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Appendix **19B**

Bankers' Acceptances and Commercial Paper as Sources of Financing

COMMERCIAL PAPER

commercial paper
Unsecured short-term debt instrument issued by corporations.

Commercial paper is an unsecured short-term promissory note issued by an FI to raise short-term cash, often to finance working capital requirements. One reason FIs use commercial paper is that FIs with strong credit ratings can generally borrow money at a lower interest rate by issuing commercial paper than by directly borrowing in the long-term debt markets.

Commercial paper is generally sold in denominations of $100,000, $250,000, $500,000, and $1 million. Maturities generally range from 1 to 270 days–the most common maturities are between 20 and 45 days. This 270-day maximum is due to a Securities and Exchange Commission (SEC) rule that securities with a maturity of more than 270 days must go through the time-consuming and costly registration process to become a public debt offering (i.e., a corporate bond). Commercial paper can be sold directly by the issuers to a buyer such as a mutual fund (a direct placement) or indirectly by dealers in the commercial paper market.

Commercial paper is generally held from the time of issue until maturity by investors. Thus, there is not an active secondary market for commercial paper. Because commercial paper is not actively traded and because it is also unsecured debt, the credit rating of the FI is of particular importance in determining the marketability of a commercial paper issue. Credit ratings provide potential investors with information regarding the ability of the FI to repay the borrowed funds, as promised, and to compare the commercial paper issues of different companies. Several credit rating firms (e.g., Standard & Poor's, Moody's, and Fitch ICBA, Inc.) rate commercial paper issues. Standard & Poor's rates commercial paper from A-1 for highest-quality issues to D for lowest-quality issues, while Moody's rates commercial paper from P-1 for highest-quality issues to "not rated" for lowest-quality issues. Virtually all FIs that issue commercial paper obtain ratings from at least one rating service company, and most obtain two rating evaluations.

BANKERS' ACCEPTANCES

bankers' acceptance
Time draft payable to seller of goods that is guaranteed by a bank.

A **bankers' acceptance** is a time draft payable to a seller of goods with payment guaranteed by a bank. Time drafts issued by a bank are orders for the bank to pay a specified amount of money to the bearer of the time draft on a given date. Many bankers' acceptances arise from international trade transactions and the underlying letters of credit (or time drafts) that are used to finance trade in goods that have yet to be shipped from a foreign exporter (seller) to a domestic importer (buyer). Foreign exporters often prefer that banks act as guarantors for payment before sending goods to domestic importers, particularly when the foreign supplier has not previously done business with the domestic importer on a regular basis. In the United States, the majority of all acceptances are originated in New York, Chicago, and San Francisco. The U.S. bank insures the international transaction by stamping "Accepted" on a time

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draft written against the letter of credit between the exporter and the importer, signifying its obligation to pay the foreign exporter (or its bank) on a specified date should the importer fail to pay for the goods. Foreign exporters can then hold the bankers' acceptance (the accepted time draft written against the letter of credit) until the date specified on the letter of credit. If they have an immediate need for cash, they can sell the acceptance before that date at a discount from the face value to a buyer in the money market (e.g., a bank).

If the U.S. bank pays the foreign exporter's bank for the acceptance before the maturity date (on a discounted basis), the bank can either hold the acceptance as an investment until it matures or sell the bankers' acceptance in the secondary market. They are, thus, a source of financing for the bank. In this case, the ultimate bearer will receive the face value of the bankers' acceptance on maturity.

Further, because bankers' acceptances are payable to the bearer at maturity, they can be and are traded in secondary markets. Maturities on bankers' acceptances traded in secondary markets range from 30 to 270 days. Denominations of bankers' acceptances are determined by the size of the original transaction (between the domestic importer and the foreign exporter). Once in the secondary markets, however, bankers' acceptances are often bundled and traded in round lots, mainly of $100,000 and $500,000.

Only the largest U.S. banks are active in the bankers' acceptance market. Because the risk of default is very low (essentially an investor is buying a security that is fully backed by commercial bank guarantees), interest rates on bankers' acceptance are low. Specifically, there is a form of double protection underlying bankers' acceptances that reduces their default risk. Since it requires both the importer and the importer's bank to default on the transaction before the investor is subject to risk, the investor is also protected by the value of the goods imported to which he or she now has a debtor's claim–the goods underlying the transaction can be viewed as collateral.

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