# INTRODUCTION TO FIXED INCOME SECURITIES

Fixed-income securities constitute the most prevalent means of raising capital globally based on total market value. These instruments allow governments, companies, and other issuers to borrow from investors, promising future interest payments and the return of principal, which are contractual (legal) obligations of the issuer. Fixed-income securities are the largest source of capital for government, not-for-profit, and other entities that do not issue equity. For private companies, fixed-income investors differ from shareholders in not having ownership rights. Payments of interest and repayment of principal (amount borrowed) are a higher priority claim on the company's earnings and assets compared with the claim of common shareholders. Since fixed-income claims rank above shareholder claims in the capital structure, a company's fixed-income securities have, in theory, lower risk than their common shares.

## DEFINITION

A debt security is one type of financial asset that represents money that one party owes to another party. For example, a government entity or a corporation may issue debt securities to raise money for their operations. Investors buy the debt security and provide that money. In return, they receive interest on their money and repayment of the principal at maturity.

Debt securities are called fixed-income securities since they generate a fixed amount of interest each year. If they are held to maturity, they also return the initial principal to the investor. Debt securities are not without risk. During the lifetime of debt securities, the risk occurs because the company might go bankrupt or default on its obligations. In the event of bankruptcy, bondholders get paid before stockholders.

**Difference between Debt and Equity**

| Debt Capital | Equity Capital |
|---|---|
| **Definition** | |
| Debt Capital is the borrowing of funds from individuals and organisations for a fixed tenure. | Equity capital is the funds raised by the company in exchange for ownership rights for the investors. |
| **Role** | |
| Debt Capital is a liability for the company that they have to pay back within a fixed tenure. | Equity Capital is an asset for the company that they show in the books as the entity's funds. |
| **Duration** | |
| Debt Capital is a short term loan for the organisation. | Equity Capital is a relatively longer-term fund for the company. |
| **Status of the Lender** | |
| A debt financier is a creditor for the organisation. | A shareholder is the owner of the company. |
| **Types** | |
| Debt Capital is of three types:<br>• Term Loans<br>• Debentures<br>• Bonds<br>• Money Market | Equity Capital is of two types:<br>• Equity Shares<br>• Preference Shares |
| **Risk of the Investor** | |
| Debt Capital is a low-risk investment | Equity Capital is a high-risk investment |
| **Payoff** | |

| | |
|---|---|
| The lender of Debt Capital gets interest income along with the principal amount. | Shareholders get dividends/profits on their shares. |
| **Security** | |
| Debt Capital is either secured (against the surety of an asset) or unsecured. | Equity Capital is unsecured since the shareholders get ownership rights. |
| **Regulator** | |
| SEBI | RBI and SEBI in case of Coporate Bond market |
| **Cost of Capital to Issuer** | |
| High | Low |

## WHY WOULD COMPANIES PREFER DEBT FINANCING OVER EQUITY?

- A loan does not provide an ownership stake and, so, does not cause dilution to the owners' equity position in the business.
- Debt can be a less expensive source of growth capital if the Company is growing at a high rate.
- Leveraging the business using debt is a way consistently to build equity value for shareholders as the debt principal is repaid.
- Interest on debt is a deductible business expenses for tax purposes, making it an even more cost-effective form of financing.
- Debt can be somewhat less complicated to arrange than equity financing and may not require shareholder approval.
- Once the debt is repaid, it's gone. Equity remains outstanding unless repurchased by the Company, which typically requires the shareholder's consent.
- Debt can be used to finance a wide variety of business activities including working capital (to acquire inventory, for example), capital expenditures (such as to finance equipment purchases) and acquisitions of other companies, to name a few.
- From the borrower's perspective, debt has a fixed cost, the interest rate, but it represents a significant potential threat to the company's existence. If interest and principal are not paid as agreed, lenders can foreclose, possibly requiring the business to cease operations and liquidate its assets.

## CLASSIFICATION OF DEBT SECURITIES:

These classifications are useful for the analysis of debt securities markets from the perspective of monetary policy formulation and monitoring, financial integration, financial market regulation and financial stability. Debt market instruments can be classified on the following basis.

### (1) Classification by issuing sector and sub-sector:

From a monetary policy and financial stability perspective, it is important to analyse and understand the relative size of the different issuing sectors and sub-sectors, including non¬residents' issues. An indication of the openness of national capital markets may also be obtained from having accurate data on the issuance activity of non-residents in domestic markets.

Groups resident institutional units into five mutually exclusive sectors:

- non-financial corporations,
- financial corporations,
- general,

- government,
- households.

Additional sub-sectors for debt securities issues:

The financial corporation's sector could be broken down into debt securities issued by:
- the central bank;
- other money-issuing corporations comprising the sub- sectors "deposit taking corporations;
- securitization corporations, and
- other financial corporations,

The general government sector could be broken down into debt securities issued by:
- the central government, and state government,
- local government and
- social security funds (Pension funds, insurance funds etc.).

**(2) Classification by currency:**

It is important to distinguish between currency of denomination and currency of settlement. Data on the currency composition of debt securities can be important for financial stability analysis. For example, potential currency mismatches can emerge in countries with debt denominated in foreign currencies that experience sudden and large exchange rate depreciation. These countries can be vulnerable to a large increase in domestic currency-denominated debt repayments, even if the initial level of debt is not high. Hence, statistics on debt securities issues can be classified according to whether issues are denominated in:
- Domestic currency or
- Foreign currencies.

These data can be aggregated to show debt securities issued in all currencies. Currency of denomination and currency of settlement for debt securities issues.

**(3) Classification by maturity:**

This classification addresses two different concepts of maturity:
- Short-term and long-term maturity, and
- Original and
- Remaining maturity.

These concepts can assist in the understanding of debt securities issuance activity, the debt position of issuers and their debt servicing capacity. Statistics on debt securities issues classified by maturity are also helpful for liquidity analysis.

**Short-term and long-term maturity:**

Debt securities can be classified as having short-term or long-term maturity. A debt security with a short-term maturity is, defined as one that is payable on demand or in one year or less. A debt security with a long-term maturity is defined as one that is payable in more than one year or with no stated maturity. It is also possible to break down statistics _ on long-term debt securities issues into four sub-items:
- more than one year and up to and including two years;
- more than two years and up to and including five years;
- more than five years and up to and including ten years, and
- more than ten years.

**Original maturity:**
Original maturity is the period from the issue date until the final contractually scheduled payment (a). On an original maturity basis, debt securities that mature in one year or less are classified as short term, even if they are issued under long-term facilities. Debt securities that mature in more than one year are classified as long term. This category also covers debt securities with optional maturity dates, the last of which is more than one year away, and those with indefinite maturity dates.

**Remaining (or residual) maturity:**
Remaining (or residual) maturity is the period from the reference date of a debt security until the final contractually scheduled payment.. Short term debt securities with a remaining maturity of one year or less comprise those securities with an original maturity of one year or less and those with an original maturity of more than one year that will mature within one year.

**(4) Classification by Duration:**
When deciding whether debt securities statistics should be recorded on an original or remaining maturity basis, it is important to consider the duration concept. Duration is the weighted average term to maturity of a debt security. It can be used to measure the impact on the value of a debt security that will result from a one percentage point change in interest rates. Unlike maturity, duration takes into account interest payments that occur throughout the life of the debt security. De facto, duration is a weighted average payment schedule.

**(5) Classification by Interest rate:**
From a financial stability perspective, institutional units that issue a large share of debt securities with a variable interest rate may be exposed to more financial stress during periods of financial shocks.
Furthermore, the operation of the transmission mechanism of monetary policy may be influenced by the mix of:

- Fixed interest rate and
- Variable interest rate debt securities.

Fixed interest rate debt securities cover those listed below.

- **Plain debt securities** are issued and redeemed at face value.
- **Debt securities issued at a discount to their face value**, with the exception of zero-coupon bonds (see below), and that usually pay no coupon. For example, Treasury bills, commercial paper, promissory notes, bill acceptances, and bill endorsements.
- **Deep discounted bonds** have small coupon payments and are issued at a discount to face value.
- **Zero-coupon bonds** are single payment debt securities with no coupon payments. The bond is sold at a discount to its face value and the Face value is also known as par value, or simply par principal is repaid at maturity.
- **Separate trading of registered interest and principal of securities (STRIPS)**, or stripped debt securities, are securities that have been transformed from a principal amount with periodic interest coupons into a series of zero coupon bonds, whose range of maturities matches the coupon payment dates and the redemption date of the principal amount.
- **Perpetual with a fixed interest rate**, callable (redeemable) and puttable debt securities, and debt securities with sinking fund provision.

- **Convertible bonds**, usually classified as fixed interest rate debt securities, may, at the option of the issuer (or the holder), be converted into the equity of the issuer, at which point they are classified as equity securities.
- **Exchangeable bonds** are usually fixed interest rate securities with an embedded option allowing them to be exchanged for equity securities in a corporation other than the issuer (usually a subsidiary or company in which the issuer owns a stake) at some future date and under agreed conditions.

Debt securities interest that is linked to the credit rating of another borrower should be classified as fixed interest rate debt securities, as credit ratings do not change continuously in response to market conditions.

- **Equity warrant bonds** are debt securities that incorporate warrants, which give the holder the option to purchase equity in the issuer or another company during a predetermined period, or at a particular date and at a fixed contract price. The exercise of the equity warrant will normally increase the total funding of the issuer because the debt is not replaced by equity but remains outstanding until the date of its redemption. The warrant may be detachable and traded separately from the debt security. As a result, two separate financial instruments can be presented - the warrant, as a financial derivative, and the bond, as a debt security.

Equity warrant bonds may also be issued as variable interest rate convertible bonds. This is also applies for convertible bonds and exchangeable bonds in the market or as the result of an over-the-counter transaction.

- **Variable Interest Rate Debt Securities**: Variable interest rate debt securities have their coupon or principal payments (or both) linked to a general price index for goods and services (such as the CPI - consumer price index), interest rate (such as the LIBOR - the London interbank offered rate - or a bond yield) or asset price. Variable interest rate debt securities include those issued as inflation-linked bonds, and asset price-linked bonds.

The redemption value of an asset price-linked bond includes those linked to the price of a commodity.

**(6) Classification by market:**

This classification allows an understanding of the relative importance of debt securities issues by different resident sectors and non-residents across markets. In the absence of information on the currency denomination of debt securities, data on securities issued in international markets can provide a broad indication of the domestic foreign currency composition of debt securities issues.

- Domestic Markets and
- International Markets

This classification is particularly important for emerging market economies, where connections between the two markets are in their early stages. This would induce an inflow of foreign capital, reduce the cost of borrowing for domestic institutional units, and promote economic growth.

**(7) Classification by default risk:**

A qualitative feature of debt securities refers to the default risk attached to them. Due to its relevance to monetary policy and financial stability analysis, it is important to outline some aspects concerning the possibility of classifying debt securities issues by default risk.

Various methods include the use of external ratings and reference yield curves.

- Debt securities ratings as provided by credit rating agencies.
- External ratings are designed by specialised national and international agencies based on risk analysis and ratings . tools, which the agencies have developed.

The ratings tools all use an alphabetical, ordinal structure to rate debt securities issues, although some agencies also use an alphanumerical grading scale. Their credit quality designations cover the range from

high, through medium to low, which correspond respectively to the low, medium, and high probability of default.

Aggregate data on debt securities issues containing information on credit ratings are valuable for a number of reasons.

- They can assist policymakers and analysts to focus on sectors (or sub-sectors).
- They also help to identify the riskiest types of debt securities.
- They assist financial investment decisions with respect to transparency between creditors and debtors, and promote the efficient operation of the debt securities market.
- Ratings information provides a measure of the state of development of domestic and international securities markets in terms of their capacity . to accommodate issuers of different credit standings

## TYPES OF DEBT MARKET INSTRUMENTS

There are a variety of instruments offered in the debt market. The different types of bonds in the Indian bond market can be categorized into the following:

**(1) Government bonds:**

These bonds are issued directly by the government of India, also called G-Sec. A Government security is a tradable instrument issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Such securities are short term (usually called treasury bills, with original maturities of less than one year) or long term (usually called Government bonds or dated securities with original maturity of one year or more). In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). Government securities carry practically no risk of default and, hence, are called risk-free gilt-edged instruments. Government of India also issues savings instruments (Savings Bonds, National Saving Certificates (NSCs), etc.) or special securities (oil bonds, Food Corporation of India bonds, fertiliser bonds, power bonds, etc.). They are, usually not fully tradable and are, therefore, not eligible to be SLR securities.

**(2) Corporate Debt Instruments:**

Funds are raised from external sources either in the form of equity or debt or hybrid instruments that combine the features of both debt and equity. The capital raised by companies through debt instruments is broadly referred to as corporate debt.

Corporate debt consists of broadly two types - bank borrowings and bond. Corporates borrow from banks and other financial institutions for various business purposes and for varying durations through non-standardized and negotiated bank loans. Bank finance takes the form of project loans, syndicated loans, working capital, trade finance, etc.

Corporate bonds are transferable debt instruments issued by a company to a broad base of investors (including but not restricted to banks and other financial institutions). The distinguish between

- public debt (debt issued by central and state governments, municipal authorities); and
- private debt (bonds issued by private issuers: financial and non-financial corporates).

Certain typical features of corporate bonds, include the following:

- corporate bonds are issued to the public (similar to equity instruments);
- listed on stock exchanges and traded in secondary markets are transferable possess a broad base of issuers (ranging from small companies to conglomerates and multinationals) and investors (including retail participants), and are under the additional purview of the regulators of the securities market other than the central bank or other banking supervisor.

Corporate bond markets are further defined as the segment of capital markets in the economy that deals with corporate bonds. There are three main pillars that make up the corporate bond market ecosystem - the institutions, participants and the instruments. The institutions comprise of the securities market regulator, the banking regulator, the credit rating agencies, clearing houses, stock exchanges and the regulations and governance norms prescribed by these institutions. The participants comprise of the market players - investors on the demand side and issuers on the supply side.

**(3) Treasury Bills (T-bills):**

Treasury bills or T-bills, which are money market instruments, are short term debt instruments issued by the Government of India and are presently issued in three tenors, namely, 91 day, 182 day and 364 day. Treasury bills are zero coupon securities and pay no interest. They are issued at a discount and redeemed at the face value at maturity.

**(4) Dated Government Securities:**

Dated Government securities are long term securities and carry a fixed or floating coupon (interest rate) which is paid on the face value, payable at fixed time periods (usually half-yearly). The tenor of dated - securities can be up to 30 years. The features of a typical dated fixed coupon Government. security contain the following features - coupon, name of the issuer, maturity and face value.

If the coupon payment date falls on a Sunday or a holiday, the coupon payment is made on the next working day. However, if the maturity date falls on a Sunday or a holiday, the redemption proceeds are paid on the previous working day itself.

**(5) Collateralized Borrowing and Lending Obligation (CBLO)**

The Collateralized Borrowing and Lending Obligation (CBLO) market is a money market segment operated by the Clearing Corporation of India Ltd (CCIL). In the CBLO market, financial entities can avail short term loans by providing prescribed securities as collateral. In terms of functioning and objectives, the CBLO market is almost similar to the 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.

**Who are the participants in the CBLO market?**

Institutions participating in CBLO are entities who have either no access or restricted access to the inter - bank call money market. Still, institutions active in the call money market can participate in the CBLO market. Nationalized Banks, Private Banks, Foreign Banks, Co-operative Banks, Insurance Companies, Mutual Funds, Primary Dealers, Bank cum Primary Dealers, NBFC, Corporate, Provident/ Pension Funds etc., are eligible for CBLO membership. These institutions have to avail a CBLO membership to do activities in the market.

**Instrument under the CBLO market**

Collateralized Borrowing and Lending Obligation (CBLO) is the instrument in the CBLO market. It is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to one year.

The CCIL provides the Dealing System through Indian Financial Network (INFINET) and Negotiated Dealing System for participating in the market.

In the CBLO market, members can borrow or lend funds against the collateral of eligible securities. Eligible securities are Central Government securities including Treasury Bills, and such other securities as specified by the CCIL. Borrowers in CBLO have to deposit the required amount of eligible securities with the CCIL. For trading, the CCIL matches the borrowing and lending orders (order matching) submitted by the members. Borrowers have to pay interest to the lenders in accordance with the bid.

**(6) Fixed Rate Bonds:**

These are bonds on which the coupon rate is fixed for the entire life of the bond. Most Government bonds are issued as fixed rate bonds.

For example: 8.24% GS 2018 was issued on April 22, 2020 for a tenor of 10 years maturing on April 22, 2030. Coupon on this security will be paid half-yearly at 4.12% (half yearly payment being the half of the annual coupon of 8.24%) of the face value on October 22 and April 22 of each year.

**(7) Floating Rate Bonds:**

Floating Rate Bonds are securities which do not have a fixed coupon rate. The coupon is re-set at pre-announced intervals (say, every six months or one year) by adding a spread over a base rate. In the case of most floating rate bonds issued by the Government of India so far, the base rate is the weighted average cut-off yield of the last three 364- day Treasury Bill auctions preceding the coupon re-set date and the spread is decided through the auction.

Floating Rate Bonds were first issued in September 1995 in India.

For example: A Floating Rate Bond was issued on July 2, 2002 for a tenor of 15 years, thus maturing on July 2, 2017. The base rate on the bond for the coupon payments was fixed at 6.50% being the weighted average rate of implicit yield on 364-day Treasury Bills during the preceding six auctions. In the bond auction, a cut-off spread (mark-up over the benchmark rate) of 34 basis points (0.34%) decided. Hence the coupon for the first six months was fixed at 6.84%.

**(8) Zero Coupon Bonds:**

Zero coupon bonds are bonds with no coupon payments. Like Treasury Bills, they are issued at a discount to the face value. The Government of India issued such securities in the nineties. It has not issued zero coupon bond after that.

**(9) Capital Indexed Bonds:**

These are bonds, the principal of which is linked to an accepted index of inflation with a view to protecting the holder from inflation. A capital indexed bond, with the principal hedged against inflation, was issued in December 1997. These bonds matured in 2002.

The government is currently working on a fresh issuance of Inflation Indexed Bonds wherein payment of both, the coupon and the principal on the bonds, will be linked to an Inflation Index (Wholesale Price Index).In the proposed structure, the principal will be indexed and the coupon will be calculated on the indexed principal. In order to provide the holders protection against actual inflation, the final WPI will be used for indexation.

**(10) 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 during the currency of the bond. 6.72% GS 2012 was issued on July 18, 2002 for a maturity of 10 years maturing on July 18, 2012. The optionality on the bond could be exercised after completion of five years tenure from the date of issuance on any coupon date falling thereafter. The Government has the right to buy back the bond (call option) at par value (equal to the face value) while the investor has the right to sell the bond (put option) to the Government at par value at the time of any of the half-yearly coupon dates starting from July 18,2007.

The other instruments that prevalent in the debt market are:

- **Borrowing by state governments:** made by single states within India;
- **Tax free bonds:** issued directly by quasi-sovereign companies allow market expansion for investors and, in particular, embody retail interest into the market;
- **Banks and other financial institutions bonds.**
- **Tax-savings bonds:** issued directly by the government of India, they provide investors with tax rebates, in addition the normal rate of interest.
- **Tax-saving infrastructure bonds:** issued directly by infrastructure companies approved by the government, they offer tax rebates along with a decent rate of interest.
- **MIBOR linked bonds:** MIBOR (Mumbai Inter Bank Offered Rate) bonds are closely modelled on the LIBOR (London Inter Bank Offered Rate) bonds. Currently, Reuters and the National Stock Exchange (NSE), are the two calculating agents for the benchmark. The NSE MIBOR benchmark is the more popular of the two and is based on rates polled by NSE from a representative panel of 31 banks/institutions/primary dealers.
- **Commercial Papers (CPs):** These are short term unsecured promissory notes, generally issued by corporate entities.
- **Certificate of Deposits (CDs):** These are issued by banks.
- **Medium- to long-term bonds:** These are issued by corporate entities/financial institutions. They can feature fixed or floating rates.
- **Call money market:** This represents overnight and term money between banks and institutions.
- **Repo transactions:** These represent temporary sale with an agreement to buy back the securities at a future date at a specified price.
- **Special Securities:** In addition to Treasury Bills and dated securities issued by the Government of India under the market borrowing programme, the Government of India also issues, from time to time, special securities to entities like Oil Marketing Companies, Fertilizer Companies, the Food Corporation of India, etc. as compensation to these companies in lieu of cash subsidies. These securities are usually long dated securities carrying coupon with a spread of about 20-25 basis points over the yield of the dated securities of comparable maturity. These securities are, however, not eligible SLR securities but are eligible as collateral for market repo transactions. The beneficiary oil marketing companies may divest these securities in the secondary market to banks, insurance companies / Primary Dealers, etc., for raising cash.
- **Others** like Debentures, Secured premium notes, Deep Discount Bonds, PSU Bonds / and Interest Rate Derivative products etc.

## NEW DEBT MARKET INSTRUMENTS

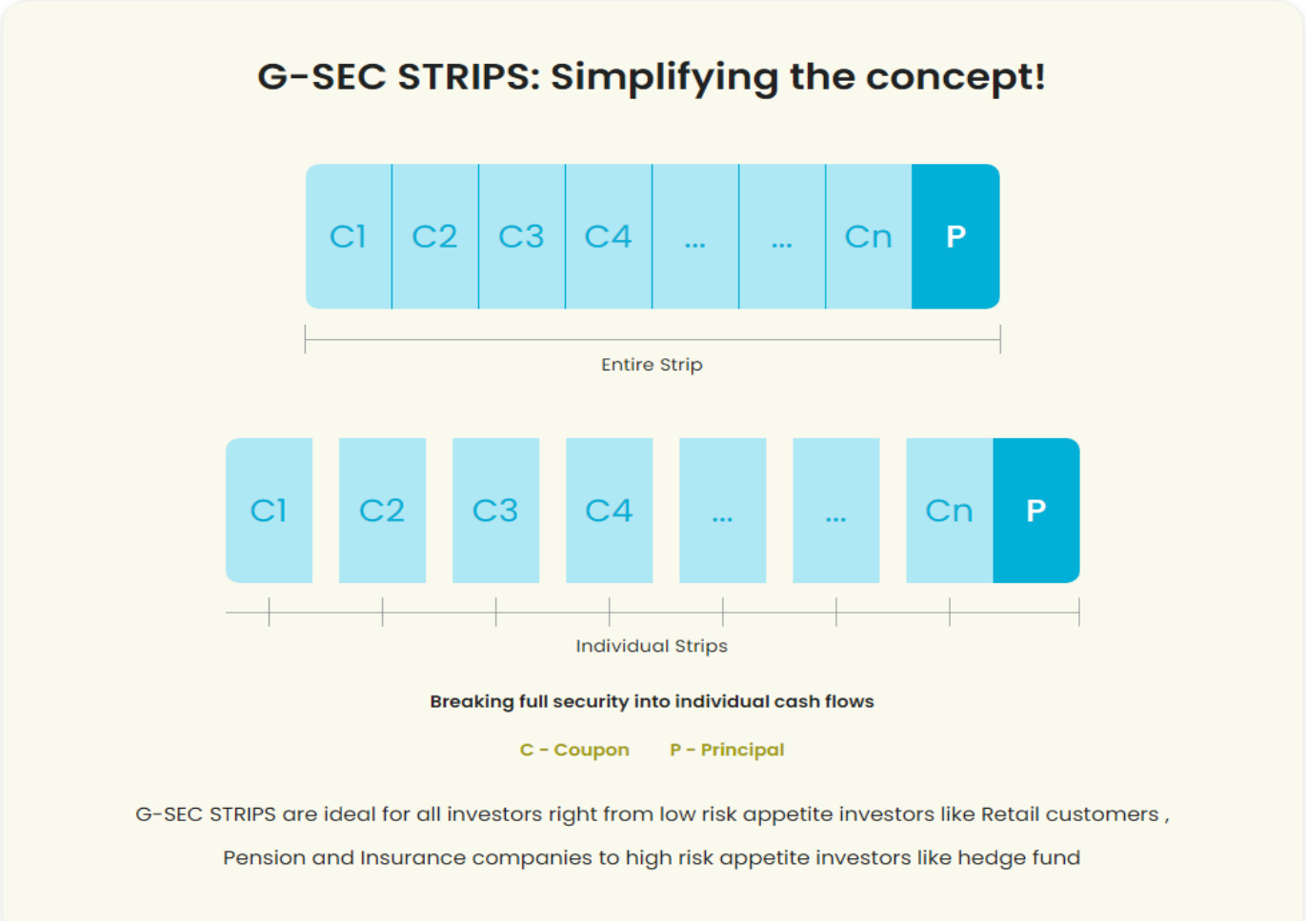
### (1) STRIPS – Separate Trading of Registered Interest and Principal of Securities

STRIPS is the acronym for Separate Trading of Registered Interest and Principal Securities. Stripping is the process of separating a standard coupon-bearing bond into its individual coupon and principal components. For example, a 5 year coupon bearing bond can be stripped into 10 coupon and one principal instruments, all of which thenceforth would become zero coupon bonds.

STRIPS take the form of zero-coupon securities. That is, they make no periodic interest payments, as most bonds do. Instead, you buy them at a deep discount from their face value, which is the amount you receive when they mature. This means that investors know exactly how much they will earn from their STRIPS investments. This, along with the high security of the bonds that back them, make STRIPS popular with some investors.

### STRIPS EXPLAINED WITH A DIAGRAM

Stripping is the process of separating a standard coupon-bearing bond into its individual coupon and principal components. For example, a 10 year coupon bearing bond can be stripped into 20 coupon and one principal instruments, all of which thenceforth would become zero coupon bonds.



# What do we get post stripping?

### COUPON STRIPS

Multiple Coupon G-SEC STRIPS with each coupon flow maturity having a unique ISIN.

### PRINCIPAL STRIPS

One Principal G-STRIP with principal flow of the original security having a distinct ISIN.

Revised guidelines announced by RBI on **May 3, 2018**

***All fixed rate, transferable, SLR eligible G-sec can now be STRIPped!***

With G-STRIPS, investors can now get **Zero Coupon Bond G-secs** across the full maturity spectrum of G-secs issued by **Government of India**

- *A single cash flow from a STRIP means no coupons in between*
- *No re-investment risk*

# Pricing of G-STRIPS

Each G-STRIP to be priced as a ZCB.

Transactions take place at the **yield (to 4 decimals) agreed by the buyer and the seller.**

## Yield quoting convention

**MONEY MARKET**

*For less than 6 months*

**SEMI ANNUAL**

*For greater than 6 months*

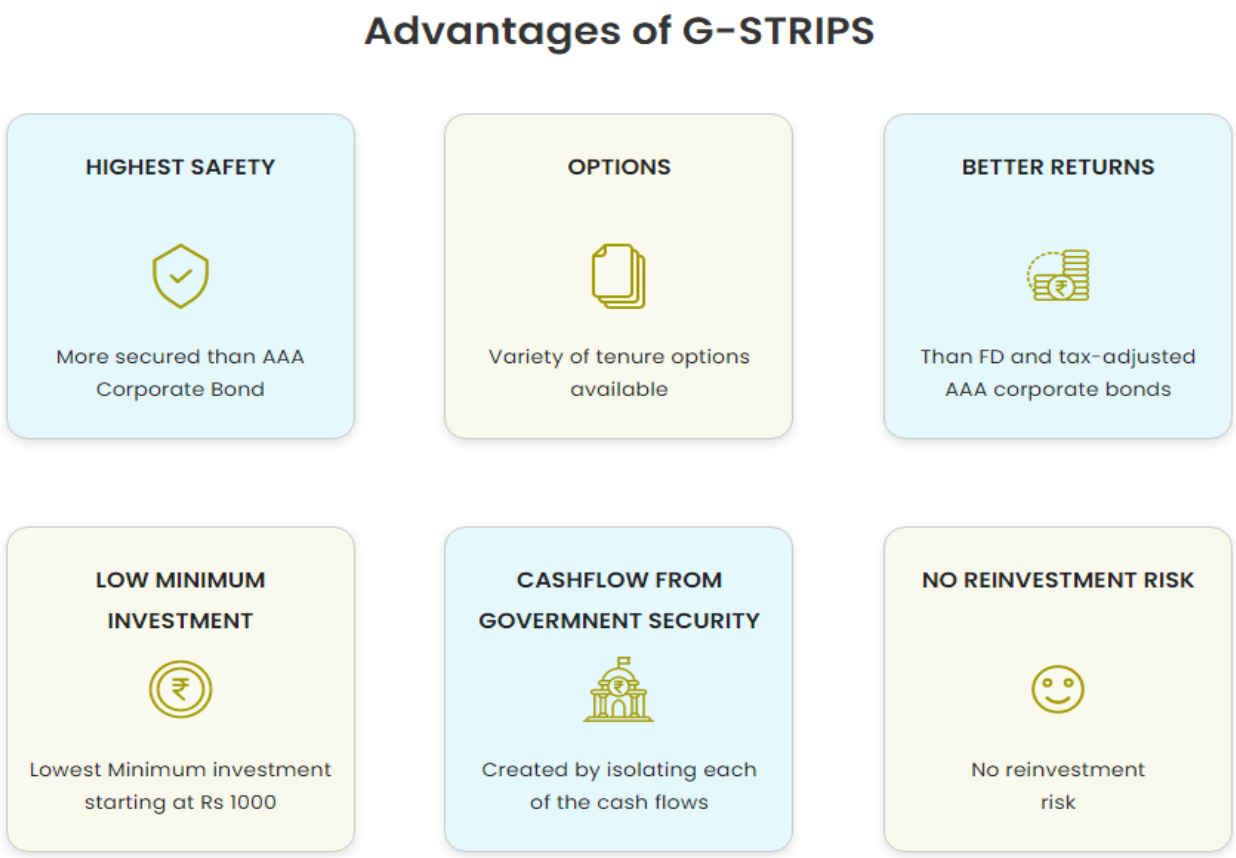
Price arrived at by discounting the single cash flow of the G-STRIP at the agreed yield. Price expressed as Discounted Value per Rs. 100 Face Value.

**Example**

Let's understand the pricing better with the help of an example.

The face value of a G-Strip Bond is Rs 1000. The bond bears a coupon rate of 9% with coupon payments being made at the end of each year. The maturity of the bond is 4 years. If the bond is redeemable at a premium of 11%. What would be the present market price of the bond?

| Years | Cash Flow | PV Factor @ 11% | PV of Cash Flow |
|---|---|---|---|
| 1 to 4 | 90 | 3.102 | 279.22 |
| 4 | 1110 | 0.658 | 730.38 |
| | | Total Present Value | **1009.6** |




## (2) CASH MANAGEMENT BILLS (CMBs)

Cash Management Bills (CMBs) are short term bills issued by central government to meet its immediate cash needs. The bills are issued by the RBI on behalf of the government. Hence the CMBs are short-term money market instruments that help the government to meet its temporary cash flow mismatches. Following are the features of CMBs.

1. CMBs have a maturity of less than 91 days.

2. The CMBs have the generic character of Treasury Bills as the CMBs are issued at a discount and redeemed at face value at maturity. For example, if the face value of a CMB is Rs 100, we can get the bill at Rs 97 and at the end of the maturity date, say 60 after days, we can get Rs 100. Here, there is no interest payment as the maturity period is so small. But the return for buying CMB is obtained in the form of a discount.

3. The tenure or maturity, notified amount (how much total CMBs to be issued) and date of issue of the CMBs depends upon the temporary cash requirement of the Government.

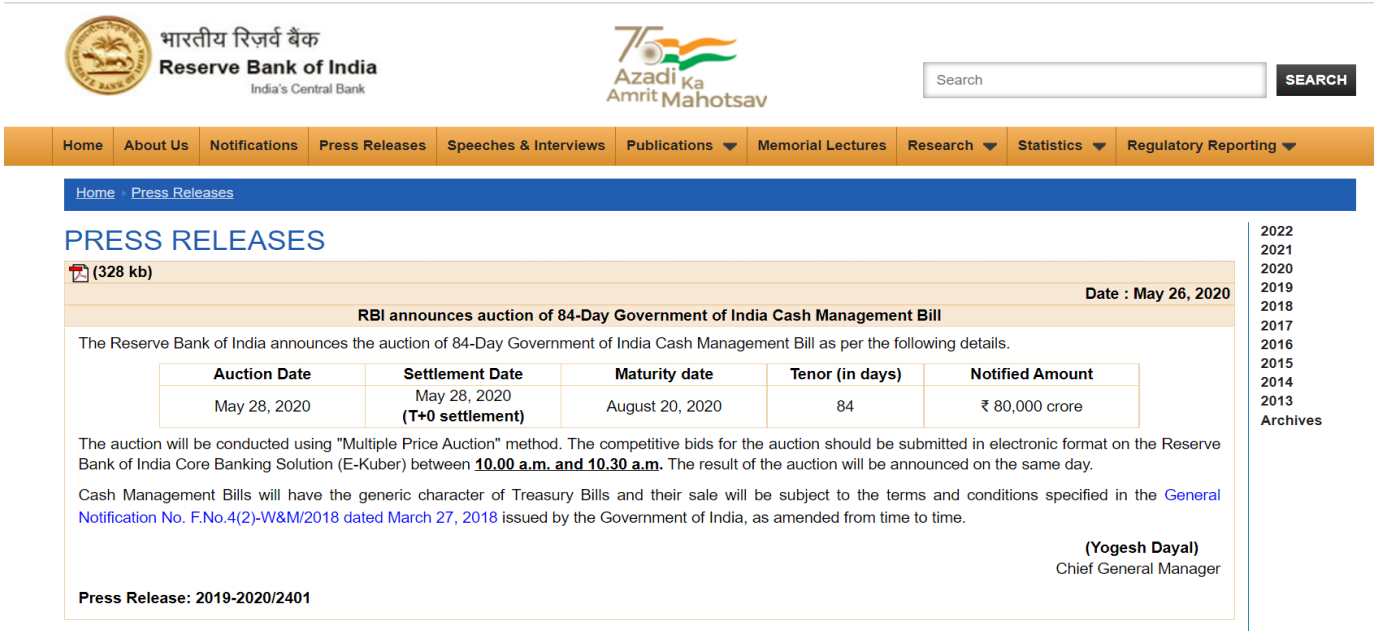
4. CMBs are eligible as SLR securities. Investment in CMBs is also recognized as an eligible investment in Government securities by banks for SLR purpose under Section 24 of the Banking Regulation Act, 1949.

CMBs are issued first on May 12, 2010. The purpose of the mechanism is to enable the government to get short term money. Another similar method for the government to get short term money is Ways and Means Advances (WMA). Under WMA, the RBI gives temporary loan facilities to the centre and state governments as a banker to government for upto 90 days.

**What is the difference between CMBs and Treasury Bills?**

Difference between CMBs and Treasury bills is that CMBs are issued for less than 90 days whereas treasury bills are issue for more than 90 days (91 day and 364-day treasury bills).

Check this article when GOI had raised money through CMBs.
https://economictimes.indiatimes.com/markets/bonds/rbi-to-raise-rs-80000-crore-via-cash-management-bills/articleshow/76002019.cms



भारतीय रिज़र्व बैंक
Reserve Bank of India
India's Central Bank

Azadi Ka Amrit Mahotsav

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PRESS RELEASES

(328 kb)

Date : May 26, 2020

**RBI announces auction of 84-Day Government of India Cash Management Bill**

The Reserve Bank of India announces the auction of 84-Day Government of India Cash Management Bill as per the following details.

| Auction Date | Settlement Date | Maturity date | Tenor (in days) | Notified Amount |
|---|---|---|---|---|
| May 28, 2020 | May 28, 2020 **(T+0 settlement)** | August 20, 2020 | 84 | ₹ 80,000 crore |

The auction will be conducted using "Multiple Price Auction" method. The competitive bids for the auction should be submitted in electronic format on the Reserve Bank of India Core Banking Solution (E-Kuber) between **10.00 a.m. and 10.30 a.m.** The result of the auction will be announced on the same day.

Cash Management Bills will have the generic character of Treasury Bills and their sale will be subject to the terms and conditions specified in the General Notification No. F.No.4(2)-W&M/2018 dated March 27, 2018 issued by the Government of India, as amended from time to time.

**(Yogesh Dayal)**
Chief General Manager

**Press Release: 2019-2020/2401**

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3. MASALA BONDS

Masala Bonds are rupee-denominated bonds. It is a debt instrument issued by an Indian entity in foreign markets to raise money, in Indian currency, instead of dollars or local denomination.

Masala Bonds were introduced in India in 2014 by International Finance Corporation (IFC). The IFC issued the first masala bonds in India to fund infrastructure projects.

In 2019, Kerala became the first Indian state to issue Masala Bonds worth Rs. 2,150 crore on the London Stock Exchange. State-owned Kerala Infrastructure Investment Fund Board (KIIFB) had issued the bonds to raise funds in the overseas market.

There are certain rules and regulations which have been set up by the Reserve Bank of India (RBI) regarding Masala Bonds:

Any corporate and Indian bank is eligible to issue Rupee denominated bonds overseas Money raised through these bonds cannot be invested in real-estate activities. However, they can be used for the development of integrated township or affordable housing projects Also, the money raised through Masala Bonds cannot be invested in capital markets

**Characteristics of Masala Bonds**

- **Investors**

These bonds can only be issued to a resident of such a country which is a member of the Financial Action Task Force (FATF). Also, the security market regulator of the country must be a member of the International Organisation of Securities Commission. These bonds can also be subscribed by regional and multilateral financial institutions where India is a member country

- **Maturity Period**

The minimum original maturity period for bonds raised up to 50 million US Dollars equivalent in INR per financial year should be 3 years
The minimum original maturity period for bonds raised above 50 million US Dollars equivalent in INR per financial year should be 5 years

- **Eligibility**

Investors from outside of India who are interested to invest in Indian assets are eligible to invest in Masala bonds. HDFC, NTPC, Indiabulls Housing Finance, are a few Indian entities who have raised funds using Masala Bonds

**Benefits of Masala Bonds**

- Masala bonds have opened up an investment route for global investors who have no access to the domestic market through the Foreign Institutional Investor (FII) or Foreign Portfolio Investment (FPI) route
- The documentation work is also less as the registration does not have to be made as FPI in India
- For borrowers, it is beneficial as the cost of funds is cheaper and is issued below 7% interest rate
- The companies issuing these bonds do not have to worry about the depreciation of rupee
- Since, the interest rates in the US dollar, pound sterling, euro, and yen, are at very low levels, it benefits Indian companies to raise funds via issuing Masala Bonds
- It is an easy medium to internationalise Indian rupee by making it familiar to the International investors
- It will also boost the development of domestic bond markets due to competition with overseas market

**Limitations of Masala Bond**

- RBI has been making periodical rate cuts in Masala Bonds which has made it a bit less appealing to the investors
- The money raised through these bonds cannot be used everywhere. There are fixed fields where the money can be invested
- As per Moody's, the sustainability of financing via Masala Bonds is a challenge as investors are expected to be cautious in taking on currency risks from emerging markets

(3) ASSETS BACKED SECURITIES (ABS) also referred to as Securitization

Asset-backed securities, also called "ABS," are pools of loans that are packaged and sold to investors as securities—a process known as "securitization." The type of loans that are typically securitized includes

home mortgages, credit card receivables, auto loans (including loans for recreational vehicles), home equity loans, student loans, and loans for boats.

When a consumer takes out a loan, their debt becomes an asset on the balance sheet of the lender. The lender, in turn, can sell these assets to a trust or "special purpose vehicle," which packages them into asset-backed security that can be sold in the public market. The interest and principal payments made by consumers "pass-through" to the investors that own the asset-backed securities.

**What about the risk? And would it lead to another financial crisis of 2008?**
Thankfully, since the big crisis, the BASEL Committee has ensured that the regulations are stricter and enforced with adequate oversight.

The primary reason for the occurrence of the '2008- Financial Crisis' was not the heavy use of ABS but actually the banks' team which did not perform their duties of verifying the customers' backgrounds.
Primarily, defaults occurred due to 3 reasons-

- The majority of loans were NINJA Loans (Given to people with no source of Income) and Liar Loans (Where the backgrounds and documents of loan borrowers were not thoroughly verified. The main aim of loan generators was to generate more quantity since compensation structures were structured favoring quantity over quality.
- Regulators also did not verify the pool ratings, since these ratings were based on the credit quality of borrowers initiated during earlier times, and not considering the new speculation going around in the market.
- Lastly, the banks had no issue in generating poor-quality loans since they did not retain any risk.
- However, since then, there have been stricter regulations introduced to ensure reliability and lower defaults.

For example, according to Section 15G in states, the banks are required to hold 5% of the risk in raw form, without hedging or transferring/mitigating risk.

But apart from the US Regulations, the Indian regulators, SEBI, and RBI have ensured to be more proactive and enforce even stricter regulations to avoid or to even let a mere probability of a global crisis exist.

They have established the following rules to ensure investor safety and protection-

- Minimum Holding Period- Where NBFC's are not allowed to securities products until a certain threshold amount of time has elapsed, to ensure that there is sufficient repayment data available to investors.
- It provides First Loan Default Guarantee (FLDG) to the bank to a certain extent (8–15%) of the limit sanctioned in the form of a security deposit with the bank so as to maintain its stake in the loan portfolio.

**The advantages of securitization**
**For the seller**

- For the originator, the main reason for securitizing is to reduce (some might say "get rid of") the amount of assigned debt from his balance sheet, which on the one hand leads to a corresponding reduction in his regulatory capital requirements under Basel II, and on the other hand enables him to bring in additional liquidity (which can be used to make new loans).

**For the investor**

- Higher Returns to investors! (From 8% - 23%)
- Wider access for loans to people that initially did not receive them- due to the creation of tranches based on credit quality!
- Alternative sources of investments since these pools are backed by varying assets! ( Gold, Furniture, Vehicles, etc)
- Lower default risk, in case a wider pool of people is chosen with sufficient credibility

**For the market**

- In principle, securitization helps to spread out risk within the market, so that the risk is no longer concentrated solely in the hands of credit agencies.

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