CHAPTER

16 CERTIFICATES OF DEPOSITS

INTRODUCTION

The Chakravarty Committee (1985) was the first to make comprehensive recommendations for the development of the Indian money market. This was followed by the Vaghul Committee (1987) set up by the Reserve Bank to examine various aspects for widening and deepening of the money market. Following the recommendations of these two committees, several new initiatives were taken. Instrument of Certificates of Deposits (CDs) were introduced to increase the range of instruments.

CERTIFICATES OF DEPOSITS

The Certificates of Deposits (CDs) were introduced in June 1989 to widen the range of money market instruments and provide greater flexibility for deploying their short-term funds. Certificates of Deposits are basically negotiable money market instruments issued by banks and financial institutions during tight liquidity conditions, at relatively, higher discount rates as compared to term deposits.

Features of Certificate of Deposit

(i) Document of title to time deposit

(ii) Unsecured negotiable pronotes

(iii) Freely transferable by endorsement and delivery

(iv) Issued at discount to face value

(v) Repayable on a fixed date without grace days

(vi) Subject to stamp duty like the usance promissory notes.

Issuers

The issuers of certificate of deposits are commercial banks, financial institutions, etc.

Subscribers

CDs are available subscription by individuals, corporations, trusts, Associations and NRIs.

On the recommendations of the Vaghul Committee, (1987), the RBI formulated a scheme in June 1989 permitting scheduled commercial banks (excluding RRBs) to issue CDs. In terms of the scheme, CDs can be issued by SCBs at a discount on face value and the discount rates are market determined.

The Reserve Bank of India has announced the detailed scheme of Certificates of Deposits (CDs). The salient features of the scheme announced by the Governor vide his circular letter dated March 27, 1989, are given below:

Eligibility

CDs can be issued only by scheduled commercial banks excluding Regional Rural Banks (RRBs).

Aggregate Amount

CDs issued by a bank and outstanding at any point of time should not exceed one per cent of the fortnightly average aggregate deposits during the financial year 1988-89. The ceiling on the amount of CDs which can be issued are communicated to each bank separately.

Minimum Size of Issue and Denominations

Minimum amount of a CD should be ` 1 crore, *i.e.,* the minimum deposit that could be accepted from a single subscriber should not be less than ` 1 crore. The CDs above ` 1 crore will be in multiples of ` 25 lakh.

Who Can Subscribe?

CDs can be issued to individuals, corporations, companies, trusts, funds, associations, etc., Non-Resident Indians (NRIs) may also subscribe to CDs, but only on non-repatriable basis which should be clearly stated on the Certificate. Such CDs cannot be endorsed to another NRI in the secondary market.

Maturity

The maturity period of CDs should be not less than 3 months and not more than one year.

Discount

CDs should be issued at a discount on face value. The issuing bank is free to determine the discount rate. Reserve requirements

Banks have to maintain CRR and SLR on the issue price of the CDs.

Transferability CDs will be freely transferable by endorsement an delivery but only after 45 days of the date of issue.

Loans/Buy-backs

Banks cannot grant loans against CDs. Furthermore, banks cannot buyback their own CDs before maturity.

Format of CDs

CDs will be in the form of a usance promissory note and will attract stamp duty. There will be no grace period for payment of CDs. If the maturity date happens to be a holiday, the issuing bank should make payment on the immediate preceding working day. Banks may, therefore, so fix the period of deposit that the maturity date does not coincide with a holiday to avoid loss of discount.

Application Forms

Is desirable that banks prescribe an appropriate application form for issue of CDs and obtain usual introduction, etc., as in the case of other deposits.

Security Aspect

Since CDs are freely transferable by endorsement and delivery, it will be necessary for banks to see that the certificates are printed on good quality security paper and necessary precautions are taken to guard against tampering with the document. They should be signed by two or more authorized signatories.

Payment of Certificate

Since CDs are transferable, the certificate may be presented for payment by the last holder. The question of liability on account of any defect in the chain of endoresements may arise. It is, therefore, desirable that banks take necessary precautions and make payment only by a crossed cheque. Those who deal in these CDs may also be suitably cautioned.

Issue of Duplicate Certificates

Banks should not issue a duplicate in cases a CD is reported lost. In case an issuing bank is given a notice of loss of certificate, it should be noted for the purpose of exercising caution. The issuing bank may also take precautions before payment like —

(i) Waiting for a reasonable period after due date to see whether the CD is presented by any holder.

(ii) Giving public notice, and

(iii) Obtaining as appropriate indemnity/guarantee while making payment in such cases.

Accounting

Banks may account the issue price under the head "CDs issued" and show them under deposits. Accounting entries towards discount will be made as in the case of "cash certificates."

Banks should maintain a register of CDs issued with complete particulars.

Reporting

Banks should include the amount of CDs in the fortnightly return under Section 42 of the Reserve Bank of India Act and also separately indicate the amount so included by way of a footnote in the return.

Advantages of CDs

- CDs are the most convenient instruments to depositors as they enable their short-term surpluses to earn higher return.
- CDs also offer maximum liquidity as they are transferable by endorsement and delivery. The holder can resell his certificate to another.
- For the issuing bank, CD is a vehicle to raise resources at times of need and improve their lending capacity.
- CDs are fixed term deposits which cannot be withdrawn until the date of redemption.
- An ideal instrument for banks with short-term surplus funds to invest at attractive rates.

Relaxations in Guidelines

The guidelines concerning CDs have been relaxed over time. These include.

(i) Freeing of CDs from interest rate regulation in 1992,

(ii) Lowering the minimum maturity period of CDs issued by banks to 7 days (April 2005) with a view to aligning minimum tenor for CPs and CDs as recommened by Narasimham Committee (1998);

(iii) Permitting select all-India financial institutions to issue CDs for maturity period of 1 to 3 years;

(iv) Abolishing limits to CD issuance as a certain proportion of average fortnightly outstanding aggregate deposits effective October 16, 1993 with a view to enabling it as a market determined instrument.

(v) Reducing the minimum issuance size from ` 1 crore in 1989 to ` 1 lakh in June 2002;

(vi) Withdrawal of restrictions on a minimum period for transferability with a view to providing flexibility and depth to the secondary market activity;

(vii) Requiring banks and FIs to issue CDs only in dematerialised form, effective June 30, 2002, in order to impart more transparency and encourage secondary market; and

(viii) Permitting banks in October 2002 to issue floating rate CDs as a coupon bearing instrument, so as to promote flexible pricing in this instrument.

Activity in the CD Market

Trends in CDs	
Year	Outstandings ` crore
1992-93	8,266
1995-96	14,045
2001-02	949
2002-03	1,224
2003-04	4,461
2004-05	12,078
2005-06	43,568
2006-07	93,272
28-09-07	1,18,481*

* With the range of discount rate of 6.87-10.00 per cent.

The steady increase of CDs mirrors liquidity conditions. The CD issuance by banks and FIs pick up during periods of tight liquidity. The demand for CDs issued by the SCBs remained strong during 2006-07. In view of the sustained credit demand, the SCBs resorted to deposit mobilisation through CDs. The amount of outstanding CDs increased from ` 43,568 crore at end-March 2006 (4.8 per cent to aggregate deposits of issuing banks) to ` 93,272 crore (4.83 per cent of aggregate deposits of issuing banks with significant intra-group variation) by March 30, 2007. The overall weighted average discount rate (WADR) for CDs, which had risen to 8.62 per cent by end-March 2006, declined to 7.03 per cent by end-April 2006. The interest rate on CDs firmed up again beginning July with the WADR rising to 10.75 per cent by March 30, 2007. As on April 13, 2007, the WADR of CDs stood at 10.15 per cent. Some of the private sector and foreign banks are also taking increased recourse to the CD route to meet the resource gap. Institutional investors such as mutual funds are investing in these certificates to deploy short-term resources.

The steady increase in CDs has been on account of several factors such as the revised guidelines by the RBI on investments by banks in non-SLR debt securities, reduction of stamp duty on CDs effective March 1, 2004, withdrawal of tax deduction at source, disallowing premature closure of deposits under CDs vis-à-vis alternative competing instruments such as fixed deposits and greater opportunity for secondary market trading on the demand side, the Securities and Exchange Board of India (SEBI) placing a bar on mutual funds from parking funds in bank deposits coupled with improved funds position with MFs provided an impetus to the CD market. An encouraging development in the CD market is that some of the top rated banks have been setting their CDs rated for better access to the market even when such rating is not mandatory under the extant guidelines.

CONCLUSION

The narrower set of issuers in an environment of easy liquidity when banks generally do not issue CDs, reflects that it is the bank-specific factors which have been driving the growth of CDs in recent period. In this context, it has been found that select foreign and private sector banks have been raising resources through issuance of CDs on account of not only lesser number of branches but also their cost effectiveness. Even then, the steady issuance of CDs has been on account of a number of macro factors which include revised guidelines by the Reserve Bank on investments by banks in non-SLR debt securities, reduction in stamp duty on CDs effective March1, 2004, no tax deduction at source, no prepayment or premature closure as in the case of fixed deposits and greater opportunity for secondary market trading. On the demand side, the Securities and Exchange Board of India (SEBI) placing a bar on Mutual Funds (MFs) from parking funds in bank deposits coupled with improved funds position with MFs provided an impetus for the CD market. An encouraging development that ensued was that some of the top rated banks had been getting their CDs rated for better access to the market even when such rating is not mandatory under the extant guidelines.

The certificates of deposits has emerged as a useful instrument of the money market. For banks it is an additional tool of deposit mobilisations. As such, during 2006-07, CDs account for 4.83 per cent of aggregate deposits. Yet, there is a need for developing an active and liquid secondary market for CDs. The DFHI, the designated institution to trade in the CDs in the secondary market to further strengthen and deepen it, so that banks and financial institutions actively invest in CDs and also trade in the secondary market.

SELF ASSESSMENT QUESTIONS

(1) What are commercial Deposits

(2) Discuss the special features of commercial

(3) Analyses the activity in the CD market.