Fixed Income Securities

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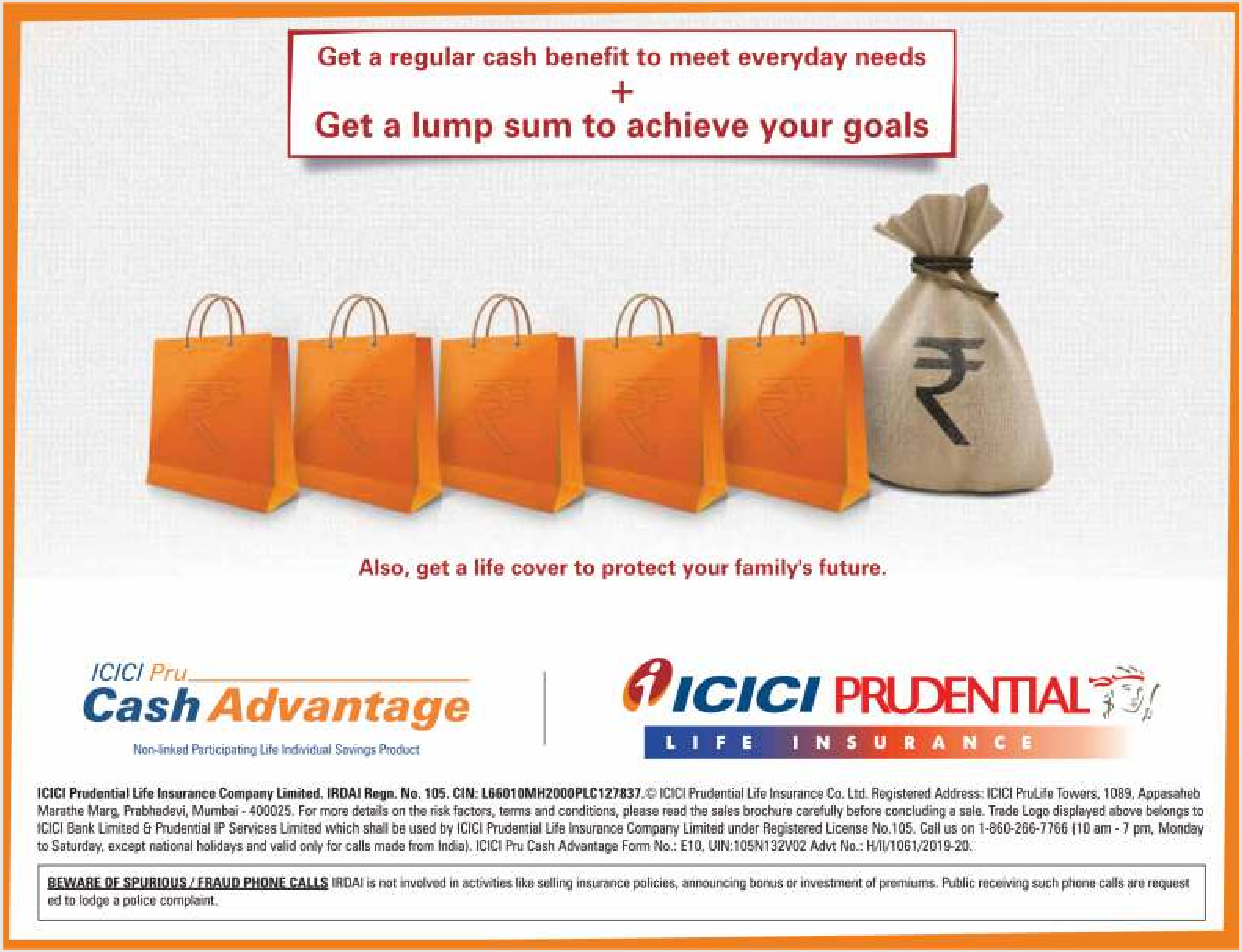
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First Edition: 2020

About this book

Every investor would prefer an investment that gives better return with minimum risk. Fixed income is an investment approach focused on preservation of capital and income. Most of Investors would go in for traditional products such as Fixed Deposits with Banks, Public Provident Fund, Post office schemes, etc. In this booklet, we have compiled information about other popular Fixed Income instruments.

We hope you would find this information useful.

Happy Reading!

Rs.40/-

Published by
Investors Financial Education Academy
Park View, Basement, 85/17, G.N.Chetty Road,
T.Nagar, Chennai - 600 017.

Fixed Income Securities

Fixed income securities refer to debt instruments that offer a fixed return on the investment. The corpus value that a person would receive post maturity of the securities is known in advance. Because of this, risk-averse investors prefer fixed

income securities over market-linked securities; these securities are apt for people who want to earn steady return as well. Also, some of the fixed income securities like government bonds, treasury bills are backed by the government which ensures minimal chances of default.

Why to invest in Fixed Income Securities?

If the financial goals involve earning steady return coupled with low risk, fixed income securities are the best investment option available in the market. Compared to investment in equities, return from these securities might be low but they are guaranteed.

For an active investor, investment in fixed income securities will diversify their portfolio and yield return even during turbulent market swings. This reduces the overall risk of the investment portfolio.

Some of the fixed income securities have tax saving options, which serves as another incentive for investing in these securities.

Types of Fixed Income Securities

Bank Fixed Deposits (FD):

Bank fixed deposits are one of the most popular investment options. A fixed deposit account essentially offers fixed interest rate on their principal investment. This fixed-income security is offered by almost every scheduled bank .

An investor makes a lump-sum principal investment that earns interest during the deposit period. At maturity, the investor gets the principal and the accrued interest.

Different banks provide Fixed Deposit accounts with different maturities. Investors can opt for FD accounts with maturity period ranging from 7 days to 10 years. Some banks offer Fixed Deposits for tax saving purposes. They come with lock-in of 5 years.

Treasury Bills :

Treasury bills or T- Bills are issued by the Central Government for raising money. They have short term maturities with highest up to one year. Currently, T- Bills are issued with 3 different maturity periods, which are, 91 days T-Bills, 182 days T- Bills and 1 year T – Bills.

T-Bills are issued at a discount to the face value. At maturity, the investor gets the face value amount. This difference between the initial value and face value is the return earned by the investor. They are the safest short term fixed income investments as they are backed by Government of India.

Recurring Deposits :

Recurring deposits are similar to SIP Investment in Mutual Funds. An individual deposits a small amount of money as a monthly installment for a fixed duration that ranges from 1 year to 10 years in a Recurring Deposit. The interest rate is the same as that of fixed deposits. This enables retail investors with small amounts of money to generate a good corpus of wealth in the long run.

Corporate bonds:

Investors who buy corporate bonds are lending money to the company issuing the bond. In return, the company makes a legal commitment to pay interest on the principal and, in most cases, to return the principal when the bond comes due, or matures. These bonds are also called as Non-convertible debentures.

Features of NCDs

a. Taxation

NCDs are taxed as per the slab rate, which means if the tax payer is in the highest tax bracket, the interest they earn will be taxed. Hence, their post-tax returns will be much lower. NCDs can work for those in the lower tax category or those with no taxable income. While investing in any instrument, always factor in your post-tax return and not just the coupon rate.

b. Credit Rating

Companies are ranked by credit rating agencies such as CRISIL, CARE etc. To determine the potential of a company, its rating plays a major role. Higher credit rating means that the company has the ability to fulfill credit obligations. However, low credit rating means that the company has high credit risks involved.

c. Interest

NCDs offer interest better than bank deposits. Interest payouts are either monthly, quarterly, half-yearly or annually. NCDs do offer cumulative payout option, as well.

Types of NCDs

Following are the two kinds of non-convertible debentures:

- **Secured NCDs:** Secured NCDs are considered safer of the two kinds as their issues are backed by the assets of the company. In the event of the company failing to pay on time, then the investors can recover their dues by liquidating the company's assets. However, the interest offered on NCDs is slightly lower than unsecured NCDs.
- **Unsecured NCDs:** Unsecured NCDs are much riskier than the secured NCDs as the assets of the company do not back these. Hence, when the company defaults on its payment, the investors have no choice but to wait until they receive payments as there are no assets of the company to recover their dues. However, the interest rate offered on unsecured NCDs is higher than that of secured NCDs.

Key Benefits of NCD:

1

Better return

NCDs provide a higher interest rate to their investors when compared to other fixed income products.

2

Good Liquidity

Sell NCD investments on stock exchanges or exercise the Put/Call option.

3

No Upfront Tax

No tax is deducted at source as per the provisions of Sec 193 of the IT Act.

4

Diversification

NCD Investments add diversification to portfolio with income security.

5

Demat

These Bonds are issued in Demat mode only. Hence it is easier to maintain and monitor the investments.

Points to be considered while buying NCD's:

a. Credit Rating of the issuer

Choose a company with an AA rating or above. Credit rating calculates the firm's potential to raise cash from its internal and external operations and its sustainability. This is the best parameter that can reveal the financial position of the company.

b. Level of Debts

Some background check on the asset quality of the company can go a long way for NCD investors. Do not invest if the company allocates more than 50% of its total assets towards unsecured loans.

c. Capital Adequacy Ratio (CAR)

CAR gauges the company's capital and sees if the company has sufficient funds to survive potential losses.

d. Provisions for Non Performing Assets

The company must keep aside at least 50% of their assets towards NPAs as this is a positive indicator of their asset quality. If the quality drops due to bad debts, take it as a red flag.

e. Interest Coverage Ratio

The Interest Coverage Ratio or ICR determines the firm ability to comfortably settle the interest on its loans at any given time. This ensures that the company can handle possible evasions.

Corporate Fixed Deposits:

Corporate Fixed deposits are term deposits provided by non-banking financial companies (NBFCs) and Companies, which offer a pre-decided interest on the amount of money invested, for a fixed period. FD interest rates vary as per the tenor chosen by the depositor. They are the most stable investment options that assure guaranteed and high returns, than fixed-income instruments like Bank FDs and post office fixed deposits.

Features of Corporate FD's:

- **Term:** The term of Corporate FDs are usually less than 5 years. The performance of the company and rating may change with time. So as a matter of safety, shorter terms are preferred. The term as regulated by RBI cannot be less than 12 months or more than 5 years.
- **Rating of a company:** Rating is mandatory for any Corporate FDs. The rating will be given by institutions like CRISIL, ICRA etc., based on Company's Net Owned Fund (NOF) with certain ceilings and slabs. Based on the rating, investors may decide whether they should invest or not in a company.
- **Interest rates:** Interest rates offered by a company are higher than regular banks. This is one of the major reasons that people are interested in these schemes. Premature withdrawals are also permitted and the lock in period will be 3 months. Interest accrued and penalties are as per the terms and conditions of the company.

Benefits of Corporate Fixed Deposit

There are a few benefits of company fixed deposit that makes it preferable over other counterparts.

1

Interest rates

Interest rates in general higher than bank fixed deposits.

2

Liquidity

On a short term they earn better income with good liquidity.

3

Nomination

The deposit scheme also has nomination facility.

4

Process

The application process and eligibility are much simpler than those of regular bank fixed deposit scheme.

Points to be remembered while choosing the right Corporate FD's:

- **Company standing** – A well-managed and credible company with a long history of profitability is a good choice.
- **Past repayment history** – A company with timely interest payments and no default in repayment of fixed deposits is ideal.
- **The credit rating of the company** - Company fixed deposits are rated by credit rating agencies such as CRISIL and ICRA on a 14-point rating system, which determine the assumed risk levels. These will inform regarding the stability aspect of the company fixed deposit from time to time. The higher the rating, the safer the investment. They can also compare the track record of company fixed deposit rates and determine the ones offering higher interest rate.

Benefits of Fixed Income Securities:

There are four key features to fixed income securities that make them desirable to investors. Each feature provides a unique set of benefits that vary depending upon the type of fixed income security.

- **Diversification**

  Fixed income securities, specifically high-credit-quality bonds, can help smooth out the highs and lows in a stock portfolio. That's because stock and bond prices have historically tended to move independently and with different magnitudes at any given time. However, diversifying with bonds does not ensure a profit and does not protect against a loss in a declining market

- **Capital preservation**

  Fixed income securities are ideal when preservation of capital is a priority. Specifically with bonds, principal is usually returned at a set maturity date. Higher-quality fixed income investments have the best potential for protecting principal. Though preserving capital is a key feature of fixed income securities, there is still the risk that the issuer of the bond will not make good on paying back the principal

- **Income generation:**

  Fixed-income securities provide investors with a steady stream of income generated from a portfolio's balance. Bonds, preferred stocks, and CDs all pay a steady dividend and interest payments to investors, creating a consistent cash inflow to investors

- **Predictable Return:**

  While many investments provide some form of income, fixed income investments tend to offer attractive and reliable income streams. Most importantly, a diversified fixed income portfolio can provide income with a lower level of risk, as opposed to equities, and may offer higher income than money market funds or term deposits.

Risk Involved in Fixed Income Securities:

The following are the risk involved in fixed income securities:

- **Interest Rate Risk:**

  Investors don't have to buy bonds directly from the issuer and hold them until maturity. Instead, bonds can be bought from and sold to other investors on what's called the secondary market. Bond prices on the secondary market can be higher or lower than the face value of the bond depending on the economic environment and market conditions—both of which can be affected significantly by a change in interest rates. If the investors decide to sell a bond before its maturity, the price they would receive could result in a loss or gain depending on the current interest rate environment.

- **Credit Risk:**

  Some securities carry risk of default (also known as credit risk). If in case the company financials does not sound good, they could default and make their investors lose their interest

- **Reinvestment Risk:**

  This happens when the security that is being invested can't fetch the same return at maturity or at the time of reinvestment, there would be a falling interest rate regime

- **Price Risk:**

  A number of fixed income securities are listed on stock exchanges. Sometimes investors might want to exit fixed income securities before the maturity date. The prices of fixed income securities are impacted by the interest rate movement and volume of trading. The investors might exit the investment in periods of low liquidity and might not get the right price for it

- **Purchasing power risk:**

  If the returns from fixed income securities are not able to beat inflation the purchasing power risk comes into the picture. In this risk the investors has to consider the returns after taxation and these returns must beat inflation.

FREQUENTLY ASKED QUESTIONS FAQ

1. **What is the difference between a fixed income security and equity?**

   Holders of fixed-income securities are creditors of the issuer, not owners. Equity represents a share in the ownership of the issuer.

2. **What are fixed interest rate securities and floating interest rate securities?**

   Fixed interest rate securities are those in which the interest payable is fixed beforehand. Floating interest rate securities are those in which the interest payable is reset from at pre-determined intervals according to a pre-determined benchmark.

3. **What are the key components of fixed income securities?**

   Credit quality, yield, and tenure are key components of fixed-income securities.

4. Who can invest in T-Bill?

Banks, Primary Dealers, State Governments, Provident Funds, Financial Institutions, Insurance Companies, NBFCs, FIIs (as per prescribed norms), NRIs & OCBs can invest in T-Bills.

5. Who can issue Fixed Income Securities?

Central Government, State Governments, Government Agencies/ Statutory Bodies, Public Sector Units, Corporate, Banks, Financial Institutions, NBFCs.

6. Who regulates the fixed income markets?

As debt market trade both government and corporate debt instruments, we have following two regulators:

- RBI: It regulates and also facilitates the government bonds and other securities on behalf of governments.
- SEBI: It regulates corporate bonds, both PSU (Public sector undertaking) and private sector.

7. What's the difference between Treasury Bills, Bonds, and Notes?

The difference between bills, notes, and bonds is the amount of time the securities take to reach maturity. A bill generally has a maturity of less than one year, a note ranges anywhere from one to 10 years, and a bond has a maturity of 10 years or more.

8. What are the major difference between Corporate FD's and NCD's?

Corporate FD's:

- Highly unsafe, whereas, bank FDs are insured up to Rs.1lakh.
- Can be withdrawn before maturity with a small penalty applicable on an early withdrawal. However, premature withdrawals do not apply to all types of FDs.
- One cannot sell FD in the market; FDs enjoy more liquidity than NCDs.
- No interest risk.

NCD's:

- Either secured or unsecured depending on the principal amount and interest rate issued by the company offering debentures.
- Cannot be withdrawn before maturity. Since NCDs are listed on the stock market they can be sold in the secondary market.

- Can trade NCD, but not withdraw it prematurely.
- The Interest varies as per market.

9. What is basic process of premature withdrawal Of Corporate Fixed Deposit?

The basic process of premature withdrawal of corporate fixed deposits is as follows

- :Submit the original FDR Certificate with all holders signature;
- Submit a Cancelled cheque;
- Request letter from client for premature withdrawal with reason (All Holders Signature).

10. When can client apply for premature withdrawal of Corporate FD's?

A client can apply for premature withdrawal subject to certain rules and conditions. Premature withdrawal will not be allowed before completion of 3 months from the date of deposit. In case of request for premature withdrawal after the expiry of 3 months, the following rates table shall apply.

11. What is Put Option in a NCD?

A put option in NCD means that the investor has an option to surrender the NCD if he wants to, and get back his/her principal. The put option provides the investor with a lot of flexibility. If NCD interest rates go up, and the investor can get better rates from the market, he can exercise the put option and get back his/her principal which can be invested elsewhere.

12. What is Call Option in a NCD?

A call option in NCD means that the company has an option to ask the investor to surrender the NCD in exchange for the principal investment. A call option gives flexibility to the company. If NCD interest rates go down, and the company can get funds at lower rates from the market, it can exercise the call option to give the money back and can raise money from the market at lower rates.

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Notes

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About IFE Academy

IFE Academy was established in 2011 as a Not-for-Profit entity to promote Financial Education. IFE Academy conducts Investor Awareness Programs across the country with the support of other market participants. www.ifea.in is a comprehensive website on Financial Education. It has various sections such as Videos, Puzzles & Games, Financial Calculators and Library. It gives a holistic view on financial education combining various aspects such as Savings, Investments, Credit, Insurance and Pension at a single place. IFE Academy periodically publishes Investor Educational materials and distributes it to general public.

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