



# **Module-D Unit- 4**

## **JAIIB PAPER-1**

**Indian Economy and Indian  
Financial System (IE & IFS)**



## JAIIB Paper 1 IE & IFS Module D Unit 4 Fixed Income Markets Debt and Bond Markets

### Introduction

- A country's financial development hinges around the existence of deep and liquid government securities market.
- Besides providing flexibility to the public debt manager to manage borrowing obligations and the maturity profile of public debt, while minimising rollover risks, this market also determines risk-free interest rates, leading to price discovery in other segments of the market spectrum, such as markets for money market instruments and corporate bonds.

### Government Securities

- The Government securities market consists of securities issued by **the State and the Central governments**. Government securities include Central Government securities, Treasury bills and State Development Loans.
- They are issued in order to finance the fiscal deficit and managing the temporary cash mismatches of the Government. All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations.

### Bond Valuation And Theorems

Three important parameters for any bond are its face value, maturity and coupon (interest) rate.

- The price of a bond also depends up on the prevailing market interest rate (yield). To determine the fair price of a bond, we have to understand that the market interest rate for the term to maturity (or the residual term to maturity) of a bond keeps changing in the real world.
- Although the coupon of a bond (interest payable by the bond issuer to the bond holder) is never changed, as the market interest rate changes, adjustments will have to be made in the price of bonds, in order to reflect the ongoing market interest rate.

There are four important bond theorems, based on the interplay of its price and the market interest rate. Without going deep into the details of the theorems, which may be outside the scope of this courseware, ***the theorems can be stated as follows:***

- **Theorem 1:** The price of a bond is inversely related to the change in interest rate.
- **Theorem 2:** The increase in the price of a bond when the interest rate goes down by a certain percentage, is greater than the decrease in its price when the interest rate goes up by the same percentage.

- **Theorem 3:** Longer the term to maturity of a bond, higher will be its price sensitivity.
- **Theorem 4:** Between two bonds of same maturity but different coupons, the bond with the lower coupon will experience more price sensitivity than the one with higher coupon.

### **Auction Of Government Securities**

- As stated earlier, Government securities are issued through auctions (Multiple Price Auctions or Uniform Price Auctions), **which are conducted by the RBI.**
- Investment in the Government Securities may be made by any person resident in India, including firms, companies, corporate bodies, institutions, State Governments, Provident Funds and Trusts, Non-Resident Indians, Overseas Citizens of India **Foreign Portfolio Investors (FPIs) registered with the Securities and Exchange Board of India (SEBI) and approved by Reserve Bank of India (RBI) and other person not resident in India**, as specified by the RBI with the prior approval of the Government of India, in this regard.
- Foreign Central Banks (FCBs) will also be eligible to invest in the Government securities subject to the terms and conditions stipulated by the RBI, in consultation with the Government of India, in the Scheme for Rupee Investments by FCBs. Investment by a person resident outside India or a Company which is incorporated outside India or any branch of such Company shall be subject to the provisions of the Foreign Exchange Management Act, 1999 (FEMA) and Regulations framed there under, in addition to the other provisions of law applicable to Government Securities.

**Note:** Government Securities will be issued for a **minimum amount of Rs. 10,000 (Face Value) and in multiples of Rs.10,000 thereafter.**

### **Primary Dealers**

- One of the very important players in the Government securities market are the Primary Dealers (PDs). Primary dealers are entities, registered with RBI, who have the license to purchase and sell government securities.
- They are entities who buy government securities directly from RBI, aiming to resell them to other buyers. In this way, the Primary Dealers create a market for government securities. The Primary Dealers system in the government securities market was **introduced by the RBI in 1995.**
- The PDs, thus serve to promote transactions in government securities market. A facilitating arrangement is essential for selling of government securities as government is the single largest borrower in the market, which borrows through the issue of its securities, i.e., treasury bills and bonds.
- RBI guidelines stipulate that PDs should have a minimum turnover ratio, bidding ratio, underwriting ratio, secondary market participation, etc., in order to ensure that they are active in supporting the trade in government securities.

## Eligibility Conditions for Primary Dealers

- Subsidiary of scheduled commercial bank/s and All India Financial Institutions
- Subsidiaries/ joint ventures set up in India by entities incorporated abroad.
- Company incorporated under the Companies Act, 1956 and does not fall under (a) or (b). The applicant for PD should register as an NBFC for at least one year prior to the submission of its application for PD. The decision to authorise PDs is taken by RBI, based on its perception of market needs, suitability of the applicant and the likely value addition to the system.

## Role and Functions of Primary Dealers

*The role of Primary Dealers is to:*

- Commit participation as principals in Government of India issues through bidding in auctions,
- Provide underwriting services,
- Offer firm buy – sell/bid-ask quotes for T-Bills & dated securities, and
- Development of Secondary Debt Market

## Fixed Income Money Market and Derivatives Association Of India (FIMMDA)

**FIMMDA is the Self-Regulatory Organisation (SRO), associated with the fixed income and derivative markets in India.** It is an association of Commercial Banks, Financial Institutions and Primary Dealers and is a voluntary self-regulating institution for the bond, money and derivatives markets.

*The role of FIMMDA is as follows:*

- To function as the principal interface with the regulators on various issues that impact the functioning of these markets.
- To undertake developmental activities, such as, introduction of benchmark rates and new derivatives instruments, etc.
- To provide training and development support to dealers and support personnel at member institutions.
- To adopt and develop international standard practices and a code of conduct in the above fields of activity.
- To devise standardised best market practices.
- To function as an arbitrator for disputes, if any, between member institutions.
- To develop standardised sets of documentation.
- To assume any other relevant role facilitating smooth and orderly functioning of the said markets.

## RBI Retail Direct Scheme (RDS)

In order to deepen the government securities market and enable retail individual investors to participate in the process of nation building by giving them access to the G-

Sec market, RBI launched its Retail Direct Scheme (RDS) on 12th November, 2021. **The salient features of RDS are as under:**

### Securities Eligible

**RDS would enable retail investors to buy and sell the following types of Government securities:**

- Government of India Treasury Bills;
- Government of India dated securities;
- Sovereign Gold Bonds (SGB);
- State Development Loans (SDLs).

### Scope of the Scheme

'RBI Retail Direct' is a comprehensive scheme, which provides the following facilities to retail investors in **government securities market through an online portal:**

- Open and maintain a 'Retail Direct Gilt Account' (RDG Account)
- Access to primary issuance of Government securities
- Access to NDS-OM

### Eligibility of Investors

Retail investors, as defined under the scheme, can register under the Scheme and maintain a RDG Account, **if they have the following:**

- Rupee savings bank account maintained in India;
- Permanent Account Number (PAN) issued by the Income Tax Department;
- Any OVD for KYC purpose;
- Valid email ID; and
- Registered mobile number.

Non-Resident retail investors eligible to invest in **Government Securities under Foreign Exchange Management Act, 1999, are eligible under the scheme.**

The RDG account can be opened singly or jointly with another retail investor who meets the eligibility criteria.

### **Corporate Bond Market**

- The Corporate Debt Market in India is at a relatively early stage, in terms of an efficient price discovery mechanism as well as market participation.
- Primary corporate debt market is dominated by finance companies and relatively a small amount of funds is raised by manufacturing and other service industries through this market. Indian firms are still seeking bank finance as the path to fulfill the funding requirements.
- An efficient bond market would help corporates reduce their financing costs and allow them to structure their asset-liability profiles better. A well-developed corporate bond market is also necessary for long-term financing of corporates.

**Objectives of development of a robust corporate bond market are as follows:**

- To diffuse stress on banks, by diversifying credit risk across the various investors.
- To supply long-term investment products, for long-term investors.
- To reduce funding cost for corporate and others, by eliminating agency and disintermediation cost.
- To ensure that capital is allocated more efficiently among various enterprises.

### **Inter-Corporate Deposits**

- An Inter-Corporate Deposit (ICD), is an unsecured borrowing by corporates and FIs from other corporate entities, registered **under the Companies Act, 1956 or the Companies Act, 2013.**
- The corporate having surplus funds would lend to another corporate, in need of funds. This lending would be on uncollateralised basis and hence, a higher rate of interest would be demanded by the lender.
- The short-term credit rating of the corporate would determine the rate at which, the corporate would be able to borrow funds. Further, the credit spreads demanded even for the top-rated corporates would be higher than similar rated banks and the rates on ICDs would be higher than those in the Certificate of Deposit (CD) market.
- The tenor of ICD may range from one day to one year, but the **most common tenor of borrowing is for 90 days.** Primary Dealers are only permitted to borrow in the ICD market. The borrowing **under ICD is restricted to 150% of the Net Owned Funds and the minimum tenor of borrowing is for 7 days.**

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