

The early development of the sterling commercial paper market

The Bank issued on 29 April 1986 a notice⁽¹⁾ setting out arrangements which would for the first time allow certain companies to make issues of short-term (up to one year) debt securities in sterling, ie sterling commercial paper, without publication of a prospectus. This followed a notice issued on 19 March 1985⁽²⁾ which facilitated the issue of short-term corporate bonds. Together, the provisions of these two notices represented a considerable widening of the short-term financing opportunities available onshore to companies, which had previously been restricted largely to bills of exchange, syndicated loans, advances and overdrafts. This article considers the development of the sterling commercial paper (SCP) market up to August 1987.

The regulatory environment

The earlier notice on short-term corporate bonds announced measures being taken to enable certain companies to issue securities of one to five years' maturity without contravening either the Banking Act or the Bank's previously established guidelines on capital market issues. The necessary exemptions from the Banking Act were made subject to certain conditions set out in the notice.

These arrangements were put into place in response to enquiries from companies about the possibility of such issues and were consistent with the view on the desirability of such an extension of corporate borrowing powers expressed in the Bank's written evidence to the Wilson Committee in 1977. The development of the euronote and eurocommercial paper markets in London stimulated interest in the possibility of making even shorter term sterling note issues as a new form of sterling money-market instrument. Previously, one-name sterling money-market instruments had been issued only by the Treasury, local authorities, banks, licensed deposit-takers and building societies. Money-market instruments other than such single-name paper carried at least two names, that of the issuer and that of one other good name. The vast bulk of such paper consisted of eligible bank bills—bills drawn by a company and accepted by an eligible bank—which the Bank was willing to buy in its money-market operations.

Bill finance was sufficiently attractive to many borrowers to suggest that the scope for a commercial paper market seemed less in sterling than in other currencies. Nevertheless the expressed demand for SCP appeared to indicate that the Bank should not stand in the way of the development of such a market, provided that adequate investor protection safeguards could be established. The Bank took the view that, given such demand, unnecessary restrictions were not only undesirable in themselves but could also lead to a shift of business offshore, thereby

fragmenting the London sterling market, or to the use of artificial devices to evade the existing restrictions.

Consequently the powers conferred on the Treasury by the Banking Act 1979 to remove specified transactions from the definition of deposit-taking within that Act were used to allow corporate issues of sterling short-term debt, subject to certain requirements designed to provide investor protection.⁽³⁾ These requirements are as follows:

- (i) The issuing company should be listed on the International Stock Exchange and have net assets of £50 million or more, or be the subsidiary, and issue under the guarantee, of such a company.
- (ii) Issues should have an original maturity of between 7 and 364 days.
- (iii) Issues should be in minimum denominations of £500,000.⁽⁴⁾
- (iv) Issues must carry a statement that the issuer or its guaranteeing parent is in compliance with the International Stock Exchange Listing Rules and there has been no significant adverse change in its circumstances since information was last published in accordance with such rules.

In addition, the notice issued by the Bank recognised that some issuers might wish to have the paper guaranteed by a recognised bank or licensed deposit-taker and the Regulations allowed for this, but the Bank stated that guarantees should not come from any other source except for parents of wholly-owned subsidiary issuers.

The Bank also recognised that issuers might wish to employ an intermediary to manage issues. Because of the uneven competitive environment that would have arisen from the different regulatory regimes applied by different supervisory authorities to different intermediaries active in the United Kingdom, management of issues was

(1) Reproduced in the June 1986 *Bulletin* pages 198-9.

(2) Reproduced in the March 1985 *Bulletin*, page 36.

(3) By exempt transactions regulations under Section 2 of the Banking Act 1979 (Exempt Transactions) Regulations 1986.

(4) To restrict such issues to the 'professional' market.

initially restricted to recognised banks and licensed deposit-takers incorporated in the United Kingdom and thus subject to the Bank's own capital adequacy and liquidity arrangements. Other prospective intermediaries were, however, able to participate, subject to arrangements agreed individually with the Bank to ensure level competition in terms of regulatory arrangements.

Issues of SCP do not require timing consent from the Bank under the Control of Borrowing Order, which was suitably amended. For statistical purposes, issuers are asked to notify the Bank at the commencement or extension of any programme of the total amount of paper they propose to issue under that programme and to provide monthly returns of the amount of SCP outstanding and of issues and redemptions made since the previous return.

Development

The first programmes were announced in May 1986 and were all for overseas companies, mainly the overseas financing subsidiaries of UK companies. There was initially some uncertainty about the legal position of UK companies issuing such paper without a prospectus, hence the use of overseas financing subsidiaries, but the Financial Services Act removed the uncertainty, with the result that by October 1986 new programmes for domestic issuers outnumbered those for overseas issuers, although it was not until February 1987 that this was true for the total of outstanding programmes. The number of programmes in existence has increased steadily (Table A and Chart 1). By end-August 1987, seventy-nine programmes had been notified to the Bank, in nine of which SCP was one option in a wider borrowing programme. July 1987 was the first month in which no new programmes were notified to the Bank.

When notifying the Bank of a new programme, issuers are asked to indicate the maximum amount of paper issuable.

Table A
The growth of the SCP market

£ millions, numbers of programmes in italics

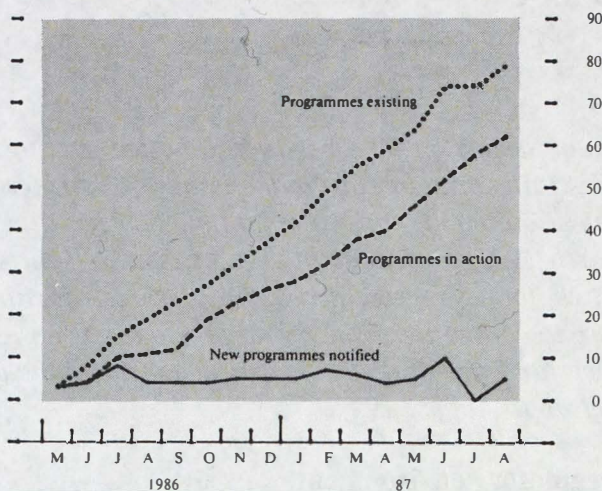
	Programmes notified to the Bank (cumulative)	Programmes activated (cumulative)	Issues	Maturities	Total paper in issue
1986(a)					
May	3	280	3	280	30
June	8	630	4	330	57
July	15	1,475	10	830	165
August	19	1,815	11	930	215
September	23	2,170	12	1,030	297
October	27	2,670	19	1,615	466
November	32	3,065	23	1,885	620
December	37	3,610	26	2,210	398
1987					
January	42	4,030	28	2,410	589
February	49	4,780	32	2,760	786
March	55	5,230	38	3,477	825
April	59	5,580	40	3,612	953
May	64	6,030(b)	46	4,037	1,083
June	74	6,915	52	4,787	1,563
July	74	6,915	58	5,122	1,579
August	79	7,615	62	5,747	1,575

(a) Banking months until September 1986, which covers the period banking September and 18-30 September; calendar months thereafter.

(b) In addition one existing programme was increased by £25 million.

Chart 1
Number of SCP programmes notified to the Bank

Banking months until September 1986



By end-August 1987 £7,615 million of programmes had been notified, £730 million being within multi-option facilities, for which the amounts quoted are for the maximum borrowing for the entire programme. The average size of programmes established without being part of a wider facility is £97 million, with the smallest being for £20 million and the largest for £300 million.

Not all programmes announced have been activated immediately: at end-August 1987, sixty-two out of seventy-nine programmes announced had been activated. This reflects the anticipatory behaviour of borrowers, who set up programmes as an addition to their borrowing options, to be used when market conditions are appropriate. The amount of issues activated has shown some bunching, particularly in July and October 1986 and March, June and August 1987. By end-August 1987, £5,747 million of programmes had been initiated, out of a total of £7,615 million of programmes announced. Table A and Chart 2 show that the relationship between the two, while not static, has varied little.

The amount of paper actually in issue grew fairly steadily to £700 million by end-November 1986, fell back modestly in December, perhaps reflecting end-year influences, and then resumed growth to reach £2,073 million outstanding at end-August 1987. Gross issues have totalled £11,201 million, with redemptions of £9,128 million. There are no data available on the original maturity of issues, but the scale of issues and redemptions so far, relative to the total outstanding at any time, suggests that on average it is very short. In each month to date, the sum of gross issues and redemptions has exceeded the total amount of paper in issue. In some months the proportion of gross issues from new programmes redeemed within the reporting period has been almost one third (Table B). This limited evidence supports the general belief that most SCP has an original maturity of between fifteen and forty-five days, although reports of longer maturities, some out to the maximum term allowable, are increasing.

Chart 2
Value of SCP programmes notified to the Bank

Banking months until September 1986

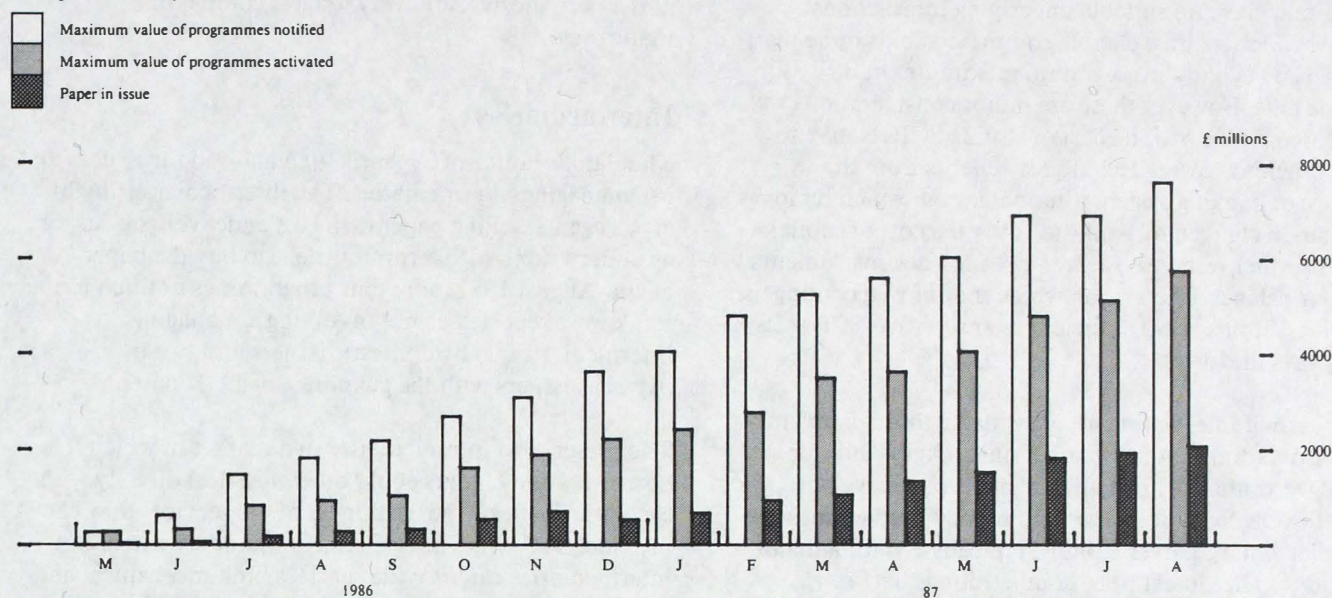


Table B
Gross issues and maturities of SCP

£ millions

	New programmes		Existing programmes	
	Gross issues	Maturities	Gross issues	Maturities
1986(a)				
May	30	—	—	—
June	30	—	27	23
July	132	1	33	50
August	86	11	129	100
September	10	—	287	252
October	170	9	296	252
November	30	—	590	452
December	105	34	293	537
1987				
January	10	—	579	454
February	132	38	654	479
March	186	59	639	657
April	61	—	892	665
May	69	2	1014	891
June	177	—	1386	1264
July	70	3	1509	1461
August	56	—	1519	1434

(a) Banking months until September 1986, which covers the period banking September and 18–30 September: calendar months thereafter.

Issuers of SCP

Compared with the eurocommercial paper market (where the paper is denominated in dollars) the SCP market is small. At end-August, approximately five hundred eurocommercial paper programmes had been announced and nearly four hundred activated. Paper in issue, as estimated by Euro-clear, amounted to about \$31 billion.⁽¹⁾ The difference in size reflects not only the later development of the SCP market but also its primarily domestic nature.

Out of a total of seventy-nine programmes notified to the Bank by end-August 1987, fifty-four were for domestic issuers (eight guaranteed by domestic parents and two guaranteed by overseas parents), fifteen were for overseas

companies guaranteed by a UK parent, and ten were other issues for overseas borrowers.⁽²⁾ In terms of value, £5,222 million of programmes have been for domestic issuers, £1,328 million for overseas companies guaranteed by a UK parent and £1,065 million for overseas issuers. Forty-six, ten and six programmes respectively have been activated, totalling £4,062 million, £1,085 million and £600 million, with £1,360 million, £666 million and £47 million of paper in issue.

The Bank's notice of 29 April 1986 stated that 'there will be no objection to issuers arranging for their paper to be guaranteed by a recognised bank or licensed deposit-taker'.⁽³⁾ However, no other source of guarantee, apart from that given to a wholly-owned subsidiary, was permitted. To end-July none of the programmes notified to the Bank carried the guarantee of a bank or licensed deposit-taker and thus the only guarantees have been given by parent companies.

Most of the very largest companies have not yet made use of the market. For many of these companies the market may be too small for them to use, given the scale of their borrowing requirements. Another important factor may be the availability to them of cheaper finance in the US and eurocommercial paper markets: even when transaction costs have been taken into account, some major names are thought to be able to borrow at around 10 basis points below LIBID, considerably cheaper than SCP costs (see below). These markets are far larger than the SCP market and have a different perception of and appetite for short-term corporate debt.⁽⁴⁾

For other corporate borrowers the choice between issuing SCP and borrowing through other means may be

(1) See also 'Statistics on euronotes and eurocommercial paper' on pages 533–5.

(2) One issue by an overseas company guaranteed by a UK company has since been replaced with an issue by the UK parent.

(3) Institutions authorised under the Banking Act since 1 October 1987.

(4) See the February 1987 *Bulletin*, pages 46–53, for a discussion of these markets.

determined by a number of factors. For example, non-standard maturities are common in SCP issues; the issuer may have no suitable underlying transactions against which to draw eligible commercial bills or he may wish to go beyond the six-month maximum maturity for eligible bills. However these are minor considerations compared with cost. The cost of issuing SCP relative to most other borrowing techniques benefits from the absence of banking system intermediation, which removes the margin charged by banks to cover the cost of capital, and any other reserve costs, required to back instruments on their balance sheets or on which they have a contingent liability. Yet this is not sufficient to ensure that SCP costs are always the lowest.

Short-term domestic finance is available through several routes: overdraft, money-market lines, eligible bills or SCP. Overdrafts are normally the most expensive but most flexible form of finance and money-market lines are priced at a margin over LIBOR, typically $\frac{1}{8}\%$ for a major corporate. The closest price competition is between eligible bills and SCP. The cost of borrowing through bills is determined by the rate at which eligible bills are discounted in the market and the acceptance commission charged by eligible banks. The eligible bill rate is a money-market rate influenced by, and itself influencing, other money-market rates. Commissions vary but a typical commission rate might be $\frac{1}{8}\%$ for a major borrower and $\frac{1}{16}\%$ for a lesser one.

An additional feature of the acceptance market is the use by the Bank of England of eligible bank bills in its daily money-market operations. The Bank will purchase Treasury bills, local authority bills and eligible bank bills in order to supply cash to the money market when needed. This adds to the liquidity of the bill market, and the expansion of the Bank's list of eligible institutions has contributed to highly competitive commissions.

It is difficult in the young SCP market to talk of a typical cost to an issuer, and while the very largest and best known issuers might be able to borrow at LIBOR, others might have to pay up to 12 basis points over LIBOR—a range of 25 basis points. This variation may reflect in some cases the presence or absence of a rating for the issuer or its programme. A good rating seems to have little direct impact on the price of an issue, but it may widen the investor base and therefore make placing the issue easier and reduce its cost somewhat. Some investors will not buy unrated paper.

With relatively few active SCP issuers in a young market and with such a wide spread of pricing, it is not yet sensible to attempt to make direct comparisons between SCP prices and other costs of borrowing, other than of the day-to-day type made by issuers at the moment when they wish to borrow. However, it is clear that for borrowers the most important comparison is with eligible bills, and on this comparison two features stand out, although these are sensitive to overall market conditions. First, the

relationship between the two is volatile on a day-to-day basis. Second, in general, SCP is more likely to be cheaper at the very shortest and very longest comparable maturities.

Intermediaries

The Bank's notice of 29 April 1986 allowed for issuers to use managing intermediaries. The intermediaries might act as agents, selling paper on a best endeavours basis, or as underwriters with a commitment to buy the paper. As at end-August 1987, only four programmes notified to the Bank were reported as not involving a managing intermediary, two by domestic issuers and two by overseas issuers with the guarantee of a UK parent.

The presence of intermediaries in a market in which borrowers and lenders could otherwise deal directly with each other reflects the usefulness of the services they can provide. SCP issues are generally not underwritten, but intermediaries can provide services both mechanical and strategic. An intermediary can act as a settlement agency processing paper at both issue and redemption, perhaps taking advantage of an existing settlements function and a physical location within the City. In addition, intermediaries are able to advise on opportunities to issue cheaply, using their knowledge of, and contact with, a wider investor base than many of the issuers may have themselves.

A typical dealership arrangement for an issuer might incorporate several dealers who stand prepared to advise an issuer on the suitability of an issue and to bid for paper when requested. However this would not normally carry a firm commitment to buy paper, nor would it exclude other intermediaries who wished to bid for paper. At least one issuer uses a tender panel arrangement whereby interested parties are invited to bid for paper.

Most dealers claim that their role is to place their issuers' paper in firm hands, and in order to do this they need to identify potential investor demand before advising a borrower to issue. This would include matching the maturity desired by the investor to that required by the borrower. On occasion it may not be possible to achieve this exactly and the intermediary may take the paper on to his book over the period of mismatch. In general, however, the intermediary may prefer not to hold paper, because of capital requirements or other limits.

Another possible function of an intermediary is to provide market liquidity. Some holders of SCP, like holders of other money-market instruments, such as CDs and acceptances, may regard it as important to be able to sell paper if they need to raise funds quickly, and intermediaries may be prepared to perform the function of market making so as to provide the liquidity and increase the attractiveness of the paper to investors. However, they may be reluctant to carry positions because of the capital backing required or because of limits on

such positions. But in practice the vast bulk of paper so far issued is held to maturity: most issues are short term and intermediaries attempt to match the maturities desired by borrowers and investors. Nevertheless, dealers generally regard it as their responsibility to bid for 'their' paper and ensure that it does not trade too cheaply.

Anecdotal evidence suggests that the margin between the yield at which dealers buy SCP from issuers and that at which they on-sell it to investors is typically 2 basis points. Total gross issues to the end of August 1987 were £11,201 million, so that such a turn of 2 basis points would have generated total direct dealer earnings of a little over £2 million. Nevertheless, even though the direct returns from acting as an intermediary in SCP are not great, many intermediaries may regard the provision of SCP facilities as a necessary component of a full range of services.

Investors in SCP

There are no data available to show who invests in SCP, either by purchasing it at issue or in the secondary market, other than for holdings by monetary sector institutions (directly or on behalf of non-residents). The statistics relating to bank own-holdings of SCP show that the proportion of paper held by banks was 27%, (£560 million), at end-August 1987. These holdings may, however, have arisen through purchase at issue, through secondary market purchases to provide liquidity, or through investment purchases. Table C shows that monetary sector institutions' holdings have fluctuated between 20% and 30% at reporting dates. In addition non-bank intermediaries may play an important role in the market—their holdings are not known.

Table C
Monetary sector holdings of SCP

	Total (£ millions)	Per cent of SCP in issue
1986		
June	19	30
September	82	25
December	121	23
1987		
March	270	26
June	407	22
July	475	25
August	560	27

Industrial and commercial companies are thought to be the most important investors, anecdotal evidence suggesting that they hold at least 60% of paper in issue, with some large issuers also active as investors. Corporate investors are looking for a gain in yield over alternative short-term investments, with the additional advantage that they are frequently able to obtain paper of a maturity to match exactly their expected cash flow requirements. Liquidity is available to them through the dealers' normal willingness to bid for paper offered back to them. Institutions are not reported to be significant investors yet, but are becoming increasingly important.

Overseas investors are also thought to be relatively inactive in the SCP market. This may reflect unfamiliarity with the borrowers. Also SCP programmes are not registered under SEC rules and therefore cannot be sold to most US investors. The only information available on overseas investors is the holdings on their behalf reported by the UK monetary sector, which at end-August amounted to £3 million, or 0.1% of the paper in issue.

The secondary market

It is not possible to identify a significant secondary market in SCP. In part this may be because of uncertainties about the legality of such transactions, since SCP issues are generally made as private placements or oral offerings and potential market makers are reluctant to quote prices on-screen. Of equal importance may be the short average maturity of SCP and the role of intermediaries in matching the chosen maturities of borrowers and investors. If the maturity of SCP issues were to lengthen, an active secondary market might develop as an increasing number of investors needed to liquidate investments: conversely, maturities might not lengthen until potential investors felt confident about liquidity. Until now, liquidity has been available through dealers' willingness to bid for paper offered back to them by their investor base, and anecdotal evidence suggests that very little is in fact offered back before maturity. This absence of a secondary market in SCP reflects the experience of other commercial paper markets, in which such a market has not developed despite, in the United States at least, the long-standing existence of the primary market. In the United States this is in part explained by the predominantly very short maturity of commercial paper, usually less than one month.

SCP and monetary policy

Only SCP issues held by institutions within the monetary sector appear in the banking figures, as bank lending within the asset counterparts to M3, and thus within the counterparts to M4 and M5 as well. Although SCP is a form of money-market instrument, it does not appear alongside non-bank, non-building-society private sector holdings of similar instruments among the components of M5.⁽¹⁾ Bank holdings on own account of SCP were £560 million at end-August, 0.3% of bank lending in sterling, and 0.2% of the lending counterparts to M5.⁽²⁾ Holdings outside M5 of £1,513 million were equivalent to only 0.5% of that aggregate. If in the absence of the SCP market issuers had instead had recourse to bank borrowing, bank lending would have been higher by 0.8%.

There appears to be a greater degree of potential substitution between SCP and eligible bank bills than between SCP and general bank borrowing. Table D shows that it is too early to make any inferences about the

(1) See the May 1987 *Bulletin*, pages 212-19.

(2) Sterling borrowing by the non-bank, non-building-society private sector from banks and building societies, together with non-bank, non-building-society holdings of bank acceptances.

Table D
Eligible bills and SCP outstanding

£ millions

	SCP	Eligible bills	SCP plus bills
1986			
June	67	15,912	15,979
September	327	15,616	15,943
October	532	17,491	18,023
November	700	17,919	18,619
December	527	20,251	20,778
1987			
January	662	21,058	21,720
February	931	20,055	20,986
March	1,040	17,425	18,465
April	1,328	16,920	18,248
May	1,518	14,954	16,472
June	1,817	15,413	17,230
July	1,932	17,783	19,715
August	2,073	15,815	17,888

impact of the growth of SCP outstanding on the eligible bill market, with the seasonal pattern of bills obscuring any trend that may have been established. However there is no evidence that the Bank's operational need for eligible bills may be frustrated, although the extra option for

borrowers provided by SCP may cloud further any evidence of a link between the Bank's activities in the bill market and the behaviour of other forms of borrowing.

Further development of the market

In its first eighteen months the SCP market has made a positive start, and the growth of SCP issues has been steady. Although SCP is not in all cases an exact competitor with eligible bills, for most issuers the obvious comparison is between the two, and there is as yet no evidence that SCP has supplanted bills. Further development of SCP may depend in part on the pricing relationship with bills, but it will also depend on the continuing growth in both investor and borrower demand. For the former the increasing involvement of investors outside the corporate sector may be important. For the latter both the entry of the largest potential borrowers and the spread of SCP programmes among eligible issuers as a usual part of facilities available will be important.