

**THE FUTURE ROLE OF FINANCIAL INTERMEDIARIES  
IN THE SOUTH AFRICAN COMMERCIAL PAPER MARKET**

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**by**

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*Dedicated to my wife Elouise for her support,  
encouragement and patience,  
and to our children  
Christine,  
Herman  
& René*

## SINOPSIS

Handelspapier is 'n onversekerde promesse met 'n vasgestelde of 'n swewende vervaldatum. Die uitreiker van handelspapier belowe om die regmatige houer daarvan 'n sekere bedrag geld, naamlik die sigwaarde van die wissel op vervaldatum te betaal.

In die Amerikaanse en Europese markte is handelspapier onversekerd. Die uitreiker verpand geen bates nie maar alleenlik sy vermoë en toekomstige verdienste wat hom in staat sal stel om sy verpligtinge teenoor die houer op die vervaldatum te kan nakom.

Die handelspapiermarkte bestaan al sedert die negentiende eeu in die Vereenigde State van Amerika. Gedurende die periode 1920 tot en met 1960 is die mark deur finansiële instellings oorheers. Die grootste beleggers gedurende hierdie periode was die Amerikaanse banke.

General Motors Acceptance Corporation was in 1920 die eerste maatskappy in Amerika wat handelspapier direk uitgereik het aan beleggers sonder om gebruik te maak van finansiële tussengangers soos banke of makelaars. 'n Hele aantal bekende Amerikaanse ondernemings het General Motors Acceptance Corporation se voorbeeld gevolg en sodoende was daar betreklik gou 'n gesonde aanbod van kwaliteit handelspapier.

Die aanvanklike weiering van The Bank of England om sy steun te gee aan die vorming van 'n Sterling-handelspapiermark was grootliks die rede dat handelspapier vir lank 'n Amerikaanse verskynsel gebly het.

Die handelspapiermark in Engeland het eers in Mei 1986 geopen. Aanvanklik het die Sterling handelspapiermark redelik baie probleme ondervind met 'n aantal wetlike regulasies en reëlings wat die ontwikkeling van die mark gestrem het.

Wetgewing wat die totstandkoming van die Suid-Afrikaanse handelspapiermark moontlik gemaak het, is gepromulgeer op 3 Januarie 1992. Regulasies wat die uitreiking van handelspapier in terme van Die Bank Wet (94/1990) reguleer, word elke Januarie in die Staatskoerant gepubliseer. Hierdie regulasies bly van krag vir 'n periode van een jaar totdat nuwe regulasies dan weer uitgevaardig word.

Die Suid-Afrikaanse monitêre owerhede het sedert 1990 die ontwikkeling van 'n plaaslike handelspapiermark sterk aangemoedig. Ongelukkig is die ontwikkeling van die plaaslike mark ook gekortwiek deur dieselfde probleme wat deur die Britse mark ondervind is.

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Sekere deelnemers aan die Suid-Afrikaanse geldmark het gemengde gevoelens oor die regulasies wat volgens hul oorhaastig uitgereik is na die ondergang van Masterbond Holdings en Supreme Bond Holdings.

Die mees kritiese probleem wat in die pad staan van die plaaslike handelspapiermark is die houding van sekere banke jeens handelspapier. Die banke sien handelspapier as 'n bedreiging eerder as 'n uitdaging om nog 'n beter dienslewering aan hul multi-miljoen korporatiewe kliënte te kan bied.

Die feit dat alle handelspapier onderworpe is aan seëlregte met die uitsondering van staat en semi-staatsinstellings wat spesifiek daarvan vrygestel is, veroorsaak 'n baie ongelyke speelveld vir die onderskeie deelnemers aan die Suid-Afrikaanse geldmark.

Die meeste maatskappye is nie baie gretig om handelspapier uit te reik nie aangesien daar nog 'n groot mate van onsekerheid bestaan by korporatiewe tesouriers aangaande wetgewing en die basiese beginsels van handelspapier.

Die redelike beskikbaarheid van fondse deur middel van oortrokke fasiliteite aan die uitsoek korporatiewe-marksegment dra beslis ook nie by tot die vorming van 'n volwaardige plaaslike handelspapiermark nie.

Voornemende beleggers in handelspapier sal nie alleen rentekoersrisikos moet kan bestuur nie maar ook kapitaalrisikos wat gekoppel is aan handelspapier wat nie deur 'n bank geëndosseer is nie.

Huidiglik bestaan daar slegs een graderingsagentskap van ondernemings in Suid-Afrika, naamlik Republic Ratings. Die hooffunksie van so 'n graderingsagentskap is om 'n onafhanklike kredietevaluasië van 'n maatskappy te kan maak. Ongelukkig is die verkryging van so 'n kredietevaluasië 'n baie duur proses en daar bestaan 'n sekere mate van skeptisisme oor die vermoë van enige krediet-evalueringagentskap om 'n objektiewe beoordeling te kan maak.

Die hoofdoelwit van hierdie studie is om die toekomstige rol wat finansiële tussengangers mag vervul met die totstandkoming van 'n formele en aktiewe Suid-Afrikaanse handelspapiermark te bepaal met inagneming van die huidige vloeibare ekonomiese en politieke klimaat.

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Die sekondêre doelwitte van die studie is:

Die daarstelling en die omskrywing van sekere riglyne vir korporatiewe tesouriers en ander moontlike deelnemers aan die Suid-Afrikaanse handelspapiermark;

Die daarstelling vir riglyne aan voornemende uitreikers van handelspapier;

Die daarstelling vir riglyne aan voornemende beleggers in handelspapier;

Die ontleding en vergelyking van alternatiewe finansierings- en beleggingsmoontlikhede;

Die vergelyking tussen tradisionele bank korporatiewe lenings en makelaarsfooi-inkomste wat verdien kan word deur op te tree as agent tussen die korporatiewe beleggers en leners in die geldmark.

Ten slotte, Suid-Afrikaanse banke sal moet betrokke raak in die handelspapiermark om relevant te kan bly in die korporatiewe mark. Die prys om nie deel van hierdie mark te wees nie sal baie hoog wees. Die gevolg sal 'n verlore markaandeel wees wat baie inspanning en tyd sal verg om te herower. Suid-Afrikaanse bankiers kan baie leer uit die ervaring van buitelandse bankiers en deelnemers aan hierdie mark.

Die studie is gegrond op boeke, tydskrifte, artikels en die ongepubliseerde konsep dokument van Die Suid-Afrikaanse Handelspapier Forum: "Market Practice Document for the Issue and Trading of CP Notes", die ondervinding van die skrywer in tesouriebestuur en geld- en kapitaalmarkverhandeling by 'n toonaangewende Suid-Afrikaanse handelsbank.

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## SYNOPSIS

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## CHAPTER 1

# AN OVERVIEW OF THE STUDY

### 1.1 INTRODUCTION

Commercial paper is an unsecured promissory note with a fixed or a floating date maturity. The issuer promises to pay the holder a certain amount of money, the face value of the bill on the maturity thereof.

In the American and European markets commercial paper are unsecured and the issuer pledges no assets but only his ability and future earning power that will enable him to honour his commitment on the maturity of the paper.

The commercial paper market has been in existence since the nineteenth century in the United States of America. From 1920 to 1960 the American market was dominated by finance companies. During 1960 the amount of non-financial paper outstanding was \$0,8 Billion, in 1978 the figure was \$17 Billion which represented 51% of the total commercial and industrial loans advanced in New York. The figure has grown to \$88 Billion by the end of 1985 – which was equal to 151% of the commercial and industrial loans advanced by New York banks for the same period.

The reluctance of the Bank of England to give its blessing to the formation of a commercial paper market and their traditional insistence on two name paper, meant that commercial paper remained an American phenomenon until the early nineteen eighties.

The United Kingdom market was only opened in May 1986 and was plagued by a number of legal and regulatory problems that slowed the initial start-up of the market.

Legislation enabling the formation of a South African commercial paper market was promulgated on 3 January 1992. Regulations governing the commercial

## CHAPTER 1

paper market are regulated in terms of The Banks Act (94/1990) as noted in the annual Government Notice that is noted in the Government Gazette every January.

### 1.2 PROBLEM STATEMENT

The South African authorities have been actively encouraging the introduction of a formal commercial paper market since the early nineties but the process has been hampered by some of the very same problems that plagued the United Kingdom market.

Government Notice No. 152 published in the Government Gazette dated 26 January 1993 Volume 331 No. 14553, that is governing commercial paper, will expire on the last day of the year. Notwithstanding the expiry date, the procedures and practises covered in this citation should cover the basic principles and market practice that will persist in the South African market.

Certain money market participants have reserved feelings over the existing legislation and is of opinion that the recent demise of Masterbond Holdings and Supreme Bond Holdings led to the over-hasty promulgation of the current regulations.

The most critical current problem is that the major South African banking institutions perceive the advent of commercial paper as a threat rather than an opportunity. The perceived danger is that their traditional multimillion corporate borrowing and lending markets will be eroded by commercial paper and thus profit contributions obtained from this market segment will be diminished.

The mere fact that all negotiable instruments bear stamp duty and that the parastatals are specially exempted from stamp duty, is producing a very uneven playing field for all possible participants.

## CHAPTER 1

The levelling of the playing field will ensure that more participants will come to the fore. The probability does exist under current legislation that one of the parastatals can become the lender of last resort to the major South African corporate companies.

Most of the corporate borrowers are not keen to issue commercial paper as uncertainty does persist among corporate treasurers, regarding the concepts and mechanisms relating to commercial paper issues.

The relative ease of obtaining credit facilities by the blue chip corporate sector and Government institutions from the regulated banking sector does not contribute to the number of prospective commercial paper issuers.

The traditional bullishness of major South African market participants does not contribute to the longer term commercial paper market.

The major money market investors like mining houses, insurance companies, pension and provident funds are not geared to invest in negotiable instruments which are not endorsed by a reputable banking organization. Prospective investors in commercial paper which is not bank endorsed will not only have to manage interest rate risks which are a pertinent part of any negotiable paper transaction but also the capital risks related to the financial standing of the issuer on maturity date.

Currently only one rating agency does exist in South Africa namely Republic Ratings. The primary function of a rating agency is to provide an unbiased rating on an issue. Unfortunately, to obtain a rating from Republic Ratings is a very costly process for any prospective borrower and a certain amount of animosity does exist in the market regarding the ability of any rating agency to provide an unbiased rating.

## CHAPTER 1

### 1.3 STUDY OBJECTIVES

#### Main Objective

The establishing of a future role which South African banking institutions can fulfil with the establishment of a formal and active commercial paper market in the Republic of South Africa taking into consideration the uncertain political and economic climate.

#### Auxiliary Objectives

1. The setting and explanation of basic guidelines for corporate treasurers and other possible participants in the South African commercial paper market.
2. Guidelines for prospective issuers of commercial paper.
3. Guidelines for prospective investors.
4. The possibility of establishing a single depository to handle all South African commercial paper transactions.
5. The identification of alternative forms of financing.
6. The identification of current legislation that may hamper the development of the formal commercial paper market in South Africa.
7. The feasibility of the formation of off-balance sheet commercial paper operations for South African banking institutions.

## CHAPTER 1

### 1.4 RESEARCH METHODOLOGY

A comprehensive literature study on various aspects pertaining to commercial paper and other short term negotiable interest-bearing instruments was undertaken. Due to the complete lack of published works on the South African commercial paper market all the literature studies were based on the overseas markets with special reference to market practice and the secondary markets that do exist in the American and European markets.

Corporate treasurers, general managers, treasury managers and senior legal advisers of major banking institutions, brokers and officials of the Commercial Paper Forum of South Africa were interviewed on an informal but structured basis to obtain more insight into their different expectations of the market.

An actual commercial paper deal was structured for a private company as a learning process for both the issuer and the issuing and paying agent to identify possible pitfalls in legislation, accounting procedure and systems procedure.

This exercise proved to be the ideal vehicle to transfer some the theory contained in this document into practise. The result of this exercise was that an actual transaction was concluded on behalf of this company. Due to an undertaking provided to the issuer, none of the actual documentation will be reproduced in this document.

No questionnaires were circulated during this study as this method has proved to be time consuming and in the event of having them completed, it is usually done at the lowest possible level in the organization.

## **CHAPTER 1**

### **1.5 LIMITATIONS OF THE STUDY**

This paper will focus primarily on the development of the South African market although the literature study was completed on the international markets.

No reference will be made to options and futures in commercial paper as these markets do not exist as yet in the South African context. Commercial paper futures and options provide sufficient possibilities and alternatives for another separate study in this field.

Debentures will not be discussed in detail although per definition they can also qualify as commercial paper.

No specific reference is made to any possible tax based deals which can also be done through commercial paper.

### **1.6 DEPLOYMENT**

Chapter two introduces the background to the development of the international commercial paper market. The market started to develop in the nineteenth century in the Federal States of America and then rapidly expanded after the turn of this century as a result of the massive need for the mobilisation of corporate finance. Chapter two also analyses the current South African situation and then outlines the problem areas that face the various participants in this market.

Chapter three deals mainly with the development on the European commercial paper markets. The markets in Great Britain, France and Germany are discussed in detail with special emphasis on the development and the current functionality of these markets.

## CHAPTER 1

Chapter four deals with the current legislation and regulations that are controlling the South African commercial paper market.

The Banks Act (94/1990) and the Regulations issued in terms thereof;

The Companies Act (61/1973);

The Stamp Duties Act (77/1968);

The Marketable Securities Act (32/1968); and

The Bills of Exchange Act (34/1964).

Chapter five deals with commercial paper variations and the related dealing mathematics. The pricing of the various types of paper is discussed and measurement norms are provided for the inexperienced or new participants in the negotiable fixed interest securities market.

Chapter six provides a framework for the establishment of a commercial paper programme for a would-be issuer. All the required steps are discussed in detail to guide the prospective issuer through the process of issuing commercial paper.

The focus in chapter seven falls on the various roles that financial intermediaries can fulfil. This chapter is of special importance to the banking sector, money brokers or "bucket shops" as they are often referred to.

The perceived role of the South African banking industry in the commercial paper markets is discussed in this chapter and this might provide money market treasurers and dealers with some guide-line as to their future roles and functions in the commercial paper market.

Chapter eight explores the feasibility of an off-balance sheet operation for a bank.

Chapter nine is the conclusion of the study. This chapter will indicate to all possible participants that a commercial paper market can exist in South Africa outside the formal financial services industry, and that even the banks have more than one role to fulfil in this market.

## CHAPTER 1

The research is based on books, journals, articles, the unpublished draft document of the South African Commercial Paper Forum : "Market Practice Document for the issue and Trading of CP Notes", and the experience of the author in treasury management and money and capital market trading with a major South African commercial bank.

## CHAPTER 2

# CAUSAL FACTORS TO THE STUDY

### 2.1 INTRODUCTION

"The financial system may be defined briefly as a complex set of arrangements embracing the borrowing and lending of funds by non-financial economic units and the intermediation of this function by financial institutions to facilitate the transfer of funds, to provide additional money when required, and to create markets in debt in order that the price of funds, and therefore the allocation of funds, be determined efficiently." (Falkena et al, 1988:200.)

The South African interest-bearing securities market has been a very buoyant market over the past three decades. In the interest-bearing securities market there are primarily two markets, namely the money market and the capital market.

The objective of this chapter is to provide some basic background to the South African interest-bearing securities market, and to identify the markets in which secondary commercial paper trades will take place.

The chapter will provide a brief overview of the historic development of the commercial paper market in the United States and the subsequent development in Europe.

Particular emphasis will be placed on debentures and the shorter end of the negotiable-interest bearing securities market, namely the money market. World-wide experience is that most of the commercial paper transactions are fairly short dated and it is very possible that in South Africa a similar trend will persist.

## CHAPTER 2

The South African capital markets will be briefly discussed as this will provide a better background to the local financial markets. Four main types of instruments that are classified as capital market instruments in South Africa are:

- (i) Fixed-interest securities;
- (ii) Variable-interest securities;
- (iii) Equities and debentures; and
- (iv) Negotiable documents.

Under certain circumstances debentures will fall into the ambit of the Banks Act (94/1990) and Government notice no. 152 issued on 26 January 1993, which specifies that debentures that are not quoted on a legal exchange in South Africa and with a maturity of less than five years, will be classified as commercial paper.

As far as commercial paper is concerned, there can also be a definite overlap between the money market and the fixed-interest securities market. Money market transactions can be loosely defined as transactions with a maturity of no longer than three years. Gilt transactions can be described as trading in fixed-interest securities of the South African Government and Semi-Gilts as the fixed-interest securities of the parastatals.

The third objective of this chapter is to provide some insight into current developments in the South African commercial paper markets and what the future might have in store for this relatively new instrument in the South African interest-bearing securities market.

## CHAPTER 2

### 2.2 HISTORIC OVERVIEW OF THE COMMERCIAL PAPER MARKET.

Commercial paper is one of the oldest forms of financing in The United States. Negotiable paper transactions can be traced back to the early nineteenth century in the former British colony.

A well-developed money market was established in negotiable interest-bearing instruments by the middle of the nineteenth century in New York. Amongst the securities that were traded in, was the practice of selling Commercial Notes directly in and out of dealer inventories.

A credit worthy company could be an issuer of commercial paper with the principal investors being various banks. These notes were traded through a vast network of dealers and brokers.

In 1920 General Motors Acceptance Corporation began issuing commercial paper notes directly to major investors, thereby by-passing the broking fraternity. Several other issuing companies followed the example as set by General Motors Acceptance Corporation in this way becoming direct issuers.

The rapid growth experienced by the American car manufacturers combined with the growth rate in the need for the financing of other activities resulted in the demand for credit exceeding the traditional credit supply lines of the American banks. This resulted in more conglomerates turning to the commercial paper markets to satisfy their increasing demand for credit.

The American Banks Act of 1933 regulated that no interest was payable on demand deposits. This regulation forced investors to look for more lucrative means and ways to invest their surplus liquidity. The flexibility plus the returns on short-dated commercial paper made this alternative very attractive to short term corporate investors.

During the fifties direct issues of commercial paper in the United States constituted for almost two thirds of the total amount of commercial paper outstanding.

## CHAPTER 2

The credit crunch that existed during the sixties led to a further expansion in the commercial paper market which lasted into the eighties. Restrictions in monetary policy led to expansion of this market by almost 400 percent in the eighties, as corporates were encouraged by their bankers to issue commercial paper notes.

Over the past two decades the lending base of the American banking system has eroded with more and more blue chip companies making use of commercial paper. The large corporate conglomerates realised that they could tap the credit markets directly at a much lower cost to them than they could borrow from their own bankers.

The growth in commercial paper or short-term corporate acknowledgment of debt notes has reshaped the world-wide corporate lending business in more ways than one and is still continuing to do so.

Historically commercial paper is perceived to be the enemy of the traditional banking system. The commercial paper experience has been the same world-wide. The only difference is the time frames in which the American, European and South African markets are developing.

Banks world-wide are trying to recover some of the lost ground which was created by commercial paper. American Banks are offering asset-backed commercial paper. This development is the combination of traditional bank lending against the security of assets combined with the flexibility of commercial paper.

The South African market is experiencing currently what the European markets have experienced since the mid eighties. The banking fraternity is very reluctant to get involved in this market as they have never been too supportive of any movement, product or innovation that bears a mere resemblance to competitiveness.

## CHAPTER 2

### 2.3 THE CURRENT SITUATION

#### 2.3.1 The South African Capital Market

##### 2.3.1.1 Background

The capital market constitutes the long-term part of the financial system, acting as a source of funds with maturities of longer than three years

"The capital market can be seen as the complex of institutions and the mechanisms through which funds in a term of more than three years are pooled and be made available to public and private bodies." (Falkena et al, 1988:253)

The basic instruments that are traded in the South African capital market are:

- Fixed-interest securities;
- Variable-interest Securities;
- Equities; and
- Negotiable documents such as options.

The Rand volumes traded in gilts on the Johannesburg Stock Exchange are far greater than the volumes traded in ordinary shares.

## CHAPTER 2

### 2.3.1.2 Fixed-Interest Securities

#### (A) Gilts and Semi-Gilts

Fixed-interest securities issued by the government are known as gilt-edged securities and those issued by public sector bodies are known as semi-gilts.

In the South African market gilts are traded at a yield to maturity and on the overseas markets fixed interest securities are traded at a price. The yield to maturity is always expressed as an interest rate which discounts the net present value of the future six monthly coupon payments and the capital value on expiry date.

The price will always be quoted as a price per hundred of the face value of the stock.

The first golden rule for all participants in this market is:

"The lower the yield the higher the price."

#### (B) Debentures

A debenture can either be a fixed or a floating-interest bearing acknowledgement of debt issued by a company. The debenture is a loan contract between the issuing company and the investor.

The debenture consists of two sections namely the debenture itself and the trust deed which is issued in support of the debenture.

## CHAPTER 2

The debenture is a primary contract between the issuing company and the investor and represents a promise to pay a certain amount of interest at regular intervals, and to repay the capital amount of the debenture on a specified maturity date.

In theory a debenture can also be issued at a floating interest rate with a floating maturity date but there is currently no secondary market for this type of debenture.

The trust deed is also part of the debenture . This supplementary contract is between the issuing company and the trustees. The trustees are the representatives of the debenture holders.

In the trust deed the rights of the debenture holders are detailed . the function of the trustees are to protect the rights of the debenture holders and to see that the issuing companies adhere to the terms and conditions of the issue.

### **Categories of debentures:**

There are three broad categories of debentures:

#### **(i) Secured or Unsecured**

Debentures can be secured or unsecured. The nature of the secured or unsecured status will depend on what investment rating is given to the issuing company by the investment community. It is very unlikely that blue chip companies will issue secured debentures.

Secured debentures which are secured by a registered mortgage bond of fixed property or a notarial bond in the case of movable property.

## CHAPTER 2

### **(ii) Terms of Issue:**

The term of issue of a debenture can be redeemable before maturity or at specific intervals as specified in the trust deed.

### **(iii) Redeemable debentures**

There are various types of redeemable debentures which are discussed below:

#### **(a) Convertible debentures**

Convertible debentures are fixed interest-bearing debentures that may be converted at the option of the issuer into some other securities, usually shares as specified in the original terms of issue.

#### **(b) Call debentures**

Call debentures are interest-bearing securities where the capital is repayable at any time at the option of the issuer of the callable debenture.

### **Various Methods of Interest Payments:**

#### **(i) Fixed Yield Debentures**

Fixed yield debentures are issued at a fixed interest rate for a specific period. The date of future interest payments will be specified in the terms and conditions of the issue.

## CHAPTER 2

### **(ii) Participating or Profit-sharing Debentures**

Participating or profit-sharing debentures stipulates that the holder will receive a predetermined interest rate on the debenture as well as the possibility to share in the future profits of the issuer.

The future share will be stipulated in the issuing terms of the debenture issue.

### **(iii) Linked-Rate Debentures**

Linked-Rate debentures are debentures where the interest coupons are linked to other rates in the money or capital markets. The type of linked rate that may be used will depend on the original maturity of the debenture.

Interest rates that can be used as linked-rates are the Prime lending rate of the major commercial banks, the treasury bill rate, the three month negotiable certificate of deposit rate or any rate which may be appropriate for the duration of the issue.

Income debentures can also be issued where the future income streams are dependant on the profitability of the issuing company.

## CHAPTER 2

### 2.3.2 The South African Money Market

#### 2.3.2.1 Background

The money market can be described as the shorter end of the interest-bearing securities market. The market generally deals with instruments with a maturity of up to three years.

The three elements of the South African money market are:

- (i) The borrowers and the lenders;
- (ii) The financial intermediaries; and
- (iii) The money market instruments.

#### 2.3.2.2 The Lenders and Borrowers in the Money Market are:

- The household sector;
- The corporate sector;
- General government sector; and
- The foreign sector

Commercial paper can resort under the corporate as well as the general government sector as far as borrowing and lending are concerned.

## CHAPTER 2

### 2.3.2.3 The Financial Intermediaries in the South African Money Market

The financial intermediaries can be classified into two main groups, namely:

The deposit taking intermediaries and non-deposit-taking intermediaries.

The banking intermediaries are:

- The South African Reserve bank;
- The private banks;
- The Land and Agriculture Bank; and the
- Development Bank of Southern Africa

The non-deposit taking intermediaries are:

- The insurance companies;
- The pension funds;
- Investment trusts; and the
- National Housing Commission.

## CHAPTER 2

### 2.3.2.4 Instruments of the Money Market

#### **Introduction**

There are various formats and denominations of commercial paper and other interest-bearing negotiable instruments, representing the obligations of debtors right throughout the world.

Negotiable interest-bearing securities can be categorised into three categories; namely –

#### **(A) Primary Securities**

These securities represent the debt obligations of the ultimate borrowers in the economic system namely the public sector, the private sector and the semi-public sector.

Commercial paper, bankers acceptances, bills of exchange, promissory notes, trade bills, company debentures, securitised mortgages, treasury bills, Government stock and Eskom stock are all examples of primary securities that are found in South Africa.

#### **(B) Indirect Securities**

Indirect securities represent the debt obligations of banks and mutual building societies.

Some example of indirect securities are: negotiable certificates of deposit issued by banks and mutual building societies, South African Reserve Bank debentures, Land Bank bills, Land Bank promissory notes and Land Bank debentures.

## CHAPTER 2

### (C) Repurchase Agreements

"A repurchase agreement is a sale of securities with an undertaking by the seller to repurchase the same securities after a specified period of time at a price (yield) determined at the time of the sale. The essence of a repurchase agreement is to adjust the original maturity of a particular money market asset to suit the need of the investor." (Falkena *et al.*, 1989:246)

The last sentence in the above quotation can be altered to read as such:

"The essence of a repurchase agreement is to adjust the original maturity of a particular money *or capital* market asset to suit the *needs of both parties to the agreement.*"

Money market and capital market trading can span all three tiers of interest-bearing securities trading. Money market trading usually refers to trading in negotiable interest-bearing securities and derivatives thereof with a maturity of less than three years.

Money market instruments can have a tenor of any number of days but instruments, with a maturity of longer than three years from dealing date are very seldom traded in the secondary market.

Capital market instruments in the South African context are bonds of Government and semi-government institutions and derivative instruments thereof, irrespective of the maturity date.

The needs of both parties have to be fulfilled before a repurchase agreement is entered into. The seller of the repurchase agreement might be looking for a higher return on his investment for the period of the repurchase agreement or might need the proceeds to suit his own internal cash flow needs.

## CHAPTER 2

On the other hand the purchaser of the repurchase agreement might need a certain amount of liquid assets (like in the case of a bank) for a certain period or the purchaser might be looking for a short term investment yielding a better return than a bank deposit or a short-dated negotiable interest-bearing instrument for a similar period.

### 2.4 SITUATION APPRAISAL

#### 2.4.1 Introduction

The South African commercial paper market came into existence on 3 January 1992 when the South African commercial paper market was promulgated.

During 1992 very little happened on the South African commercial paper market. A major obstacle under the previous regulations was that any commercial paper issue required bank endorsement. This controversial endorsement fell away with the 1993 regulations.

Government Notice No. 152, published in the Government gazette dated 26 January 1993 Volume 311 No. 14553 regulates the issue, trade and investment in South African commercial paper.

The current scenario is that there is a very lack lustre growth in the South commercial paper market. There may be various reasons for the lack of growth in this area.

The general feeling is that the market will begin to develop and grow, once there are signs of an economic recovery. The short term borrowing

## CHAPTER 2

requirements of the major South African conglomerates are almost non-existent as they have been cutting down due to the current domestic uncertainty and the general world-wide recession.

Eskom and Iscor have already issued commercial paper. The benefit for these parastatals is that their commercial paper do not require revenue stamps.

There were definite constraints in the 1993 regulations that were hindering the issue of commercial paper. Some of these constraints were:

That the net asset value of the issuing company should be in excess of R100 Million. The argument is that the net asset value of a company is not always a true reflection on the financial prosperity of the company. The company with the net asset value might be an under performer compared to a smaller company with a net asset value of below R100 Million.

The net asset valuation has been disregarded in the 1994 regulations pertaining to the issue of commercial paper.

Commercial paper cannot be used as a means to acquire overnight funding. In the regulations, call bonds are classified as commercial paper. Call bonds are used by many public companies to acquire overnight funding.

## CHAPTER 2

### 2.4.2 The South African Commercial Paper Forum

The South African Commercial Forum was formed during 1992 with the purpose to discuss issues relating to the creation of a commercial paper market in South Africa.

"The purpose of the forum is to discuss issues relating to the creation of and operation of a commercial paper market, to develop and to review operating guide-lines for the commercial paper market and to discuss developments within the market. It has an interface with the South African Reserve Bank which provides a channel for discussion on issues concerning commercial paper and for consultation between participants in the commercial paper market and the reserve bank." (CP Forum 1992:1)

One of the objectives of the forum is that the market will become self-regulating which is more acceptable than a centrally regulated market. The forum are currently trying to standardise the various issues and procedures attached to commercial paper.

The commercial paper forum has issued a draft document during 1992 and a further document during 1993 entitled: "Market Practice Document For The Issue And Trading of CP Notes"

The work that was completed by the South African commercial paper Forum, is based on a document that was released during December 1986 by the British Banker's Association (in association with The Association of Corporate Treasurers) entitled: " Sterling Commercial Paper (interim guide-lines)".

## CHAPTER 2

### 2.5 CONCLUSION

The South African banking fraternity will have to keep themselves up to date with the latest developments in the commercial paper markets.

The market for commercial paper may be a very small and cumbersome market in which to partake but the international experience has shown that commercial paper can seriously erode the corporate lending base of the traditional banking institutions.

In the study special emphasise will also be given to the future roles that banking institutions may fulfil in this market.

## CHAPTER 3

# THE EUROPEAN COMMERCIAL PAPER MARKET

### 3.1 INTRODUCTION

The American commercial paper market has been in existence since the nineteenth century and currently is a market with a multibillion dollar per annum turnover. In comparison to the American markets the domestic European markets are very immature and still developing markets.

The Sterling commercial paper was the first European market to open during 1986 with the French Franc and Dutch Gilder markets to open shortly afterwards. The significance is that the current South African legislation is very much based on the Sterling commercial paper legislation.

Some of the very problems that have plagued the development of the British markets are being experienced by would be issuers in the South African market. In the British market issuers with a net asset value of fifty million pounds do not need any endorsement or guarantee on their commercial paper. In South Africa the limit use to be R100 Million.

The objective of this chapter is to provide some insight into the European domestic commercial paper markets. Commercial paper markets do exist in Britain, France, Holland and a number of other European countries.

The Sterling market will be looked at in more detail than the other European markets due to its significance for the South African markets, both as a major trading partner and the relevant current South African legislation.

With the lifting of sanctions against the Pretoria regime, vast opportunities have opened up to South African importers and exporters and this chapter will also supply some basic information to would be participants in these international markets.

## CHAPTER 3

### 3.2 THE STERLING COMMERCIAL PAPER MARKET

#### 3.2.1 Introduction

Her Majesties Treasury and the Bank Of England announced statutory changes to The British Banks Act (1979) and the previous published regulations to allow the issue of Sterling commercial paper. This announcement took place on 29 April 1986.

The Sterling commercial paper market was launched on 20 May 1986 when The Banking Act was amended to exempt borrowers from being classified as deposit takers.

There have been regular issues of commercial paper in Britain but both taxation and legal issues placed constraints on the rapid development of the Sterling market.

#### 3.2.2 Regulatory Framework

There are four principal acts of British Parliament which are governing the issue, sale and distribution of Sterling commercial paper, namely

- The Banking Act 1979;
- The Companies Act 1985;
- The Financial Services Act 1986, and
- The Prevention of Fraud (investments) Act 1958.

The significance of The British Banking Act (1979) as far as Sterling commercial paper is concerned, is the determination of the fact of who may and who may not accept deposits from the public.

## CHAPTER 3

The amended regulations that were published on 29 April 1986 empowered the Treasury to exempt under certain conditions the issuers of Sterling commercial paper from the ambit of The British Banking Act (1979).

The announcement of the Bank of England can be summarised as follows:

The issuer of Sterling commercial paper should have a net asset value of £50 million and should have a listing on the London Stock Exchange. The subsidiaries of such companies may also issue Sterling commercial paper if their paper is guaranteed by their holding companies.

The term net assets, is defined in the British Companies Act 1985 in Section 264(2) as follows:

"The aggregate of the company's assets less the aggregate of its liabilities."

British banks and building societies cannot use the Sterling commercial paper market. State controlled institutions can thus not issue commercial paper as they fall outside the provisos of this regulation.

Sterling commercial paper must bear a clause witnessing there has been no material change in the financial state of the company since the publication of its previous listing particulars.

The tenor of a Sterling commercial paper note can not be shorter than seven days and may not be issued for a period longer than one year.

The minimum denomination of a Sterling commercial paper note is £500,000. Most of the notes in issue are in Sterling denominations of 1 Million. The Bank of England is looking at the market implications of reducing the minimum Sterling denomination of commercial paper.

## CHAPTER 3

Sterling commercial paper must bear the following clause:

"Sterling commercial paper issued in compliance with Regulation 15 of the Banking Act 1979 (Exempt Transactions) Regulations 1986."

If the issuer of sterling commercial paper complies with the above, he is exempted from the definition of the Banking Act (1979) and is therefore exempted from the definition of deposit taking institution.

The above-mentioned requirements do not apply, if any issue of sterling commercial paper is endorsed by a licensed United Kingdom-incorporated banking institution or deposit-taker.

### 3.2.3 Market Liquidity

Although certain investors and issuers are still finding their way around in the Sterling commercial paper market, there is a high investor demand for short dated paper.

The tenor of the paper in this market is very short with most of the paper being issued for periods of thirty days. Sterling commercial paper provides a very attractive investment avenue for investors up to ninety days and the rates are very competitive with other short dated negotiable-interest instruments.

Private UK investors are limiting their investment exposure to £1 or £2 million in this market but are expected to increase their holdings of commercial paper, once the uncertainty that does persist in the market is overcome.

Banks are still reluctant to invest in this market as unsecured paper will attract capital coefficients and thus are more likely to perform the roles of issuing and paying agent, market maker and dealer.

## CHAPTER 3

The secondary market is not very active in Sterling commercial paper, the reason being that most of the paper is being issued for very short periods and that investors prefer to keep their notes till the maturity thereof.

Although the Sterling commercial paper market is still very much a London domestic market, a tremendous growth potential does exist in this market to fulfil in the requirements of non United Kingdom investors. Many of these investors can use the Sterling notes as an alternative means to Sterling equities or gilts to hedge against their own domestic currencies if required.

### 3.3 DEUTSCHMARK COMMERCIAL PAPER

#### 3.3.1 Introduction

The Deutschmark commercial paper market has developed very rapidly since its inception in 1991. The first issuer of Deutschmark commercial paper was Daimler-Benz with a programme of DM 500 million which was arranged by Deutsche Bank AG.

Other highly rated German issuers also issued DM commercial paper in 1991 and investors very eagerly invested in this new avenue of investment.

#### 3.3.2 Regulatory Framework

The Deutschmark commercial paper market developed after the abolishing of the stock exchange turnover tax and paragraph 795 BGB of the German Civil Code.

Paragraph 795 stipulated that the issuance of Deutschmark commercial paper or any bearer securities required permission from the Minister of Finance and in conjunction with the federal state in which the would be issuer was allocated.

## CHAPTER 3

The issuer of Deutschmark commercial paper must be domiciled in Germany. In the advent of a German subsidiary of an international wanting to issue Deutschmark commercial paper, the parent company would have to furnish guarantees to underwrite the issue of such notes.

Commercial paper notes in Germany may be issued in a series of not less than DM 5 million. The face value of each note in the series may not be smaller than DM 500,000.

Notes issued in a specific series must have identical terms and conditions. Deutschmark commercial paper are all issued at a discount to par with no interim interest payments. Even when notes are issued for the maximum tenor of two years interest will only be payable on maturity.

Any Deutschmark commercial paper programme must have a minimum prospective issuance of DM 100 Million. During the time period of the total amount of the notes in issue may not exceed the maximum amount as for the program.

The tenor of Deutschmark commercial paper may range from seven days to two years.

### 3.3.3 Market Liquidity

Deutsche Bank AG is the biggest dealer in the Deutschmark commercial paper market. They have also manage to set up the most Deutschmark commercial paper issuing programmes.

Deutsche Bank AG is followed by Dresdner Bank AG as the second largest participant in this market.

Only German banks can act as dealers for Deutschmark commercial paper. The paper is placed directly with investors and usually these dealers will have no underwriting commitment to the issuer.

## CHAPTER 3

Dealers in the Deutschmark commercial paper have no commitment to buy paper from issuers and there is no commitment from issuer to issue any paper at any stage. Primary issues are thus very dependant on the interest rate views of the issuers.

The demand for notes with a tenor from seven days up to three months are very popular with investors.

The investors in Deutschmark commercial paper are mutual investment funds, pension funds and insurance companies and local and foreign corporate companies. Private individuals can also invest in this market but stronger demand are being experienced from non German investors.

Rates quoted on Deutschmark commercial paper are very much in line with domestic money market rates for similar periods. Most of the paper trade takes place at below at Deutschmark Fibor level. These are the money market lending rates quoted by prime German banks for relevant periods.

The Deutschmark commercial paper market is the biggest and most successful commercial paper market in Europe. With quality issuers like Daimler-Benz AG, Sudzucker AG, Volkswagen AG, Bayerische Motoren Werke AG and Hoechst AG, it is hardly surprising that the market has really taken off in a relative short space of time.

It is very unlikely that Deutshemark commercial paper will ever be quoted on the German Stock Exchange due to the short term nature of the instrument. German banks can also not issue Deutschmark commercial paper as they attract minimum capital and reserve requirements.

## CHAPTER 3

### 3.4 FRENCH BILLETS DE TRÉSORERIE

#### 3.4.1 Introduction

The French commercial paper market was established in 1985 as part of the deregulation of the French monetary system.

The French market has the biggest number of issuers of commercial paper in Europe.

French Billets de Trésorerie represent more than ten percent of the total negotiable interest-bearing securities market in France. Since the end of 1988 the market has grown with almost four hundred percent.

#### 3.4.2 Regulatory Framework

French Billets de Trésorerie may be issued for a tenor of not less than 10 days and not more than seven years. Notes are issued at a discount to par for periods of less than one year. French Billets de Trésorerie issued for longer than one year may be issued at fixed or floating interest rates.

The minimum denomination of French Billets de Trésorerie are Ffr 1 Million.

The French Billets de Trésorerie may exist in a dematerialised form. This exemption was authorised by the French authorities in 1991. What this really means that French Billets de Trésorerie may be issued by means of a book entry.

Thus no physical delivery takes place to investors.

It is very rare for French Billets de Trésorerie to be guaranteed although they may be guaranteed by a bank or a corporation.

## CHAPTER 3

Issuers of French Billets de Trésorerie must have been in existence for longer than two years and also should have published at least two annual reports. Minimum paid-up share capitals of issuing companies should be at least Ffr 1 million.

Issuers of French billets de Trésorerie may be either French or foreign private of public companies. Foreign investors are exempted from withholding tax.

### 3.4.3 Market Liquidity

In contrast with the American commercial paper market most of the French Billets de Trésorerie are placed via intermediaries.

The banks are playing a very important role in the French commercial paper market as about forty five percent of all trades are executed by them. The most important dealing banks are Banque Nationale de Paris which execute about twenty percent of the deals this market.

Rating agencies play a very important role in the in the issuing of commercial paper although it is no legal requirement in France. There are three rating agencies which are officially recognised by the French authorities namely:

- Moody's France SA and Moody's Investors Service;
- Standard & Poor Adef; and
- Euronotation France.

It is interesting to note that two of the three are American subsidiaries.

## CHAPTER 3

Major issuers of French Billets de Trésorerie are Rhone-Polonce, Fiat France, Peugeot Finance Holding and Cofim Renault.

The investors are pension and mutual funds and insurance companies which do not have access to the French interbank market.

Secondary market trading is very rare in French Billets de Trésorerie as most of the investors tend to hold onto the paper till the maturity thereof.

The French authorities and issuing community are hoping for more foreign issuers and investors to add liquidity to the French Billets de Trésorerie market. The market should be of very special interest for international companies who are looking for French Franc funding to finance their activities in France.

### 3.5 CONCLUSION

Commercial paper markets also do exist to a smaller extent in the following European countries and were also developed from 1986 onwards:

- Belgium
- Finland
- Holland
- Sweden
- Switzerland

The commercial paper markets have shown steady growth in most of the European countries over the previous five years. The fastest growing market is the Deutschmark commercial paper market which is a very protective market for German issuers and investors.

The most troublesome market was the Sterling commercial paper market which has experienced quite a few start-up hiccups.

### CHAPTER 3

In commercial paper literature the Sterling market is very much criticized by authors due to the unappropriated legislation that controls the market.

The legislation that controls the South African commercial paper market is unfortunately based to a large extent upon British legislation that is controlling the Sterling commercial paper market.

## CHAPTER 4

# THE REGULATORY FRAMEWORK CONTROLLING THE SOUTH AFRICAN COMMERCIAL PAPER MARKET

### 4.1 INTRODUCTION

There are six principle Acts of Parliament which are governing the issue, sale and distribution of commercial paper in the Republic of South Africa:

The Banks Act (94/1990) and the regulations issued in terms thereof on the 26 January 1993 and all further amendments that may be issued;

The Companies Act (61/1973);

The Stamp Duties Act (77/1968);

The Marketable Securities Tax Act (32/1968);

The Bills of Exchange Act (34/1964); and

The Safe Deposit of Securities Act (85/1992).

The significance of The Banks Act (94/1990) regarding the issue, trading and the investment in commercial paper pertains to the question of who may and who may not accept deposits from the general public.

Government Notice No. 122 issued on 23 January 1993 covers the designation of an activity not falling within the meaning "The business of a deposit-taking institution" (commercial paper).

The fact that the above-mentioned Government Notice expired on 31 December 1993, does not reduce its overall impact on the South African commercial paper market.

## CHAPTER 4

The annual review of this notice implies that it is subject to revision and that certain of the prescribed elements and provisos may change from time to time. It is generally accepted that the spirit and the ambit in which this regulation was issued, will not change and that the annual review of the notice is being done to accommodate problems that may be experienced both by issuers and investors in this market.

The Stamp Duties Act (34/1964) specifies which negotiable interest-bearing documents must be revenue-stamped. The selective application of The Stamp Duties Act will have serious consequences on the future of the South African commercial paper market as it is creating a very uneven playing field in the South African money market.

The Companies Act (61/1973) regulates, amongst other things, the issuing of debentures. Debentures that are issued for a period of less than five years and not quoted on a registered exchange, will fall into the ambit of The Banks Act (94/1990) and all other subsequent notices issued in terms of the definition of commercial paper.

The issuance of all debentures are controlled by The Companies Act (61/1973).

The Marketable Securities Tax Act (32/1968) specifies which marketable securities are subject to marketable securities tax and the instances in which negotiable instruments are exempted from this tax.

## CHAPTER 4

### 4.2 THE BANKS ACT (94/1990)

Section one of The Banks Act (94/1990) regulates amongst other things, who may or may not accept deposits from the public.

The relevance of this section lies in the interpretation that the regular issue of short term Rand instruments, such as commercial paper, is in effect deposit-taking which is prohibited in terms of The Banks Act (94/1990) for institutions or individuals other than registered banking institutions.

"The business of a bank means"

- (a) the acceptance of deposits from the general public as a regular feature of the business in question, including, in relation to such an institution, from persons in its employ;
- (b) the soliciting of/ or advertising for deposits;
- (c) the utilisation of money, or of the interest or other income earned on money, accepted by way of deposit as contemplated in paragraph (a) –
  - (i) for the granting by any person, acting as lender in his own name or through the medium of a trust or nominee; of loans to other persons.
  - (ii) for the investment by any person, acting as an investor in his own name or through the medium of a trust or nominee, or;

## CHAPTER 4

- (iii) for the financing, wholly or to any material extent, by any person of any other business activity conducted by him in his own name or through the medium of a trust or nominee;
- (d) the obtaining, as a regular feature of the business in question, of money through the sale of an asset, to any other person than a bank, subject to an agreement in terms of which the seller undertakes to purchase from the buyer at a future date the asset so sold or any other asset, or;
- (e) any other activity which the Registrar has after consultation with the Governor of the Reserve Bank, by notice in the Government Gazette declared to be the business of a bank.

In terms of The Banks Act (94/1990) the business of a bank can be rather widely defined as the acceptance of deposits from the general public.

## CHAPTER 4

### 4.3 GOVERNMENT NOTICE NO. 122 DATED 26 JANUARY 1993

#### 4.3.1 Introduction

Government Notice No. 122 published in the Government Gazette dated 26 January 1993, Volume 311 No. 14553, exempts companies issuing commercial paper from the ambit of The Banks Act (94/1990) as far as the definition of a bank, provided that certain conditions are met.

The definition of commercial paper and the conditions of issue are, in summary:

#### 4.3.2 Definition

" Commercial paper is defined as short term secured or unsecured promissory notes with fixed or floating maturity, call bonds as well as any other written acknowledgement of debt,

issued to acquire working capital; and

debentures and any other interest-bearing written acknowledgement of debt issued for a fixed term in accordance of the Companies Act of 1973.

but does not include bank endorsed acceptances."

(Government Notice, 122/1993)

## CHAPTER 4

### 4.3.3 General Conditions

Instruments to be issued:–

- (a) minimum denominations R1 Million;
- (b) issued by a company which holds net assets, as certified by its auditors, in excess of R100 Million;  
unless:–
  - (i) the instruments are listed on a recognized financial exchange; or
  - (ii) the instruments are endorsed by a deposit-taking institution; or
  - (iii) the instruments are issued for a period longer than five years; or
  - (iv) the instruments are backed by an explicit Central Government guarantee; or
  - (v) the instruments are issued by the Central Government

### 4.3.4 Use of funds

The funds to be raised through the issue of commercial paper shall be applied for a specific purpose , and may not be applied, either directly or indirectly, for credit extension (other than customary credit in respect of the sale of goods and or services by the issuer of such commercial paper) to the general public in contravention of the provision of the Act.

## CHAPTER 4

### 4.3.5 Disclosure in Placing Documents

A placing document or prospectus relating to the issue of commercial paper should disclose at least the following information: –

- (i) the name of the issuer who at all times shall be the ultimate borrower;
- (ii) the purpose for which the funds raised are to be assigned;
- (iii) whether the issue is secured or unsecured;
- (iv) a statement signed by two directors of the issuer to the effect that the issuer is a going concern and that can in all circumstances be reasonably expected to meet its commitments;
- (v) whether the issue complies fully with the provisions of the exemptions to The Banks Act (94/1990);
- (vi) whether or not the issue is to be listed;
- (vii) the total amount, as certified by its auditors, of the issuer's capital and reserves;
- (viii) the total amount, as certified by its auditors, of the issuer's capital and reserves;
- (ix) the name of the auditor of the issuer;
- (x) the total amount of commercial paper already issued by the issuer, as well as the estimated amount of commercial paper still to be issued by the issuer;
- (xi) all other information which might be necessary to enable the lender to ascertain the risk attached to his investment;
- (xii) whether or not the issue complies in all respects with the provisions of this notice.

## CHAPTER 4

### 4.3.6 Disclosure on Certificate

A commercial paper certificate is to contain at least the following information:–

### 4.3.7 Statutory Requirements

- (i) the name of the issuer, who at all times shall be the ultimate borrower;
- (ii) a statement signed by two of the directors of the issuer that the company is indeed a going concern and can in all reasonable circumstances expected to meet its commitments.
- (iii) whether or not the issue complies in all respects of the act.

### 4.3.8 Statutory Returns

A bank that endorses commercial paper, shall clearly indicate in its DI 100 that component of its business that relates to such endorsements.

### 4.3.9 Returns by Issuers of Commercial Paper

All issuers of commercial paper shall furnish a monthly return in the prescribed format to the Registrar.

## CHAPTER 4

### 4.3.10 Market Making

- (a) Commercial paper may be issued at a fixed or floating interest rate and may be used in market making therein, subject to the following conditions:
- (b) the instruments are issued in denominations equal; or
- (c) the instruments are issued on a recognized financial exchange; or
- (e) the instruments are endorsed by a financial institution

Provided that—

- (i) Commercial paper may not be utilised for the obtaining of overnight market funds.
- (ii) No market may be made in unlisted debentures issued for a period longer than five years.

### 4.4 THE BILLS OF EXCHANGE ACT (34/1964)

#### Definition of a Promissory Note

In terms of section 87 of The Bills of Exchange Act (34/1964) a promissory note is defined as an unconditional promise in writing made by one person to another, signed by the maker, and undertaking to pay on demand or at a fixed or determinable future time, a sum certain in money, to a specified person or his order to bearer.

## CHAPTER 4

### 4.5 THE STAMP DUTIES ACT (77/1968)

#### 4.5.1 Introduction

The Stamp Duties Handbook specifies amongst other things the following:

"Where a bill of exchange or a promissory note undertakes the payment of a definite sum, together with relative liability for interest and bank charges whether the rate is stated or not, duty is payable only on the amount of the definite sum."

Commercial paper will have to be revenue-stamped at 0,05% of the nominal value of the note.

The cost of revenue stamps makes the issue of longer dated or floating date maturity commercial paper much more attractive than shorter dated issues.

## CHAPTER 4

### 4.5.2 COMPARISON OF THE STAMP COST WITH THE TENOR OF A COMMERCIAL PAPER NOTE

TENOR	REVENUE STAMP COST
30 DAYS	.60 %
60 DAYS	.30 %
90 DAYS	.20 %
120 DAYS	.15 %
6 MONTHS	.10 %
12 MONTHS	.05%
18 MONTHS	.033 %
24 MONTHS	.025 %
36 MONTHS	.017 %
48 MONTHS	.013 %
60 MONTHS	.010%

From the above table it can clearly be seen that it is more economical to issue longer dated commercial paper as far as stamp duty is concerned. The actual tenor of an issue will be determined by the cash flow requirements of an issuer as well as his interest rate view over the period for which he requires the funding.

## CHAPTER 4

### 4.6 THE MARKETABLE SECURITIES TAX ACT (32/1968)

A marketable security is defined so as to mean any security, stock, debenture, share or other interest-bearing instrument which is capable of being sold in a share market or otherwise, and, where the context so requires, includes the scrip, certificate, warrant or other instrument by which ownership or title to any such security, stock, debenture, share or other interest is represented.

There is no listed commercial paper on the Johannesburg Stock Exchange or any other recognized exchange in South Africa and the likelihood of listed commercial paper coming into existence seems very remote. The reason is that the commercial paper issues are issued for relative short term periods which will make any listing extremely short-lived, thus only complicating the secondary market trading and the issuing of primary commercial paper.

As a result of a commercial paper customarily being unlisted, they do qualify for any exemptions from stamp duty in The Stamp Duties Act (77/1968).

The customarily promissory note status of the commercial paper note removes them from the ambit of The Marketable Securities Act (32/1968) and therefore will not attract marketable securities tax when traded.

## CHAPTER 4

### 4.7 DEBENTURES

#### Definition of a Debenture

A debenture is not defined in either The Stamp Duties Act (77/1968) or The Bills of Exchange Act (34/1968).

The Companies Act (61/1973) does not define debentures *per Se* but determines in general that debentures include debenture stocks, debenture bonds and any other securities of a company whether it forms part of a claim against the assets of the company or not. The result is that the word debenture encompasses all issues of debt by a company and that it would not be possible to circumvent the statutory requirements for debentures by using alternative names like loan issues, bonds, acknowledgement of debt, et cetera.

In the regulations issued in terms of The Banks Act (94/1990), a debenture is required to comply with the general conditions for the issue of commercial paper; unless—

- (i) the debenture is listed on a recognized financial exchange;  
or
- (ii) the debenture is issued for a period of longer than five years.

No market may be made in unlisted debentures issued for a period of less than five years.

## CHAPTER 4

### 4.8 SUMMARY:

The South African legislation controlling the local financial markets is based upon legislation that has developed over the years in Britain. The reasons for this traditional link can be found in the traditional links that existed between South Africa and the United Kingdom until the winds of change started to blow over the African subcontinent more than thirty years ago.

During this period of financial isolation, the South African financial regulatory authorities still followed world-wide trends and used the British financial legislation as a basis for relevant South African financial legislation.

"South Africa is following international banking trends by following in the spirit of the 1983 Basle Concordat and the 1988 Basle Accord although the country is not a signatory to these agreements." (Goodspeed,1991:44)

The fact that South Africa was following British banking legislation and spirit of the 1983 Basle Concordat, will definitely help the return of South Africa as a welcome participant in the international banking world and the International Monetary Fund.

Government Notice No. 122 published in the Government Gazette dated 26 January 1993 Volume 311 No. 14553 expired on 31 December 1993 and a new Notice will be gazetted shortly afterwards. The fact this notice expired, does not reduce the impact or the overall significance of this Government Notice (122/1993) on the South African interest-bearing securities market.

## COMMERCIAL PAPER VARIATIONS AND CALCULATIONS

### 5.1 INTRODUCTION

There are various formats and denominations of commercial paper and other interest-bearing negotiable instruments that are representing the obligations of debtors right throughout the world.

The characteristics and structure of a commercial paper note, like for example the format, tenor, possible endorsements, denominations and other features will be determined by the legislation and the market practice that is in existence in the country of issue.

In the South African money market various short-term negotiable interest-bearing instruments are being traded. Some of these instruments might be more frequently traded than others. The negotiable and popularity of the various types of instruments may fluctuate as actual interest rates and the expected future yield curves of investors move to new levels of expectancy.

The objective of this chapter is to summarise the various generic types of commercial paper that have been issued up to date in the South African market and those ones that are most likely to be issued. The 48 hour commercial paper note is a proposal by the author to encourage market making in short dated commercial paper. The floating maturity date ensures that the same note may be issued more than once, and that revenue stamp cost may be saved in this manner.

During formal discussions with Keyser Trading (Pty) Limited it was learnt that they have developed a very similar product that is also linked to the call deposit rate in the South African money market.

## CHAPTER 5

The variations that are discussed below are all primarily based on existing South African negotiable money market instruments. All these variations have not yet been seen in the local market but the level of innovation that does exist in the market will also produce other variations. No options or futures markets do exist as yet in Rand commercial paper and the opportunities for hybrid forms are endless.

Repurchase agreements will also be discussed as they may prove to be a very convenient method of refinancing the short-term liquidity needs of the commercial paper note holder. The short-term investment opportunity on the other hand might offer an excellent investment for the company with short-term excess liquidity.

Special emphasis will be placed on the various characteristics of commercial paper as far as the:

- (i) Description of the instrument;
- (ii) Application;
- (iii) Features;
- (iv) Form of Issue;
- (v) Dealing mathematics for primary issues and secondary trading;
- (vi) Settlement on the maturity date;
- (vii) Benefits for the issuer;
- (vi) Options of the issuer; and the
- (vii) Options of the investor.

The various types of commercial paper that will be discussed are:

- (i) Commercial paper issued at a discount to par;
- (ii) Interest coupon commercial paper notes;
- (iii) 48 Hour call bonds; and
- (iv) Zero coupon bonds.

## CHAPTER 5

### 5.2 COMMERCIAL PAPER VARIATIONS

#### 5.2.1 Introduction

The issuer of Rand commercial paper notes have to comply with the various statutory requirements as prescribed in The Banks Act (94/1990) and Government Notice No. 152 issued on 26 January 1993.

The statutory requirements and general accepted South African market practice will initially be discussed and thereafter the variations of South African commercial paper.

#### 5.2.2 Denominations

##### Statutory Requirements

The currency denomination in which South African commercial paper is issued and traded in, is the South African Commercial Rand. The official world-wide accepted abbreviation is ZAR.

It is not advisable for Financial Rand investors to invest in short-dated negotiable instruments because of the statutory constraints on the negotiability thereof.

The 1993 regulations stated that the minimum ZAR commercial paper denomination is one million unless it is quoted on a recognized exchange. Debentures that are quoted on a recognized South African exchange or in the advent of the commercial paper being endorsed by a South African banking institution may have Rand denominations of below R 1 million.

## CHAPTER 5

The 1994 regulations however stipulates that the minimum denomination will be R1 Million, irrespective of whether the issue is underwritten or endorsed by a South African banking institution.

### **Market Practice**

The money market practice is for commercial paper to be issued in the following denominations:

- ZAR 5,000,000
- ZAR 1,000,000

and if endorsed negotiable paper, other than commercial paper:

- ZAR 500,000
- ZAR 100,000

Bucket-shops and small brokers prefer smaller denominations that they can sell to the orphans, widows, and income tax evaders at a much bigger profit margin for themselves.

Major players are not keen on smaller denominations as the transaction cost per individual note becomes very expensive with small individual transactions. Safekeeping, handling fees and trace-ability of small bills through the system are expensive and are not to be encouraged.

## CHAPTER 5

### 5.2.3 Revenue Stamps

#### **Statutory Requirements:**

All commercial paper notes, excluding debentures that are quoted on a recognized exchange, are subjected to revenue stamps. These revenue stamps are to be displayed on the face of the bill.

Commercial paper is subjected to revenue stamps of 5 cents per one hundred Rand (or part thereof) based on the nominal or face value of the note. Commercial paper of Governmental departments is exempted from The Stamp Duties Act.

The exemption of these Governmental departments from the ambit of The Stamp Duties Act are creating a very uneven commercial paper market playing field. Eskom who is currently the biggest issuer of commercial paper notes are exempted from The Stamp Duties Act (34/1964).

Stamp duty is making short issues ( 30 days or less ) not viable as there are alternative avenues of attracting funds at a much lower cost to the ultimate borrower.

Stamp duty is also the reason why American issue, redemption and cancellation of commercial paper procedures cannot be pursued locally. The Stamp Duties Act (34/1964) is definitely curtailing the growth of the South African commercial paper market.

Floating maturity commercial paper notes are discussed later in this chapter which may offer some relief to the issuer in as far as stamp duty is concerned.

## CHAPTER 5

### 5.2.4 Statutory Disclosures on the Commercial Paper Note.

The following minimum information has to appear on a commercial paper note in accordance with Government Notice No. 122 issued on 26 January 1993:

- (i) The name of the issuer who at all times will be the ultimate borrower, as a heading on the face of the bill.
- (ii) A statement signed by the two directors of the issuing company that the company is a going concern and that in all circumstances can be reasonably be expected to meet its commitments.
- (iii) A clause that the issue in all respects complies in all respect with the provisions of the above-mentioned notice.

These requirements are retained in the 1994 regulations.

## CHAPTER 5

### 5.3 THE FOUR GENERIC COMMERCIAL PAPER VARIATIONS

#### 5.3.1 Commercial Paper Issued At A Discount To Par

##### (i) Description

It is market practice in South Africa that commercial paper is issued and traded on a discount basis up to 365 days. The rate may be quoted as an effective yield related to the number of days till the maturity date of the instrument, the quoted yield will then be converted into a discount to calculate the price of a bill.

A commercial paper note that is issued at a discount to par is a short-term debt obligation of the issuing company. The tenor of the commercial paper will be for one year or shorter and the most popular tenor will be in the ninety day area.

##### (ii) Application

The commercial paper application is the financing of the short to medium term working capital requirements of the issuer who must also be the ultimate borrower.

##### (iii) Features:

The term of issue will generally be a maximum period of one year. The most popular tenor is expected to be in the ninety day area as in the case with other negotiable acknowledgment of debt instruments like bankers acceptances that are issued at a discount to par.

## CHAPTER 5

The lending will be at a fixed rate and for a fixed period.

**(iv) Form of Issue:**

The note will usually be issued in bearer form. The name of the original purchaser of the bill may be inserted on the face of the bill.

If the name of the original purchaser appears on the face of the bill, it can be endorsed on the back of the bill by the original owner and transferred to its new owner.

Transfer will usually take place with the physical delivery of the bill.

## CHAPTER 5

### (v) Dealing Mathematics

#### (a) Primary Issue:

#### Example

A commercial paper note with a face value of R1,000,000 (One Million Rand) and a tenor of 90 days is discounted at a commercial bank at a discount rate of 10.00% per annum and the issuer is not exempted from stamp duty.

Calculate the principal amount due to the issuer on the date of issue.

#### Formula:

$$\text{Settlement Amount} = \text{Face Value minus Discount Amount}$$

\* The revenue stamp cost of 5 cents per Hundred Rand or part thereof is payable by the issuer on the date of issue.

#### The Calculation of the Discount Amount:

$$\frac{\text{Face Value} \times \text{Number of Days to Maturity} \times \text{Discount Rate}}{36500}$$

$$= \frac{R1,000,000 \times 90 \times 10}{36500}$$

$$= R24,657.34$$

## CHAPTER 5

### The Calculation of the Settlement Amount:

$$\begin{aligned} &= \textit{Face Value minus Discount Amount} \\ &= R1,000,000 - R24,657.53 \\ &= R975,342.47 \end{aligned}$$

### (b) Secondary Trading:

#### Example

If the holder of the above-mentioned commercial paper note wishes to re-discount the above-mentioned bill at 9.50% discount per annum five days after acquiring the bill, the consideration will be calculated as follows:

#### Formula:

#### Calculation of the Discount Amount:

$$\begin{aligned} &\frac{\textit{Face Value} \times \textit{Number of Days to Maturity} \times \textit{Discount Rate}}{36500} \\ &= \frac{R1,000,000 \times 85 \times 9.50}{36500} \\ &= R22,123.29 \end{aligned}$$

## CHAPTER 5

### **The Calculation of the Settlement Amount:**

$$= \text{Face Value minus Discount Amount}$$

$$= R1,000,000 - R22,123.29$$

$$= R977,876.71$$

#### **(vi) Settlement on Maturity**

The commercial paper note might be M.I.C.R. encoded and on the maturity date the entitled holder can deposit it into his own banking account. The commercial paper note will thus be cleared in exactly the same manner as a cheque.

If the note is not M.I.C.R. encoded the holder have to present the original note to the appointed issuing and paying agent who will issue a cheque for the face value to the presenter of the commercial paper note.

#### **(vii) Benefits for the Issuer**

The issue of commercial paper borrowing is cheaper for the issuer compared to overdraft facilities. The finance is available to the issuer for a definite period at a fixed rate.

The discount rate level is linked to the tenor of the commercial paper bill and will always be money market related.

During period of declining interest rates, fixed interest can be very detrimental to the issuer of fixed rate commercial paper notes.

## CHAPTER 5

### **(viii) Options for the Issuer**

Some of the following financing options are available to the prospective commercial paper issuer:

- Bankers acceptance facilities;
- Overdraft facilities;
- Term lending facilities at fixed rates.

### **(ix) Options for the Investor:**

Some of the optional negotiable interest-bearing money market instruments available to commercial paper investors are:

- Bankers Acceptances;
- Negotiable Certificates of Deposit;
- Land Bank bills;
- Treasury bills;
- Promissory notes; and
- Trade bills.

## CHAPTER 5

### 5.3.2 48 Hour Commercial Paper Notes

One of the terms of Government Notice No. 122 published in the Government Gazette dated 26 January 1993, stipulates that call bonds are commercial paper. One of the provisos of the notice is that commercial paper may not be used for overnight market making.

The function of a call bond is exactly that of providing overnight liquidity to the issuer thereof.

The 48 Hour notice commercial paper note is designed to bridge this anomaly.

#### (i) Description

The 48 Hour commercial paper market can be handled by a bank or broker in exactly the same fashion as a grey market off balance-sheet transaction.

The idea is to attract call deposits and to lend the proceeds that are received from these call deposits to major corporate companies at a small interest rate differential. The differential is usually fifty points and seeing that the deals were done on a back to back basis they were regarded as off balance-sheet transactions and therefore not subjected to liquid asset requirements or capital requirements.

With a 48 hour commercial paper note both the investor and the issuer are subjected to a 48 hour notice period to buy or sell the note.

## CHAPTER 5

### (ii) Features

The 48 hour commercial paper note will have a floating maturity date. The reason is that every time a new bill is issued it must be revenue stamped.

The same note will be reissued as and when funds are required by the issuer. The commercial paper note will only be stamped once.

### (iii) Form of Issue

The note will only be issued in bearer form and one of the terms of sale is that it may only be sold back to issuer with a 48 hour notice period of intention, applicable to both the issuer and the holder thereof.

### (iv) Dealing Mathematics

48 hour commercial paper notes will be issued at par. Interest will be calculated on a daily basis and will only be payable on a monthly basis. The interest rate will be variable and can fluctuate on a daily basis.

### Example

A 48 hour commercial paper note with a face value of R 1,000,000 is issued and after 5 days it is sold back to the issuer. The interest rate is 10.00% per annum and is unchanged during the period.

### Primary Trading

The 48 hour commercial paper note is sold by the issuer at par and therefore the settlement value will be R 1,000,000 on the date of issue.

## CHAPTER 5

### (vi) Settlement on Maturity

After five days the 48 hour commercial paper note is sold back to the issuer.

**Formula:**

$$\text{Settlement Amount} = \text{Face Value plus Accrued Interest}$$

**and;**

$$\text{Accrued Interest} = \frac{d \times i \times \text{Face Value}}{36500}$$

### The Calculation of the Settlement Amount

$$= \text{Face Value plus Accrued Interest}$$

$$= R1,000,000 + R1,369.83$$

$$= R1,001,369.86$$

The settlement may be done over two instalments. The capital of R1,000,000 will be repayable on the date of the secondary trade and the interest instalment of R1,369.83 only at month end.

The reason for the split settlement is that the effective borrowing rate for the issuer becomes excessive if interest is to be paid for instance every second day on the same note.

## CHAPTER 5

### (vii) Benefits to the Issuer

The 48 hour commercial paper note is linked to call rates which will trade at a differential of about fifty points above the ruling call deposit rate for prime investors. The historical level of call rates is below the 90 day bankers acceptance level.

The natural gap between these to key money market rates is one of the reasons for the existence of the investment banks which were previously known as the four South African discount houses.

The loan is repayable by the issuer after 48 hour notice has been given by the issuer.

The notes have only to be stamped once, on the original date of issue and can be used time and time again.

## CHAPTER 5

### **(vii) Options for the Issuer**

The following options are available to the issuer of 48 hour commercial paper notes:

- Bank overdraft facilities;
- Grey market loans;
- Overnight loan facilities or call loans as they are also known in the market

### **(viii) Possible future investors**

Traditional investors in the following types of money market instruments can be canvassed as prospective investors in 48 hour commercial paper notes:

- Call accounts;
- Thirty day depositors;
- Repurchase agreement investors; and
- Investors in the grey markets and junk bond markets.

## CHAPTER 5

### 5.3.3 Interest Coupon Commercial Paper Notes

#### (i) Description

Interest coupon commercial paper notes are issued with six monthly interest payments to the holder of the commercial paper note on the predetermined interest payment day. These interest payments are known in the market as coupon payments.

#### (ii) Application

The coupon commercial paper note application is for the financing of the medium to longer term working capital requirements of the issuer who is also the ultimate borrower of the proceeds of the sale of the commercial paper issue.

#### (iii) Features

The term of issue will generally be from period longer than twelve months up to a maximum period of five years.

The interest rate are quoted on a fixed nominal interest rate per annum base with interest payable six monthly in arrears. The coupon commercial paper note can also be issued at a floating interest rate linked to the prime lending rate of a specific commercial bank.

## CHAPTER 5

### (iv) Form of Issue

The note will usually be issued in bearer form or the name of the original purchaser can be inserted on the face of the bill, who then can endorse the commercial paper note on the date of sale thereof.

On the back of the note will be a register that will state all future coupon payments. The holder of the coupon commercial paper note will have to present the note on a six monthly basis in order to the issuer to receive the coupon interest. The issuer will then record the relevant coupon payment on the back of the note to ensure that the holder of the note can not present the note more than once for the same coupon interest payment.

Knowledge of the future interest payments dates are necessary to be able to calculate the market value of the instrument in the event of a secondary trade.

### (v) Dealing Mathematics

The instrument can be issued for a period which is not an exact multiple of six. For example, a bill issued for fifteen months will have a broken coupon period of three months. This broken coupon period will be during the first three months of issue and therefore the first interest payment will take place after only three months after the date of issue.

## CHAPTER 5

### (a) Primary Issue Mathematics

The interest coupon commercial paper notes can be issued at discount to the par value thereof in which case the coupon interest will be lower than the yield to redemption. The common market practise is however to issue at face value (par) at a nominal interest rate where the interest is payable six monthly.

#### Example

An interest coupon commercial paper note with a nominal value of R1,000,000 (One Million Rand) is issued at par for a period of two years at a rate of 10.00% per annum on 15 January 1994.

The future cash flows of the issuer will be as follow:

#### Cash Flow Table:

Date	Description	Amount
15 Jan 94	Issue date	R1,000,000
15 Jul 94	Interest Coupon	(R50,000)
15 Jan 95	Interest Coupon	(R50,000)
15 Jul 95	Interest Coupon	(R50,000)
15 Jan 96	Interest Coupon	(R50,000)
15 Jan 96	Capital Repayment	(R1,000,000)

## CHAPTER 5

From the cash flow analysis can be seen, that the interest coupon payments are remaining equal and that it is not based on the actual number of days between the coupon dates and that it is merely calculated as follows:

### Six Monthly Coupon Interest Amount

$$= \frac{\text{Coupon Interest Rate Per Annum}}{2} \times \text{Face Value}$$

$$= \frac{10}{200} \times R1,000,000$$

$$= R50,000.00$$

## CHAPTER 5

### (b) Secondary Trading

#### JSE STOCK PRICE FORMULA

$$GROSSPRICE = \left( \frac{1}{1 + \frac{i}{200}} \right)^{\left( \frac{d1}{d2} \right)} * \left[ \frac{1}{2} * G * \left( \frac{1 - \left( \frac{1}{1 + \frac{i}{200}} \right)^n}{\frac{i}{200}} + e \right) + 100 * \left( \frac{1}{1 + \frac{i}{200}} \right)^n \right]$$

$i$  = yield percentage

$G$  = coupon percentage

$d1$  = Number of days from settlement date to next interest date

$d2$  = Number of days from last interest to next interest date

$n$  = Number of complete six month periods from next interest date to maturity.

$e$  = 1 (Coupon commercial paper will always be traded cum dividend as it is a bearer document).

The dealing mathematics for secondary trading will differ during the final six monthly duration of the bond.

## CHAPTER 5

### Dealing Mathematics during the final six monthly duration:

#### Example

Secondary trading in coupon commercial paper notes will be done on the Johannesburg Stock Exchange Fixed Interest Coupon Formula.

A coupon commercial paper note with a maturity value of R1,100,000 is traded at 10.00 %. The R1,100,000 is made up of the face value of R1,000,000 and the final interest coupon of R100,000. The note is maturing over thirty days.

$$\text{Consideration} = \frac{MV}{1 + \left(i * \frac{d}{36500}\right)}$$

$MV$  = Maturity Value

$i$  = Yield to redemption

$d$  = Days to maturity

$$\text{Consideration} = \frac{1,100,000}{1 + \left(10 * \frac{30}{36500}\right)}$$

$$\text{Consideration} = R1,091,032.61$$

## CHAPTER 5

### **(vi) Settlement on Maturity**

Coupon commercial paper notes should be presented to the issuer or to the duly appointed issuing and paying agent of the issuer for redemption. The redemption amount will consist of the face value of the coupon commercial paper note plus the last interest coupon payment.

### **(vii) Benefits For the Issuer**

Coupon commercial paper notes will provide medium to longer term financing at a predetermined fixed interest rate. During an period of escalating interest rates fixed rate borrowing can be extremely beneficial the borrower . The opposite is also true during a period of declining interest rates.

The six monthly interest payments will improve the cash flow position of the issuer in between coupon payment dates.

Term lending in a negotiable format is cheaper than a fixed rate term loan that is not negotiable. The reason is twofold, firstly the investor in the negotiable term loan can very easily liquidate his investment and therefore reduce the interest rate risk if he becomes bearish in a bull market. The second reason is that the holder can meet his future cash flow needs by either selling his investment or alternatively he can enter into a repurchase agreement with an investor to bridge his envisaged negative cash flow period.

## CHAPTER 5

### **(viii) Options for the Issuer**

The issuer can have the following financing alternatives which he may consider instead of coupon commercial paper notes:

- Fixed rate term loans; or
- The issuing of debentures if the financing is required for a period longer than five years.

Debentures that are not quoted on a recognized exchange with a tenor of less than five years also fall into the ambit of the Banks Act (94/1990).

### **(ix) Options for the Investor**

The following alternative investments are available to the investor who might consider investing in coupon commercial paper notes.

- Negotiable certificates of deposit; and
- Government, Umgeni Waterboard, Post Office or Eskom stock with a maturity of less than five years.

The bullish investor who is less adverse to risk will tend to invest in a longer dated stock to maximise his possible future income stream.

## CHAPTER 5

### 5.3.4 Zero Coupon Commercial Paper Notes

#### (i) Description

Zero coupon commercial paper notes differ from fixed rate commercial paper notes due to the fact that all interest on the note is only payable on the maturity date thereon. The capital amount as well as all accrued interest streams and future interest streams on this commercial paper note are included in the face value of the bill.

The concept is very much the same as the commercial paper note that is discounted at par. The discount or the future interest streams in both cases are included in the face value.

#### (ii) Features

The zero coupon commercial paper note is a fixed period fixed rate bearer document. The period of issue may be for a maximum period of five years like in the case of all other commercial paper issues.

A very distinct disadvantage is that revenue stamp cost is payable on the future interest accruals on this instrument. The true cost of this disadvantage will depend on the duration of the issue and the level of interest rates in the market at the time of issue.

The higher the interest rate levels for the same period of issue the higher the disadvantage will be for the issuer.

#### (iii) Form of Issue

The instrument will be issued in a negotiable format.

## CHAPTER 5

### (iv) Dealing Mathematics

Zero coupon bonds are issued and traded on the basis of a yield to maturity. The interest coupon is calculated at the yield to maturity and the interest coupon is capitalised six monthly.

The interest coupons conversions are assumed to be six monthly with the final conversion on maturity, and the preceding conversions exactly six calendar months apart.

### Primary Issue and Secondary Trading

$$\textit{Consideration} = \frac{1,100,000}{1 + \left(10 * \frac{30}{36500}\right)}$$

$MV =$  Maturity Value

$n =$  Number of six monthly conversion periods to maturity

$i =$  Yield to maturity issued or traded at

Note:

In the event of a trade taking place on a day other than a notional interest coupon date, the conversion periods will have to be amended as follow:  
N will be equal to the number of six monthly coupon periods to maturity, plus the number of days to the next interest conversion divided by the number of days from the previous interest conversion to the next notional interest conversion.

## CHAPTER 5

### **(v) Settlement on Maturity**

The nominal value or the face value of the zero coupon commercial paper note will be payable to the holder on the maturity date.

### **(vi) Benefits for the Issuer**

The benefits for the issuer is that this type of commercial paper note is less of an administrative burden than other coupon issues where interest coupons have to be settled six monthly.

The cash flow of the nature of this note may be more advantageous to the issuer as the capital and the interest amount are only payable once, on the maturity date of the zero coupon commercial paper note.

### **(vii) Benefits for the Investor**

During times of declining interest rate holders of zero coupon commercial paper notes will benefit more than holders of coupon investments. The opposite is also true in a bear market.

The true yield to maturity can be calculated on the duration of the investment. With coupon paper it is assumed that the six monthly coupons are re-invested at the original yield to maturity.

The investor do not have to collect interest payments every six months and the future cash flow of his investment is very simple.

## CHAPTER 5

### (viii) Options for the Issuer

The following alternatives are available to prospective issuers of zero coupon commercial paper notes:

- The issuer can borrow the money from a banking institution for a fixed period at a fixed rate. However, financial institutions are not keen to lend for fixed periods at fixed rates during times of low interest rates;
- Fixed rate term loans; or
- The issuing of debentures if the financing is required for a period longer than five years.

Debentures that are not quoted on a recognized exchange with a tenor of less than five years also fall into the ambit of the Banks Act (94/1990).

## CHAPTER 5

### 5.4 REPURCHASE AGREEMENTS

"A repurchase agreement is a sale of securities with an undertaking by the seller to repurchase the same securities after a specified period of time at a price (yield) determined at the time of the sale. The essence of a repurchase agreement is to adjust the original maturity of a particular money market asset to suit the need of the investor." (Falkena *et al.*, 1989:246)

The above-mentioned definition has been discussed in great detail in chapter two and can be summarised as follows:

"The essence of a repurchase agreement is to adjust the original maturity of a particular money *or capital* market asset to suit the *needs of both parties to the agreement.*"

#### **The Commercial Paper Repurchase Agreement.**

The significance of the commercial paper repurchase agreement is very important to enhance the overall liquidity and the opportunity to enhance the attractiveness of this market both to the investor and the issuer.

The holder of a commercial paper note might need to liquidate his investment to provide bridging finance for a relative short period.

## CHAPTER 5

### Example

The holder of a commercial paper note with a face value of R1,000,000 that is maturing in twelve months time needs an amount of R900,000 for two weeks to satisfy his cash flow needs over the period. The investor bought the commercial paper note at a very good yield and is not keen to sell it before maturity as the market perception is that interest rates will steadily decline over the next twelve months.

There are two possible solutions that can solve the short-term liquidity problems of the holder:

Firstly, he can either obtain an overdraft facility and surrender his commercial paper note as security for a bank loan. The cost of the loan will either be at the prime-lending rate of the bank or slightly above depending on the financial standing of the client.

The second alternative is for the holder to enter into a repurchase agreement with an investor who is looking for a short-term investment opportunity. The investor might be looking at a slightly better return than offered by the banks on a call deposit account or a term investment for fourteen days.

## CHAPTER 5

### Dealing Mathematics

Repurchase agreements are dealt on an interest rate base calculated on a 365 day per annum basis.

The maturity value of the repurchase agreement will be calculated in terms of the following formula:

$i$  = interest rate per annum

$d$  = duration of the repurchase agreement expressed in the number of days

$P$  = Principal amount of the loan

### *Settlement Amount*

$$= P + \frac{i \times d \times P}{36500}$$

$$= R900,000.00 + \frac{10 \times 14 \times 900,000}{36500}$$

$$= R900,000.00 + 3,452.06$$

$$= R903,452.06$$

## CHAPTER 5

Calculation of the interest amount:

$$\text{Interest Amount} = \frac{i \times d \times P}{36500}$$

Other South African terminology that is also being used for a repurchase agreement are:

- carrie(s);
- warehousing;
- resale agreement (from the buyers prospective);
- reverse repurchase agreement (from the buyers prospective);

It will be prudent for any purchaser of a repurchase agreement to ensure that the principal amount of the repurchase agreement is equal or preferably below the market value of the underlying asset. The reason for a conservative valuation of the underlying asset is that in the event of an increase in interest rates, the asset will be devalued.

## CHAPTER 5

### 5.5 CONCLUSION

There are various other formats and hybrids of commercial paper that do exist world-wide. There is definitely no lack of new instruments that are flooding the world-wide financial markets on a daily basis. All of these variations and future innovations on commercial paper are hybrids of the four generic types of commercial paper that are discussed in this chapter.

Any format of a negotiable interest-bearing instrument can be converted into one or other hybrid of a commercial paper note.

Legislative and tax issues for issuer and investors seem to be the primary driving forces in the world of commercial paper innovation.

The most important rule for any issuer of commercial paper is to ensure that the terms and conditions of the issue and the applicable dealing mathematics confirms to acceptable South African market practice. The price of non conforming will be very high for the issuer as well as for the purchaser with the forfeiting of acceptability and negotiability of the instrument.

The price of non conforming will be reflected in a trading premium on the issue compared to the issues with a similar duration of companies that are rated similar to the non confirming issuer.

## CHAPTER 6

# THE ESTABLISHMENT OF A COMMERCIAL PAPER PROGRAMME

### 6.1 INTRODUCTION

The objective of this chapter is to describe the various processes that prospective South African issuers have to complete to establish a commercial paper programme.

Currently very few South African corporate lawyers, directors of companies and chartered accountants understand the term commercial paper, the terminology and the legislation that is an integral part of any commercial paper issue. People tend to cloud the issue by criticising the current legislation, instead of utilising the opportunities that have opened up to corporate treasurers and investors with the formal introduction of legislation that made the issue of commercial paper possible in South Africa.

The various statutory documentation that is required in terms of The Banks Act (94/1990), Government Notice No. 122 issued on 26 January 1993 and also certain of the documentation that is proposed by the South African commercial paper Forum to standardise market procedures, are discussed.

The importance and the possible implications of the various required steps will be discussed to enable the corporate treasurer to establish a commercial paper programme for his company. This will enable any prospective issuer with a game plan to tap a new source of financing in a relative easy manner.

## CHAPTER 6

Prospective issuers and investors must be careful not to confuse certain of the proposed market practices with the statutory requirements. These proposals can under certain circumstances be more complicated than the actual statutory requirements. These ambiguous proposals were drafted around the needs of specific market participants and will be ignored in the scope of this chapter, as they tend to cloud matters further.

The issue of commercial paper is relatively easy in the South African money market for any company regarded highly by the financial community. The banking fraternity already have their own confidential ratings on the top echelon of the South African corporate market. The establishment of a commercial paper programme for smaller or lesser known companies may be slightly more cumbersome than for the blue chip South African companies.

The appointed dealer may play a very important role in advising the prospective issuer of the various processes that the issuer has to go through. The dealer will not only trade in the commercial paper of the issuer but also form a strong advisory bond with the issuer.

The role of the issuing and paying agent will be discussed as this will form a very important link in the settlement procedure between the issuer and the investor. The issuing and paying agent will preferably be situated in the financial district of Johannesburg in order to enable relatively easy and quick access to settlements and the transfer of the relevant securities.

Chapter seven deals with some of the required steps for the establishment of a commercial paper programme, but from the perspective of financial intermediaries in order to establish their possible future roles which they can fulfil in this market.

## **CHAPTER 6**

The following required steps will be discussed in this chapter with the emphasis being on the perspective of the prospective issuer of commercial paper:

### **The Required Steps for the Establishment of a Commercial Paper Programme**

#### **The Selection Process**

- Selection of a commercial paper dealer;
- Selection of an issuing and paying agent; and
- The appointment of the issuing auditor.

#### **The Initiation of the Following Documentation:**

- The placement document;
- The dealer agreement; and
- The issuing and paying agent agreement.

## CHAPTER 6

### **The Establishment of the Following:**

- A commercial paper endorsement facility;
- A commercial paper standby loan facility;
- Safe custody facilities;
- Settlement procedures;
- Rating of the company;
- The dealer agreement;
- The issuing and paying agreement;
- The placement document;
- The statutory required conformation by the issuing auditor; and
- The monthly statutory report to the South African Reserve Bank.

## CHAPTER 6

### **6.2 THE REQUIRED STEPS TO ESTABLISH A COMMERCIAL PAPER PROGRAMME**

#### **6.2.1 Selection of A Commercial Paper Dealer**

The selection of a commercial paper dealer is a very important task for any corporate company who do not have their own money market trading desk. Most of the major money market participants, like the mining houses, oil companies, insurance companies, pension and provident funds have there own internal money market dealers.

In the event of a major conglomerate issuing commercial paper the appointment of a dealer may not be as important as that of a smaller, or less experienced money market participant.

The role of the appointed dealer can be narrowed down to the selling of the commercial paper notes of a net cash shortage money market participant to a net surplus participant.

## CHAPTER 6

### 6.2.1.1. The Role Of The Dealer

"The role of the dealer as far as the implementing the overall selling strategy, particularly with regard to maturity management, should be an important consideration in the ultimate evaluation of the effectiveness of that dealer." (Felix R; 1987: 11)

The main responsibility of the commercial paper dealer is to advise the issuer on how to obtain the cheapest form of financing over the period required. The maturity structure of any fixed term issue can have an adverse effect on the interest rate levels of an issue.

In the event of one or more major maturities of commercial paper issues are to be rolled on a specific day, it will have an adverse effect on the interest rate issue levels. It is very important not to flood the market on the same day with too much paper with a similar maturity profile.

In South African short-term interest rates tend to peak over month ends. Month ends are traditionally the most difficult period of credit advancement for the South African banks as the local note flows reach their highest peaks over these periods.

The reason is that being a third world country, a very big portion of the blue collar workers are paid monthly in cash due to a lack of cashing and credit facilities that are available to this market segment. This segment constitutes the biggest percentage of the local work force.

The size of the note flow can reach peaks of more than Eleven Billion Rand (R11,000,000,000). This effectively reduces the amount of credit available in the local banking sector with a similar amount, without even applying the multiplier effect.

## CHAPTER 6

A very important factor is the level of communication that does exist between the dealer and the issuer on an on-going basis. The experienced dealer who can read and manipulate the market to his own advantage will ultimately generate a massive interest saving for any issuer.

The dealer can work on a pre-negotiated fee-income basis for the issuer. Terms on compensation can vary greatly in the market and it is advisable to obtain more than one quote before the appointment of a dealer.

This dealer will be responsible for all the primary issues of commercial paper and maybe even secondary dealings in the market. The terms and conditions of the issue may stipulate that all secondary trades are to be done through the appointed dealer, for instance, with the issue of 48 Hour commercial paper notes.

The dealer fee is usually about five to ten basis points for fixed term commercial paper issues, depending on the tenor of the issue, and fifty points for commercial paper notes that operate on an almost call bond basis.

The appointed dealer can be either a banking institution or a member of the local broking fraternity. Certain members of the broking fraternity have a higher standing than others in the financial markets. The association with the correct marketeers for a commercial paper issue is of strategic importance for the success of any issue.

## CHAPTER 6

### 6.3 SELECTION OF AN ISSUING AND PAYING AGENT

The selection of the issuing and paying agent is not a statutory requirement but this does not reduce the importance of the issuing and paying agent to the establishment of the commercial paper programme.

The issuing and paying agent does not have to be a bank but current South African market circumstances almost dictates that the issuing and paying agent will be a banking institution. There is no central depository for negotiable interest-bearing documents which may also act as an official clearing house for commercial paper.

## CHAPTER 6

### 6.3.1 The Functions Of The Issuing And Paying Agent

" The issuing and paying agent will receive the duly signed commercial paper notes from the issuer. The issuing and paying agent will be responsible for:

- the safe custody of the unissued signed notes;
- the completion of the notes in accordance with the instructions of the issuer or his duly appointed dealer;
- the possible authentication of the commercial paper notes at the time of issue;
- the stamping of the commercial paper notes at the time of issue; and
- the receipt of the proceeds of the sale of the Commercial Paper notes from the dealer or direct investors.
- the making of interim interest payments to holders if required in terms of the type of Commercial paper issued; and
- the settlement of all commercial paper maturities."

(South African CP Forum, 1993:10)

## CHAPTER 6

The issuing and paying agent can also act as custodian for issued notes depending on the nature of the notes or if requested to do so by the purchaser of the note.

The importance of the issuing and paying agent must not be understated as he is the administrative king pin around which the daily settlement processes evolve.

The major commercial banks have their own depositories which can fulfil the various functions of the issuing and paying agent at very competitive charges.

The fact that all major investors, dealers and issuers only have to deal with four issuing and paying agents will help paving the way for the establishment of a smooth running South African commercial paper market.

The feasibility of establishing a single central depository is currently being investigated by Safex. The idea is that all negotiable-interest bearing documents are lodged centrally and that effective transfer of these negotiable documents will be done by means of book entries only. There are various advantages that can be envisaged by establishing such a central depository:

- No physical movement of securities;
- The clearing and transferring process of securities will be much smoother;
- This eliminates the need for a major investor to have an own securities department;
- Trading in tainted stock or bearer instruments will be difficult; and

## CHAPTER 6

- The tracing of the transfer of any security right throughout its life cycle, will be feasible.

The funding of such a depository will be done by issuing shares to all market participants, from the Government Treasury down to the "bucket-shop" owner.

When appointing an issuing agent the issuer should be led by the preference of the dealer who has daily interactions with the various issuing and paying agents.

Price is important but with the keen competition in this market, prices will remain competitive so that is not worthwhile considering price as the only criteria in the appointment of the issuing and paying agent.

### 6.4 THE ISSUING AUDITOR

The statutory function of the issuing auditor is to certify the following requirements in the placement document of the commercial paper issuer:

Firstly, the certification of the issuer's capital, and reserves;

Secondly the certification of the issuer's other liabilities that are not related to the specific commercial paper issue referred to in the placement document.

For all practical purposes the auditor of the issue will also be the duly appointed auditor of the issuing company.

## CHAPTER 6

### 6.5 THE COMMERCIAL PAPER ENDORSEMENT FACILITY

The cost of endorsement will depend on the credit rating that a banking institution places on the issuer of commercial paper. The guide-line is that the cost will be a minimum of fifty points per annum.

The endorsement fee should be the same as the acceptance commission that is being charged to the issuer by his bankers for the discounting of promissory notes or bankers acceptances.

The endorsement of a prime bank will enhance the marketibility of any commercial paper note. Listed companies who do not require bank endorsements on their commercial paper notes, should also consider prime bank endorsement as their paper will be rated much higher by the investment community.

## CHAPTER 6

### 6.6 THE COMMERCIAL PAPER STANDBY FACILITY

The commercial paper standby facility is required by the appointed dealer to ensure that there will always be liquidity available in the event of a commercial paper note redemption.

In theory the dealer will know well in advance when a note is maturing and should issue a new note on the day of maturity if requested to do so. The dealer might advise the issuer not to roll his maturing commercial paper note as he expects lower interest rates. The issuer will then make use of his commercial paper standby facility to finance his working capital requirements and repay the facility out of future positive cash flows, or by issuing further commercial paper notes.

Commercial paper standby facilities are extremely important for the issuers of 48 hour commercial paper notes. In the event of the dealer not being able to sell a note, he should be able to make use of the commercial paper standby facility of the issuer on the overnight market.

The conservative size of the commercial paper standby facility should be equal to the total amount of commercial paper in issue.

The above-mentioned size is based on American market practice where commercial paper notes may be issued for a maximum period of 270 days compared to the maximum period of five years in South Africa.

The commercial paper standby facilities of the issuer can be structured specifically for commercial paper issues but it is recommended that this facility should be part of the existing banking facilities of the issuer.

## CHAPTER 6

### 6.7 THE SETTLEMENT PROCEDURES

The settlement procedures should be handled by the issuing and placing agent of the commercial paper.

In the event of the issue being a once only issue of commercial paper by the issuer, arrangements can be made with the banker of the issuer to handle all settlements if there is no appointed issuing and paying agent.

The possibility of M.I.C.R. encoded notes should also be explored to make settlement on maturity date a lot easier. This will enable the entitled holder of the note on expiry date to deposit the note into his current account. The note is then cleared in exactly the same manner as a cheque.

## CHAPTER 6

### 6.8 THE RATING OF THE ISSUER

The role of the rating agency will not be discussed in great detail as there is only one rating agency in South Africa. The role of the rating agency is not really of any importance in an isolated Rand commercial paper market. The reasons are twofold, namely:

Firstly, under the 1993 regulations, the commercial paper issues of companies with a net asset value of less than One Hundred Million Rand require a statutory banking endorsement which effectively makes any rating of the issuing company unnecessary as issuers will have full recourse to the endorsing bank in the unfortunate event of the issuer defaulting.

(This required endorsement has fallen by the way-side with the 1994 regulations.)

In the second instance, due to the competition that does exist amongst South African banks in the corporate sector most of the public quoted companies are rated almost automatically by the individual banks.

Major South African investors like insurance companies have been buying shares in quoted companies without the help of independent rating agencies over the years. By making use of their own share analysts, corporate treasurers can easily draw up recommendations of which major corporate names may be added to their commercial paper shopping list.

Corporate treasurers who can not persuade the major insurance companies to add the names of their companies to their list of approved commercial paper issuers, should contemplate bank endorsement of their issue seriously in order to improve the negotiability and the marketability of the issue.

## CHAPTER 6

The role of the rating agency may become important as markets started to open up as a result of the official lifting of United States sanctions against South Africa on 25 September 1993. The initial influence of overseas investors will not be felt in the South African commercial paper unless internal stability and political certainty can be achieved.

There are very few private companies in South Africa that have a net asset value in excess of R 100,000,000. The annual reports and balance sheets of these companies are not public documents as with public quoted companies. These types of issues are best to handle as private placements to ensure that the financial statements do not become public documents, if so required by the issuers.

Permission may be granted in terms of the 1994 regulations by The Registrar of Financial Institutions, to companies who are not quoted on the Johannesburg Stock Exchange, and other institutions, to issue commercial paper.

It is interesting to note that in the American commercial paper markets, there are two specific companies that have been rated by the same rating agency and both these companies received the same rating. However, their paper are treated differently by the investment fraternity as the one is trading at a discount to the other.

## CHAPTER 6

### 6.9 THE PLACEMENT DOCUMENT

The placement document or the commercial paper prospectus is a statutory required document and should at least contain the following information:

- (i) The name of the borrower who should also be the ultimate borrower, and that the proceeds will not be on lent to any subsidiary of the issuing company;
- (ii) a statement signed by two of the directors confirming that the company is a going concern and that in all circumstances can be reasonably expected to meet its commitments;
- (iii) the certified amount of the company's capital and reserves;
- (iv) the certified amount of the liabilities of the company that are not related to this issue;
- (v) the name of the auditor of the company;
- (vi) the amount of commercial paper previously issued by the company and the estimated amount still to be issued during their current financial year;
- (vii) whether the commercial paper is to be listed or not;
- (viii) the specific purpose for which the capital will be raised;
- (ix) whether the issue is secured or unsecured;
- (x) whether or not the prospectus confirms to all the statutory requirements of a commercial paper note;

## CHAPTER 6

- (xi) stating that the company is a public company listed on the Johannesburg Stock Exchange; or
- (xii) a statement to the effect that permission was received from the Registrar of Financial Institutions for the issue of commercial paper by an institution, or a company not listed on the Johannesburg Stock Exchange.

## CHAPTER 6

### 6.9.1 The Financial Statements

The latest audited financial statements, which were issued on a date not earlier than twelve months prior to the issue of the placement document, should be part of the placement document.

However, in the 1994 regulations provision is made for the event of the latest audited financial statements being older than twelve months, a statement verifying the reasons for the non-availability of such statements, must accompany the placement document. This statement must be signed by the duly appointed directors and auditors of the issuer.

## CHAPTER 6

### 6.10 SUMMARY

The various required steps through which the prospective commercial paper issuer has to go through can be very time consuming, especially if it is the first issue of commercial paper.

The process of the appointment of a dealer or dealers, and the issuing and paying agent should be done, only after careful consideration and consultations with other market participants.

Great care should be exercised that the commercial paper programme does not only conform to the statutory requirements in terms of The Banks Act (94/1990) and the regulations issued in terms thereof, but also to South African money market practice.

The conforming to the local market practice will not only enhance the commercial paper programme and the negotiability of the paper issued in terms thereof, but it can also save the issuer a lot of future interest, administrative and even legal costs.

## CHAPTER 7

# THE PERCEIVED ROLES OF FINANCIAL INTERMEDIARIES IN THE COMMERCIAL PAPER MARKET

### 7.1 INTRODUCTION

The banking industry world-wide perceived commercial paper to be a major threat to their then existing corporate market lending base. Banks have never been too keen on any competition and through the ages, banking has been a very protected industry.

Commercial paper is a subject that banks have preferred to ignore for a very long time. In the American corporate lending markets, certain of the banking institutions are trying to regain market share in this once lucrative market. These banks are constructing asset backed commercial paper instruments for their corporate lending clients.

The significance of this instrument is that bankers are fulfilling the traditional function of setting up lending transactions, but without reflecting these deals on their balance sheets. The significance of having these deals off-balance sheet is to minimise the cost of their capital requirements that become applicable, once these transactions are reflected on the balance sheet of the institution.

## CHAPTER 7

The South African commercial paper market is almost non-existent and most of the major South African banks are not too keen to get involved. The view of the South African banks are exactly the same as those of their American counterparts thirty years ago, and the European banks in the mid-eighties.

The South African banking fraternity also perceives commercial paper to be a threat to their once-lucrative corporate lending markets. The blue-chip corporate lending market in South Africa is a very cut-throat market for the banking industry, and a new perspective from a bank point of view is required.

There are various reasons for this predicament that the banking industry finds itself in. Many bankers still believe in the old myth that higher volumes and a bigger balance sheet automatically generate bigger profits.

South African banks will have to seek ways and means to get involved and to remain involved in the local commercial paper market to stay relevant in the corporate lending market.

The objective of this chapter is to provide some insight into the future role which financial intermediaries can fulfil in this market. If the banking industry is going to lose its control over this market, it will be a very expensive and a time-consuming process to regain market share.

## CHAPTER 7

South African commercial paper is here to stay and it should be exploited as an opportunity and not regarded as something that will fade away in obscurity, if ignored long enough by the banking industry.

The following perceived roles of the banking institutions and money market brokers will be explored in this chapter:

- Setting up commercial paper programmes;
- Issuing and paying agent;
- Preparation of the placement document;
- Custodian;
- Underwriter;
- Endorser;
- Provision of standby facilities;
- Dealer or market maker; and
- Assisting with statutory reporting.

## CHAPTER 7

### **7.2 FUNCTIONS THAT THE BANKING INDUSTRY CAN FULFIL IN THE COMMERCIAL PAPER MARKET**

#### **7.2.1 The Setting Up Of A Commercial Paper Issuing Programme**

Banking institutions can set up commercial paper issuing programmes on behalf of their corporate clients. The various steps which the corporate issuer has to go through, can be done at a fraction of the cost by a financial institution.

The world-wide move is for banks to move away from interest margin income and to concentrate on fee-income projects, and charges for specialised services rendered. Over recent years the specific roles of the merchant banks and the commercial banks have become very vague with the establishment of specialised corporate banking divisions within the commercial banking sector.

The various functions that a bank can fulfil as a part of a commercial paper programme are described below and can be done separately or as part of setting up a commercial paper programme on behalf of a client.

## CHAPTER 7

### 7.2.2 Issuing and Paying Agent

The appointment of an issuing and paying agent is not a statutory requirement for any commercial paper issue. There are no statutory prescriptions or definition on the role or functions of the issuing and paying agent.

The issuing and paying agreement may be between the issuer of a specific issue of commercial paper and will cover inter alia:

- Settlement procedures on the date of issue and on the maturity date of commercial paper notes.
- Custodianship of unissued notes;
- The update of the register of holders if required in terms of the issue;
- The calculation of all interest payments and the payment thereof if required by the characteristics of a specific issue; and
- The safekeeping of an authentic issuing document that will be available for inspection by any prospective investor.

## CHAPTER 7

### 7.3 PLACEMENT DOCUMENT

The placement document or prospectus is a statutory requirement that has to be published by any issuer of commercial paper, before such paper may be placed in the market.

The placement document can be standardised to a large extent. The legal preparation of such a document for a first time issuer, may be a costly and lengthy legal process. A banking institution can assist prospective issuers with the initial placement document that will be designed in a standardised format to meet all the legal requirements as set out in The Banks Act (94/1990) and in terms of all regulations issued in this regard.

South African corporate conglomerates have their own in-house legal representatives which can alter a standardised placement document to suit the specific needs of the prospective issuer.

It is very unlikely that the placement document would be a glossy marketing document for a major corporate issuer. The financial market segment of commercial paper buyers is a very specific and specialised market, and investors are more interested in the terms and conditions of an issue, than any glossy paraphernalia that may be part of the issuing document or prospectus.

The provision of a service to prepare and issue a placement document, is one the services that may lure the corporate client to make use of the corporate services of the bank, for instance acting as the issuing and paying agent on behalf the client.

This service of the bank will greatly reduce the development and implementation time of a commercial paper programme to a number of days, which will save the issuer a fortune in legal and auditing fees.

## CHAPTER 7

### 7.4 CUSTODIAN

It is foreseen that a banking intermediary can act as custodian for certain issuers and holders of commercial paper as far as:

- Safekeeping on behalf of the holder; and
- Safekeeping of unissued notes.

It is also foreseen that certain types of commercial paper might not be delivered to clients, due to the structure and nature and even limitations on negotiability. In the event of 48 hour notice commercial paper being issued, negotiability will be restricted that will limit the holder to sell only to the issuer.

The keeping of such documents in safe custody will enhance the marketing and sale thereof. Due to the structure and liquidity of the prevailing South African interest-bearing securities market it is not always practical to physically deliver short dated securities to the entitled holder.

Some of the major investors are situated in Cape Town and most of the issuers will be situated in the P.W.V. Region.

The fees charged for these facilities are minimal compared, to the cost and effort in the event of a negotiable interest-bearing document being misplaced or stolen.

## CHAPTER 7

### 7.5 MARKET MAKING

#### 7.5.1 Introduction

The basic function of the commercial paper dealer can be defined very narrowly as the provision of short term liquidity to the issuer by selling the notes of the issuer to various investors.

The function of the treasury division of a bank, as a market maker, will be to quote two way prices on the commercial paper, in which the division is doing market making in, on behalf of the approved issuers. The reason for approved issuers only is, that most of the commercial notes will not be bank endorsed, and therefore capital risks will be attached to the purchasing and holding of such paper.

The holding of any commercial paper in the portfolio of a bank will attract capital coefficients in exactly the same manner as any advance to the client, whether it is a utilised overdrawn facility or a utilised bill facility.

The paper which may be held in the trading or investment portfolio of a bank, should be part and parcel of the overall utilised facilities of the commercial paper issuer. The reason is, that it will ensure that dealers do not participate in the junk bond markets for the sake of a few risky trading points. The role of any commercial paper trader is to manage interest rate risks and not capital risks.

## CHAPTER 7

The treasury division of a bank can also perform a market making function in the following types of commercial paper:

- (i) 48 Hour commercial paper notes;
- (ii) Commercial paper issued at a discount to par;
- (iii) Coupon interest commercial paper; and
- (iv) Zero coupon commercial paper.

A bank or a broker should always be in a position to discuss any new innovations with their clients, with the view to tailor-make an instrument which will suit the needs of the client.

## CHAPTER 7

### 7.5.2 The Perceived Benefits for a Bank

The perceived benefits for a bank to do market making on behalf of a client in commercial paper will have very definite benefits, as well as certain spin-offs that will not always be quantifiable.

The bank can set a certain fee for acting as a market maker on behalf of a client. This fee can be calculated as a few points on the quoted buying and selling rates, or even a predetermined fee that may be established in the dealer agreement that may exist between the issuer and the nominated dealer.

A bank can also realise additional trading profit depending on the type of paper that is traded in. Trading profits or losses in call bonds are very marginal and tend to be bigger on longer dated securities with the same face value.

Market making or acting as the appointed dealer for a blue chip company can be seen as part of the total corporate package that the bank is offering to its major corporate clients.

The obtaining of official status as an appointed dealer for a major corporate client can raise the standing in the markets of the concerned financial institution. This might even add value in the short term for its shareholders.

## CHAPTER 7

### 7.5.3 Perceived Benefits For the Commercial Paper Issuer.

The appointment of a financial intermediary to perform the function of a market maker in the commercial paper of the issuer will enhance the marketability of the paper greatly.

The quoting of a two way price on commercial paper enhances the marketability of the paper tremendously. Investors can rest assured that they can always liquidate their investment, even before maturity date to suit their own cash flows or investment strategies.

The South African Reserve Bank started to quote two way prices on the R150 stock during 1992. The stock is equitable to the Eskom L168 which is maturing on 1 June 2008. Before the South African Reserve Bank started quoting two way prices on the R150 stock, it was trading at a premium of up to fifty points above the L168 and afterwards it was trading at a discount to the L168.

This exercise enhanced the marketability of the stock greatly and therefore enabled the issuer to tap the same stock at a lower interest cost.

In South Africa most of the conglomerates have their own treasuries which are staffed by expensive people. In certain instances it has proved to be more economical to close inefficient corporate dealing operations and to hand the portfolio to a professional intermediary.

## CHAPTER 7

### 7.6 UNDERWRITER

A financial institution can act as an underwriter for any primary issue of commercial paper. Underwriting will enhance the issue tremendously from the issuer's prospective as far as a guaranteed positive cash flow on the date of issue.

The mere fact that a respectable financial institution is underwriting an issue can greatly enhance the marketability of such paper.

Underwriting fees can be negotiated with the issuer in terms of the following parameters:

- Size of the issue;
- The credit rating of the issuer;
- Bank endorsements or the lack thereof;
- The tenor of the issue;and
- The complexity of the issue.

## CHAPTER 7

### 7.7 ENDORSEMENT OF COMMERCIAL PAPER

In terms of the Banks Act (94/1990) and the provisions as noted in Government Notice No. 152 published in the Government Gazette dated 26 January 1993, Volume 331 No. 14553 it is specified, amongst other things that if the net asset value of the issuer of commercial paper is below R100 Million (One Hundred Million Rand), the paper must be bank endorsed.

In the 1994 regulations the minimum regulatory net asset value has fallen away and is being replaced by the proviso that the issuing company must be quoted on the Johannesburg Stock Exchange.

The endorsement of commercial paper was a controversial issue because some of the financial institutions that can endorse commercial paper, do not have a net asset value of R100 Million (One Hundred Million Rand). The net asset value of the endorser of the first official commercial paper issue in South Africa, was a few hundred times lower than that of the issuer.

The endorsement of commercial paper by a prime bank can be a major factor bank to enhance the negotiability of any issue. There are various reasons for the issuer to consider endorsement by a prime bank, even if not required in terms of the above-mentioned regulations.

Firstly, the issuer can save the tremendous expense of having his company rated by the one and only rating agency in the Republic of South Africa.

## CHAPTER 7

All major investors in South Africa do not accept the official published ratings of this rating agency and this will place a negotiability premium on the paper of such an issuer. These major investors can do their own credit ratings, and even have very prudent corporate and banking exposure limits for their own treasuries to operate within.

These banking limits of these major corporates will determine the amount of deposits, and endorsed negotiable interest-bearing instruments that the specific corporate treasury may invest in.

The cost of endorsement of an issue will be dependant on the risk profile of the issuer as seen by the endorser. Endorsement fees are quoted from a minimum of a half percent per annum based on the credit rating of the issuer by the endorser.

The benefits of bank endorsement should be carefully evaluated and considered by any issuer as it will impact positively on the marketability of the issue as the investor will be trading the paper of the prime rated endorser and not the name of a lesser known entity. The paper can then be traded on the two way price system for prime negotiable interest-bearing instruments that does exist in the South African money market.

A final word of caution to any would-be issuer of commercial paper.

There are four major banks in South Africa but they are rated differently by the major money market players. The reason is the restricted negotiability of the paper of the one institution.

## CHAPTER 7

Over a five year period this institution emerged after the merging of three relative big financial institutions. These three institutions operated under various brand names in the market, each with their own money market operation.

Most of the corporate investors have reduced their previously combined banking limits for this specific institution. This resulted in a surplus of the negotiable paper issued or endorsed by the said institution. The end result was a lower demand for this paper which made negotiability even more difficult.

The said institution is therefore not regarded as an issuer of prime paper by the upper echelon of the South African investment fraternity.

The disadvantage for financials institution is that any endorsement forms part and parcel of their capital requirements and therefore the endorsement should be priced accordingly.

In the event of a financial institution having surplus capital for the period of the issue, marginal costing methods are not recommended as the cost of capital is already a sunken cost, and that average costing might be more meaningful to apply.

Any additional cost of capital recovery will make a positive contribution to the bottom line to the bank in question.

## CHAPTER 7

### 7.8 STANDBY FACILITIES

The provision of a standby facility is very important to the commercial paper issuer. These standby facilities can be either be in the format of an overdraft, or an overnight call loan facility.

The stand by facility is of the utmost importance for the issuer.

Firstly, if an issuer or a dealer, on behalf of an issuer, makes a two way price on his own paper, rates might move against him if no buyers for his paper can be found at a specific time of day.

The issuer can then hedge his short term selling price by withdrawing his surplus paper unknowingly to other market participants. The issuer will then refinance his requirements by means of a standby facility on an overnight or for even a slightly longer period. If the issuer is a major conglomerate it is advisable to have standby facilities at more than one banking institution.

## CHAPTER 7

The following reasons can be given for the advantage of split standby facilities:

- It is very difficult to refund a major cash outflow during afternoon trading. The bulk of money market trading is done before midday as dealers usually partake in other activities in the afternoons.
- Split banking facilities ensure that the client is always aware what rates are doing during the day, overnight lending rates to corporate clients are not always based on the bank rating of their clients, but on the astuteness of the corporate issuer or borrower.
- The lending rate in this market is thus not only always based upon the availability of funds, but also dependent on the interest rate level the borrower is prepared to pay.

## CHAPTER 7

### 7.9 CONCLUSION

There are various functions which financial intermediaries in the South African money and capital markets can fulfil which have not been discussed or even mentioned in this chapter.

Commercial paper is an integral subsection of the South African interest-bearing securities markets. Brokers and bucket-shops are operating in this market and the sooner the commercial banking sector becomes involved, the better it will be to maintain or even grow their market share in this segment.

The most buoyant European commercial paper market is in Germany, not only through legislation that supplements and controls the marketing function thereof, but by German Banks being actively involved with the setting-up of commercial paper issuing programmes on behalf of their clients.

If the major banks are going to ignore this market over the short term it will be very expensive for them to recapture lost market share.

## CHAPTER 8

# CORPORATE LENDING: INTEREST MARGIN OR FEE-INCOME ?

### 8.1 BACKGROUND

The purpose of this chapter is to compare traditional corporate borrowing and lending, as it is reflected on the balance sheet of a bank, with the fee-income that a bank can generate by acting as a nominated dealer in the South African commercial paper market.

This chapter will use the 48 hour notice commercial paper note as a reference mechanism for comparative purposes. Comparisons will be done between traditional bank lending, and broking between the issuer and the purchaser of a commercial paper note.

Comparisons will be done on a marginal funding cost basis rather than the average cost of monies of a banking institution. The average cost of monies of a commercial banking institution is traditionally lower than the marginal cost to employ the next additional Million Rand.

The chapter will also provide further insight into the future role which the banking industry can fulfil in the corporate lending market. In the event of any bank losing its influence in this market segment, it will be a very costly and difficult exercise to remain relevant both in the corporate segment and to regain market share at a later stage in the blue chip corporate lending market.

The spin-offs that are derived from competitive lending to the corporate sector, are not always possible to quantify, but the paper will reflect in the overall bottom line performance of the bank and thus the perception of the investor fraternity as a whole, both clients and shareholders.

South African commercial paper is here to stay and it should be explored as an opportunity and not regarded as something that will fade away in obscurity.

## CHAPTER 8

The perceived advantages and disadvantages as a possible result of the involvement of a bank in the commercial paper market will be discussed in this chapter:

- (i) Prudential capital requirements for South African banks;
- (ii) Capital risk weighting applied to a R 1 Million advance;
- (iii) Liquid asset requirements;
- (iv) Supplementary cash reserves;
- (v) The marginal balance sheet of Bank X.Y.Z.;
- (vi) Forecast of possible fee-income on commercial paper programmes;
- (vii) Considerations before selecting the commercial paper option;
- (viii) The ultimate reduction in liquid asset and cash reserve requirements; and
- (ix) The reduction in the future capital requirements of the bank and the subsequent lower cost of capital for a bank.

## CHAPTER 8

### 8.2 PRUDENTIAL CAPITAL REQUIREMENTS FOR SOUTH AFRICAN BANKS

Although not a signatory to the 1974 Basle Concordat as yet, South African banks like all international recognized banks are subjected to certain minimum share capital, and unimpaired reserve funds. Only the very basic principles behind the theory will be outlined.

Capital adequacies effectively control the structure and balance sheet size of any South African banking institution. Capital adequacies were introduced to protect investors, to ensure that banks expand in a prudent fashion in relation to their capital base, and above all to secure the interest of the depositor.

The Registrar of Financial Institutions may with the permission of the Minister of Finance, at any time change these minimum capital requirements.

Prudential capital requirements for South African banks will be phased in by 1 January 1995 as shown in the following two tables that have been summarized from The Banks Act (94/1990).

Table 8.1

#### The Phasing in of Capital Requirements

1 January 1991 to 31 December 1991	4,50 %
1 January 1992 to 31 December 1992	5,00 %
1 January 1993 to 31 December 1993	6,00 %
1 January 1994 to 31 December 1994	7,00 %
1 January 1995 and thereafter	8,00 %

## CHAPTER 8

**Table 8.2**

### A Summary of Certain Asset Risk Weightings

Description	Risk Weighting
Bank Notes and subsidiary Coin	0 %
Gold coin and bullion	0 %
Deposits with the Reserve bank	0 %
Deposits with banks in own group	0 %
Deposits with other banks	20 %
Credit card holders	100 %
<b>Mortgage loans:</b>	
Residential property	50 %
Residential property loans in arrears	100 %
Non-residential property	100 %
<b>Commercial Paper,</b> bills promissory notes and similar acknowledgement of debt discounted; Overdrafts and loans; <b>Commercial Paper</b> and other bill endorsements; and Investments in the Securities of:	
Relating to the Central Government	0%
Relating to the Land Bank, other the governments of Botswana, Lesotho, Namibia and Swaziland	10%
Relating to the public sector bodies in Botswana, Lesotho, Namibia and Swaziland or the previously called Bantustans; and	20%
Other Advances or Investments	100 %

## CHAPTER 8

The required issued share capital and unimpaired reserves for a bank to advance One Million Rand for various types of loans, is set out below in Table 8.3.

**Table 8.3**

**Capital Risk Weighting Applied to a R 1 Million Advance**

Description of Loan	Risk Weighting  (x)	Maximum Capital Weighting (1995)  (y)	Capital Required Per R1-Mil. Advance (x * y)
Overnight lending	100 %	8 %	R80,000
Commercial Paper Endorsement	100 %	8 %	R80,000
Investment in Commercial Paper	100 %	8 %	R80,000
Government Stock	0 %	8 %	R Nil
Land Bank Bills	10 %	8 %	R 8,000
Residential Mortgage lending	50 %	8 %	R40,000

Table 8.3 shows amongst other things, that a bank must employ R80,000 of its issued share capital or unimpaired reserves to advance R1 Million in overnight lending.

## CHAPTER 8

### Example

In the event of a bank being fully lent, (no surplus capital or reserves), the cost of the capital that will be allocated to a marginal corporate loan of R 1 Million will be calculated as follows:

Amount of corporate advance	R1,000,000
Capital allocation	R 80,000
Marginal cost of capital	16 %
Expressed in Rand Per Annum	R12,800

The marginal capital cost to increase the balance sheet of the bank will thus be R12,800 per annum.

### 8.3 LIQUID ASSET REQUIREMENTS

South African Reserve Bank Circular (8/1993) specified, amongst other things the minimum amount of liquid assets that banks must comply with as from 1 January 1994.

Liquid asset requirements are based upon all the liabilities to the public, excluding capital and reserves, as follows:

Interest bearing liquid assets to be held, based upon all short, medium and long term deposits:	1,00%
Cash Reserves to be held, based upon all short, medium and long term deposits:	1,00 %
Total Liquid Asset Requirements	2,00 %

## CHAPTER 8

The interest bearing liquid assets may only consist of the following:

- Treasury bills;
- Landbank Bills; and
- Government Stock with a maturity of less than three years.

The cash reserve, that is a part of the minimum liquid asset requirements, can be held either in vault cash or as an interest-free deposit at the Reserve bank.

### 8.4 SUPPLEMENTARY CASH RESERVE

A further cash reserve of one percent is applicable to short term deposits. This supplementary cash reserve must be maintained at the South African Reserve Bank. This additional one percent cash reserve requirement is not a liquid asset requirement, but rather a method to mop up excess liquidity in the market and to keep money supply figures under control.

The interest rate payable on this cash reserve is 50 points below the weekly average Treasury Bill tender. The Treasury Bill rate is set by means of a weekly tender on the last trading day of every week.

## CHAPTER 8

### 8.5 The Marginal Balance Sheet of Bank X.Y.Z.

The following marginal balance sheet was constructed to emulate the influence of an overnight facility of R 1 Million funded by an overnight call deposit at an interest rate differential of 0,50 %.

#### 8.5.1 Marginal Pricing

The presentation of the case study is very hypothetical as it is very unlikely that a bank will advance a corporate loan, raise a call deposit, undertake a rights-issue, buy treasury bills for liquid asset purposes, all on the same day. However, the principles that are applied in this illustration, are all applicable to the marginal investment decision.

The argument for applying marginal and not average costing is the following:

In the event of a bank advancing a One Hundred Million Rand overnight advance, the bank will have to refinance the advance in the following manner:

Attract call deposits for One Hundred Million Rand; or

Sell money market assets; or

Recall other money market advances; or

Obtain an overnight facility from the Reserve Bank by offering liquid assets as security for the loan; or

Attract long term deposits; or

Issue negotiable certificates of deposit; or

Any possible combination of the above, or any other possibilities that might exist.

## CHAPTER 8

The average cost of money for a commercial bank will traditionally be below the cost of marginal money market deposits. The reasons being the following:

- (i) Commercial banks have huge credit balances on cheque and savings accounts at relative low rates.
- (ii) On average retail monies, or deposits below R100,000 are cheaper than wholesale deposits or money market deposits above R100,000.

Retail deposits are more difficult to attract than wholesale monies of equal amounts. A retail rate is a strategic decision by the bank to pay a certain rate for an amount of money for a specified or unspecified period, like on savings. A wholesale deposit rate is an interest rate that is negotiated between a money market dealer and the investor of a specific investment.

### 8.5.2 Steps Required to Advance a Marginal One Million Rand Overnight Corporate Loan.

#### Assumptions:

- (i) The bank does not hold any surplus capital;
- (ii) The only way to refinance the overnight loan is to attract a call deposit, which typically will be possible at 50 points below the marginal lending rate;
- (iii) The bank does not hold any surplus liquid assets;
- (iv) The only liquid assets available are treasury bills at the ruling issue rate.
- (v) The bank would like to increase its lending portfolio by One Million Rand and therefore will do a rights-issue of ordinary share capital to accommodate the marginal lending growth.

## CHAPTER 8

### Interest Rate and Cost of Capital Levels:

Prime lending rate	16,00 %
Overnight corporate lending rate	12,00 %
Cost of Primary Capital	16,00 %
Call deposit rate	11,00 %
Treasury bill rate (as a yield)	12,25 %

All interest rates are quoted as nominal interest rates and interest amounts are annualised to make the comparisons, that will follow, meaningful.

### 8.5.3 Capital and Reserve Requirements:

Interest bearing liquid assets	1,00 %
Cash reserve (non interest-bearing)	1,00 %
Supplementary cash reserve (interest rate: Treasury bill rate minus 50 points)	1,00 %

## CHAPTER 8

### 8.5.4 Equation To Determine Marginal Balance Sheet Size

#### (A) ASSETS

##### (i) Corporate Loan (CL):

The amount advanced is R1,000,000

##### (ii) Liquid Assets (LA):

The minimum required liquid assets are 1,00 % of the required call deposit.

$$\text{Liquid Assets}(LA) = \frac{1}{100} \text{Call Deposit}(CD)$$

##### (iii) Cash Reserve (CR):

The cash reserve is 1,00 % of the required call deposit.

$$\text{Cash Reserve}(CR) = \frac{1}{100} \text{Call Deposit}(CD)$$

##### (iv) Supplementary Cash Reserve (SCR):

The supplementary cash reserve is 1,00 % of the required call deposit, a short term liability.

$$\text{Supplementary Cash Reserve}(SCR) = \frac{1}{100} \text{Call Deposit}(CD)$$

## CHAPTER 8

### (B) LIABILITIES

#### (i) Required Capital (RC):

The required share capital is 8,00 % of the amount advanced.

$$\text{ShareCapital}(SC) = \frac{8}{100} \text{Corporate Loan}(CL)$$

#### (ii) Required Call Deposit (CD)

The Call Deposit (CD) required will be calculated to balance the following equation:

$$\text{Assets} = \text{Liabilities}$$

$$CL + LA + CR + SCR = SC + CD$$

$$CL + \frac{1}{100}CD + \frac{1}{100}CD + \frac{1}{100}CD = \frac{8}{100}CL + CD$$

$$1,000,000 + \frac{3}{100}CD = 80,000 + CD$$

$$920,000 = CD - \frac{3}{100}CD$$

$$920,000 = ,97CD$$

$$\frac{920,000}{,97} = CD$$

$$R948,453.608 = CD$$

CHAPTER 8

8.5.5

X.Y.Z. BANK LIMITED

Marginal Balance Sheet

Description	Amount	Rate % p.a.	Annualised Income (Cost)
<b>Assets:</b>			
Corporate Overnight Loan	R1,000,000.00	12,00	R 120 000.00
<b>Liquid Assets:</b>			
Treasury bills	R 9,484.54	12,25	R 1,161.85
Cash reserve	R 9,484.54	0,00	R 0.00
<b>Other reserves:</b>			
Supplementary cash reserve	R 9,484.54	11,75	R 1,114.33
Total	R1,028,453.61		R122,275.91
<b>Liabilities:</b>			
<b>Capital</b>			
Ordinary share capital	R 80,000.00	16,00	(R12,800.00)
<b>Deposits</b>			
Call Balance	R 948,453.61	11,50	(R109,072.16)
Total	R1.028,453.61		(R121,872.16)
Nett Income			R403.75

## CHAPTER 8

The annualised margin as calculated in table 8.3 is only R 403.75 per R 1 Million advance on a Corporate loan, based upon a 50 point gap between the call deposit rate and the overnight lending rate. The amount expressed as a percentage, is 0,04 % per annum.

The 0,04 % per annum does not include any variable or fixed cost that may be associated with the above transaction. For the purpose of this exercise it is assumed that all fixed cost are sunken cost and that the variable cost is minute.

### 8.6 CALCULATION OF THE ANNUALISED FEE-INCOME

A 50 point dealing margin as an appointed commercial paper dealer will yield R5,000 per Million Rand Advanced per annum.

A comparison of the annualised margin income versus the fee-income generated by acting as a nominated dealer, per R 1 Million advanced:

Marginal Income as reflected on the balance sheet	R 403.75	0,04 %
Dealing Commission based on ,50 % per annum	R5,000	0,50 %
Differential	R4,596.25	0,46 %

The previous table clearly indicates the huge profit potential in acting as a nominated dealer versus the role of the traditional banker.

The average size of an overnight lending book of a commercial bank might be in excess of R 1 Billion, which can also be funded on a marginal call basis, or even in a worse case scenario by means of thirty two deposit accounts. On a marginal call basis of 50 points, the annualised additional income will be R 4,6 Million Rand.

## CHAPTER 8

### 8.7 OTHER CONSIDERATIONS BEFORE SELECTING THE COMMERCIAL PAPER OPTION

The following must be taken into consideration before opting for the commercial paper solution:

#### **Current Capitalisation**

The maximum capital requirements will only be phased in from 1 January 1995. In the event of the bank having surplus capital the full benefit can only be realised in the following circumstances:

- (i) Inflation has eroded the capital basis of the bank, as a bank has to grow its balance sheet with at least the annualised inflation rate to retain the same real income. All other factors are to remain equal.
- (ii) A bank can decide to increase the future corporate market share over and above the current capital constraints.
- (iii) The bank can also decide to move into other lucrative lending areas, like for example housing loans. The bank can then in a relatively easy way mobilize existing capital for this purpose by moving the marginal lending basis into commercial paper. This will have no adverse effect on the existing share price, that can be the result of a rights-issue.
- (vi) In the event of the bank having sufficient unemployed capital to operate in the marginal overnight corporate lending market, a saving on the liquid asset cost and the supplementary cash reserve can still be achieved. This saving will depend largely on the structure of the then existing liquid asset portfolio.

## CHAPTER 8

### 8.8 CONCLUSION

This chapter looked at the possible financial benefits that may be achieved by the biggest financial intermediaries, namely the South African banking industry by acting as a nominated dealer for commercial paper issuers compared to their traditional role of borrowing and lending.

Other non-financial factors which will have to be considered seriously by the banking fraternity is the cost of losing its influence in the corporate lending market.

In the event of any bank losing its influence in this market segment, it will be a very costly and difficult exercise both to remain relevant in the corporate segment, and to regain market share at a later stage in the blue chip corporate lending market.

The spin-offs that are derived from competitive lending to the corporate sector are not always possible to quantify, but will reflect in the overall bottom line performance of the bank and thus the perception of the investor fraternity as a whole.

South African commercial paper is here to stay and it should be explored as an opportunity and not regarded as something that will fade away in posterity if ignored for long enough by the banking industry.

## CONCLUSION

### 9.1 OVERALL REVIEW OF THE STUDY

The study started with an historic overview of the world-wide commercial paper market with particular reference to the current situation in the South African negotiable-interest securities markets, namely the money and capital markets.

The objective was to seek the relation between commercial paper and other forms of South African negotiable-interest securities, that are either bank endorsed or endorsed by the Central Government. The finding was made that commercial paper can seriously erode the lending base of the traditional commercial banking sector in South Africa and that bankers and other financial intermediaries will have to keep themselves up to date with the latest developments in this market.

Chapter three looked at the development of the three biggest commercial paper markets in Europe. Special emphasis was placed on the British Sterling market due its significant impact on the South African market, both as a major trading partner and the traditional influence of British financial legislation on the local legislation, and more important the future trading role of South Africa as a member of the British Commonwealth.

Chapter four dealt with the current legislation controlling the South African commercial paper market. The 1994 regulations pertaining to commercial paper are also applied throughout the study. The 1994 regulations issued in terms of The Banks Act (94/1990) are applicable as from 1 January 1994.

## CHAPTER 9

The 1994 regulations brought the possibility of a buoyant and prosperous South African commercial paper market closer to reality. Increased financial activity, more overseas participants in the post-apartheid South Africa, will definitely help to create a more vibrant market locally.

The four generic types of commercial paper were discussed in chapter five with special emphasis on the 48 hour commercial paper note. The author feels that this instrument, or a derivative thereof has tremendous potential in the South African money market.

Chapter six can act as a guide-line for prospective South African issuers and overseas participants in the ZAR commercial paper market. Special emphasis was placed on the statutory requirements and also South African money market practice. This chapter will assist any corporate treasurer with the setting up of a commercial paper issuing programme.

The benefits and functions role of a depository were also discussed in chapter six. Depository functions are provided by all four major South African banking institutions. The service provided and keen competitive pricing provided by these institutions will be a hard act to follow.

Certain of the roles that financial intermediaries can fulfil are explored in chapter seven. The banking fraternity, as well brokers and "bucket-shop" owners may participate in either one or all the possible functions of a financial intermediary in this market.

Chapter eight the pursuance of the question of marginal interest- margin versus fee-income is discussed in great detail. The provisos of the Banks Act (94/1990) regarding capital requirements, and the essence of Reserve Bank Circular (8/1993) regarding the statutory liquid asset requirements, were combined in a single mathematical equation, that can be applied in a practical fashion to apply marginal costing in a simplified manner.

## CHAPTER 9

The pro-forma balance sheet can programmatically be extracted from this equation to calculate optimum trading portfolios and positions, without any interest or capital exposures to the financial intermediary who is making use of this proposed model.

### 9.2 IMPLICATION AND SCOPE FOR FURTHER RESEARCH

The commercial paper market is rapidly developing world-wide. New hybrids of commercial paper variations are almost seen daily in the world-markets. These new hybrids offer an almost endless scope for further study into the development of paper based transactions.

The French authorities have recently, in 1991 authorised the dematerialised Billets de Trésorerie. The dematerialised commercial paper note is a ledger based commercial paper trading system, with no physical delivery to investors. This system can be applied to the 48 hour notice commercial paper concept with relative ease.

The system also makes the possibility of a central depository concept look very dated.

The possibility of an electronic network that will link depositors and lenders directly should also be explored as this might be a world first for South African money market participants. The Commercial notes might be held centrally in safe custody and brokers notes are transmitted electronically through existing data-lines to the ledgers of participants.

Settlements can be done electronically at the end of the day . The Swift payment system and other electronic funds transfer mechanisms that are already in place in the South African clearing banking system, makes such a system a possible reality.

## CHAPTER 9

The limitations for further research in the interest-bearing securities are almost endless, and can be directed in various diversified directions, for example:

### 9.3 THE LEVELLING OF THE PLAYING FIELD

The levelling of the playing field was mentioned in various places in this study as far as revenue stamps on commercial paper is concerned. Most of these parastatals like to see and advertise themselves as being commercialised and operating on open market principles. However, all of these well intended capitalistic outlooks, tend to fade as this practical example of open market competition is mentioned.

The counter argument is that one can not tax a government institution. The argument holds definite merit, but as soon as these parastatals compete on trading positions on the open markets, with deals far exceeding their true working capital and capital requirements, the picture surely changes. The massive ZAR 3 Billion loss experienced by one of these parastatals on the open foreign exchange markets, comes to mind in the possible estimation of the size of these parastatal speculative trading positions.

The Rand money market is a zero based market. This equates to the fact that the daily Rand profits realised on these markets equals the losses, with the missing portion in the equation being the fixed and variable operational costs of the local Rand money market operations.

## CHAPTER 9

### 9.4 SUMMARY

The author endeavoured to make this study informative rather than trying to be prescriptive. The study can be used as a guide–line to would–be participants in the South African commercial paper market.

The authorities have given their blessing to this world–wide phenomenon of by–passing the traditional banking routes. The South African monetary authorities would prefer to see a commercial paper market that is self–regulatory through sound established market practice to one that is statutory controlled.

The experiences world–wide have taught that where the banking fraternity preferred to ignore the development of commercial paper in their own countries, they have become irrelevant in these once lucrative lending markets. The price of trying to regain relevance is a very expensive and a time consuming exercise.

South African bankers must take the lead and standardise this relative new local lending approach. Corporate treasurers can very easily set up a lucrative South African commercial paper market amongst themselves.

Once this has occurred, it will be very difficult for any bank to remain relevant in this multibillion blue chip corporate lending market. Insurance companies, mining houses, unit trust companies, pension and provident funds are investing Billions in equities that are quoted on the Johannesburg Stock Exchange.

Nothing is going to stop the Billions of Rand of these surplus economic units, also to be invested in shorter–dated money market securities of the same entities that are quoted on the Johannesburg Stock Exchange.

The South African banking fraternity should be preparing itself for the appearance of this world–wide growing phenomenon.

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