Money and Banking
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Lecture - 16

We were talking about a very common money market instrument called commercial paper. This is the use since promissory note which matures at a particular time period, and sold by companies for short term funds. Short term funds for a company usually working capital requirements. And I explained why working capital is important; yesterday, I explained that.

Now, from the (( )) was some RBI guidelines of 1997, 98 financial year, which said that the network of a company has to be 4 crores, I explained that. Then it is cp issue is connected with working capital limit? I said by the banks for a company, and they are substitutes which create an immense problem. So, the companies say what is the point of taking all this trouble selling cp. If my working capital limit goes down by the amount sale cp, very funny clause, in 1997, 98 financial year that they did. And then of course, the usual ones that if you were to sell cp the public must have confidence in your company. So, that you do not default payment or repayment of the money that you borrow.

So, you show the credit rating rates rates, you have to go to a credit rating agency and get your financial health checkup, and get a report and then you can sell cp. And another characteristic of cp was it was freely transferrable and negotiable; which is a kind of a technical expression. Essentially means ownership can change if you go to secondary market and sell it.

So, you can have a secondary market. You are not stuck with it. You can buy find a buyer you do not like it, you can sell it off. Now overtime 3, 4 years what happened that they linked from the working capital limits saying cp. So, cp is in addition to working capital limit given you given to you by the banks. So, cp can give you more working capital, if you require number 1. Number 2, what this dealing what they revised was the minimum issue size, that can be sold to an investor. Initially, it was 5 cp and each cp was 5000 rupees or no 5 lakhs. So, 25 lakhs one has to invest to buy cp. That also was ridiculous. It was too much too constraining. So, what they did was minimum issue size would be 1 cp only. If you want, you can buy multiple of 1, 1 2 3 4 5 6 7 8 10 20 whatever, no upper limit no upper limit. Minimum is there you have to buy at least1 cp not 5 cp anymore, this is also they did.

Now, and then they revised the matured period it was about 6 months or so from 30 days to 6 months or something initially, and no 3 months to 6 months, 91 days to 6 months which they made it from a fortnight 15 days to 1 year. So, that is a much range wider range of the maturity period, much flexible. It can be 3 months cp; it can be 6 months, 7 months, 8 months, 8 and a half months whatever.

So, that also they improved. Now, if you look and do the cp market; I will show you the data it will see a curve line like other deposits. RBI other deposits like flat on x axis. What number of years? Cp market did not develop at all for the initial years; quite a few years. And then they took off, and they are doing much better now. So, that data I will how you. And then what they found that the cp there is only very interestingly enough; I am not going to do much research here. Two types of companies were selling cps.

Alright. Two types of companies were initially selling cps. One was the manufacturing companies very few, and some financial companies very few were selling cps; non manufacturing. So, not working capital requirement. Financial capital selling cp a quite very well is they too cannot have a lot of working capital requirement they will have repayment requirements. Financial companies they sell off money for various reasons.

So, they were selling cps initially. And the secondary market for cp was nearly nonexistent. I do not know whether it exist now, hardly existed. So, somebody bought the cp they did not bother to go to the secondary market to resell it. Because the maturity is for initially it was 6 months. They did not bother to go the secondary market. And the reason for very small cp market and hardly 0 growth cp markets; as I already mentioned were the reasons that you already know. One was the working capital cp money, second was a very stringent requirement was on the credit rating. You sold a cp; you got a credit rating done. your cp is 3 months, 6 months old. As soon as the 6 months is over; you will have to sell a cp again.

The RBI said which I did not mention that, if the credit rating of your company is more than 2 months old. It is not valid anymore; go to the credit rating agency and again get a rating done. The cp's at you (( )). I do not know why government of India or RBI would make rules like that. 2 months old only, if it is more than 2 months old go and get a credit rating done. It costs the company. It is a headache also because of so much paper; so many papers are to be given information.

Then, they will judge and evaluate the financial health of your company. Sometimes they maybe the organization may be sending a person over to the company sit there somewhere and do the job collection of information. And you know how they do they come and sit here do the job collecting information etcetera; and the companies people also may be attached to him or them. To help them with sources of information etcetera that they require; other than periodic supply of chai and other things.

So, it became a headache; 2 months old cancel credit rating again. Then another thing was very interesting issue. This is an economics issue if you are selling cp; alright and there is a cp rate that will be market determined. How many people want to invest? How many people are trying to sell? Now, if that interest rate is higher than bank finance alright higher than the bank finance rate. Where you can negotiate with the bank. Who knows you for a loan at an interest rate? In addition to the working capital the short term loan or something, then it is not worth going to the cp market.

So, the cp rate is very important here in relation to the banking interest rate; the lending rate they are competing. Suppose bank A has given you a working capital. But I know bank B, they know me. Maybe I can negotiate a loan; short loan. Instead of going through all this credit rating RBI permission to sell cp. Go to the market; contract buyers of cps and then sell them and the discount rate which is uncertain. So, I would look into the current interest rate of the discount rate of cps. So, these two rates were competing with each other. So, unless the cp discount rate is substantially low than the bank lending rate, companies would have very little incentive to go to the cp market.

It is a it is an option, but whether I would use the option. If bank can give me money at a cheaper rate, why would I go to cp? Or if bank gives me or can lend me money substantially higher rate than the cp rate; of course, I will go for the cp market and go take that headache, go through that trouble and sell them. And, then of course the minimum issue size was a problem of 25 lakhs. So, companies who had institution which has a lot of money like LIC etcetera were not interested. Because they preferred on the one hand they made the issue size 25 lakhs initially. On the other hand if you are expecting LIC to come in because it is 25 lakhs; and not normally an investor would come in with 25 lakhs overnight. Alright as surplus funds of 25 lakhs and you were expecting institutions like non-banks like LIC or UTI which has lot more money to come in. Well, why would they for 6 months? What is the point?

I would go into a long term investment, let other go to long term investment. Because the insurance policy is that the sell are very long term. So, they know that the policy would because of those policies that the sell the premium would approve over a long time period. So, they would have a long term investment plan with that money. And they would not be interested in this short term. On the other hand, the issue size was too large. More investors cannot come in. There was a problem. And then very interestingly enough, if you look into. When you start working at the end of the financial year; they will give you an income tax return obligation. The company may be deducting your income tax. But the company would also tell you that in order to save tax; you can make this kind of so called investments or savings.

You can buy LIC policy. You can make mutual fund investments. Sometimes that tax exempted. You can buy infrastructure bonds. You can buy national savings certificates from the post offices. And there are various kinds of categories of investment that income tax office has in India 80 b, 80 c, 80 cc, 80 d. So, various kinds of tax exemption clause are there, and groups are there where if you put money then some portion of your income tax will be exempted.

Now, even after when they made it 5 lakhs or something would I am interested money in cp. I would be interested if the return is very high. 2 I would be interested if there is some tax exemption like a small investor, I am talking about. If there is a tax exemption infrastructure bond you have government (( )) they put a clause that the up to 1 lakhs rupees of investment; there will be an exemption of 20 percent or something or 5 percent, 10 percent. Your income tax will be exempted. cp unfortunately did not have any income tax exemption clause government did not give that the cp.

So, small investors were trying away from the cp market. So, it was a very underdeveloped market. Now, what we find when I look at the data. I have 2, 3 years old data. I have been hunting for data. I am not getting it anywhere. I wanted to look into who are the companies who were selling cps. And I found that more than three fourths of the cp three fourths; that means, 75 percent is being sold by leasing and finance companies. Companies which lease out machines etcetera to smaller companies; manufacturing companies who cannot buy them. So, they rent machines for their business, for their production and finance companies.

There are various kinds of finance companies are there. There are finance companies that do hire purchase. You know hire purchase? You know hire purchase? You want to buy a car, they would fund it. And installment wise you return that money to the company. This is hire purchase. In hire purchase; Indian middle class family use to buy household goods like refrigerator, furniture, refrigerators, and then TV many things you can buy through hire purchase. Hire purchase. So, these are various kinds of finance companies that exist in a country.

So, this finance companies and leasing companies were primarily selling cps in India. I have data up to 2009 I think. 75 three fourths. So, 75 percent of the total amounts of cps have been sold by them. I will look into the data later. Manufacturing companies are very small around 15, 16, 17 percent; and the rest are some financial institutions who are selling cps. I wonder which financial institutions are selling cps must be non banks. I do not have the details of the data. I could not find it in RBI annual report. I hunted and searched and searched and searched at least 2, 3, 4 annual reports. I just could not find the cp details. Who is the companies selling the find and lend that data to me. I will pass it on. I just could not find, which kind of companies selling cp? I found some aggregate data which have for 6 7 and 8 and 8 financial year maybe 9 I have added. Beyond 9, I do not have any data. Alright, I will show that to you later.

Now, cp market is done and these are like discount bonds. They are sold at a discount and your interest is the discount rate. So, when it matures you get back the face value of the cp. So, 25 lakhs cp is maybe sold at a discount of 5 percent say. If it is 5 percent then how much of 5 lakhs; 5 percent will be 5000 right.

Now, 25000 25000 25000. So, so 25000 will your income, if it is sold at 5000. After 6 months, if you invest 5 lakhs. So, this is the way it goes. So, minus 25000 you give to the company; 5 lakhs minus 25000 is 475000. And when it matures selling at a discount means this basically. And when it matures company gives you 5 lakhs. So, you have to wait 6 months to get your interest. The discount rate is the interest rate. Simple, alright. Now, I come to another one which is very similar. Its name is cd. It is very similar to cp. cd, cd is not your cd. The cd that you use. Not compact disc, but this cd is. Certificate of deposit, cd it is called in short cd.

Cd, cp names are rhyming words like you know abbreviations; they are very similar also. So, I can explain this today; and then next day I will explain other instruments which will take much more time. Cp is a sold by companies for short term funds. cd is very interesting sold by banks for short term funds and non banks may also be included. Yes, alright. So, banks and nonbanks were to be long term instruments like IDBI, like ICICI. They request short term funds or finance institutions like banks they can sell cds.

Banks can go to the call market; you have already learnt that. Now, I am talking about another instrument which they can use and also the big financial other institutions nonbanks like LIC, UTI, HGIC. You name them industrial development banks CIDB IDBI ICICI then industrial construction bank of India IRBI. So, there are various banks are there nonbanks. If you want to look up the list. You can open bole's book and you can get there. In fact, details of them individually very interesting to read them.

Now, these institutions, these financial institutions if they require money. Some of them can use cp. But most of them will be not being allowed cp, they would be selling cds. Very interesting; I should have had this first.cds were introduced a year before cps. It is in 1989 they were introduced today, Indian money market still quite recent. The cp cd existed in the western world god knows for how many years. Today Indian money market is still a new thing 20, 22 years old; 23 years.

The cds were introduced, as you sense promissory notes. And they are very much like bank fixed deposits. They take the money; it is fixed for a shorter time period like very short term fixed deposits. And it carries the fixed interest rate which is and has a maturity period; and they are also freely transferable and negotiable instruments. you can sell cds in the secondary market. This is unlike a fixed deposit. It might be fixed deposit is there in the bank. Bank has that money, and I cannot have it. But I can break it, at a cost. But I cannot; the fixed deposit I do not need it; yet I can sell off the fixed deposit to somebody else. And go and open a fixed deposit account in another bank. You cannot do that.

But cds is like use sense promissory note. It is like a bond paper lying with me; and I can go and sell it. Alright. But they are very much like fixed deposit. Money is stuck for a shorter period of time. Now, and they can have a secondary market. And since banks are involved with cds practically risk free. Because banks in India primarily we are talking about public sector banks and big non banks. Nobody mistrusts them. Nobody, what you call that they? They all trust nonbank. This kind of nonbanks and banks. So, they can buy cds.

According to the RBI guidelines of 1997 1980. Banks can issue cds without any upper limit, and anyone can purchase them. The minimum denomination of cd just like cp was 5 lakhs and the minimum issue size to a single investor unlike cp was only10 lakhs. Very interesting. (( )) bank cd could sell a minimum issue size to a single investor of 10 lakhs that means, 2 cps they have to buy. Whereas, in case of cp they made it initially 25 lakhs. So, when I read them I really do not understand. Why somebody like RBI such a wise institution would make rules like that. Cp company companies are not like banks, they do not have so much cash. Even the companies are doing well. And if they need cash alright, they made it initially 25 lakhs and cd banks sell source of funds RBI and other banks like call market and this much.

Minimum issue size was 10 lakhs. So, it was a multiple of 5 lakhs every cd that is the same thing. Maturity period varies between 3 months and 1 year. In case of cp, the maturity period was 91 days to 6months initially. Now, it was right from the beginning. It was 3 months and 1 year much more flexible, you can see. And if you look at data cp and cd market side by side clearly see the difference in the amount. That they are transacting through these instruments. Cp suffocate then they relax 3 4 years later. Cd right from the beginning they were much more flexible. Maturity period is from 3 months to 1 year right from the beginning. Minimum issue size 10 lakhs; that means two cds you have to buy, minimum minimum minimum upper limit.

Then around 2001 and again in 2005, 2006. About 6 years back; they reduced the maturity period. This is very interesting. To make the market competitive with call market. They reduced the maturity period to 7 days minimum maturity period. So, it can fluctuate between 7 days and 1 year. That means 1 week to 52 weeks in a year; it can vary, so much flexibility cd market.

Now, as before as I told you cd as all are sold at a discount, alright and the discount rate is market determined. Banks consider them usually a very short term time deposits. Now cds are freely transferable. But in case of cd, I do not know whether it is still there as opposed to cp they had a lock in period of 30 days. Lock in period means what? Once you buy the cd for 30 days. 1 month you cannot go to the secondary market and sell it. Alright. You cannot go to the secondary market and sell it for 1 month, it is locked in. Alright.

Now, I would talk about the type of banks that exist in India. And I have not given detail description of Indian banks they are called RRBs. They are commercial banks, but RRBs usually you and me who live and grow in an urban area do not know. Indian language for RRB is grahmin bank they are commercial banks, I will talk about them later. You will find them mostly in semi urban rural areas. RRB is the full word means regional rural banks. I will talk about banks in the last topic.

Now, RBI gave permission to all scheduled banks to sell cds. But not RRBs remember. Because RRBs were always have always been financially very weak and if they are given the right to sell cds. They may start defaulting because their funds management. Fund management is very poor. RRBs do not the reason primary reason probably is they funding agricultural activities; where there is a high rate of default or non performing assets what they call. Money is given. Money never comes back to the men. It is eaten up. Alright. Because of this also you have the farmer suicide cases. They take loan not from RRB. It will be better they take loans all often in the private money market, unorganized money market, from money lenders. And then they cannot return and then they get into trouble.

So, RRBs remember all banks were given permission. But later when you matured in this course; you realize that there is another set of commercial banks, which were created not many years ago; which are new to Indian economy. For RRBs, question may arise do RRB sell cds no. RRBs were not allowed to sell cds. Now, it is a very interesting thing 1 last, 1 or 2 points.

Once a cd is sold. Once a cd is sold by a bank; it is not like a share certificate. That bank can call it back. No, I do not need the money; return the money. I will give you a little bit of interest. It cannot happen it has a very fixed deposit type character. It matures on a particular date. You say nuisance promissory note like a bond or a fixed deposit. It has a fixed maturity period; and discount rate is market determined. It cannot change the discount rate. You cannot change sorry (( )) credit (( )) percent (( )) discount (( )) do percent (( )) do percent income. It would not happen like this very fixed interest rate. The interest rate that is mentioned on that paper or at which you buy. The discount rate remains there, even at the time of maturity. If the discount rate in a market has fallen; banks have promised that and will pay that interest.

Secondly, if they sell cds. It cannot be bought back like a share. 3 if you sell cd then suppose you buy I buy I am a bank. I buy your cd your bank's cd. Your bank has borrowed the state bank which state bank often does I buy bank offered the cd. Now, I cannot show that cd as an asset and lend against it. That bank has cd available. Cd cannot be used as collateral. Cds cannot be used as collaterals. Collateral learns this language. The term collateral means something which is valuable tangible asset which you keep at a bank; when you take a loan.

Suppose, I have a house and I need a loan I my house to the bank that is what collateral to the bank. Somebody borrowing money from a bank. Somebody will have to show collateral to the bank security, essentially. So, that in case I default the bank might take that contract than civil asset sell it at whatever price they can recover as much money as possible from towards that loan; that they gave to you. So, if I suppose today I want to go to the bank and ask for my for a loan for a flat. They might mortgage my flat till my I bought a flat and I start living in it. But the flat may still not be mine. That is still in the hands of the in the possession of the bank.

Once, I have repaid the entire amount alright the loan is over. Then I take possession of that property. Similarly, I am going to there are advertisements of TV, I have seen. I can take my gold, jewellery and other valuables properties and show them as collateral to the bank; when I want some money. This is an often able. Companies also do that. Now, you cannot use cd as collateral. Cd is a very valuable assets money market asset. But cds cannot be used as collaterals. Although; it has a fixed maturity and a fixed interest payment. It is very risk free. Even if it is risk free. RBI does not want that to be used as a security against which somebody can borrow or lend or whatever alright.

Last point. Since, the banks are there saying buying and selling cds often, Buying and selling both they are doing. Because state bank of India for instance always has surplus cash. And when bank of Baroda or Canada wants to sell cd of another bank like state banks; that purchases them, so now if you have cd money with you. A bank of Baroda she has sold she I made her bank of Baroda today; tomorrow I will make her some other bank. So, if she sells cds and she has cash. RBI says this is just like fixed deposit. Show the CRR and SLR on that. RBI does not exempt that money from CRR SLR like. When banks accept your money she or the bank will have to show the CRR and SLR to RBI; can take. They keep CRR with RBI and show SLR. I will talk about that later.

In case, of cd if she sells cd and collects the money short term funds. She will still have to show the CRR and SLR to RBI. But in case of cp, the private companies, corporate sectors selling cp there is no concept of CRR or SLR there. When they sell shares and take money there is no concept of CRR or SLR; which they have to show or keep with the company board or security and exchange board of India or something. Capital market (( )) in case of cd for banks primarily involved they have to show. So, what happens if a nonbank sells cd or cd? Banks do not only sell cd. If nonbanks sell cd. I think this is a universal rule. Non banks suddenly will have to show CRR and SLR.

So, cds universally in India. Whoever sells them and borrows money in the money market will have to meet that obligation of CRR and SLR alright. Have you understood the cd market alright? Now, when I looked into the data who are the institutions buying cds. I found a general institution like mutual funds. Mutual funds can also be a business of a commercial bank. You know that? Commercial banks can open a subsidiary which does business in mutual funds that is not bank increment, which is the mutual fund. Commercial banks have diversified. You understand diversification. I just do not produce cars only. I produce I produce motorcycles also today diversification. So, commercial banks these days have diversified a lot. So, although their main activity is commercial banking activity. But they have also diversified into mutual funds, as I have seen from 1980s or 90s.

So, the main investors in in cd market, because it is so risk less market. Big banks are involved. Nonbanks are involved. What I have seen. The main buyers of cds are investors in cd are mutual fund companies mutual fund companies. There are lots of mutual fund companies. One advertisement often I see on TV these days is milla sang

Mutual Fund Company, milla sang mutual fund company. You will see that on TV often. Earlier it used to be SBI magnum can era cans then UTI the public sector mutual fund company. UTI is a government company alright. The main investors here are mutual fund companies; who also have a lot of cash to deal with which they want to invest.

So, more or less this is the cd thing which is very similar to cp. But there are important differences between the cp and the cd market. Now, now I come to the one of the most complex markets. Initially it was it has become simpler now the treasury builds market. But it is 242 treasury build market will require an entire lecture to be delivered, this is the government build market. So, I need to go through that very carefully.