

## COMMERCIAL PAPER

### MEANING

Commercial paper securities are unsecured promissory notes, issued by corporations, that mature in no more than 270 days. Because these securities are unsecured, only the largest and most credit worthy corporations issue commercial paper.

### TERMS AND ISSUANCE

To be exempt from SEC registration, the issue must have an original maturity of less than 270 days.

About 60% of commercial paper is sold directly by the issuer to the buyer. The balance is sold by dealers in the commercial paper market. A dealer will redeem the commercial paper if a purchaser has an urgent need for cash.

## MARKET FOR COMMERCIAL PAPER

Non bank corporations use commercial paper extensively to finance the loans that they extend to their customers.

Some of the larger issuers of commercial paper choose to distribute with direct placements. In a direct placement, the issuer bypasses the dealer and sells directly to the end investor. The advantage of this method is that the issuer saves the 0.125% commission that the dealer charges.

Commercial banks were the original purchasers of commercial paper. Today the market has greatly expanded to include large insurance companies, non financial businesses, bank trust, and government pension funds. These firms are attracted by the relatively low default risk, short maturity, and high yields these securities offer.

## BANKER'S ACCEPTANCE

### MEANING

A banker's acceptance is an order to pay a specified amount of money to the bearer on a given date.

### STEPS FOR USING BANKER'S ACCEPTANCE

- The importer requests its bank to send an irrevocable letter of credit to the exporter.
- The exporter receives the letter, ships the goods, and is paid by presenting to its bank the letter along with proof that the merchandise was shipped.
- The exporter's bank creates a time draft based on the letter of credit and sends it along with proof of shipment to the importer's bank.
- The importer's bank stamps the time draft "accepted" and sends the bankers acceptance back to the exporter's bank so that the exporter's bank can sell it on the secondary market to collect payment.

- The importer's deposits funds at its bank sufficient to cover the banker's acceptance when it matures.

### SECONDARY MARKET FOR BANKERS

#### ACCEPTANCES

Since bankers acceptances are payable to the bearer, they can be bought and sold until they mature. Interest rates on bankers acceptance are low because the risk of default is very low.

## EURO

● The traditional instruments in the international bond market are known as foreign bonds. A recent innovation in the international bond market is the **euro bond**.

- Currently, over 80% of the new issues in the international bond market are Eurobonds.
- A variant of the Eurobond is Eurocurrencies, which are foreign currencies that are deposited in banks outside of the home country. The most important of the Eurocurrencies is euro dollars, which are US dollars deposited in foreign banks outside of the united states or in foreign branches of US banks. Then these short term

deposits earn interest and so are similar to short term euro bonds.

- The Euro currency market is made up of several banks (called euro bank) that accept large deposits and provide large loans in foreign currencies. These same banks also make up the euro credit market, which is distinguished from the euro currency market mainly by the longer maturities on loans.
- In the Eurodollar market, banks channel the deposited funds to other firms that need to borrow them in the form of euro dollar loans the deposit and loan transactions in Eurodollars are typically \$1m or more per transaction, so only governments and large corporations participate in this market. The growth in euro dollar volume has made the secondary market more active .

- Euro-commercial paper

It is issued without the backing of a banking syndicate. Maturities can be tailored to satisfy investors. Dealers that place commercial paper have created a secondary market by being willing to purchase existing Euro-CP before maturity. The Euro-CP rate is typically between 50 and 100 basis points above LIBOR. This market is tiny compared to the US commercial paper market.