Glossary of commonly used terminologies in the Debt / Bond Markets

Accrued interest

This is the interest that has been earned by an investor but not become due for payment to the investor. Bond buyers pay bond sellers accrued interest whenever a bond is purchased. Thus, if a bond were sold between its semiannual interest payment dates, the purchaser would pay the market price of the bond plus the appropriate fraction of the accrued coupon interest earned but not yet received by the party selling the bond.

Annuity

An equal amount paid every year in lieu of a lumpsum payment for a certain fixed period or for life. Some investment schemes offered by banks, Life Insurance Corporation, Unit Trust offer annuity payments.

Auction

Auction is a process of calling of bids with an objective of arriving at the market price. It is basically a price discovery mechanism. There are several variants of auction. Auction can be price based or yield based. In securities market we come across below mentioned auction methods.

(a) French Auction System: After receiving bids at various levels of yield expectations, a particular yield level is decided as the coupon rate. Auction participants who bid at yield levels lower than the yield determined as cut-off get full allotment at a premium. The premium amount is equivalent to price-equated differential of the bid yield and the cut-off yield. Applications of bidders who bid at levels higher than the cut-off levels are out-right rejected. This is primarily a Yield based auction.

(b) Dutch Auction Price : This is identical to the French auction system as defined above. The only difference being that the concept of premium does not exist. This means that all successful bidders get a cut-off price of Rs. 100.00 and do not need to pay any premium irrespective of the yield level bid for.

(c) Private Placement: After having discovered the coupon through the auction mechanism, if on account of some circumstances the Government / Reserve Bank of India decides to further issue the same security to expand the outstanding quantum, the government usually privately places the security with Reserve Bank of India. The Reserve Bank of India in turn may sell these securities at a later date through their open market window albeit at a different yield.

(d) On-tap issue: Under this scheme of arrangements after the initial primary placement of a security, the issue remains open to yet further subscriptions. The period for which the issue remains open may be sometimes time specific or volume specific

Banking Credit

Banks in India predominantly provide short term credit for financing working capital needs, although, some of the larger banks are aggressively providing term loans. The various types of advances provided by banks are cash credits, overdrafts, demand loans, purchase and discount of commercial bills and installment or hire purchase credit.

Bill of Exchange (BOE)

A bill of exchange is an instrument in writing, containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Bridge Loan

Bridge Loans are given at the time when the entities come out (or want to come out) with a public offer in the capital market, but need financing for
a) covering the cost of issues and for
b) using the loan proceeds as a bridge for the funds that are obtained only after the public issue gets completed.

Cash Reserve Ratio (CRR)

CRR is the statutory reserve that has to be maintained by banks either in cash or as balance with the Reserve Bank of India. CRR is intended to be a reserve by which the RBI assures itself that the bank is safe and has the liquidity for servicing its depositors. As per Section 42 of the RBI Act, RBI is allowed to announce any level of CRR depending on the market conditions within a certain band, the minimum being 3% and the maximum 15% of Net Demand & Time Liabilities (NDTL). The RBI may choose to hike the CRR to curb the liquidity of the commercial banks thereby curtailing money circulation in the market which results in lowering of inflation.

Constituent Account

Scheduled commercial banks and Financial Institutions are allowed to directly participate in the SGL account being maintained by RBI. All other entities may indirectly participate in the securities market by opening a constituent account with any of the direct SGL participants.

Coupon

Bonds typically pay interest periodically at the prespecified rate of interest. The annual rate at which the interest is paid is known as the coupon rate or simply the coupon. Interest is usually paid every half-year though some bonds pay interest monthly, quarterly, annually or at some other frequency. The dates on which the interest payments are made are known as the coupon due dates.

Credit Deposit Ratio (CDR)

It represents the ratio of Total Credit disbursed to Total Deposits garnered by a bank. Total Credit includes Loans, Overdrafts, Cash Credits and Bills purchased and Discounted. Total Deposits include the Time and Demand deposits..

Current Yield

This is the yield or return derived by the investor on purchase of the instrument (yield related to purchase price) It is calculated by dividing the coupon rate by the purchase price of the debenture. For e. g: If an investor buys a 10% Rs 100 debenture of ABC company at Rs 90, his current Yield on

the instrument would be computed as:
Current Yield = (10%*100)/90 X 100, That is 11.11% p.a.

Demand Loan

Demand loans have to be repaid when demanded by the creditor and as such they are short-term loans. The demand loan comprises of minimum level of borrowing which the borrower is expected to use throughout the year.

Discounted cash flow

Cash Flows occur over a period of time. But even under complete absence of inflation or risk, money still has time value. Rs 100/- receivable today, after one year or after 10 years are not same in value. To make an absolute comparison, these cash flows in different periods have to be expressed in terms of today's value or present value. Cash Flows that are discounted by suitable rate of return are known as discounted cash flows.

Forward Transactions

A forward transaction is an order to buy or sell a security at a future period at a specific price. Forward transactions are not exchange traded or standardized. There is no margin paid over between the counterparties, only a settlement on the agreed date.

Frequency of interest payment

Debt instruments has interest payments at regular intervals. The interest payments are either at monthly, quarterly, half-yearly or yearly rests. This frequency of interest payments is specified at the time of issue of the debt instrument.

Interest on 360 day a year basis

For all government loans and state loans, the interest is calculated on the basis of 360 days a year. In this method, each month is regarded of 30 days irrespective of actual number of days in that month. E.g.: Consider a security 11.5% GOI 2006,INTEREST DATES:

Interest on calendar year basis

The interest is calculated on the basis of 365 days a year basis. The interest on most of the debt securities excluding the government loans and the state loans are calculated on the basis of 365 days a year basis. Actual number of days that have expired since last interest payment date are counted for accrued interest payment.

Internal Rate of Return (IRR)

The IRR is that discount rate at which the NPV of a cash stream becomes zero. Here, the net present value is given (as zero) and the discount rate is calculated. If the IRR is greater than the required rate of return (discount rate), then the security/project is worth investing in, otherwise not.

Issued at Discount

An instrument that is initially issued at a price lower than its face value is know to be issued at a discount. For example, a bond having face value of Rs.100 and issued at Rs.95 is said to have been issued at a discount.

London Interbank Offered Rate (LIBOR)

LIBOR is the benchmark or the reference rate. This is calculated everyday, at a specific time, as the average of the lending rates of a group of 15 reference banks in London on short term funds lent to first class banks. Rates charged to non-bank customers on loans are stated as LIBOR plus a margin or spread.

Maturity premium

An instrument, which on maturity is redeemed at a price higher than the face value, is said to be redeemed with a premium at maturity. For example, a bond having face value of Rs.100 and redeemed at Rs. 105 at maturity is said to be redeemed at a maturity premium of Rs.5.

Mortgage

A mortgage is defined as a pledge of property (real estate) to secure payment of a debt. If the mortgagor fails to pay the lender (the mortgagee), the lender can foreclose the loan, seize the property and sell it in order to realise his dues.

Mumbai Interbank Offered Rate (MIBOR)

MIBOR is the benchmark or the indicative rate prevailing in Mumbai money markets. This is calculated everyday, at a specific time, as the average of the lending rates of a group of 18 reference banks in Mumbai on funds lent to first class borrowers.

Nationalised Banks

A Nationalised Bank is a bank whose majority ownership vests with the Government of India.

Negotiable Instruments

Section 13 of the Negotiable Instruments Act says that a negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer. The word negotiable means transferable from one person to another for consideration and instrument means a written document by which a right is created in favour of some persons. Thus, a negotiable instrument is a document which entitles a person to a sum of money and which is transferable from one person to another by mere delivery or by endorsement and delivery.

Net Demand and Time Liabilities (NDTL)

Banks have to maintain statutory reserves on their NDTL. For calculating its NDTL, a bank has to first sum up its total gross liabilities, which include all demand and term deposits. Once the gross demand and time liabilities (DTL) is determined, the bank can deduct its Interbank assets (IBA) from this DTL only to the extent of its Interbank liabilities (IBL). Usually NDTL is calculated with reference to alternate Fridays called "Reporting Fridays". The banks are required to maintain their CRR and SLR with reference to the NDTL as of the reporting Friday.

Net Present Value (NPV)

NPV of a cash stream is simply the difference between the present value of cash outflow and summation of present values of cash inflows at a given discount rate. Here, the discount rate is given and the NPV is calculated. If the NPV is positive, the security / project will be worth investing in, otherwise not. This is because a positive NPV implies that the security / project provides a return higher than the discount rate per annum.

Nidhi

A Mutual Benefit Finance company will be notified as a Nidhi company under Section 620A of the Companies Act, 1956 by the Government of India based on the performance of the company. To become a nidhi, benefit funds need to have 2000 members and a paid-up capital of Rs.25 lakhs. Once the benefit funds comply with these, Department of Company Affairs declares such companies as Nidhis.

Non Banking Finance Company (NBFC)

There are different categories of NBFC's operating under the statutory eye of RBI.They are:
a) Loan and Investment Companies
b) Equipment Leasing and Hire Purchase Companies
c) Miscellaneous Non-Banking Finance Companies and
d) Residuary Non-banking Finance companies.

Nostro Account

An account opened by an Indian bank with a foreign bank in their currency for the purpose of remittances and withdrawals is known as a nostro account.

Private Banks

Private Bank is a bank registered as public limited company under the Companies Act, 1956. The RBI may on merit grant a license under the Banking Regulation Act, 1949 for such a bank. HDFC Bank, ICICI Bank are the new generation private sector banks.

Promissory Note

According to the Negotiable Instruments Act, a Promissory Note is an instrument in writing (not being a bank note or a currency note) containing an unconditional promise, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument. Maker is the person who makes the promissory note and promises to pay, and the person to whom the payment is made is the payee.

Scheduled Banks

Scheduled banks are those, which are included in the Second schedule of Banking Regulation Act, 1965. To be included in the Second Schedule, a bank 1) must have paid-up capital and reserves of not less than Rs. 5 lakhs 2) must also satisfy the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors. Scheduled banks are required to maintain a certain amount of reserves with the RBI. They, in return, enjoy the facility of financial accommodation and remittance facilities at concessional rates from the RBI.

Statutory Liquidity Ratio (SLR)

SLR is the statutory reserve that is set aside by banks for investment in cash, gold or unencumbered approved securities valued at a price not exceeding the current market price. SLR should not be less than 25% and not exceeding 40% of NDTL as per Section 24 of the Banking Companies Regulation Act. The effective SLR level that a bank has to maintain keeps changing depending on the announcement by the RBI in its credit policies The objectives of SLR are 1) to restrict the expansion of bank credit 2) to augment the investment of the banks in Government securities and 3) to ensure solvency of banks.

Strip Transaction

In a strip transaction, an interest bearing bond is divided into separate principal and interest components. Both the principal and the future interest payments are separately tradeable. Thus, the bond is stripped and principal is traded separately as zero coupon bond and interest components are traded as annuities.

Subsidiary General Ledger (SGL)

An SGL account enables scrip less form of trading by routing all transactions through a ledger document. All scheduled commercial banks and financial institutions have an account with the Reserve Bank of India. So RBI acts as the depository and maintains SGL accounts of various entities wherein the transaction / holding is represented by a book entry.

Term Loan

Term Loans are defined as
a) loans sanctioned for a period exceeding one year with specific schedule of repayment,
b) interim cash credits / bridge loans pending disbursement of sanctioned term loans, and
c) installment credit where repayment is spread over more than one year

Value at risk

Simply speaking, value at risk is the forecasted amount that may be lost, on the investments and other exposures that the bank may have, if an adverse market move were to happen.

Vostro Account

A rupee account opened by a foreign bank with an Indian bank for the purpose of remittances and withdrawals is known as a vostro account.

Yield to maturity (YTM)

The yield to maturity is the annualised return from a debt security from the date it is bought in the secondary market to the date of its redemption. YTM is the return on holding the instrument to maturity. The YTM assumes that any coupon payments received before redemption can be reinvested at this yield.