CAIIB PAPER-2

Module-C Unit-2

Bank Financial Management(BFM)

CAIIB Paper 2 (BFM) Module C Unit 2: Treasury Products

Products of Foreign Exchange Market

- **Foreign exchange (forex) market is the most liquid market as free currencies (major currencies which are fully convertible, e.g. USD, EUR, GBP, JPY, CHF, etc.)** can be readily bought and sold here.
- Free currencies belong to those countries, whose markets are highly developed and where exchange controls are practically dispensed with. Currencies which are not fully convertible, have limited demand and may not be traded actively, but they may also enjoy high liquidity, depending on the size and stage of development of domestic market.
- For instance, Indian Rupee (INR) is only partially convertible, but the market for USD/INR is fairly liquid, owing to large domestic market and high growth rate of the economy.

Spot Trades

- **Currencies are mostly bought and sold in spot trades. The spot refers to settlement - payment and receipt of funds in respective currencies. Spot settlement takes place two working days from the trade date i.e. on the third day.** Currency may also be bought and sold, with settlement on the same day, i.e. today (TOD/Cash, ac, on the next day, i.e. tomorrow (TOM).
- All the exchange rates quoted on the screen, or in print, are for spot trade by default, unless otherwise mentioned. The TOD and TOM rates are generally quoted at a discount to the spot rate, ie. the rate is less favourable to the buyer of the currency.

Forward Rates

- **While spot trade refers to current transaction, forwards refer to purchase or sale of a currency on a future date. The** exchange rates for forward sale or forward purchase are quoted today; hence such transactions are referred to as forward contracts between the buyer and seller.
- Treasury may enter into forward contracts with customers (merchant business) or with banks (inter-bank market) as counterparties. Customers, i.e. importers,

exporters and others who expect payments or receipts in foreign currency, cover their currency risk by entering into forward contracts with their respective banks.

Swaps

- **The spot and forward transactions are the primary products in foreign exchange market. A combination of spot and forward transactions, or a combination of two forward transactions is called a swap**.
- A swap transaction is also described as an exchange of cash flows. Buying USD (with Rupees) in the spot market and selling the same amount of USD in the forward market, or vice versa, constitutes a USD/INR swap. Similarly, simultaneous purchase and sale of currency on two forward dates (forward to forward) is also a swap.

Investment of Foreign Exchange Surpluses

- **Inter-bank Loans:** Normally not exceeding one-year term, but mostly in over-night deposits with domestic and global banks, subject to pre-approved credit lines to the respective banks.
- **Short-term Investments:** Banks are permitted to invest overseas in short-term instruments of high credit quality, such as Treasury Bills/Gilts issued by foreign governments, commercial paper and other debt instruments issued by multilateral institutions and companies with AAA credit rating, subject to appropriate policy for the investments, approved at board level.
- **Nostro Accounts:** Where floating funds of the bank are parked, pending utilization/customer drawals. Nostro accounts are current accounts denominated in foreign currency, maintained by the banks with their correspondent banks in the home country of the currency (e.g. Japan for Yen, UK for Sterling, USA for Dollars etc.). Balances held in the Nostro accounts do not earn any interest.

Money Market Products

Money Markets refer to raising and deploying short-term resources, with maturity of funds generally not exceeding one year.

The inter-bank market is sub-divided into call money, notice money and term money market.

- **Call Money:** Refers to overnight placements, i.e. funds borrowed by banks need to be repaid on the next working day. Call money rates indicate liquidity available in the inter-bank market. Overnight Mumbai Interbank Offered Rate (O/N MIBOR) is the indicative rate for call money, fixed daily in the morning, used widely as a benchmark rate for overnight interest rate swaps.
- **Notice Money:** Under call money market, funds are transacted on an overnight basis, whereas under notice money market, funds are transacted for a period between 2 days and 14 days.

The prudential limits in respect of both outstanding borrowing and lending transactions in call/notice money market for scheduled commercial banks and co-operative banks and primary dealers (PDs) are as follows:

S.No.	Participant	Borrowing	Lending
1.	Scheduled Commercial Banks	On a daily average basis in a reporting fortnight, borrowing outstanding should not exceed 100% of capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125% of their capital funds on any day, during a fortnight.	On a daily average basis in a reporting fortnight, lending outstanding should not exceed 25% of their capital funds. However, banks are allowed to lend a maximum of 50% of their capital funds on any day, during a fortnight.

2.	Co-operative Banks	Outstanding borrowings of State Co-operative Banks/District Central Co-operative Banks/Urban Co-operative Banks in call/notice money market, on a daily basis should not exceed 2.0% of their aggregate deposits as at end March of the previous financial year.	No Limit
3.	PDs	PDs are allowed to borrow, on daily average basis in a reporting fortnight, up to 225 per cent of their net owned funds (NOF) as at end-March of the previous financial year.	PDs are allowed to lend in call/ notice money market, on daily average basis in a reporting fortnight, up to 25 per cent of their NOF.

- **Term Money:** Market is for placement of funds with banks for periods in excess of 14 days, but not exceeding 1 year. Typically term money placements range from 1 month to 6 months, and placements for longer periods are not very common.
- **Treasury Bills :** These are issued by Government of India through Reserve Bank for maturities of 91-days, 182 days and 364-days, for pre-determined amounts. The interest is by way of discount, so the bills are priced below Rs. 100.
- **Cash Management Bills (CMBs):** The Government of India, in consultation with the RBI, had decided to issue a new short-term instrument, known as Cash Management Bills , to meet the temporary cash flow mismatches of the Government. CMBs in India are non-standard, discounted instruments issued for maturities less than 91 days. CMBS have the generic character of Treasury Bills.

CMBs have the following features:

- The tenure, notified amount and date of issue of the proposed Cash Management Bills depends upon the temporary cash requirement of the Government. However, the tenure of the proposed Bills is less than 91 days.
- The Bills are issued at discount to the face value through auctions as in the case of the Treasury Bills.
- The announcement of the auction of the Bills is be made by the Reserve Bank of India through separate Press Release issued one day prior to date of auction
- The settlement of the auction is on T+1 basis.
- The Non-Competitive Bidding Scheme for Treasury Bills is not extended to CMBs.
- The Bills are tradable and qualify for ready forward facility (Repo, MSF and Reverse Repo facility). Investment in the proposed Bills is reckoned as an eligible investment in Government Securities by banks for SLR purpose. (Source: STCI Website)

Commercial Paper (CP)

This is a short-term debt market paper issued by corporates, with a minimum maturity of 7 days and maximum maturity of 1 year. Corporates, primary dealers and financial institutions are eligible to issue commercial paper. The issue of CP is governed by guidelines issued by RBI and market practices prescribed FIMMDA.

- **Buyback of CP:** Issuers can buyback the CP, issued by them to the investors, before maturity. Buyback of CP shall be through the secondary market and at prevailing market price. The CP should not be bought back before a minimum period of 7 days the date of issue.
- **Certificates of Deposit (CD):** This is a debt instrument similar to commercial paper, but is issued by banks or other eligible financial institution (FT) against deposit of funds. Unlike a deposit receipt, CD is a negotiable instrument and generally bears interest rates higher than regular deposits of the bank. It is also more expensive to the bank, as the CD attracts stamp duty, and is generally rated by an approved credit rating agency.
- **Repo:** Repo, in fact, is a securities transaction, but is used for lending and borrowing money market funds, for terms extending from 1 day to 1 year. Repo refers to sale of securities with a commitment to repurchase the same securities

at a later date. RBI permits repo transactions in government securities and Corporate Debt Securities. The bank in need of funds, and having surplus securities (in excess of its SLR requirement), can enter into a repo transaction with a counterparty who could be another bank, primary dealer, or financial institution. Mutual funds and corporates are also now permitted to take part in the Repo market. The bank sells the securities to the counterparty, with an agreement to repurchase the same securities, say after 3 months, at a predetermined price.

- **Collateralised Borrowing and Lending obligation (CBLO):** CBLO is a money market instrument launched by Clearing Corporation of India Ltd. (CCIL). CBLO is essentially a Repo instrument, which is used not only by banks and primary dealers, but also by all the players like financial institutions, insurance companies, mutual funds and corporates who cannot access call money market. A borrower can deposit government securities with CCIL and borrow against such securities (sell securities) from others who have surplus liquidity, subject to repayment (repurchase of securities) after a fixed term ranging from 1 day to 1 year - the underlying securities are represented by the CBLO, which is effectively the Repo instrument. CCIL acts as an intermediary for the Repo trade, so that the lenders and borrowers do not have counterparty risk.
- **Bill Rediscounting:** It provides another avenue for investment of money market funds. Treasury will discount bills of exchange of short-term nature (3 to 6 months) which are already discounted by other banks. The rediscounting is done at around money market rate and usually negotiated between the lending (rediscounting) bank and the borrowing (original discounting) bank.

Domestic and Global Markets

- **FII Investments:** Foreign investments flow in to India by way of foreign direct investment (long term project related investments), and portfolio investments (investment in stock market and debt market for short term gains). Foreign institutional investors who include investment banks and hedge funds invest mainly in portfolio investments. Private equity funds, corporate investors and other institutional investors with a long term view prefer direct investments in new projects/potentially profitable Indian companies

- .**ADR GDR Issues by Indian Companies:** Indian companies mobilize foreign currency resources by issue of equity in global markets. The holders of ADR/GDR (foreign investors) have an option to sell their holdings in domestic markets, and receive proceeds in foreign currency.
- **External Commercial Borrowings (ECB):** Indian companies can borrow in global markets, from banks (syndicated loans) or issue debt paper (floating rate notes, bonds etc.) within the guidelines issued by RBI, to fund their domestic/overseas projects.
- **Foreign Currency Funds of Banks:** Banks can use their FCNR deposit funds for investment in overseas markets as well as for domestic lending in foreign currency. They are also permitted to borrow/invest in overseas markets within a ceiling (presently 100% of Unimpaired Tier-1 capital, minimum USD 10 million), subject to guidelines issued by RBI. Banks generally use this facility to extend short term loans (usually with 6-month rollover).
- **Special Facilities to Exporters:** Exporters are permitted to hold export earnings in foreign currency accounts, designated as EEFC accounts. Banks are allowed to extend pre-shipment and post-shipment finance to exporters in foreign currency (PCFC and PSFC, respectively) in four major currencies. Banks can borrow foreign currency for the specific purpose of financing export credit (including discount of export bills).
- **Overseas Direct Investment (ODI):** RBI allows corporates to invest in joint ventures/subsidiary units overseas, from their Rupee resources subject to a cap based on their net worth (currently 4 times their net worth). This has allowed leading Indian business groups to expand globally by establishing companies near their markets or by acquiring other companies.
- **Free remittance Facility:** Individuals are now permitted to remit overseas freely, without RBI approval, up to USD 2,50,000 in a financial year under RBI's Liberalized Remittance Faclility/Remittance, for any purpose (with a few exceptions like gambling and margin trading). They may choose to invest the funds in global debt, equity or simply spend the money for consumption purposes.

Securities Market Products

Investment Business is an important part of integrated treasury and is composed of buying and selling products available in Securities Market. Investment being a subject in itself, we would outline briefly the investment products available to bank treasuries and the subject is to be studied in detail by those who would like to specialise in investment business.

- Government Securities Government Securities are issued by Public Debt Office of Reserve Bank of India on behalf of Government of India. State governments also issue State Development Loans (in the form of Bonds) through RBI.
- Government Securities are sold through auctions conducted by RBI. The interest is paid on the face value of the bonds, generally ₹100 (expressed as percentage; minimum value of bonds is Rs. 10,000) at coupon rate, but the price of the bonds is determined in the auction conducted by RBI.
- RBI arrives at a cut-off price based on the bids submitted by subscribers, including banks and primary dealers (constituting demand for the bonds) and the price may be higher or lower than the face value of Rs. 100. Government securities are actively traded in secondary market; hence the price and yield of the bonds would be constantly changing depending on the demand for bonds (which in turn depends on the liquidity available in the system).

Corporate Debt Paper

- Corporate debt paper refers to medium and long-term bonds and debentures issued by corporates and financial institutions, which are tradable. They are also referred to as non-SLR securities, to distinguish the corporate debt from government securities and other approved securities, which are eligible for meeting SLR requirement of banks. Tier-2 capital bonds issued by banks also fall under this category.
- Treasuries find corporate debt paper as an attractive investment, as yields on bonds and debentures are higher than the yield on government securities. Now that most of the corporate debt paper is issued in demat form, there is fairly active secondary market and the bonds issued by top corporates are highly liquid. (Banks are allowed to invest only in demat securities.)

Yields on corporate debt differs from instrument to instrument, depending on the credit quality, that is, higher the credit risk, higher is the yield. Most of the debt issues have credit rating by the credit rating agencies registered with SEBI. **These are:**

- The Credit Rating Information Services of India Limited (CRISIL)
- ICRA Limited
- Credit Analysis & Research Limited (CARE)
- Fitch Ratings India Private Limited
- Acuite Ratings & Research Limited
- Infomerics Valuation and Rating Private Limited (IVRPL) Global ratings are necessary if the debt paper is being issued

Debentures and Bonds

These are debt instruments, issued by corporate bodies, literally with a charge on specific assets. The literal meaning has been lost in practice and debentures and bonds may be issued with or without security. In practice, Company Law requires that debentures issued by companies are always secured (otherwise they will be subject to regulations pertaining to public deposits); hence debentures are generally secured by mortgage or with a floating charge or a lien on assets – although the latter security is more of a technical nature to give comfort to the investors.

Bonds may be issued with differing structures in order to enhance the marketability of the instruments as also to reduce the cost of issue.

The variations include:

- Structured obligations, with put/call or convertibility options,
- Zero coupon bonds - discounted securities issued at a price much lower than the face value,
- Floating rate bonds - coupon is linked to a benchmark which is reset periodically during the tenor of the security,
- Deep discount bonds – bonds sold at a discounted value where interest is paid only on maturity and not during the lock-in period.
- Instruments with step up coupons.
- Period bonds - sometimes issued with redemption in instalments over a period and sometimes with a premium on redemption in addition to coupon rate of interest.
- Collateralised obligations - bonds which are not secured by mortgages, but secured by stocks or other collateral
- Bonds with put call option and step up coupons, with the incentive of higher interest for nonredemption of the bonds in early stages.

Convertible Bonds

These are a mix of debt and equity, where the bond-holders are given an option to convert the debt into equity on a fixed date, or during a fixed period, and the conversion price is predetermined or worked out as per prevailing SEBI guidelines. If the issuer company's stock price is higher than the prefixed conversion price, the investors would prefer to convert the debt into equity. The benefit to the company is that there is no debt repayment and at the same time its equity base is strengthened. The coupon on convertible bond is generally lower than the coupon on non-convertible bond of similar credit standing. In case the bond is converted in to equity, the equity holdings of the existing shareholders get diluted.

- Equities Banks are permitted to invest in equities (shares of listed companies) subject to a limit on capital market exposure, set by RBI. Share capital of a company limited by shares can be of two kinds only, viz., equity share capital and preference share capital.

Equity share capital can be:

- With voting rights; or
- With differential rights as to dividend, voting or otherwise

Preference share capital is that capital which enjoys preferential right with respect to the dividend payment at a fixed rate and return of the capital on winding up of the company. **These can be further classified as:**

- **Cumulative or non-cumulative** - rights to claim dividend does not lapse when there is no profit or inadequate profit and is carried forward to the next year is cumulative preference shares while rights to claim dividend lapses in case of non-cumulative shares
- **Redeemable or irredeemable** - which can be redeemed, subject to fulfilment of certain conditions laid down in Section 55 of the Companies Act, 2013. Section 55(i) of the Companies Act 2013 prohibits the issue of any preference share that is irredeemable.
- **Participating or non-participating** - which have a right to participate in the surplus remaining after payment of equity capital in case of winding up of the company.
- **Convertible or non-convertible** - which would be convertible into or exchanged with equity shares at a later date, with or without the option of the preference shareholders


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