

01 Oct 2012**The little things**

- **Forex reserves:** \$293.97 billion as on 21 Sep
- **Brent Crude:** 112.22 USD / bbl as on Sep 28
- **Sensex:** 18762.74 as on 28 Sep
- **Gold (10 gm):** Rs.31800 (as on 28 Sep in Mumbai)
- **Exchange rate (Rupee):** Rs.52.88/USD as on 30 Sep

Some terminologies -

- **Matrix trading-** Bond swap strategy designed to profit from unusual yield curve differentials between bonds of different ratings or classes. This strategy tries to take advantage of situations in which differences in yields between different bond classes are not reflective of the differences in risk associated with those bond classes.
- **Parallel loan-** An arrangement in which two companies in different countries borrow each other's currency for a given period of time, in order to reduce foreign exchange risk for both of them. Also called back-to-back loans.

Contact Us:**Mail Us At**finstreet.simsr@gmail.com**Visit Us At**<http://finstreet.weebly.com>**Like Us At**<https://www.facebook.com/TeamFinstreet>**QE3 ROLLED OUT!!!**

This month has again witnessed a central bank of a leading economy announcing to inject money in its economy to fight economic slowdown. First, ECB announced Unlimited Bond-Buying program easing the situation in Euro zone. Now, the Federal Reserve has announced QE3 to bolster U.S. Economy. According to QE3 the Federal Reserve would buy \$40 billion every month of mortgage-backed securities and has promised to continue till U.S. job market improves considerably.

RBI CUTS CRR BY 25 BASIS POINTS

With Indian Economy, finally getting its due of reforms from the government, RBI was expected to trim down interest rates in its mid-quarter monetary policy. But, RBI stood by its script of fighting inflation and left the rates unchanged. It did respond to the government reforms by lowering the CRR (Cash Reserve Ratio) from 4.75% to 4.50%. This move will inject Rs.17, 000 crore in the Indian banking system.

SPAIN MOVES INTO AN AUSTERITY MODE

Spain government cuts its overall spending by 40 billion Euros. In its recent budget, it said that it is going to use 3.06 billion Euros from the pension plans for government reforms. This is the first time it is using the pension funds. Markets feel that this will allow them to be in a better position when its Prime Minister asks for bailout soon.

SEBI TAKES THE TASK OF REVIVING MUTUAL FUNDS

Sebi has decided to increase the penetration of MF (Mutual Fund) in smaller cities and hence energizing the distribution network while protecting the interest of the investors. Sebi announced that from now on MFs with high penetration can charge up to 30% of additional TER (Total Expense Ratio). Under this scheme, MFs have also agreed to provide separate plans for direct investors with low TER.

RIL BUYS BP's MALAYSIA PLANT FOR \$230 MN

Reliance Industries has agreed to buy BP Plc's Malaysian petrochemical plant for USD 230 million. The RIL unit will take over BP's 100 per cent equity in BP Chemicals (Malaysia) Sdn Bhd (BPCM).

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Cost Of Living Adjustment (COLA)- An adjustment made to Social Security and supplemental security income in order to adjust benefits to counteract the effects of inflation. COLAs are generally equal to the percentage increase in the consumer price index for urban wage earners and clerical workers (CPI-W) for a specific period.

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A Perspective on Banking Sector Liquidity

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We are all familiar with the term liquidity but do we actually understand the depth of the word. Ask anyone and each has his/here own interpretation. Well today based on my knowledge and research I hope to give my understanding of the same. Liquidity can be broadly interpreted as the exchange of financial assets in one form for another between various financial institutions. The liquidity in the financial markets also may take many forms - market liquidity (for asset markets), banking liquidity, and funding liquidity.

Banking system liquidity

I see that the best way to look at liquidity is from the Central bank's point of view as shortage of liquidity lies at the heart of a banking crisis. And in today's uncertain environment measuring systemic liquidity will help ascertain its effects on Banks' performance. Liquidity is a key factor that drives Indian financial markets and is used by banks and other financial institutions for trading & making investments. Banking system liquidity influences money market interest rates, and hence it is also important to understand what drives liquidity change.

Measuring liquidity

First we must understand how liquidity is measured to truly understand what it is. The first method of measurement is the Liquidity Adjustment Facility (LAF). LAF is a facility extended by the RBI to the scheduled commercial banks and primary dealers to avail of liquidity in case of requirement or park excess funds with the RBI in case of excess liquidity on an overnight basis against the collateral of Government securities including State Government securities. The operations of LAF are conducted by way of repurchase agreements (repos and reverse repos) with RBI being the counter-party to all the transactions. Some market participants generally consider the LAF number that is released by RBI on a daily basis as a measurement of Liquidity within the banking system.

However the LAF borrowing tends to be volatile and may not give a complete picture of actual liquidity requirements of the system. This is a result of the fortnightly Cash Reserve Requirement (CRR) system which mandates banks to maintain 4.50% of their total net demand and time liabilities for the whole fortnight. A higher CRR outflow leads to outflow from cash from banking system and therefore banks have to borrow more from RBI's LAF window when they deposit excess CRR.

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Perkins loan- A need-based, low-interest loan available to students rather than their parents. The amount of the loan is determined by each college and is based on the expected family contribution. The student will be held responsible for this loan, not the parent. Repayment doesn't begin until after a student graduates, falls below half-time student status, or leaves college. After graduating, a student typically has a nine-month grace period during which interest doesn't accrue. Perkins loans offer low interest rates to students and can be repaid within ten years

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Thus, the second method to measure Liquidity is to adjust the LAF borrowing for the variation in CRR maintenance, referred to as product adjustment. Banks prefer a more stable estimate of Liquidity the volatility of LAF borrowing number makes it hard to understand and predict liquidity. Thus market participants also adjust the LAF borrowing for product (CRR) to measure liquidity. Product is the actual cash balance maintained on a daily basis by banks with the Reserve bank of India.

Factors that drive liquidity

We also need to look at the factors that affect liquidity and drive changing liquidity conditions. Simply put, we analyze things from the perspective of the banking system. Any outflow of cash from banks to the Government/RBI/ the public will reduce banking system liquidity while any inflow will add to banking system liquidity. These factors include:

- **Government securities and Treasury bill Auctions:**

RBI, in consultation with the Government of India, issues an indicative half-yearly auction calendar containing information of the borrowing programme of the Government.

- **Open Market Operations (OMOs)**

RBI also conducts OMOs which are market operations involving sale/ purchase of Government securities to/ from the market with an objective to adjust the rupee liquidity conditions in the market on a durable basis.

- **Coupon and redemptions**

The coupons are the payment of Interest to holders of dated Government securities, long or short term that may have a fixed or floating coupon. The redemption proceeds are the amount paid to the holders of dated Government securities and Treasury bill at the time of maturity of these instruments.

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China Currency Bill- A potential law passed in September 2011 by the U.S. Senate that would add tariffs to countries - most notably China - found to be undervaluing their currency. The China currency bill's intent is to make imports more expensive from these countries, evening the trade deficit and decreasing the countries' unfair economic advantage. It is a controversial bill because China holds enormous economic clout, as it's one of the U.S.'s top trading partners, and also holds a lot of U.S. debt.

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- **FX intervention**

In the Forex markets, the RBI intervenes indirectly via Nationalised banks. In order to prevent rupee volatility, the RBI may sell dollars thus preventing rupee depreciation, however in the process rupee liquidity is sucked out of the system. Sales of dollars (purchase of rupees) is an outflow from banks while purchase of dollars (sale of rupees) is an inflow into banks

- **Tax outflows**

In India, advance tax payments flow out from the banking system. Advance tax outflow takes place on a quarterly basis after the 15th of September, December, March and June. Excise tax outflows also affect banking system liquidity

- **Cash Reserve Ratio (CRR) change**

CRR is that percentage of Scheduled Commercial Banks Net Demand & Time Liabilities (NDTL) maintained with the Reserve Bank of India on a fortnightly basis. The RBI of India is empowered to increase or decrease the said rate which is announced during the Monetary Policy of the Reserve Bank of India.

- **Government spending**

Government expenditure for paying salaries, wages, oil subsidies, defence payments, all social grants etc leads to inflow into the banking system from the government.

Thus each of the above factors either contribute to increasing or decreasing banking system liquidity, whether it is an Auction or an OMO buyback or a reduction in CRR or increase in advance tax payments. Finally we see how liquidity affects market rates. Banking system liquidity plays a key role in determining the overnight money market call rate. If bank liquidity is in surplus i.e. they are depositing excess funds in RBI's reverse repo window, the call rate in money market will be close to the reverse repo rate of 7%. However, if banks are in deficit i.e. they are borrowing from RBI's repo facility at 8%, the call rate will be slightly higher than the repo rate. As such, liquidity plays a key role in influencing money market lending and has implications for government bonds, corporate bonds and other term money lending.