

## Why companies use commercial papers as a source of funds

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Commercial papers have become one of the popular routes for corporates to raise funds when compared with loans from banks in recent times. Here is all you need to know about commercial papers.

### What is a commercial paper?

A commercial Paper (CP) is an unsecured loan raised by firms in money markets through instruments issued in the form of a promissory note. CPs can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue.

### What is the current scenario in the banking system?

Anil Gupta, vice president and sector head-financial sector ratings, ICRA, pointed out that the glut in bank deposits post demonetisation has resulted in surplus liquidity in the banking system with more than Rs. 1 trillion being parked by banks under reverse repo (currently at 5.75%) with RBI the during September 2017.

While the deposit inflows (8.5% growth year-on-year in September 2017) have been strong, credit growth has remained weak for banks (7% year-on-year in September 2017). This has also resulted in surplus liquidity, he added.

### Why are CPs popular?

Because of surplus liquidity, short-term borrowing rates in money markets have significantly declined post demonetisation and are much lower than the lowest benchmark lending rates of the banks, Mr. Gupta said. For example, the benchmark lending rates is 7.75% for SBI. On the other hand, the lowest rate at which commercial papers were issued during October was at 6%, he added.

Because banks cannot lend below the benchmark lending rates, firms with good ratings have preferred to meet short-term working capital requirements through commercial papers at lower-than-bank rates.

### Will this spike in commercial papers be sustained?

Issuance of commercial papers will continue to remain strong till there is surplus liquidity in banks and short-term rates continue to be significantly lower than benchmark lending rates of the banks, Mr. Gupta said.

He also noted that a bank or mutual fund with surplus temporary liquidity will prefer to subscribe to commercial papers and earn a slightly higher return in the short-term than parking funds under reverse repo.

Roughly 33% of outstanding commercial papers have been subscribed to by banks.

### What are the advantages of issuing CPs?

Apart from being a cheaper source of funds, it helps meet funding requirements relatively quickly

for better-rated corporates. Procedural requirements for securing bank facilities and charge creation on assets is not required.

### **What are the key challenges with CPS?**

As the CP is an unsecured loan, the investor in commercial papers largely prefers highly-rated corporates or public sector entities in terms of credit rating. Lender appetite is limited to better rated companies.

Also commercial paper markets can be seasonal and vulnerable to liquidity conditions. In case of sudden tightening of liquidity, a firm's ability to secure funding can be challenged. Within the year, liquidity conditions can become tight in certain months such as the end of a quarter, because of advance payment of taxes and the like. At such times, funding costs can also rise for the issue of CPs.

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