

A SURVEY OF THE COMMERCIAL PAPER MARKET

By

ALFREDO VILLAVERTE JR.*

The survey was conducted through sets of questionnaires patterned after the 1965 survey of Professor Nevins D. Baxter of the Wharton School of Finance and Commerce at the University of Pennsylvania in the United States. Personal interviews with responsible officers of companies involved in the survey were had to clarify certain points, and to elicit further information, if any.

As expected, some major companies refused to answer the questions put to them for various reasons. One large utility company, for instance, did not want to commit themselves because of their limited experience in commercial paper. Another large utility company felt that the questionnaires were not applicable to them simply because they are not resorting to the commercial paper market at the present time. No information was obtained from one big oil company (in terms of sales and profits) on account of policy reasons. It seems that they backed out of the commercial paper market and shifted instead to offshore financing, owing to some adverse publicity about the company's commercial paper dealings with a government institution.

One investment bank refused to participate in the survey, likewise for policy reasons. It is unfortunate that they declined participation, since it is widely accepted that they are the precursors of money market operations in the Philippines. Their contributions would have meant so much in presenting a better perspective of the commercial paper market. It is precisely this dearth of knowledge that holds back would-be participants, particularly investors, from involving themselves in commercial paper.

* Assistant Controller in charge of Management Information, Shell Company of the Philippines; Graduate Student, University of the Philippines, M.B.A. Program.

Some companies contributed information, but on a limited scale. Certain data were held back, particularly on the magnitude of their commercial paper dealings, and the interest rates acceptable to them.

Be that as it may, the following groups contributed their share of the information:

1. Three majors in the oil industry.
2. Three majors in the mining industry.
3. Two big insurance companies.
4. Commercial banks that actively participate in the market as intermediaries.
5. Two investment banks that actively deal in commercial paper.
6. Three medium-sized companies.

II. MONEY MARKET/INSTRUMENTS

Due to the absence of an integrated money market, various sub-markets have instead developed, principally numbering four: (1) the government securities market; (2) the inter-bank call money market; (3) the bank deposit market; and (4) the inter-company market.¹

GOVERNMENT SECURITIES MARKET

The government securities market is made up of notes and bonds, chiefly notable of which are Treasury Bills. Supported securities are eligible for reserves such as the PW & ED Bonds. The non-supported group consists of Treasury Bills which are classified as secondary reserves, or as a second line of defense. Five commercial and three investment banks banded together to form a National Association of Government Securities Dealers (NAGSD) to provide a secondary market for Treasury Bills.

Although governments offer the lowest yields of the money market instruments, they are endowed with attractive features that more than make up for their poor earning rate. They are redeemable on demand at agreed rates, and are eligible for reserve requirements, particularly in respect to special time deposits. It is their liquidity and reserve

¹ Bancor Development Corporation, *1965 Annual Report*, p. 117.

features that primarily account for their being the most actively traded money market instrument today.

The Treasury Bill market is an artificial one, since commercial banks are practically forced to purchase them on account of various features such as cover for STD's. Because of this, the market seems to be limited to commercial banks.

The period of higher special time deposits on imports particularly provided a blessing to the government securities market. Primary rates declined gradually, and yields returned to more reasonable levels after the rediscounting rate was hiked by the Central Bank (CB) for all banking institutions, except rural banks. Average high yields of nine percent for 91-day bills and ten percent for 12-day bills were experienced at the time. While the government securities market strengthened, the inter-bank and inter-company sector remained tight.²

INTER-BANK MARKET

Under the inter-bank call money market, unsecured call slips are utilized for inter-bank transactions, while loans are made payable on demand.³ Aside from being a reserve adjustment mechanism, its development as an important submarket strengthens the need for profitable placements of banks' excess funds, which cannot be readily invested on short notice.

BANK DEPOSIT MARKET

The bank deposit market consists of bankers' acceptances, and time certificates of deposits (CD's). Bankers' acceptances are time bills of exchange (drafts) drawn on and accepted by a bank, or bearing the credit of the accepting institution.⁴ Time certificates of deposits were established by commercial banks as a competitive reaction to the secular flow of corporate funds from demand deposits to earning assets.⁵

² Bank of Asia, "The Money Market in 1968," *Economic Research SR-MMI*, January 1969, pp. 2-3.

³ Bancom, *op. cit.*, p. 17.

⁴ Nevins D. Baxter, *The Commercial Paper Market* (Boston: The Bankers Publishing Co., 1966), p. 45.

⁵ *Ibid.*

Although legal but unrealistic interest rate ceilings of 6% were established for time certificates of deposits, bankers' acceptance are allowed by the CB to go beyond the ceiling established for deposits. The privilege to charge a higher rate places acceptances on a competitive basis with other money market instruments that had attracted substantial gains from time deposits.

INTER-COMPANY MARKET

Through the inter-company market, borrowing firms are able to finance their seasonal needs from excess funds of other companies through unsecured promissory notes. They have in fact become a permanent source of finance for many big industrial borrowers whose requirements cannot be satisfied by banks or other non-bank sources.

THE BANCOM BILL

Although the development of the inter-company promissory note market was quite encouraging, the turnover was not something to be proud of. It was partly due to the lack of acceptable instruments in the market that propelled Bancom to embark on an instrument of their own design, which in local money market parlance is known as the Bancom Bill. These Bills give the investors the option to be repaid at any time provided notice of call is submitted on a predetermined number of days beforehand. They are sold on various call periods of 1, 7 and 30 days.⁶ Bancom Bills, however, are not negotiable.

Because of the callable nature of the Bancom Bill, it is generally used to reduce overdraft balances, and, therefore cut down on interest charges. However, it does not increase the availability of credit for the individual firm.

The Bancom Bill is a "closed circuit" market in the sense that it is an informal organization of participants using one common medium, which is Bancom. The source of funds does not know who the user of the money would be. All transactions are coursed through Bancom as the intermediary acting as principal.

⁶ Bancom, *op. cit.*, p. 24.

THE COMMERCIAL PAPER

A commercial paper note is an unsecured, negotiable promissory note made payable to the bearer on a stated maturity date.⁷ In order to qualify for open-market borrowing, the credit standing of a firm must be high enough to make collateral security unnecessary.⁸ It is generally sold on a discount basis, although at the buyer's request, may be sold at part-interest payable at maturity.⁹ The paper may be purchased from a direct placer or intermediaries consisting of investment and commercial banks.¹⁰ Since a Bancom Bill is not negotiable, it is not a commercial paper in the strict sense of the term.

It is interesting to note that the initial flotation of commercial papers at the beginning of the second half of 1967 was quite successful, in spite of a reversed trend into restrictive credit policies at the time. The high credit standing of commercial paper issues, and the comparatively higher rates offered appear to be mainly responsible for a favorable market acceptance of commercial papers.

On a competitive basis, commercial papers fetch one of the highest rates among available prime money instruments. A 90-day prime commercial paper, for instance, commands a rate of 11% p.a. compared with a 6.6% for treasury bills and 9½% for bankers' acceptance with the same maturity.

By and large, the development of a local commercial paper market has been very encouraging, though not spectacular. Since there has always been a dearth of suitable money market instruments, the coming of the commercial paper has, to a certain extent, filled a void in the Philippine money market setting. Commercial paper flotation is estimated to be some P65 million at the beginning of 1968.

SECURITIES AND EXCHANGE COMMISSION (SEC) RULING

It is worthwhile mentioning that our SEC have ruled that commercial papers are not considered as securities within the purview of the

⁷ Baxter, *op. cit.*, p. 28.

⁸ G. Walter Woodworth, *The Money Market and Monetary Management* (New York: Harper & Row, 1965), p. 104.

⁹ Baxter, *loc. cit.*

¹⁰ *Ibid.*

Philippine Securities Act. Assuming, however, that commercial papers are considered as securities, it is their opinion that the sale of commercial papers to intermediaries, and to other corporations are exempt from its operation the "sale, transfer or delivery of any securities to any bank, savings institution, trust company, insurance company or to any corporation or to any broker or dealer; provided, that such broker or dealer is actually engaged in buying and selling securities as a business."¹¹

III. PARTICIPANTS

ISSUERS/BORROWERS

Commercial paper issues are, to a large extent, those of industrial borrowers. No finance company in the Philippines employs commercial paper for their borrowing needs, unlike in the United States where finance company paper is a big percentage of total commercial paper outstanding.

On the whole, the reputation of finance companies as borrowers here in the Philippines is somewhat shaky. Consequently, their pro-note issues are considered less prime, and, in many cases less satisfactory. Since most investors prefer prime paper, finance company paper, if any, is extremely difficult to sell. Even the prestigious Industrial Finance Corporation (IFC), whose assets comprise some 20% of the assets of the fifty largest finance companies in the Philippines, does not utilize commercial paper for its borrowing needs.

Commercial papers presently peddled in the money market are to a large extent prime, like oil company paper or its equivalent. Less prime paper constitutes roughly about 5% of the commercial paper market, and is sold mainly on the strength of the dealer's endorsement.

Insurance companies are very particular about the "primeness" of commercial paper that they are buying, because of the requirement that the borrower's name must first be cleared with the Office of the Insurance Commissioner before any investment could be made.

¹¹Securities and Exchange Commission, *Commission Paper Ruling*, July 20, 1967.

ROLE OF PAPER IN DEBT PICTURE

The majority of big companies surveyed are heavy users of commercial paper. The position of commercial papers in their overall debt picture is such that commercial paper outstanding is continually rolled over, and, thus, becomes a permanent source of finance.

There borrowings are of such considerable magnitude that they cannot be sustained by the commercial banking system without prejudicing smaller companies which are entirely dependent on bank loans. Some companies consequently rate commercial paper as an instrument to meet well-defined seasonal demands for funds—bank loans being their primary source of finance.

SUPPLEMENTARY SOURCE OF FINANCE

Assuming that the costs of borrowing directly from banks equal that of obtaining funds in the commercial paper market, there is unanimity among issuers that they would still sell commercial paper as a supplementary source of finance: a so-called "added string to the bow."¹² This, in effect, underscores the heavy borrowing requirements of big companies, and the unfortunate situation in the economy, where the public sector competes actively with the private sector for limited funds.

SENSITIVITY TO RELATIVE INTEREST COSTS

As a source of short-term funds, commercial paper competes directly with bank loans. Since cost of funds obtained through the sale of commercial paper is normally less than that of bank loans, the ratio of commercial paper to short-term debt rises when the cost of commercial paper funds falls relative to that of bank loans. The proportion of commercial paper is therefore responsive to changes in cost. Closely allied to the cost advantage is the fact that open-market borrowing improves the competitive position of a business firm in the credit market.¹³

¹² Baxter, *op. cit.*, p. 65.

¹³ Woodworth, *op. cit.*, p. 110.

CREDIT LINES

In the United States, all issuers of commercial papers maintain substantial lines of credit with commercial banks largely as a hedge against an open-market dry-up, and as an assurance to investors of the issuer's liquidity and credit strength.¹⁴

Only a few of the companies survived—and the small ones at that—maintain unused lines of credit at their banks in the region of 50% or under. The primary consideration is that they feel they genuinely need their lines, because commercial paper is an unreliable source of funds.

BEHAVIOR IN TIMES OF MONETARY RESTRAINT

In times of monetary restraint, it is the consensus of all users that commercial paper—as a percentage of short-term debt as well as total debt—generally decreases. Lack of funds is normally the explanation offered by the companies involved in the survey, except for one that felt that higher commercial paper borrowings would strain their bank relations.

Almost all commercial paper issuers cannot obtain all the funds needed from their banks at the going interest rate. Neither can their requirements be obtained from the commercial paper market as the supply of funds in the open-market seems to dry up in these periods. Only one firm ventured the opinion that their banks can meet all their requirements. The requirements of this company, however, pale in comparison to the demands of all utility and beverage companies.

FINANCIAL RECOGNITION AND PUBLICITY

Recognition as an open-market borrower is likely to open the door to the capital market for the sale of stocks and bonds on a more favorable basis. In fact, the commercial paper dealer may also be an underwriter of long-term securities. Moreover, the publicity received is sometimes good advertising for the sale of products.¹⁵

¹⁴ Baxter, *op. cit.*, pp. 66-7.

¹⁵ Woodworth, *op. cit.*, p. 110.

BUYERS/INVESTORS

WHO BUYS COMMERCIAL PAPER

Firms with seasonal surpluses invest in commercial paper. Placements of funds, by large corporations, however, are not always done on a competitive basis. The following factors play a meaningful role: (1) reciprocity, or collateral business; and (2) personal relationships between officers of investing and borrowing companies.

Because of their necessary involvement in commercial paper transactions, intermediaries buy commercial paper. Individual investors also purchase commercial paper, but on a limited scale.

REASONS FOR BUYING COMMERCIAL PAPER

In a tight situation, there normally exists a mad scramble for funds. Even the big borrower is often forced to offer an attractive rate to be able to secure a sizeable portion of its requirements that cannot be provided even by its regular bankers, either as a result of credit restrictions or sheer magnitude or both. It is this high-yielding rate that has primarily induced most of the companies surveyed to invest in commercial paper.

Mining companies, on the other hand, seem to favor commercial paper on the basis that it can be obtained in the exact amount and maturity required. Since their expenditures for large and foreseen outpayments such as dividends or taxes are more or less planned, the commercial paper becomes an ideal instrument for them.

A few feel that the short maturity feature is important to them. They often have substantial amounts for a few days or for an uncertain period; so that buying short-term maturity paper provides them a temporary outlet with outstanding liquidity feature, because of the absence of "market risk" from the commercial paper investment.

TYPES OF PURCHASE

None of the survey participants has its finance company paper as part of its portfolio, except for one major mining firm which claims that it has some 5% of its commercial paper portfolio in finance company

paper. This runs counter to a previous statement that no finance company employs commercial paper to support their borrowing requirements. This writer is inclined to believe that finance company paper is not acceptable in the commercial paper market. Investment banks also agree with this observation.

Risk consciousness seems to pervade among the investors as all commercial papers bought are "prime", i.e., paper issued by the best-known companies, with the lowest yield compared with "desirable" and "satisfactory" papers but with slightly higher and the highest yields, respectively.

MATURITY DISTRIBUTION

Mining companies favor long maturities (over 91 days). A big insurance company, however, prefers intermediate maturities (31-90 days) and short maturities (under 30 days), while another has a 50-50 split between intermediate and long maturities.

A commercial bank which actively plays the role of intermediary prefers 31-90 day maturities, while another commercial bank in the same category would like maturities in the vicinity of ninety days. One investment bank deals mostly in ninety-day maturities, while another caters equally to short and intermediate maturities. These variations in maturities are simply a demonstration of the fact that they are for the most part affected by the type of business, company objectives and strategies.

BEHAVIOR DURING MONETARY RESTRAINT

In times of monetary restraint, holdings of commercial paper vary in magnitude according to the requirements of each investor. Commercial banks have indicated that in tight money situations, their holdings of commercial paper generally decrease.

Banks generally purchase paper when the demand for direct loans is insufficient. Loan demand is active in tight money periods, so that the propensity for commercial paper declines. Cash flow is likewise used to finance increase in inventories and receivables. An investment bank also shares the same experience as do commercial banks.

Commercial paper holdings of insurance companies remain the same. One big mining company also shared the same situation.

It is interesting to note that while most investors experience a decrease in their paper holdings, one mining giant and an investment bank increased their investments in commercial paper. The most important factor which affects their increased holdings is the fact that commercial paper rate is high in such periods, making paper investment very attractive.

YEAR-END PRACTICE

All, except commercial banks, do not mind holding commercial paper over the year-end, unless "window-dressing" is required on corporate annual reports. A high-prevailing yield exists on paper maturity on January 2nd compared to December 31st. This feature makes investments in commercial paper at year-end the more attractive.

Commercial banks are reluctant to hold commercial paper at year-end as such holdings form part of their loan portfolio. The ceiling imposed by the CB on domestic credit all the more discourages banks from investing in commercial paper. In the United States, banks interest themselves in the purchase of commercial paper over the year-end to form part of their loans.¹⁶ There are tax-deductible additions to loss reserves which banks are permitted to make as a percentage of loans outstanding at year-end.¹⁷ This becomes an incentive for banks to build up their loan totals by buying commercial paper.

ROLE OF THE INTERMEDIARY

At the present time, there are six active and well-known intermediaries in the commercial paper market. They are the CCP Securities Corporation, Bancom Development Corporation, House of Investments, Commercial Bank and Trust Company, Far East Bank and Trust Company and Bank of Asia.

¹⁶ Baxter, *op. cit.*, p. 129.

¹⁷ *Ibid.*

DEALER-BROKER

Extreme caution is exercised by dealers in originating commercial paper, so that credit risk is minimized, and the almost spotless reputation presently enjoyed by this investment is maintained.

CCP Securities Corporation operates both as dealer and broker. They assume the functions of a dealer when they buy commercial paper of an issuer for their inventory, i.e., from their own funds; so that the paper bought forms part of their portfolio or when they sell commercial paper to an investor from their own portfolio, i.e., from their commercial paper holdings.

At certain times, an investor calls up the CCP for placement of excess funds usually on a short-term basis. The CCP, in turn, calls up a borrower-client (acceptable to the investor) who is willing to accept the funds at a mutually agreed interest rate. The borrower executes a commercial paper or papers to cover the funds borrowed which the CCP transmits to the investor after getting their usual spread as broker. For obvious reasons, the borrowing company is not aware of the source of funds.

When they sell commercial paper from inventory, the sale is usually accompanied by a repurchase agreement (*repos*), i.e., a commitment by the dealer to repurchase the paper at any time before maturity. Also known as "buyback", this arrangement enhances the liquidity of the paper being marketed, and is also a means of lending out paper for short periods while shopping around for a permanent buyer.

In their operations, the CCP normally makes use of the commercial paper designed by them—outstanding features of which, for marketability purposes, are the authentication and the paying-agent clause.

House of Investments operates both as dealer and broker, and utilizes the paper of the client to cover the transaction, i.e., an unsecured negotiable promissory note made payable to the bearer on a stated maturity date.

Intermediary banks normally purchase paper for the account of non-bank customers. Interest rate and credit information on the different commercial paper notes are made available to investors. They are also

made aware of opportunities for alternative uses of short-term funds such as Treasury Bills or certificates of deposit. When the customer buys a note that is paid off, his account is credited. One motivation for commercial banks to be dealers in commercial paper is that they are able to satisfy the additional credit requirements of prime clients over and above existing statutory ceilings for a given client.

Buying paper through a bank has the advantage of saving the investor much of the paperwork involved. Up-to-date information on the various opportunities open to him is made available from just one source—the bank. The investing firm has the choice of remaining anonymous when dealing through its banks, so that future solicitations from dealers and direct placers are avoided. Repurchase agreements seem to be common among intermediaries in order to attract investors.¹⁸

THE PRINCIPAL

In addition to performing the functions of broker and dealer, Bancom operates predominantly as the principal. As previously stated, a Bancom Bill is not commercial paper in the strict sense of the term, as there is no element of negotiability that characterizes commercial paper.

A short discussion is here presented for the purpose of informing those who are not familiar with the mechanics of the Bancom Bill. When an investor commits its funds to Bancom for placement, the latter executes a promissory note known as the Bancom Borrowing Bill in favor of the investor. This Bill gives the investor the option to be repaid at any time provided notice of call is served on a predetermined number of days beforehand. If no call is made by the investor after the Bill has run for a stipulated number of days from date of value, Bancom has the right to terminate the Bill on any day thereafter through presentation of a reverse call slip in like manner that the investor is permitted to call back the Bill. This reverse call option prevents Bancom from being "locked-in" at unreasonable rates for a long period of time.

When these funds are placed in the money market, a Bancom Lending Bill is used to cover the transaction between Bancom and the borrower. In like manner, the Bill gives Bancom the option to be repaid

¹⁸ *Ibid.*, 57.

at any time provided notice of call is made to the borrower. If no call is made by Bancom after the Bill has run for a stipulated number of days from date of value, the borrower has the right to terminate the Bill by means of a reverse call slip. The reverse call feature is a protection for the borrower against being "locked-in" during cheap money periods.

ROLE OF COMMERCIAL BANKS

WHO BUYS COMMERCIAL PAPER

At the present time, only those actively engaged in the commercial paper market as intermediaries buy commercial paper, but these are for the account of their non-bank customers. Commercial banks used to place their loanable funds in commercial paper, but later on shifted to the financing of STD's which commercial banks found more lucrative than placements in commercial paper. The imposition of a ceiling on domestic credit completely shut the door towards the purchase of commercial paper.

Commercial papers likewise suffered from the increase in the rediscounting rate of all banking institutions, except rural banks. Issuers and dealers of commercial papers hesitated to adjust their rates along with other money market securities. Funds were instead shifted from commercial papers to Treasury Bills, because of the Bill's more accepted liquidity and comparable yields.¹⁹

REASONS FOR BUYING COMMERCIAL PAPER

Assuming that the purchase of commercial paper for loan portfolio purposes is possible, the commercial bank paper dealers mentioned two factors that will influence their decision to buy the paper: (1) the rate is attractive; and (2) it provides a temporary outlet for funds at a rate more attractive than on Treasury Bills.

TYPES OF PURCHASE

Banks normally purchase "prime" commercial paper. No finance company paper is ever considered for the same reasons mentioned earlier.

¹⁹ Bank of Asia, *op. cit.*, p. 2.

BEHAVIOR OF BANKS DURING MONETARY RESTRAINT

Banks have indicated that in cases of monetary curbs, customers who borrow or are capable of borrowing in the open market are encouraged to issue commercial paper simply because banks cannot adequately meet their demands for funds during these times.

Banks also feel that in times of monetary restraint, their commercial paper holdings would probably decrease. As traders, however, their holdings would probably remain the same because of market strategies.

On the question of drawing away bank depositors to shift to commercial paper, banks argue that if they are going to lose deposits to investment banks they might as well get the business themselves.

IV. THE NEED FOR A SECONDARY MARKET

Strictly speaking, there is no secondary market for commercial paper at the present time. Some claim that the "repurchase" feature creates a secondary market for commercial paper in the sense that an investor can sell before maturity. Similarly, Bancor claims to have a secondary market for their bills because of "buyback" arrangements.

RATIONALE FOR SECONDARY MARKET

Since buyers in a secondary market are not particular about buying a primary or secondary offering at the same maturity, all costs arising therefrom should be borne by the disposers.

If potential disinvestors would pay the entire dealer's spread, this could be something similar to the rate prevailing on bankers' acceptances. Since this spread is normally smaller than the added cost of a bank loan even at the prime rate, it is anticipated that investors in need for funds would rather unload in the secondary market than borrow from banks. This is the main rationale for a secondary market for the paper.²⁰

²⁰ Baxter, *op. cit.*, p. 117.

POSSIBLE OBJECTIONS TO A SECONDARY MARKET

MARKETING DIFFICULTIES

A development would be accompanied by considerable technical changes in marketing operations of dealers and direct placers, such that a secondary market would make it more expensive to sell primary issues.

POSSIBILITY OF FRAUD

A development would also reduce the importance of a personal relationship between primary issuers and investors. Possibility of fraud would creep in, since commercial paper is not registered with the SEC. If there is a large number of issuers, it would be difficult to tell if notes traded on the secondary market are valid in the absence of a personal relationship between buyer and seller.

ALTERING THE "YIELD CURVE"

Another argument is that a secondary market might alter the "yield curve" for paper—forcing short rates higher, and high rates lower.²¹ "Riding the yield curve" means buying longer maturities, say ninety days, and selling at a date near maturity when the discount rate is normally less.²²

LOSS OF PRIMARY-PLACEMENT SPREAD

Still another is the danger of losing the primary-placement spread which directs placers, and, dealers are now able to earn.

ATTITUDES OF PARTICIPANTS

In spite of the possible opposition described above, direct placers, issuers, utilizing dealer and commercial paper dealers themselves, favor the development of a secondary market. They genuinely feel that such a development would increase the saleability of commercial paper, as it would make the paper more attractive to investors.

²¹ *Ibid.*, 114.

²² John M. Emery, "Managing Cash for Profit," *Financial Executive*, April 1968, p. 24.

INCREASING THE DESIRABILITY OF PAPER

THE "BUYBACK"

In the absence of a secondary market, dealers and brokers resort to "buyback" arrangements to increase the desirability of paper. There are other gimmicks that, though not practiced here, are nevertheless worthwhile mentioning.

"HOLE-IN-THE-MIDDLE", OR "DOUGHNUT LOANS"

"Doughnut loans" are commercial papers issued with a guaranteed take-out period for the lender during the course of the loan.²³ This arrangement allows the investor to get his money back for a few specified days during the holding period, and to receive the rate of return for the full number of days he is lending the money. For example, an investor gets a 90-day rate which he holds for 30 days, is repaid for 5 days, and then holds for an additional 60 days.²⁴ This is desirable when there is an upward-sloping yield curve.

Insurance companies which traditionally show strong cash positions at year-end normally resort to this practice by specifying their "hole-in-the-middle" for December 31st, taking out their funds on that date, and returning them on January 2nd after "window dressing" their year-end balance sheets.²⁵

"ACCUMULATING DAYS"

Also desirable when there is an upward-sloping yield curve, an investor, for example, holds the paper for twenty days, picks up the paper on maturity, and then goes into a forty-day note. He gets credit for the original twenty days, and earns the sixty-day rate on his investment.²⁶

THE "SEVEN-DAY EXTENSION"

A gimmick that is desirable when interest rates have fallen, it allows the buyer of a thirty-day note to invest for an additional seven

²³ David Mishkin, "Financial Innovation: Review and Forecast," *Financial Executive*, November 1968, p. 35.

²⁴ Baxter, *op. cit.*, p. 111.

²⁵ Mishkin, *op. cit.*, p. 35.

²⁶ Baxter, *op. cit.*, p. 112.

days at the same rate. The investor is thereby provided with the flexibility of two alternative maturity dates.

OUTLOOK FOR SECONDARY MARKET

So long as the "best efforts" system (the traditional method of redeeming dealer-paper before maturity) operates efficiently and direct placers continue to repurchase paper, there seems to be no crying need for a secondary market, although such a development would, as previously mentioned, increase the attractiveness of the paper to investors. The repurchase feature, or "buyback" arrangement, in particular, approximates a situation that, to Bancom and other dealers, is the equivalent of a secondary market. Another reason why there is no pressing need for a secondary market for commercial paper is that maturities can be tailor-made according to investors' requirements.

V. THE NEED FOR A NATIONAL CREDIT OFFICE²⁷ (NCO)

Large business corporations are the chief investors in commercial paper. Since corporate treasurers cannot usually devote the same attention to the analysis of credit position as could commercial banks, corporations tend to confine their investments to notes to large, well-known firms. This attitude on the part of investors has forced the commercial paper brokers to become increasingly selective, and to discourage all but the best credit risks from issuing papers.

In the United States, commercial paper buyers seek the assistance of the NCO, a subsidiary of Dun & Bradstreet, in assessing the credit worthiness of various notes.

The NCO collects financial data on virtually all firms issuing commercial paper. Careful checks are made of the bank relations of individual firms. A separate confidential release is then published concerning each commercial paper borrower, which is made available upon subscription to actual and potential investors.

Information concerning names of principal banks, the amount of credit lines open to the firm in question, balance sheet data, management

²⁷ *Ibid.*, 36.

information, etc. are contained in the release. The NCO then rates the paper of the company in question as "prime," "desirable" or "satisfactory." Ratings are based on the financial position of the company and are firmed up only after consultation with the company's lending bankers.

These ratings and reports are important guides to investors. The individual commercial paper buyer is saved from much credit investigation work. They immensely help speed up transactions that would otherwise take some time to finalize in the absence of ready information such as that provided by the NCO.

VI. OUTLOOK FOR COMMERCIAL PAPER

It is the opinion of a leading investment bank that commercial paper will continue to play a meaningful role in the money market. A commercial bank feels that, for the money market, this means a continuing upward push in commercial paper.

Commercial paper serves as a vehicle for funds placements at attractive yields. It also serves as an ideal instrument for investors with specific payments to make on a known future date, since directly placed paper can be tailor-made as to amount and maturity, while dealer paper can be obtained with the details closely resembling the requirements. Should an urgent unforeseen need for funds by holders of the paper arise, arrangements often accompany paper transactions, so that holders are able to recover their money when the need arises.

To an investment bank, money market operations is only one of several services offered and is related to its main function—underwriting, since the flotation of a client firm's paper serves the purpose of paving the way for an underwriting issue. In other words, it serves to introduce its name to the financial market.

There seems to be no doubt that commercial paper will assume an even greater posture in money market operations in the years ahead. Banks and other investors are rewarded in that the market provides an investment that is safe, liquid, and at the same time yields a comparatively high return. Banks often denounce the open market as an unfair competitor—taking away business, and forcing down rates on loans. Some

banks have consequently resorted to commercial paper dealings. As pointed out earlier, banks argue that if they are going to lose deposits to investment banks, they might as well get the business themselves. Such an attitude, however, is exceedingly shortsighted in terms of the larger welfare of banks. Since the business of banking carries such a heavy responsibility, banks must face the alternatives of meeting legitimate credit needs at competitive rates or of submitting to more government intervention. In a very real sense, the market is a genuine friend, since it exerts a strong influence in the direction of a healthier banking system.²⁸

²⁸ Woodworth, *op. cit.*, p. 120.