecured debt. As a result, only firms with high-quality debt ratings will easily find buyers without having to offer a substantial discount (higher cost) for the debt issue. Because commercial paper is issued by large institutions, the denominations of the commercial paper offerings are substantial, usually \$100,000 or more. Other corporations, financial institutions, wealthy individuals, and money market funds are usually buyers of commercial paper.

Advantages of commercial papers:

- 1) It is quick and cost effective way of raising working capital.
- 2) Best way to the company to take the advantage of short term interest fluctuations in the market
- 3) It provides the exit option to the investors to quit the investment.
- 4) They are cheaper than a bank loan.
- 5) As commercial papers are required to be rated, good rating reduces the cost of capital for the company.
- 6) It is unsecured and thus does not create any liens on assets of the company.
- 7) It has a wide range of maturity

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

Disadvantages of commercial papers:

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

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

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