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SUMMARY SHEET

Primary and Secondary Market (Debt Market)

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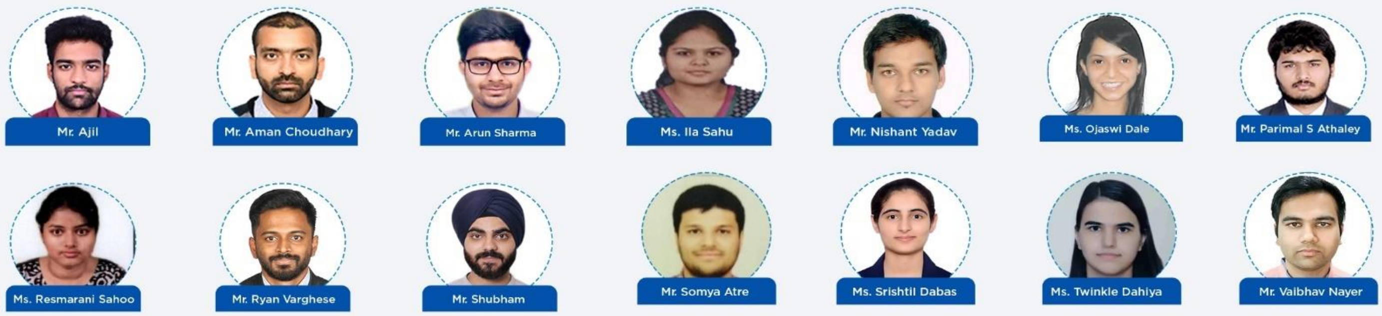
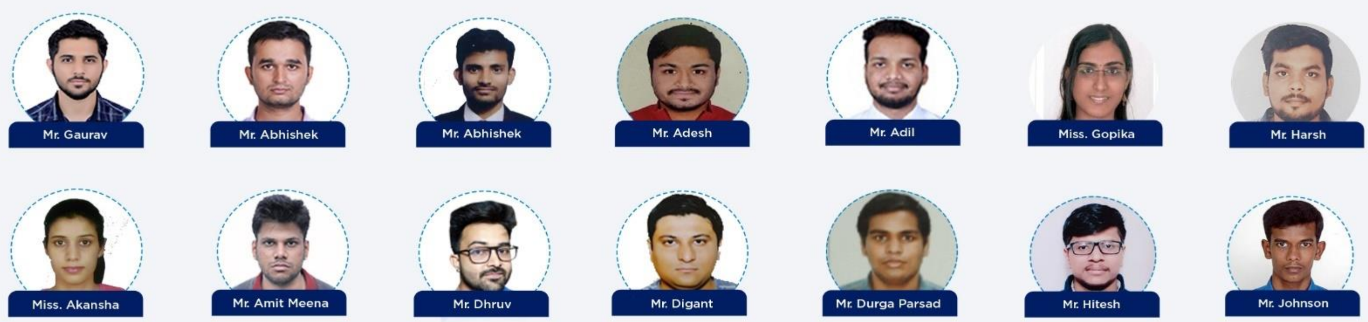
EduTap Hall of Fame

RBI Grade B 2020 - 21
198 Selections Out of 257



SEBI Grade A 2020
63 Selections Out of 80



NABARD Grade A 2020
65 Selections Out of 69

Important Points

1. This Summary Sheet shall only be used for Quick Revision after you have read the Complete Notes

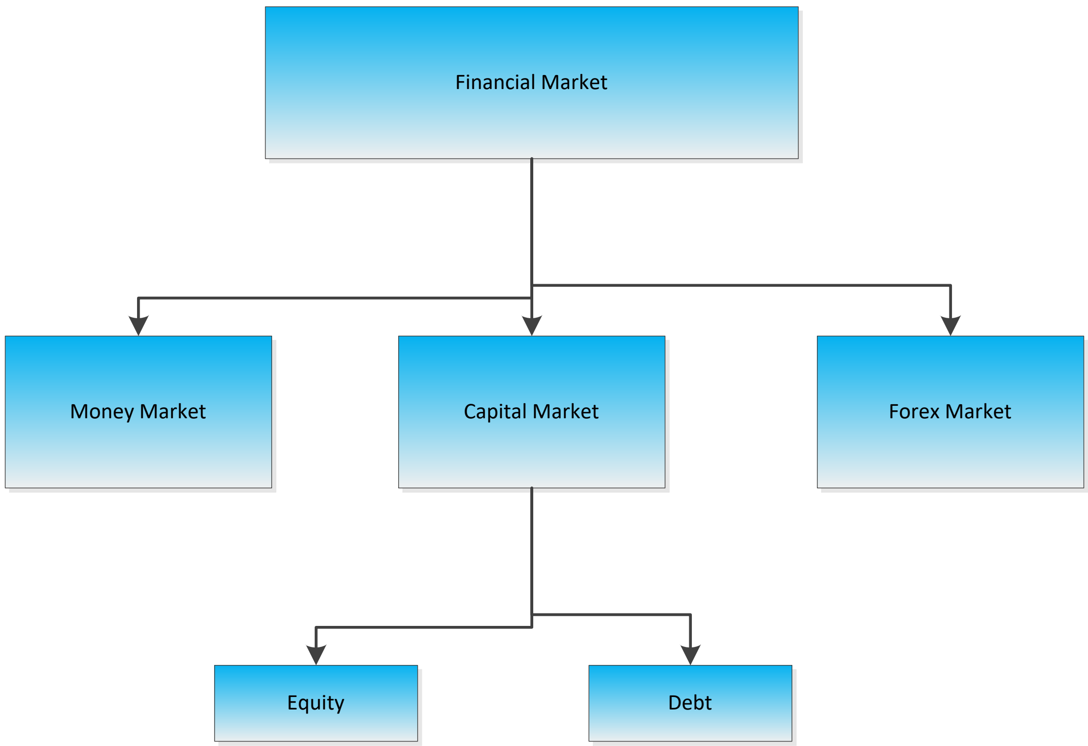
2. For Building Concepts along with examples/concept checks you should rely only on Complete Notes

3. It would be useful to go through this Summary sheet just before the exam or before any Mock Test

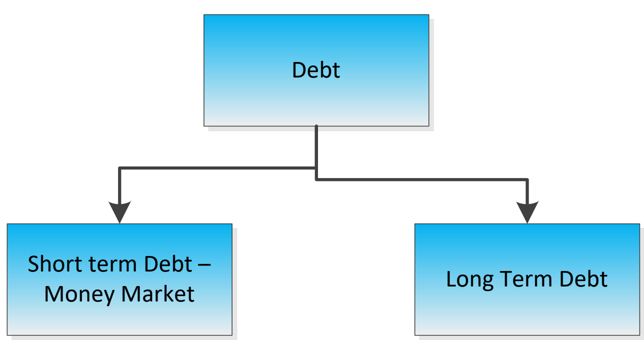
4. Questions in the exam are concept based and reading only summary sheets shall not be sufficient to answer all the questions

1 Summary Points

- **Financial Markets in India**



- **Money Markets:** Market for overnight to short-term funds and instruments having a maturity period of 1 or less than 1 year
- **Capital Market:** Market for long-term funds – both equity and debt – that have maturity period greater than year
- **Equity Market:** Market where equities(stocks) are traded or issued
- **Debt Market / Fixed Income Markets:** Market where debt instruments (bonds, debentures, etc.) are issued or traded
- **Debt are of two types:**



Equity Financing over Debt Financing	Investing in Equity over Debt
Advantages: I. Equity capital doesn't have any obligation to be returned back to the investor unlike Debt capital II. No obligation to pay interest or dividends regularly	**Advantages:** I. Possibility of higher returns over Debt investment
Disadvantages: I. Dilutes ownership of business II. Promoters get less control and management of company's operations due to investor rights III. Comply with Stock Exchange norms IV. Pressure to make profits	**Disadvantages:** I. Risking investment II. No guaranteed return III. Possibility of low or no returns too IV. **In case the company dissolves, it would be the debt investors who will have the first right to recover their Principal and Interest and only residual will be paid to the Equity investors**

- **Features of Debt Capital:**
  1. **Instrument Types:** There are various types of debt instruments depending on their tenor and interest rate, such as Bonds, Debentures, Commercial bills, Commercial papers, Certificates of deposit or Pass-through certificates
  2. **Floating or Fixed rate of interest:** Debt instruments are tied to either floating or fixed rate of interest (lender and borrower agree on a benchmark rate at a specific reset frequency)
  3. **Credit Rating:** Debt instruments are credit rated through a rating agency to indicate their ability of servicing debt
  4. **Priority**: Interest to lenders is paid before taxes and any distribution to equity investors. Even in the case of bankruptcy, debt holders have primary right on assets before stakeholders such as employees and equity investors
  5. **Security**: Mostly borrowings are secured by a mortgage on the assets of the business. These are called **secured borrowings**, where the lenders can press for sale of the asset to recover their dues, if the business is unable to pay them
  6. **Conversion:** Through the issue of **convertible debentures**, lenders may convert their debt into equity at a specific date, price, and time

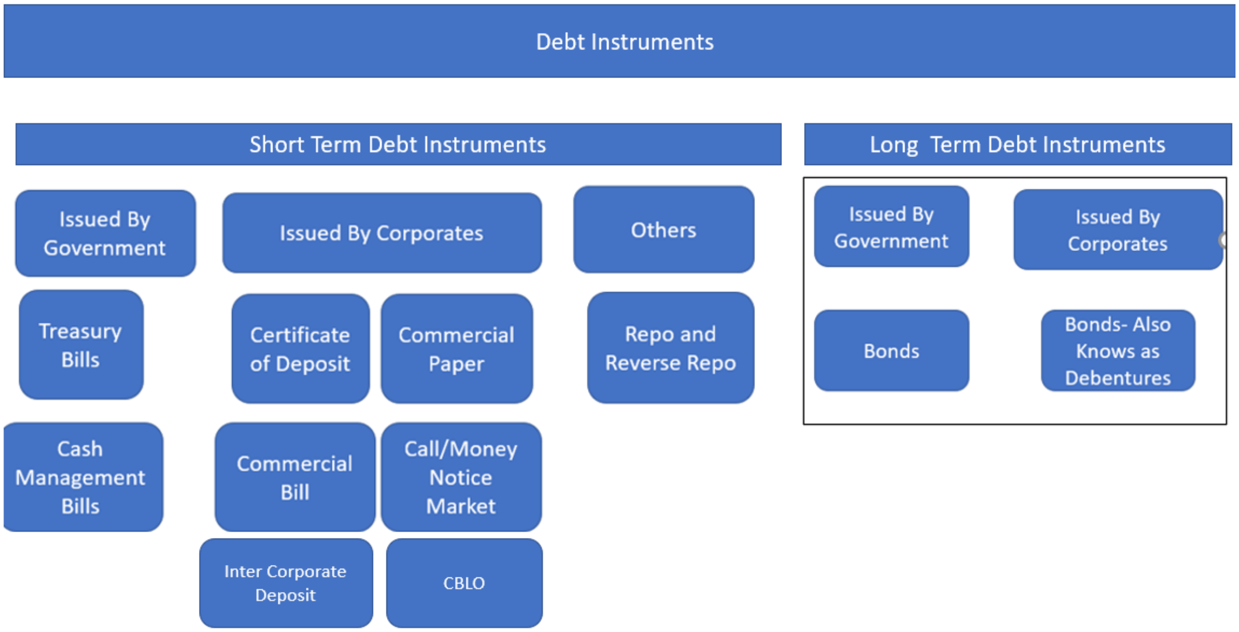
- **Factors for choosing Debt over Equity:**

1. Ability to pay periodic interest generating out of debt
2. Unwillingness to dilute the Ownership of the Company
3. Ability to give Collateral as Security
4. When Short-term Capital is required

- **Regulation of Debt Markets in India:**
  1. Contracts for sale and purchase of government securities, gold related securities and money market securities in debt segment issued by government are regulated by RBI
  2. Corporate Debt Market and sale/purchase of government securities on stock exchanges are regulated by SEBI
- **Concept of Debt Capital**

1. The people who invest small chunks of money are called Lenders/Investors
2. Company or Entity who is the borrower of debt is also called Issuer
3. A debt security denotes a contract between the issuer (company) and the lender (investor) which allows the issuer to borrow a sum of money at pre-determined terms. These predetermined terms are:
   a. **Principal** The principal is the amount borrowed by the issuer. The face value of the security is the amount of the principal that is due on each debt security
   b. **Coupon:** The coupon is the **rate of interest** paid by the borrower to the investor. Also, The periodicity of interest payment (**quarterly, semi-annually, annually**) is also agreed upon in the debt contract
   c. **Maturity:** The maturity of a bond refers to the date on which the contract requires the borrower to repay the principal amount
- **Example:** Company XYZ borrows Rs. 1000 from its investors at 10% annually with 10 years as maturity
  1. Principal amount / Face Value for each security is 1000
  2. Coupon rate is 10% which means investor would get 10% of 1000 = 100 each year as interest
  3. Maturity date is 10 years from now which means person would get interest of 100 each year for next 10 years after which the principal of 1000 would be returned bac

➢ **Types of Debt Instruments:**



1. Debt Instruments can be short term or long-term debt. Short term is basically less than 1 year, and long term are typically longer than 1 year
2. Short Term Market for Debt Instruments is also called Money Market
3. Both Government and Private Sector Issue Debt instruments in the short and long-term duration debt
4. We will discuss various instruments issued by Government and Private Sector in the Long term and short-term duration debt market. But before that we will discuss the distinction between government and Private Debt instruments

➢ **Government Securities** include central government bonds, as well as quasi-government bonds issued by state governments. Central government can issue securities in short term market such as Treasury bill and Cash Management bills or issue in long term market which are called **Bonds or Dated securities.** State government can issue only long-term securities which are called **bonds or dated securities**.

<u>Risk Free</u>: G-Secs **carry** practically no risk of default and, hence, are called **risk-free gilt-edged instruments**. This is because the government can unilaterally increase taxes to repay its obligations, borrow easily from other entities, or print notes to repay debt in the extreme case

Contribution to SLR: Government securities are approved for such investments to be counted under SLR

- **Major players in the G-Secs market:**
  1. In includes commercial banks and Primary Dealers (PDs), financial institutions besides institutional investors like insurance companies.
  2. Other participants include co-operative banks, regional rural banks, mutual funds, trust, provident and pension funds.
  3. Foreign Portfolio Investors (FPIs) and FIIs are allowed to participate in the G-Secs market within the quantitative limits prescribed from time to time.
  4. Corporates, partnership firms are also buy/ sell the G-Secs to manage their overall portfolio.
  5. State governments, Nepal Rastriya Bank are also eligible to participate.
  6. **Under certain instruments there are some restrictions on the participants that we will study later in the document**

  A primary dealer is a firm that buys government securities directly from a government, with the intention of reselling them to others, thus acting as **a market maker** of government securities. A market maker provides firm two-way quotes in the market i.e. both buy and sell executable quotes for the concerned securities. **For example**, if market makers would not have been there, then Person A would want to sell share at price of 11 whereas person B would like to buy it at 10. There is gap of 1 rupee. In this situation as an example market maker will make a sell quote (**ask quote**) for Rs. 10.50 and buy quote (**bid quote**) of Rs. 10.40. Person A will get a better price of 10.40 as compared to if he would have sold the same to Person B at Rs. 10. Similarly person B would get a better price of 10.50 as compared to if he would have bought the same from Person A at Rs. 11. Market maker will also make a profit of .10 in this transaction

  They help to ensure there's enough liquidity in the markets, meaning there's enough volume of trading so trades can be done seamlessly. Without market makers, there would likely be little liquidity. In other words, investors who want to sell securities would be unable to unwind their positions in a situation when everyone wants to buy

- **How are Gsecs issued?** G-Secs are issued through auctions conducted by RBI. Auctions are conducted on the electronic platform called the **E-Kuber**, the Core Banking Solution (CBS) platform of RBI.

  <u>Different Type of Auctions Conducted</u>?

  With the introduction of auctions, the rate of interest (coupon rate) gets fixed through a market-based price discovery process. An auction may be yield based or price based

1. **Yield based Auction**: A yield-based auction is generally conducted when a new G-Sec is issued. Investors bid in yield terms up to two decimal places (e.g., 8.19%, 8.20%, etc.). Bids are arranged in ascending order and the cut-off yield is arrived at the yield corresponding to the notified amount of the auction. The cut-off yield is then fixed as the coupon rate for the security. Successful bidders are those who have bid at or below the cut-off yield. Bids which are higher than the cut-off yield are rejected. An illustrative example of the yield-based auction is given below. Total amount to be issued is 1000 crore and cut-off yield at which 1000th crore can be issued 8.22%. This 8.22 will become the yield for these issued bonds

Details of bids received in the increasing order of bid yields				
Bid No.	**Bid Yield**	**Amount of bid (₹ Cr)**	**Cumulative amount (₹ Cr)**	**Price* with coupon as 8.22%**
1	8.19%	300	300	100.19
2	8.20%	200	500	100.14
3	8.20%	250	750	100.13
4	8.21%	150	900	100.09
5	8.22%	100	1000	100
6	8.22%	100	1100	100
7	8.23%	150	1250	99.93
8	8.24%	100	1350	99.87
The issuer would get the notified amount by accepting bids up to bid at sl. no. 5. Since the bid number 6 also is at the same yield, bid numbers 5 and 6 would get allotment on pro-rata basis so that the notified amount is not exceeded. In the above case each of bidder at sl. no. 5 and 6 would get ₹ 50 crore. Bid numbers 7 and 8 are rejected as the yields are higher than the cut-off yield.				

2. **Price Based Auction:** Price based auction is conducted when Government of India re-issues securities which have already been issued earlier. Bidders quote in terms of price per ₹100 of face value of the security (e.g., ₹102.00, ₹101.00, ₹100.00, ₹ 99.00, etc., per ₹100/-). Bids are arranged in descending order of price offered and the successful bidders are those who have bid at or above the cut-off price. Bids which are below the cut-off price are rejected. An illustrative example of price-based auction is given below. In this example 1000 crores of securities are to be re-issued and the last best price which government can get is 100 for 1000th crore security. So, this 100 becomes of cut-off price

Details of bids received in the decreasing order of bid price				
Bid no.	Price of bid	Amount of bid (₹ Cr)	Implicit yield	Cumulative amount (₹ Cr)
1	100.19	300	8.19%	300
2	100.14	200	8.20%	500
3	100.13	250	8.20%	750
4	100.09	150	8.21%	900
5	100	100	8.22%	1000
6	100	100	8.22%	1100
7	99.93	150	8.23%	1250
8	99.87	100	8.24%	1350
The issuer would get the notified amount by accepting bids up to 5. Since the bid number 6 also is at the same price, bid numbers 5 and 6 would get allotment in proportion so that the notified amount is not exceeded. In the above case each of bidders at sl. no. 5 and 6 would get securities worth ₹ 50 crore. Bid numbers 7 and 8 are rejected as the price quoted is less than the cut-off price.				

The allocation to successful bidders might be done on **Uniform Price basis or Multiple Price basis**. **In a Uniform Price auction**, all the successful bidders are required to pay for the allotted quantity of securities at the same rate, i.e., at the auction cut-off rate, irrespective of the rate quoted by them. On the other hand, in a **Multiple Price auction**, the successful bidders are required to pay for the allotted quantity of securities at the respective price / yield at which they have bid. In the example for price-based auctions above, if the auction was Uniform Price based, all bidders would get allotment at the cut-off price, i.e., ₹100.00. On the other hand, if the auction was Multiple Price based, each bidder would get the allotment at the price he/ she has bid, i.e., bidder 1 at ₹100.19, bidder 2 at ₹100.14 and so on.

Competitive and Non-Competitive Bidding: The price and yield based auctions that we discussed above is basically competitive bidding in which parties compete to buy the securities. With a view to encouraging wider participation and retail holding of Government securities, retail investors are allowed participation on "**non-competitive**" basis in select auctions of Government of India (GoI) **date securities and T-bills** . Allocation of non-competitive bids from retail investors will be restricted to a **maximum of five percent of the aggregate nominal amount of the issue** within the notified amount as specified by the Government of India, or any other percentage determined by Reserve Bank of India. The minimum amount for bidding will be ₹10,000 (face value) and thereafter in multiples in ₹10,000 as hitherto. In the auctions of GoI dated securities, the retail investors can make a single bid for an amount not more than 2 crores

- **How are Gsecs Traded in Secondary market?** There is active secondary market for G-secs. The securities can be bought / sold in the secondary market either through the below mentioned 4 sources. **The market is open from 9 a.m. to 5 p.m. from Monday to Friday**
  i. Negotiated Dealing System-Order Matching (NDS-OM) (anonymous online trading) or through. **NDS-OM is operated by the CCIL on behalf of the RBI**
  ii. Over the Counter (OTC) and reported on NDS-OM or
  iii. NDS-OM-Web or
  iv. Stock exchanges

  The CCIL is the clearing agency for G-Secs, Foreign Exchange and Derivatives Market. It acts as a Central Counter Party (CCP) for all transactions in G-Secs by interposing itself between two counterparties. **This process where CCIL acts a counter party to both the seller and the buyer is called novation**

- **Settlement Period in Primary and Secondary Market:**
  i. **Primary Market**: The settlement cycle for auctions of all kind of G-Secs i.e. **dated securities, T-Bills, CMBs or SDLs, is T+1**, i.e. funds and securities are settled on next working day from the conclusion of the trade
  ii. **Secondary Market** : All outright secondary market transactions in G-Secs are settled on a **T+1 basis**. However, in case of repo transactions in G-Secs, the market participants have the choice of settling the first leg on either T+0 basis or T+1 basis as per their requirement. **We will discuss about Repo later in the document in detail**

- **How are Gsecs held by the Buyer**
  i. SGL (**Subsidiary General Ledger Account**): It is a securities account maintained by banks, primary dealers, and financial institutions with the RBI
  ii. **Constituent Subsidiary General Ledger Account (CSGL):** In case an entity is not eligible to open a Subsidiary General Ledger, account has the option of opening a **Gilt Account** with a bank or a PD which will further open a CSGL account with the RBI
  iii. Investors also have the option of holding G-Secs in a dematerialized account with a depository (NSDL / CDSL, etc.). **This facilitates trading of G-Secs on the stock exchanges**

- **What us shut period?**
  'Shut period' means the period for which the securities cannot be traded. During the period under shut, no trading of the security which is under shut is allowed

- **Risk Involved in G-sec**

The following are the major risks associated with holding G-Secs:

1. ***Market risk* –** Market risk arises out of adverse movement of prices of the securities due to changes in interest rates. This will result in valuation losses on marking to market or realizing a loss if the securities are sold at adverse prices.

2. ***Reinvestment risk* –** Cash flows on a G-Sec includes a coupon every half year and repayment of principal at maturity. These cash flows need to be reinvested whenever they are paid. Hence there is a risk that the investor may not be able to reinvest these proceeds at yield prevalent at the time of making investment due to decrease in interest rates prevailing at the time of receipt of cash flows by investors.

3. **Liquidity risk –** Liquidity in G-Secs is referred to as the ease with which security can be bought and sold i.e. availability of buy-sell quotes with narrow spreads. Liquidity risk refers to the inability of an investor to liquidate (sell) his holdings due to non-availability of buyers for the security

- **Debt Instruments issued by Private Sector**

Corporate Debt markets are also of 2 types

1. **Short-term instruments like commercial papers. Banks issue short-term debt securities called certificates of deposit**
2. **Long-term bonds** issued by the corporate sector

The rate at which corporates, banks and institutions borrow depends upon the credit quality of the borrower. The credit or default risk of the borrower is measured by the credit rating of the bond. Higher the credit rating, lower the risk of default

- **Money Market Securities: Short-Term Debt Instruments**

1. **Treasury Bills (T-Bills)**
   - ✓ The central government borrows extensively in the money market for its daily operations through the issue of **short-term debt securities** called Treasury bills (T-bills)
   - ✓ Predominantly issued to **fund the fiscal deficit** of the government
   - ✓ T-bills are short-term securities that mature in one year or less from their issue date

- ✓ Issued at a price less than par (face) value and Government buys them back at face value. So these are zero coupon securities
- ✓ Interest is the difference between the purchase price of the security and what one gets at maturity
- ✓ Example: 90-day T-bill with face value of 10000 issued at 9,800 and held it until maturity will have 2.04% as yield ((10000-9800)/9800)
- ✓ The Reserve Bank issues T-bills of three maturities—**91-days, 182-days, and 364-days**
- ✓ These bills are also called auctioned T-Bills. **Banks, mutual funds, insurance companies, provident funds, primary dealers and FIs bid in these auctions**
- ✓ **T-Bills will be issued for a minimum amount of ` 10,000 (Rupees Ten Thousand only) and in multiples of ` 10,000**
- ✓ Eligible to be counted for SLR purposes
- ✓ Treasury Bills are sold through auctions. There are two types of auctions as discussed previously
  - **Multiple-price Auction:**
  - **Uniform-price Auction:**

2. **Cash Management Bills**
   - ✓ Issued by RBI on behalf of GOI
   - ✓ Short-term instrument to meet the temporary mismatches in the cash flow of the Government
   - ✓ Issued for maturities **less than 91 days**
   - ✓ Issued at a discount and redeemed at face value at maturity
   - ✓ Investment in CMB's is also counted in investments for SLR
3. **Certificate of Deposit (CD)**
   - ✓ A time deposit with a bank and **issued by**
     - ➢ Scheduled Commercial Banks
     - ➢ Regional Rural Banks
     - ➢ Small Finance Banks
     - ➢ Financial institutions like IFCI which are permitted by RBI
   - ✓ Difference between CD and FD is that CD is tradeable and transferable
   - ✓ Offers slightly higher yield than T-Bills due to risk of default present in case of banks
   - ✓ CDs are issued by banks during periods of tight liquidity, at relatively high interest rates
   - ✓ Banks resort to CD when the deposit growth is sluggish but credit demand is high
   - ✓ Transaction cost of CD is lower than retail deposits

- ✓ **Non-negotiable CDs** cannot be sold before its maturity while **Negotiable CDs** can be sold before maturity in the secondary money market
- ✓ A CD should have a minimum amount of **Rs 5 lakh** and multiples thereof
- ✓ **For Banks**, maturity period should not be **less than 7 days** and not more than one year
- ✓ **For Financial institutions**, maturity period should not be **less than one year** and not exceeding three years from the date of issue.
- ✓ These instruments can be invested by person's resident in India
- ✓ CDs can be issued at a discount to face value just like T-bills. But they can also offer a fixed or floating coupon rate and in such a case they are issued at face value
- ✓ Fixed Income Money Market and Derivatives Association of India (FIMMDA) may prescribe, in consultation with the RBI, for operational flexibility and smooth functioning of the CD market,
- ✓ **Loans cannot be granted against certificate of deposits**
- ✓ Buyback of CDs can be made only **7 days** after the date of issue of the CD
- ✓ **CD Ladders:** A strategy used to access higher rates – usually reserved for long-term CDs – while still allowing a portion of your money to be accessible at short-term intervals

2. **Commercial Paper:**
    - ✓ An **unsecured**, short-term loan **issued by a corporation**, typically for financing accounts receivable and inventories
    - ✓ Also called **unsecured promissory note** since the issuer makes a promise to pay back the face value after the maturity period but that promise is unsecured
    - ✓ CP is issued at a discount to face value
    - ✓ Typically only companies with high credit ratings and credit worthiness issue commercial paper
    - ✓ **Who can issue CP?**
        - ➢ **Companies, Primary Dealers and All India FIs** are eligible to issue CPs subject to the condition that any fund-based facility availed of from bank(s) and/or financial institutions is classified as a standard asset i.e., it is not a stressed asset
        - ➢ A company would be eligible to issue CP provided The tangible net worth of the company, as per the latest audited balance sheet, is not less than **Rs.4 crore**

- ✓ CP can be issued for maturities between a **minimum of 7 days and a maximum of up to one year** from the date of issue
- ✓ Issuer must receive at least two ratings from a credit agency, and would have to assign the lower rating from these ratings to the CP
- ✓ minimum rating required is **A-3**
- ✓ No approval from RBI is required to issue CP's
- ✓ CP can be issued in denominations of Rs. 5 lakh or multiples thereof
- ✓ Individuals, banks, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians and Foreign Institutional Investors (FIIs) shall be eligible to invest in CP.
- ✓ FIIs shall be eligible to invest in CPs subject to (i) such conditions as may be set for them by the Securities and Exchange Board of India (SEBI); and (ii) compliance with the provisions of the Foreign Exchange Management Act, 1999,
- ✓ CPs are actively traded in the OTC market on FIMMDA Platform. Such transactions, however, are to be reported to the Financial Market Trade Reporting and Confirmation Platform ("F-TRAC") of Clearcorp Dealing System (India) Ltd. within 15 minutes of the trade.
- ✓ **<u>Buyback of CP</u>**

  i. The buyback of a CP, in full or part, shall be at the prevailing market price.
  ii. The buyback offer should be extended to all investors in the CP issue. The terms of the buyback should be identical for all investors in the issue.
  iii. The buyback offer may not be made **before 30 days** from the date of issue.
  iv. CPs **bought** back shall stand extinguished

- ✓ **Form of Instrument to be issued as CP**
  i. **CP shall be issued in the form of a promissory and held in physical form or in a dematerialized form** through any of the depositories approved by and registered with SEBI, provided that all RBI regulated entities can deal in and hold CP only in dematerialized form through such depositories.

  ii. **No issuer shall have the issue of CP underwritten** or co-accepted i.e. no party can guarantee to the issuer that they will subscribe the commercial paper if there are not enough subscribers in the market

iii. **Options (call/put) are not permitted** on a CP.

✓ **Duties and Obligations of Issuer, IPA and Credit Rating Agency**

There are three parties to the issuance of CP – Issuer, IPA and Credit Rating Agency. The issuer is the one who has to issue CP. Issuer has to appoint IPA which basically acts as a verifier of the information provided by the issuer. The credit rating agency does financial appraisal to find out exact financial position of the company and comes out with a rating

Issuer – The issuer of CP shall

a. Appoint an IPA for issuance of a CP.
b. Comply with all relevant requirements under these directions and furnish a declaration in this regard to the IPA.
c. Ensure that the proceeds from CP issues are for declared end uses.
d. Inform the CRA and IPA on the same day about any default/delay in CP related payments.
e. The issuer who has defaulted on a CP shall not be allowed to access the CP market for six months from the date of repayment of the defaulted obligation.

Issuing and Paying Agent – The IPA for a CP issuance shall

a. Ensure that the borrower is appropriately authorised to borrow through CPs.
b. Verify all information disclosed in the offer document before issuance.
c. Verify and hold certified copies of original documents and/or digitally signed documents in its custody.

Credit Rating Agency

a. A Credit Rating Agency (CRA) must act responsibly in rating CP issuances and continuously monitor the rating assigned to an issue and disseminate rating revisions, if any, to public through its publications and on its website.
b. A CRA must publicly disseminate the ratings of the CP and any subsequent change in the ratings, on the date of rating or change in rating, as the case may be.

✓ CPs are actively traded in the OTC market on FIMMDA Platform

2. **Commercial Bills:**
    - ✓ Commercial Bills are issued by the **seller(drawer)** on the **buyer (drawee)** for the value of goods delivered by him
    - ✓ These Bills are of 30 days, 60 days or 90 days maturity
    - ✓ **Demand Bill**: Bill that is payable on demand
    - ✓ **Usance Bill:** A Usance bill is payable on some future date agreed by the seller
    - ✓ If the seller is in need of funds before the maturity date, he can also approach the bank to accept the bill
    - ✓ The bank charges a commission for the acceptance of bill and promises to make payment if buyer defaults. Once this process is done, the seller can sell the bill in market and in this way commercial bill becomes a marketable investment
    - ✓ Or Seller can even go to the Bank for discounting of the bill. Banks pays him after deducting interest for the remaining period of the bill and service charges from the face value of the bill. This interest rate is called **discount rate on bills**
    - ✓ **Rediscounting of Commercial Bills:** The Bank that accepts the bill is in need of fund and therefore trades the bill with institutions such as LIC, UTI, GIC, ICICI etc then the bill gets discounted again. This process is called re-discounting
3. **Call Money/ Notice Money**
    - ✓ Call Money is required mostly by Banks to borrow money without collateral from other banks to maintain a minimum cash balance known as **CRR(Cash Reserve Ratio)**
    - ✓ Under **call money market**, funds are transacted on **overnight basis** and under **notice money market**, funds are borrowed/lent for a period between **2-14 days.** When money is borrowed for a period exceeding 14 days, it is called Term money market
    - ✓ **All scheduled Commercial Banks and RRBs, Cooperative Banks other than Land Development banks, Small Finance Banks, Payment Banks and Primary dealers are the participants in the market**
    - ✓ **<u>Borrowing Limits in Call Money/Notice Money Market</u>**

Table 1: Prudential limits for outstanding borrowing transactions in Call, Notice and Term Money Markets[1]		
Sr. No.	**Participant Category**	**Prudential Limit**
1	Scheduled Commercial Banks (including Small Finance Banks)	**Call and Notice Money:** (i) 100% of capital funds, on a daily average basis in a reporting fortnight, and (ii) 125% of capital funds on any given day. **Term Money:** (i) Internal board approved limit within the prudential limits for inter-bank liabilities.
2	Payment Banks, andRegional Rural Banks	**Call, Notice and Term Money:** (i) 100% of capital funds, on a daily average basis in a reporting fortnight, and (ii) 125% of capital funds on any given day.
3	Co-operative Banks	**Call, Notice and Term Money:** (i) 2.0% of aggregate deposits as at the end of the previous financial year.
4	Primary Dealers	**Call and Notice Money:** (i) 225% of Net Owned Fund (NOF) as at the end of the previous financial year on a daily average basis in a reporting fortnight. **Term Money:** (i) 225% of Net Owned Fund (NOF) as at the end of previous financial year.

- ✓ An over the counter (OTC) market without the intermediation of brokers
- ✓ Highly liquid market
- ✓ **Call Rate:** The interest rate paid on call loans
- ✓ **The Call/Notice Money transactions can be executed either on NDS-Call**, a screen–based, negotiated, quote-driven electronic trading system managed by the **Clearing Corporation of India (CCIL)**.

4. **Collateralized Borrowing and Lending Obligation(CBLO)**
   - ✓ For **non-bank entities** to borrow money against government securities(**collateral**) with maturity ranging from **1 day to 1 year**
   - ✓ It is a **discounted instrument**
   - ✓ **How it is different from Call Money Market**: The uniqueness of CBLO is that lenders and borrowers use collateral for their activities. For example, borrowers of fund have to provide collateral in the form of government securities and lenders will get it while giving loans. There is no such need of a collateral under the call money market.
   - ✓ CBLO is now discontinued since Nov 2018 and is now replaced by Triparty Repo
5. **Repurchase Agreement (Repo)**
   - ✓ A money market instrument combining elements of 2 different types of transactions, i.e., **lending-borrowing and sale-purchase**

- ✓ It is an instrument for **borrowing funds** by **selling securities** with an agreement to repurchase the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed
- ✓ The repo transactions has 2 legs:
    - In first leg, Seller sells securities and receives cash while the purchaser buys securities and parts with cash
    - In second leg, securities are repurchased by the original holder. He pays to the counter party the amount originally received by him plus the return on the money for the number of days for which the money was used by him
    - The consideration amount in the first leg of the repo transactions is the amount borrowed by the seller of the security. Suppose seller sells the securities to the buyer in Rs. 1000 then seller is borrowing 1000 from the buyer. Sometimes the buyer does not give the seller the whole amount and keeps certain amount as margin. This is called **haircut**. In our example suppose buyer pays only 900 to the seller and keeps 100 as the haircut amount.
- ✓ Under repo, RBI injects funds to organizations(SCBs and Primary dealers) which have both current account and SGL account with the RBI
- ✓ **Reverse repo:** Exactly opposite of Repo transaction and is used for absorption of liquidity. It is an instrument for **lending funds** by **purchasing securities** with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent
- ✓ **Overnight Repo:** The maturity Contract with 1-day maturity is called Overnight repo
- ✓ **Term Repo:** The maturity Contract with certain specified contract date more than 1 day is called Term Repo
- ✓ **Open Repo:** The maturity Contract with no specified contract date is called Term Repo
- ✓ **Tenor: 1 day to 1 year**
- ✓ **Triparty Repo:** Tri-party repo" means a repo contract where a third entity (apart from the borrower and lender), called a **Tri-Party Agent**, acts as an intermediary between the two parties to the repo to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction
- ✓ **Eligible Securities for Repo:**
    - **Government securities** issued by the Central Government or a State Government. So, Treasury bills and Cash Management bill will be eligible

- **Listed corporate bonds and debentures**, subject to the condition that no participant shall borrow against the collateral of its own securities, or securities issued by a related entity.
- Commercial Papers (CPs) and Certificate of Deposits (CDs).
- Units of Debt ETF
- Any other security of a local authority as may be specified in this behalf by the Central Government.
- Any other entity approved by the Reserve Bank from time to time for this purpose

✓ **Eligible Participants:** The following are eligible to participate in repo transaction under these Directions:

- (a) Any regulated entity.
- (b) Any listed corporate.
- (c) Any unlisted company, which has been issued special securities by the Government of India, using only such special securities as collateral.
- (d) Any All India Financial Institution (FIs) viz. Exim Bank, NABARD, NHB and Small Industries Development Bank of India (SIDBI), constituted by an Act of Parliament and

✓ **Haircut Regulations**

- Listed corporate bonds and debentures shall carry a minimum haircut of **2%** of market value. Additional haircut may be charged based on tenor and illiquidity of the security.
- CPs and CDs shall carry a minimum haircut of **1.5%** of market value.
- Securities issued by a local authority shall carry a minimum haircut of **2%** of market value. Additional haircut may be charged based on tenor and illiquidity of the security.

6. **Inter Corporate Deposits:**

✓ An Inter corporate deposits (ICD) is an unsecured borrowing by corporates an FIs from other corporate entities.

✓ The tenure of ICD may range from **1 day to 1 year**, but most common tenor of borrowing is 90 days.

✓ **Primary Dealers are only permitted to borrow in the ICD market**. The borrowing under ICD is restricted to 150% of the Net Owned Funds and the minimum tenor of borrowing is for 7 days

➢ **Tools for managing liquidity in Money Market:**

1. **Cash Reserve Ratio(CRR):** Each commercial bank has to maintain a minimum cash balance with the RBI as a certain percentage of net demand and time liabilities(NDTL) relating to second preceding fortnight
2. **Statutory Liquidity Ratio(SLR):** Scheduled commercial banks have to invest in government and other approved securities, gold , cash certain minimum amount as SLR on daily basis
3. **Base Rate:** It is the minimum interest rate of a bank below which it cannot lend, except in few cases allowed by the RBI
4. **Bank Rate:** The rate of discount fixed by the central bank of the country for the rediscounting of eligible paper. On introduction of LAF, this use has been discontinued due to which it is **used for calculating penalty on default in CRR and SLR**
5. **Liquidity Adjustment Facility(LAF):** Tools used are repo and reverse repos as well as MSS(Market Stabilization Scheme)
6. **Market Stabilization Scheme(MSS):**
   - ✓ Introduced in 2004 following MOU between RBI and GOI
   - ✓ The RBI buys dollars to prevent rupee appreciation. This leads to a large supply of rupees in the market which can create inflation and cause asset prices to go up
   - ✓ To prevent a rise in inflation, the RBI issues bonds to mop up the rupee released in the system. This is known as **sterilization process**
   - ✓ In this, government issues securities specifically for the purpose of sterilisation operations
   - ✓ In order to neutralize the monetary and budgetary impart of MSS, the proceeds under it are parked in a separate deposit maintained by the GOI with the RBI
   - ✓ **Before demonetization**, the limit for RBI to issue MSB's was only up to **0.3 lakh crores. After demonetization**, it was increased to **6 lakh crores**

➢ **Long-Term Debt Instruments:**

1. Long-term debt instrument denoting the borrowing of **a government organization is called a bond or dated G-secs** and **that of the private corporate sector is called debenture**
2. <u>**Dated G-Secs**</u> are securities which carry a **fixed or floating coupon (interest rate) which is paid on the face value, on half-yearly basis**. Generally, the tenor of dated securities ranges from 5 years to 40 years.

   i. The nomenclature of a typical dated fixed coupon G-Sec contains the following features - **coupon, name of the issuer, maturity year**. For example, - 7.17% GS 2028 would mean:

Coupon	: 7.17% paid on face value
Name of Issuer	: Government of India
Date of Issue	: January 8, 2018
Maturity	: January 8, 2028
Coupon Payment Dates	: Half-yearly (July 08 and January 08) every year
Minimum Amount of issue/ sale	: ₹10,000

i. In case, there are two securities with the same coupon and are maturing in the same year, then one of the securities will have the month attached as suffix in the nomenclature. e.g. 6.05% GS 2019 FEB, would mean that G-Sec having coupon 6.05% that mature in February 2019

ii. These are dated G-secs because these are identified by their date of maturity and the coupon. As told in the above example, 7.17% GS 2028 would mean government security maturing in 2017 and carrying a coupon of 7.99%

3. Corporate debt consists of bonds issued by public sector units(PSUs) as well as private sector entities
4. PSU bonds can be taxable as well as tax-free bonds. Few of them also offer free tax for long term capital gains
5. Corporate bonds are issued at a spread to the G-sec yield. The difference between the two yields is **called credit spread**. Credit spread depends on the credit rating and the expected default probability associated with the issuing company, its industry of operation as well the overall credit and liquidity situation in the economy. **Higher the credit rating, lower the credit spread and lowers the rate at which bonds can be issued**
6. Corporate Bonds usually carry a rating form AAA to D depending on various factors the major being their financial position. These rating indicate level of risk of default from the issuer with AAA indicating least risk (low yield) and D indicating an extremely high probability of default and hence high yield. **Bonds up to rating of BBB are categorized as investment grade**
7. **Types of Bonds in Long Term Debt Market**

   i. **Fixed Rate Bonds** – These are bonds on which the coupon rate is fixed for the entire life (i.e. till maturity) of the bond. Most Government bonds in India are issued as fixed rate bonds.

   ii. **Floating Rate Bonds (FRB)** – FRBs are securities which do not have a fixed coupon rate. Instead it has a variable coupon rate which is re-set at pre-announced intervals (say, every six months or one year). FRBs were first issued in September 1995 in India.

iii. **Capital Indexed Bonds** – These are bonds, the principal of which is linked to an accepted index of inflation with a view to protecting the Principal amount of the investors from inflation. A 5-year Capital Indexed Bond was first issued in December 1997 which matured in 2002.

iv. **Inflation Indexed Bonds (IIBs)** - IIBs are bonds wherein both coupon flows (Interest) and Principal amounts are protected against inflation. The inflation index used in IIBs may be Wholesale Price Index (WPI) or Consumer Price Index (CPI). Globally, IIBs were first issued in 1981 in UK. In India, Government of India through RBI issued IIBs (linked to WPI) in June 2013. The difference between Capital indexed bonds and Inflation indexed bonds is that Capital indexed bonds only protect capital whereas Inflation Indexed bonds protect both capital and interest.

v. **Bonds with Call/ Put Options**: Bonds can also be issued with features of optionality wherein the issuer can have the option to buy-back (call option) or the investor can have the option to sell the bond (put option) to the issuer before the maturity of the bond

vi. **STRIPS**: Separate trading for registered interest and principal of securities (STRIPS) is a process of stripping a conventional coupon bearing security into a number of zero-coupon securities which can be traded separately.

To illustrate, a 10-year government security with **semi-annual coupon** payments can be stripped into a principal component and a set of 20 individual coupon payments. The Coupon Payments are 20 because payment is half-yearly for 10 years.

Suppose the Face Value of original bond is 1000 and Coupon rate is 10% then we would have 21 stripped securities can be treated as zero coupon bonds

Security 1 would be a zero-coupon bond with face value = first coupon payment of 5% of 1000 = 50

Like this security 2 to Security 20 would be other zero-coupon bond with face value 50 The last

The (21^{st}) security would-be zero-coupon bond with face value = Principal Component of 1000

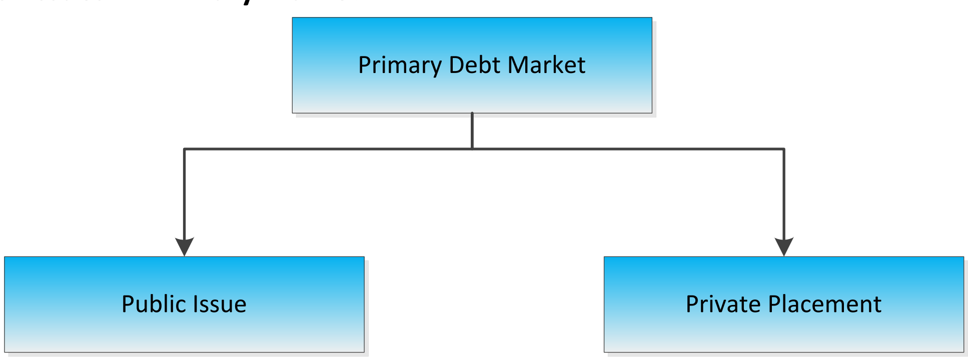
The conversion of one underlying security into a number of zero-coupon securities called STRIPS increases the breadth of the debt market and provides a continuous market which ultimately helps in improving liquidity.

STRIPs are also called bonds with same coupon but varying maturities

vii. **Convertible debentures:** It is a type of loan issued by a company that can be converted into equity shares of the company at a future date. It is a hybrid instrument. **Fully Convertible debentures** are the one where the entire face value of the debenture is converted into equity shares. Partly **convertible debentures** (PCD) are the one where a portion of the debenture is converted into equity. The non-convertible portion will continue to remain as debentures, earn interest income and will be repaid on redemption. **Optionally convertible debentures** (OCDs) are convertible into equity shares at the discretion of the debenture holders. They may choose to convert into equity, or continue to hold the instrument as debt depending on their need

viii. **Foreign Currency Convertible Bonds (FCCBs):** FCCBs are a foreign currency (usually dollar) denominated debt raised by companies in international markets, but which have the option of converting into equity shares of the company before they mature. **The payment of interest and repayment of principal is in foreign currency**. **FCCBs are regulated by RBI** notifications under the Foreign Exchange Management Act (FEMA). **The Issue of Foreign Currency Convertible Bonds and Ordinary Shares** (Through Depository Receipt Mechanism), 1993 lays down the guidelines for such issues.

- Company can issue debt directly from the people in Primary Market
- **Types of Issues in Primary Market:**



- **Public Issue:**
  1. Securities are issued to the members of the public
  2. Issue of debt securities is **regulated by the provisions of the Companies Act and SEBI's Issue and Listing of Debt Securities Regulations, 2008**

3. A public issue of debt securities is possible by a company registered as a public limited company under the Companies Act, 2013
4. An unlisted company can make a public issue of debentures and list them on a stock exchange
5. The base issue size shall be **a minimum of Rs.100 crore**
6. A company making an issue of debt securities has to file a draft **offer document** with the stock exchange where the issue is proposed to be listed
7. Eligible entities are permitted to file a shelf prospectus with the Registrar of Companies and make multiple issues, not exceeding 4, on the basis of this document
8. The debentures issued under a public offer have to **mandatorily** be listed on a stock exchange
9. Credit rating has to be obtained from at least one credit rating agency and the rating has to be disclosed in the offer document
10. **Minimum subscription** in a public issue of debt securities is specified at 75% of the base issue size
11. The issuer has to enter into an agreement with a depository for dematerialization of the securities
12. **Debenture trustees:** Need to be appointed to oversee the interests of the investors. Trustees are banks and financial institutions who are registered with SEBI to act as debenture trustees
13. **Debenture Redemption Reserve:** The issuer transfers a portion of profits into this reserve each year till the redemption of the debentures

- **Private Placement:** Offer made by a company to a select group of investors such as financial institutions, banks and mutual funds
- **Regulation of Debt Markets:**
  1. **Money Market**: RBI is the regulator of money markets irrespective of securities being government securities or corporate securities. Though mainly money markets are regulated by RBI, the procedure and mechanism of settlement on stock exchanges should be as per regulation of SEBI. **For example**: Repo in both government securities and corporate bonds will be regulated by RBI though their settlement procedure on stock exchange shall be regulated by SEBI
  2. **Long Term Debt Market**: RBI regulates the long-term government securities while the long-term corporate debt market comes under the purview of the Securities Exchange and Board of India (SEBI). The procedure and mechanism of settlement of both government and corporate long-term securities on stock exchanges should be as per regulation of SEBI. **For example**: The long-term bonds owned by government will be regulated by RBI and the long-term bonds issued by corporates shall be regulated by SEBI. The settlement procedure for both on stock exchange shall be regulated by SEBI

- **Ways and Means Advances (WMA):** Temporary loan facilities to the center and state governments by RBI
  1. **WMA to Central Govt:** Used to meet temporary mismatches in the receipts and payments of the government.
  2. **WMA to State Govt:** There are two types of WMA here, - Special and Normal WMA
     - **Special WMA:** Extended against the collateral of the government securities held by the State Government
     - **Normal WMA:** WMA limits are based on three-year average of actual revenue and capital expenditure of the state
  3. **LIBOR and MIBOR:**

     <u>LIBOR</u>

     - The London Interbank Offered Rate (LIBOR) is a benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans.
     - LIBOR, which stands for London Interbank Offered Rate, serves as a globally accepted key benchmark interest rate that indicates borrowing costs between banks. The rate is calculated and published each day by the Intercontinental Exchange (ICE). Earlier British Bankers association used to calculate this but now this is replaced by ICE.
     - Each day, ICE asks major global banks how much they would charge other banks for short-term loans. The association takes out the 4 highest and 4 lowest figures, then calculates the average from the remaining numbers. This is known as the **trimmed average**. This rate is posted each morning as the daily rate, so it is not a static figure.

     <u>MIBOR</u>

     - MIBOR stands for Mumbai Inter Bank Offer Rate and is closely modeled on the LIBOR. It was launched on June 15, 1998 as an overnight rate. by committee for development of Debt markets so that a benchmark rate is available in the debt markets.
     - Since their launch MIBOR rates have been used as benchmark rates for majority of money market deals in India. MIBOR is now an interest rate at which majority of banks can borrow funds from other banks in the India Interbank market
     - There are two agencies to calculate MIBOR – NSE and Reuters. The one by NSE is more popular and widely used. NSE calculates it on daily basis using average of lending rates reported by group of banks. There are 31 banks/institutions/Primary dealers which for part of this group who report their lending rates

- **Floating Rate Bond**: Coupon rate on such bond is linked to some benchmark such as MIBOR

- **Zero Coupon Bonds**: Bonds which do not pay any interest
- **Deep Discount Bonds**: Zero coupon bonds with extremely high Maturity
- **Zero Interest Secured Premium Convertible Bond:** The investor can convert his bond into an equity share at 30 per cent discount on average price at the end of one year
- **Zero Interest Fully Convertible Debenture:** No interest paid and after a notified period, fully convertible debentures (FCDs) will be automatically and compulsorily converted into shares
- **Differential Shares**: Shares with differential rights to voting and dividends
- **Securitized Paper:** Process by which a company raises money by selling off its receivables at RBI