Financial Institutions and Markets

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Lecture - 40
Miscellaneous Short-Term Money Market – II

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So, in the previous class we discussed about the commercial papers market. In this session we will be discussing about another in major instrument, which is certificate of deposits. So, what do you mean by the certificate of deposits? That is basically represents a bank deposit accounts which are transferable from one party to the another or we can say that it is a marketable and non negotiable in short term instruments in bearer form and known as the negotiable certificate of deposits right.

So, this is again a promissory note or kind of short term instruments in the bearer form and it should by the different banks or financial institutions to raise the money from the public. So, this is highly marketable and negotiable also. This is a marketable instruments and as well as the negotiable instrument that actually keep in mind here it is n basically it is not required. So, you remember this is a marketable or and non negotiable short term instruments in the bearer form and as known as negotiable certificate of deposits.

It is highly liquid because it is short term in nature and the marketability is very high it is highly liquid. So, instrument in the market because it is easily converted into cash and another thing is that is it is basically issued by the banks for attracting the large corporate deposits, rather than mobilizing the individual savings. For mobilization of the individual savings we have the savings account; for mobilization of the savings we have the savings account.

But whenever we are talking about the CDs, through CDs the banks are basically trying to attract the large corporate deposits not the small savings from the different investors. And here you see relatively again the CD market in India is again relatively new or not that way highly developed.

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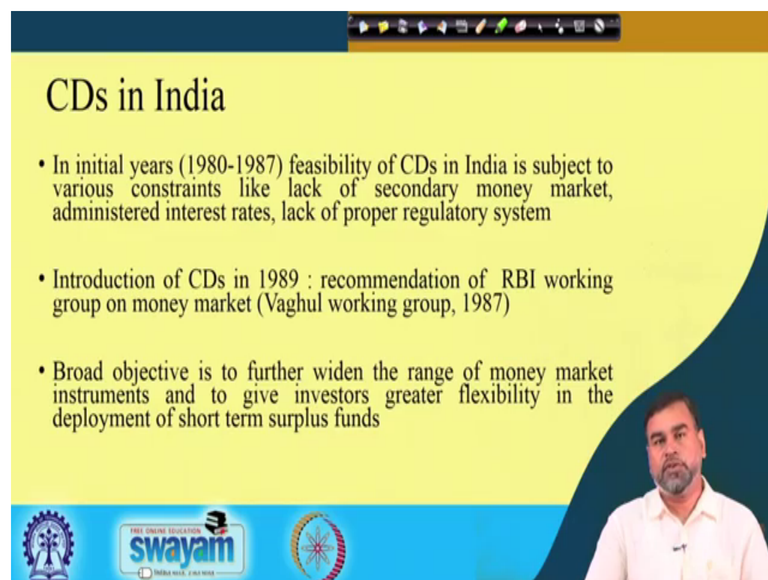

So, here whenever this CD was started, it was started in properly 1989; with the recommendation of a RBI marking committee group report which is called the Vaghul committee report in 1987. In the initial years the feasibility of CDs in India its object to various constants like lack of secondary money market interest rates were highly controlled by the regulatory bodies there was a regulatory system was not very proper for the CDs. So, those kind of things were prevent in the early stages.

And in 1989 with the recommendation of the Vaghul committee the CD market or instrument like CD was introduced in Indian market and what was the objective for introduction of CDs in the Indian market?

The basic objective of introduction of CD are the certificate of deposits into the Indian market was to give the investors a greater flexibility in the deployment of the short term funds. The money which was available with the investor and where the money can be invested; if they want to invest at all in the short term money market instruments. So, although there are some money market instruments which are available like to the rebels and all.

But still to increase that portfolio to diversify that portfolio, the Vaghul committee has recommended the introduction of CDs or the Certificate of Deposits. So, these certificate of deposits basically try to widen the availability of the money market instruments in the Indian financial system.

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And who are eligible to issue the CDs already I told you the banks can issue the CDs, but not all the banks are eligible to issue the CDs we have to exclude the regional and rural banks and the local area banks. Basically the sort we call it the RRBs the Regional Rural Banks and we have the local area banks.

So, these type of banks are not eligible to issue the CDs to the investors. And there are some all India financial institutions select all India financial institutions they are also eligible to issue the CDs. And there is no such kind of restrictions, but the banks have the freedom to issue the CDs depending upon their funding requirements. On the basis of the requirements of the banks; the banks can decide that how much money they want to raise

through the certificate of deposits. And minimum amount of CD should be rupees 1 lakh and the minimum deposit that could be accepted from a single subscriber should not be less than 1 lakh.

If somebody is going to invest in the CDs the minimum amount of investment should be 1 lakh or it is a multiple of 1 lakh. The particular CD amount deposits certificate of deposits should not be less than 1 lakh rupees. If any kind of investor wanted to invest in that particular type of security that basically we have to keep in the mind. Then who are the investor who can invest in the CDs? Individuals, companies, com trust or then we have the funds mutual funds, then with the associations NRIs there all are eligible to a subscribe the CDs.

So, already in the beginning we did we basically we are discussing the CDs are mostly was available in the market or mostly are available in the market to attract the large corporations to mobilize their savings. So, major objective is not to attract the retail investors for the individuals, but still the individuals can invest in this particular kind of security, but the minimum amount they have to always invest in that particular security is 1 lakh or the multiple of 1 lakhs what is the maturity period? Because there are here if you see broadly there are two types of institutions, who are basically able to provide the CDs or the certificate of deposits.

Who are those? 1 is your banks other 1 is the all India financial institutions. If there are two types of entities as for the RBI norms or RBI guidelines, the maturity period of the CDs vary on the basis of the types of issuer. If the issuer is a bank then the maturity period varies from 7 days to 1 year. If the particular CDs are issued by a bank the maturity period varies between 7 days to 1 year it is just like the commercial papers what we have discussed already.

But if this particular instrument it is issued by a financial institutions or the particular financial institutions all India financial institutions, who are allowed to invest or allowed to issue the studies CDs there the period varies between 1 year to 3 years. So, there is some kind of deviation in between. So, if this particular CDs are issued by the banks, then the maturity period varies from 7 days to 1 year, but if it is issued by any kind of all India financial institutions then it is basically varies between 1 year to 3 years.

So, this is the way the majority period basically different on the basis of the issuer, who is issuing that particular instrument and the CDs are issued at a discount on the face value. The CDs are always certificate of deposits or issued always at a discount on the face value of that particular security that is the another feature that of that particular certificate of deposit that what we see. So, this is another characteristics what you can observe in terms of the CDs market in India.

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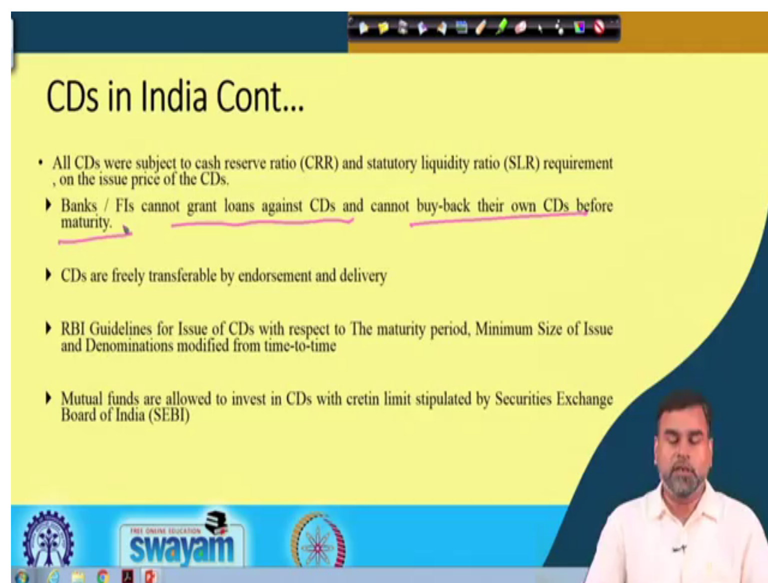

Then we have to see that what are those other issues related to the CDs? The CDs are subject to the cash reserve ratio and SLR Statutory Liquidity Ratio requirement on the issue price of the CDs. That means, the banks are always subject to or always have to maintain this CRR and statutory liquid ratio to provide the CDs or to issue the CDs into the market. Banks and FIS cannot grant loans against CDs and cannot buy back their own CDs before the maturity. You remember this point any kind of loan cannot be given by taking CDs as a collateral or any kind of loan cannot be given against the certificate deposits whatever this investor has.

And also they cannot buy back their own CDs before the maturity; that means, before 1 year if the maturity period is 1 year, then the particular banks cannot buy back that particular certificate of deposit before 1 year. And another feature the CD has it is freely transferable by endorsement and delivery, that is a unique feature of the CDs that is freely transferable by endorsement and the delivery. The maturity period minimum size

of the issue, denominations these are all always subject to since and RBI is empower to change those kind of things from time to time.

Its not that once it is fixed that will remain for a very large period of time or long period of time, that is not the case and according to RBI guidelines those kind of features are subject to change that can be changed in the market. Mutual funds are also allowed to invest in the CDs with certain limit which is stipulated by SEBI because the mutual funds are regulated by SEBI.

So, if any mutual fund wanted to invest in certificate of deposits, then there are some kind of prescribed norms which are prescribed regulations which are already mentioned by SEBI or Securities Exchange Board of India, then accordingly the mutual funds are allowed or they will be ready or they will be basically allowed to invest in the CDs market in the Indian financial system.

So, these are the different features which are related to CDs market. I can share one thing with you the CDs market also not very developed in the Indian context, because of the lack of secondary market it has or very underdeveloped secondary market it has and another thing that CDs market does not attract the investors particularly the large corporate investors. The reason is basically there are other alternatives which are developed in the market which basically face more return that what the CDs are giving. So, because there are certain kind of limitations in the CDs market, but the regulatory bodies like a RBI is taking lot of steps to make this park market more developed.

Or maybe they are making regular changes with respect to the regulatory norms in the that with respect to that particular security. By that the market can be more attractive and the investors will be more interested to invest in that particular security at least to maximize their return. This is what basically the overview of the CDs market and this is the way the CDs market work in the Indian financial system.

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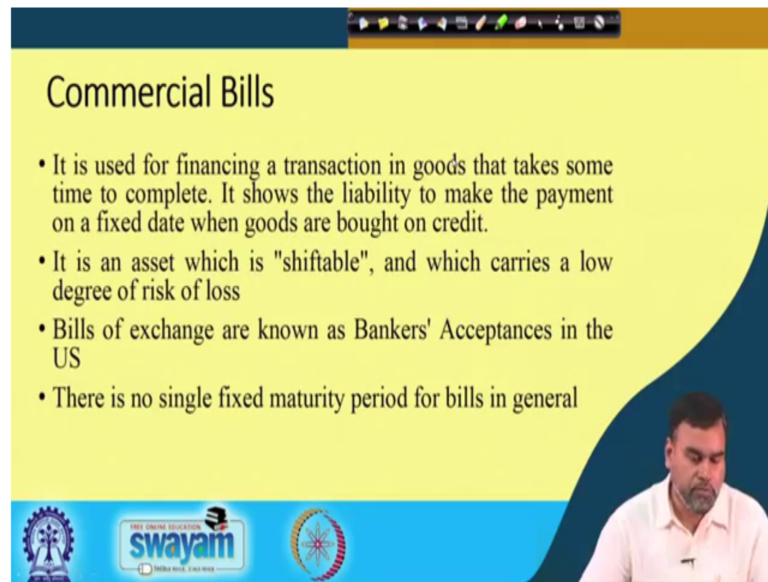

Then we have another type of things which is now nowadays not very developed or it has the usability of this particular security is relatively less in the market. But still it is it has some significance or it was the significance before largely whenever the technology and as well as the banking system was not that way very developed. We have another instrument called the commercial bills now what do mean by the commercial bills? It is used for financing a transaction in goods and services that takes some time to complete.

It shows the liability to make the payment on a fixed date when goods are bought on credit. The commercial bills are used to whenever any trader or any kind of import or an exporter basically they go for certain kind of buying certain kind of commodities.

But the money was not paid at that particular point of time. So, that time the buyer basically provides that particular commercial bill to the seller and at a particular date the seller can so, that particular bail to a particular bank or particular financial institutions to get back the money. So, it is a bill which was issued against some kind of a individual or some kind of company to get back that particular payment, after certain time of the transactions of the delivery or the transactions of the delivery of the goods.

Once the goods are delivered after that only the bills can be shown to that particular financial institutions for the payments. So, this is what basically the commercial bills are and they are already I told you that this particular bill will work whenever the goods are bought on the credit. Credit means the money is not paid to buy that particular

commodity or particular goods in that particular point of time. So, this is an asset which is shiftable and which carries a low degree of risk of loss and the bills of exchanges the other name of bills of exchange is bankers acceptances in a US market.

In Indian context we call it the commercial bills, but if you have heard about the name called the bankers acceptances. The bankers acceptances are a popular word which is used in the US market and there is no single fixed maturity period for bills in general. What should be the maximum period through which that or within that period of the money should be paid or the bill will expire those things there is no single maturated varies from one individual or one particular company to another company depending upon their requirement the maturity period basically varies.

So, that is why it depends upon the buyers and sellers agreement that how much maturity period the commercial bill would have for the completeness of that particular transactions. So, that is what basically happens, that is why there is no such fixed period or maturity period which was been assigned whenever any transactions in the financial market takes place in terms of the commercial bills. So, this is why this bills are defined.

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Classification of Bills

- **Demand bill**
  - A bill in which no time for payment is specified
- **Usance or time bill**
  - It is payable at a specified later date
- **Inland bill**
  - Must (a) be drawn or made in India, and must be payable in India, or (b) be drawn upon any person resident in India
- **Foreign bill**
  - Drawn outside India and may be payable in and by a party outside India, or may be payable in India or drawn on a party resident in India, or (b) drawn in India and made payable outside India

So, then we have the what are those different types of bills? There are different types of bills we have a demand bill we have a time bill what do you mean by the demand bill? The demand bill is nothing,, but it is a bill in which known time for payment its specified.

Already I told you that no time or we have discussed now just now, that no specific time is mentioned in that particular bill. So, any point of time the bill can produce before the bank and the money can be paid against that. So, that is basically called the demand bill. But whenever it is a time bill or the issuance bill what we call it, it is payable at a specific or specified latter date the date will be mentioned after that for example, it will be valid or the money the bill can be always redeemed or bill can be used only after 3 months or after 2 months or after 1 months.

So, that will be mentioned in that bill or the date will be mentioned in that bill. So, after that only the particular holder of the bill can go with that bill to that particular organization to get back that particular money. So, that is why in terms of the payment period or the time, we have two types of classifications we have the demand bill and we have the time bill. So, in the time bill this particular it is payable only after a specific date, but whenever it is a demand bill there is no time for payment is specified. So, at any point of time the holder of the bill can go to the financial entity to get back that particular money or the money can be payable.

Then we have another classifications we have inland bill and we have the foreign bill. So, whenever we talk about the inland bill mostly it is drawn or made in India and must be payable in India number 1. Number 2 it can be drawn upon any person resident in India it will be drawn in India it will be payable in India and also to whom the payment will be done that person also is a resident of India. Because it is a inland bill so, all the parties which are involved in that particular commercial bill are basically the Indian residents and the transactions which are happening with respect to that bill all are happening within the country. That is why it is called the in land bill.

Then we have a foreign bill the foreign bill is basically drawn out side India and maybe payable in or by a party outside India or maybe payable in India or drawn on a party resident in India or drawn in India and made payable outside India. That means, here the foreign transactions are foreign parties are involved. So, the foreign banks also might be involved. So, in that context we call it the foreign bill. So, any financial entity or financial institutions who are basically is responsible for that particular payment they have played a very significant role in terms of this.

So, in case of foreign bill, it is drawn outside India and payable in India or by a party outside India or may be payable in India or drawn in on a party resident in India or it is drawn in India and made payable outside India, that actually keep in the mind. More or less what we are saying that this in if it is a foreign bill then only we can say that not only this Indian parties are involved for the transactions, the foreign transactions or the foreign parties are involved in that, it is not only confined to the Indian residents or the all the parties may not belong to the Indian resident.

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Discount Market

- Banks borrow funds temporarily at the discount window of the Central Bank; they are permitted to borrow or are given the privilege of doing so from the Central Bank against certain types of eligible paper (collateral), such as the commercial bill or treasury bill, which the Central Bank stands ready to discount (to rediscount, strictly speaking) for the purpose of financial accommodation to banks.

Then we will see that another market we have that is called the discount market. Those markets are very underdeveloped in Indian context like bills market were there before, but now those transactions are the bills or use of the bills of relatively has gone down. The reason is basically the technological development the adaptation of new kind of methods for the payment and as well as we have the kind of other alternative assets which are available. So, those kind of things has always reduced the importance of the commercial bills in the modern financial system that is what basically we have observed.

But it was there is some importance of that particular market was there, what the people are using that commercial bill for payments whenever they are buying the commodities or the goods at credit. This is what about the idea brief idea about the commercial bills market which is working in the Indian context,, but you keep in the mind already told you this market is not that way very developed whenever we think in the today's context

or the current context or current prospective if you analyze, that market is not is a very government market if you talk about the Indian financial system.

Was I just share you that those markets were there and those markets also played a significant contribution to the Indian financial system as a whole. Then we have another market called the discount market the discount market is basically what? The banks if you understand discount market what did the exactly it is, the banks borrow funds temporarily are the discount window of the central bank because already all of you know their banks can borrow from the central bank at the time of requirement.

They are permitted to borrow or are given a privilege of doing so, from the central bank against certain types of eligible papers. The eligible papers are basically the collateral and the collateral can be anything they are the commercial bills, treasury bills etcetera. Those bills are used to raise the money from the central bank and those bills are used as the collateral by the central bank whenever they provide the loan to the commercial bank. And here the central bank basically is there or stands ready to discount or to the discount what we can say for the purpose of financial accommodation to the banks.

So, those kind of bills those kind of financing instruments which the banks are using as collateral to get their loan, those bills are discounted or rediscounted by the central bank to provide the loan to the commercial bank. So, that is the major objective of the discount market. So, it has is own relevance it has his own significance, because once the every time the commercial banks borrow from the central bank the central bank is always provides to loan with certain kind of mortgages or certain kind of collateral and the co laterals are nothing, but the government securities.

And the government securities are discounted or rediscounted by the RBI or by the central bank to provide the loan to the commercial bank. So, these kind of operations these kind of transactions basically always dealt always we see in the discount market. The discount market is basically deals with this kind of transactions in the financial system.

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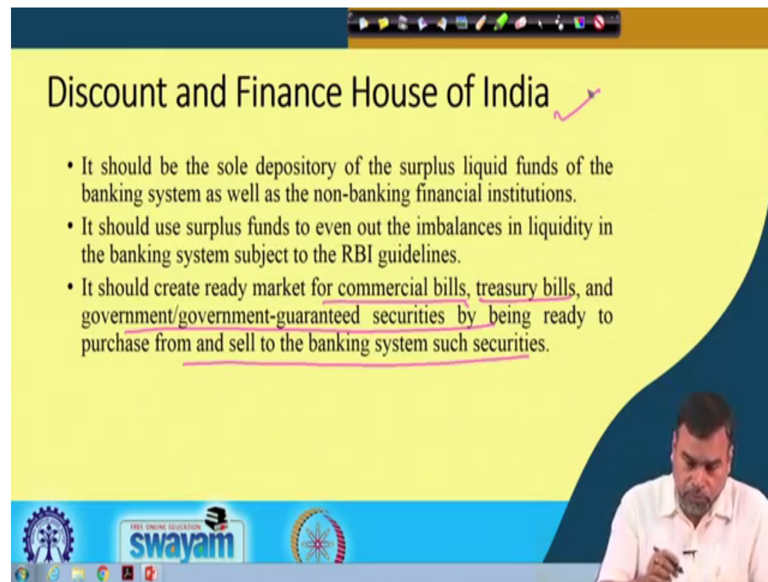

Then we will see that for this kind of thing we have a discount and finance house of India. So, it was the sole depository of the surplus liquid funds of the banking system as well as non banking financial institutions and it yields it should basically use the surplus funds to even out the imbalance ends in liquidity; liquidity in the banking systems subject to RBI guidelines and it should create the responsibility of this DFHI is this would create ready market for commercial bills.

That is why as we sell that these are the things we will be discounted commercial bills, you have a treasury bills and government guaranteed securities being ready to purchase from and sell to the banking system or rediscounting this particular securities to provide the loan to the bank system either in terms of buying or in terms of selling. So, this is the major job of DFHI in India which was played which was playing a very significant role for the discounting this different type of instrument, which are insured by the different financial organizations.

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Discount and Finance House of India Cont...

- Discount and Finance House of India Ltd. was set up by the RBI with the objective of deepening and activating the money market
- It became operative with effect from 25 April 1988. It was a joint stock company in form and is jointly owned by the RBI, public sector banks, and all-India financial institutions which have contributed its paid-up capital of Rs 200 crore (the authorised share capital of Rs 250 crore) in the proportion of 5:3:2
- Further in the year 2004 DFHI has been merged with SBI Guilt Ltd, a subsidiary of SBI and a new company has been formed which is known as SBI DFHI Ltd.
- Now it has been considered as a primary dealer and it has been created by RBI to support the book building process in Primary Auctions of Government securities and provide necessary depth and liquidity to the Secondary market in Government Securities.

So, if you see in the today's scenario the DFHI basically was set up by RBI with the objective of the activating the money market. It starts operating since 1988 as a bank as a company, it is a joint stock company owned by jointly owned by RBI and the public sector banks and all India financial institutions. And all have contributed the pair of capital of 200 crore in the proportion of 5 is to 3 is to 2. So, mostly the major share is basically the reserve bank of India, then we have the other parties which are public sector banks and all India financial institutions.

Further in the 2004 the DFHI has been merged with SBI gilt limited a subsidiary of state bank of India and now it is working as a new company which is known as SBI DFHI limited. So, the name of the DFHI has been changed because they it has been merged into the SBI guilt limited, which is a subsidiary of the state bank of India now it is called as the SBI DFHI limited. Now it is also considered as a primary dealer DFI is considered as a primary dealer and it has been created by RBI to support the book building process of the primary auctions of the government securities and provide necessary depth and liquidity to the secondary market in the government securities.

I will discuss more on the book building process already we know that the auction basically always the auction process what we discussed in the treasury bills market that is basically done through a process called the book building process. So, this is more relevant this is more used in the equity market or the stock market whenever we go for

the pricing of the equity in the IPO market or the new issue markets. We will discuss more on that, but now these are the status of DFHI which is known as SBI DFHI limited and this is also considered as a primary dealer they got the license of the primary dealer by the Reserve Bank of India. This is what basically the your DFHI or the recent developments which has happened to the DFHI in the Indian market.

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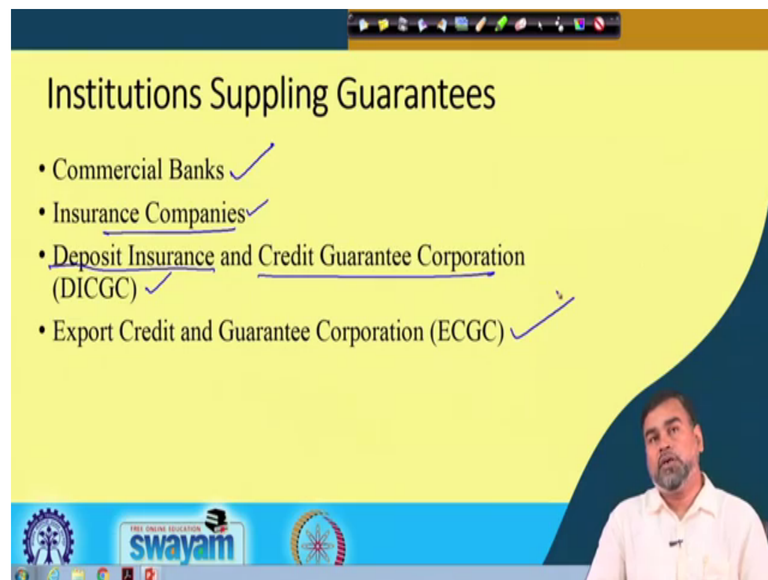

Then who are those there is another kind of organization which is basically provide the guarantee and to the system, that is a market for the guarantee which also works in the Indian financial system and this guarantees are basically given by the different kind of entities for the different kind of transactions.

The guarantees can be given by commercial banks for some reasons, the guarantees also given by the insurance companies if there is in a department and there is some specific organizations which are also responsible to provide the guarantee for any kind of financial transaction that is a market for the guarantees. So, these are the different organizations who are basically provided the guarantee as a third party whenever any kind of financial transactions take place.

So, there is a another one is Deposit a Insurance and Credit Guarantee Corporation, that is your DICGC. Here they provide the deposit insurance with the bank deposits then also the credit guarantee corporation whenever any kind of transactions takes place between the banks and then one of the third parties. Then we have the export credit and guaranty

corporation who are basically provides the guarantee the transactions related to the export and import the for the trading purpose.

This is for the international trade, this particular organization plays a significant role in terms of the providing the guarantee. So, these are the different kind of further entities which work in the financial system which was making this market for guarantees relevant in the Indian financial system and they also play a very significant role for the holistic development of the financial system in India. This is about the money markets or different type of money market which work in the Indians of Indian financial system as a whole.

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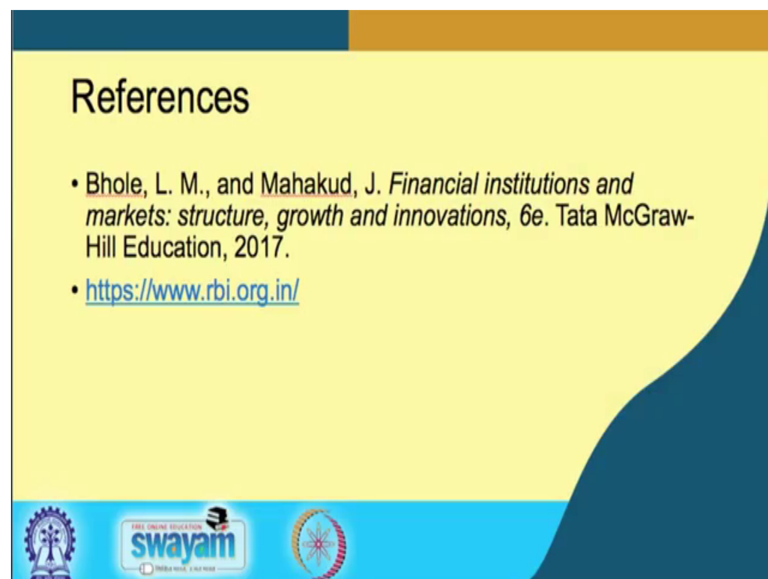

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Thank you.