<u>Money Market and its Instruments</u>

Money Market: Money market means market where money or its equivalent can be traded. Money is synonym of liquidity. Money market consists of financial institutions and dealers in money or credit who wish to generate liquidity. It is better known as a place where large institutions and government manage their short term cash needs. For generation of liquidity, short term borrowing and lending is done by these financial institutions and dealers. Money Market is part of financial market where instruments with high liquidity and very short term maturities are traded. Due to highly liquid nature of securities and their short term maturities, money market is treated as a safe place. *Hence, money market is a market where short term obligations such as treasury bills, commercial papers and banker's acceptances are bought and sold.*

Benefits and functions of Money Market: Money markets exist to facilitate efficient transfer of short-term funds between holders and borrowers of cash assets. For the lender/investor, it provides a good return on their funds. For the borrower, it enables rapid and relatively inexpensive acquisition of cash to cover short-term liabilities. One of the primary functions of money market is to provide focal point for RBI's intervention for influencing liquidity and general levels of interest rates in the economy. RBI being the main constituent in the money market aims at ensuring that liquidity and short term interest rates are consistent with the monetary policy objectives.

Money Market & Capital Market: Money Market is a place for short term lending and borrowing, typically within a year. It deals in short term debt financing and investments. On the other hand, Capital Market refers to stock market, which refers to trading in shares and bonds of companies on recognized stock exchanges. Individual players cannot invest in money market as the value of investments is large, on the other hand, in capital market, anybody can make investments through a broker. Stock Market is associated with high risk and high return as against money market which is more secure. Further, in case of money market, deals are transacted on phone or through electronic systems as against capital market where trading is through recognized stock exchanges.

Money Market Futures and Options: Active trading in money market futures and options occurs on number of commodity exchanges. They function in the similar manner like any other futures and options.

Money Market Instruments: Investment in money market is done through money market instruments. Money market instrument meets short term requirements of the borrowers and provides liquidity to the lenders. Common Money Market Instruments are as follows:

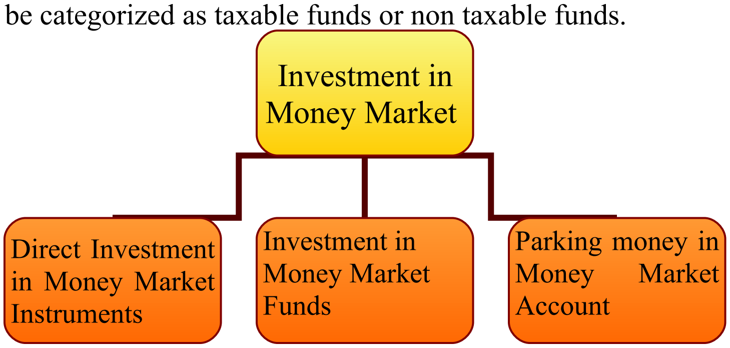
- ***<u>Treasury Bills (T-Bills):</u>*** Treasury Bills, one of the safest money market instruments, are short term borrowing instruments of the Central Government of the Country issued through the Central Bank (RBI in India). They are zero risk instruments, and hence the returns are not so attractive. It is available both in primary market as well as secondary market. It is a promise to pay a said sum after a specified period. T-bills are short-term securities that mature in one year or less from their issue date. They are issued with three-month, six-month and one-year maturity periods. The Central Government issues T- Bills at a price less than their face value (par value). They are issued with a promise to pay full face value on maturity. So, when the T-Bills mature, the government pays the holder its face value. The difference between the purchase price and the maturity value is the interest income earned by the purchaser of the instrument. T-Bills are issued through a bidding process at auctions. The bid can be prepared either competitively or non-competitively. In the second type of bidding, return required is not specified and the one determined at the auction is received on maturity. Whereas, in case of competitive bidding, the return required on maturity is specified in the bid. In case the return specified is too high then the T-Bill might not be issued to the bidder. At present, the Government of India issues three types of treasury bills through auctions, namely, 91-day, 182-day and 364-day. There are no treasury bills issued by State Governments. Treasury bills are available for a minimum amount of Rs.25K and in its multiples. While 91-day T-bills are auctioned every week on Wednesdays, 182-day and 364-day T-bills are auctioned every alternate week on Wednesdays. The Reserve Bank of India issues a quarterly calendar of T-bill auctions which is available at the Banks' website. It also announces the exact dates of auction, the amount to be auctioned and payment dates by issuing press releases prior to every auction. Payment by allottees at the auction is required to be made by debit to their/ custodian's current account. T-bills auctions are held on the Negotiated Dealing System (NDS) and the members electronically submit their bids on the system. NDS is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. RBI issues these instruments to absorb liquidity from the market by contracting the money supply. In banking terms, this is called Reverse Repurchase (Reverse Repo). On the other hand, when RBI purchases back these instruments at a specified date mentioned at the time of transaction, liquidity is infused in the market. This is called Repo (Repurchase) transaction.

- ***Repurchase Agreements:*** Repurchase transactions, called Repo or Reverse Repo are transactions or short term loans in which two parties agree to sell and repurchase the same security. They are usually used for overnight borrowing. Repo/Reverse Repo transactions can be done only between the parties approved by RBI and in RBI approved securities viz. GOI and State Govt Securities, T-Bills, PSU Bonds, FI Bonds, Corporate Bonds etc. Under repurchase agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date at a predetermined price. Such a transaction is called a Repo when viewed from the perspective of the seller of the securities and Reverse Repo when viewed from the perspective of the buyer of the securities. Thus, whether a given agreement is termed as a Repo or Reverse Repo depends on which party initiated the transaction. The lender or buyer in a Repo is entitled to receive compensation for use of funds provided to the counterparty. Effectively the seller of the security borrows money for a period of time (Repo period) at a particular rate of interest mutually agreed with the buyer of the security who has lent the funds to the seller. The rate of interest agreed upon is called the Repo rate. The Repo rate is negotiated by the counterparties independently of the coupon rate or rates of the underlying securities and is influenced by overall money market conditions.
- ***Commercial Papers:*** Commercial paper is a low-cost alternative to bank loans. It is a short term unsecured promissory note issued by corporates and financial institutions at a discounted value on face value. They are usually issued with fixed maturity between one to 270 days and for financing of accounts receivables, inventories and meeting short term liabilities. Say, for example, a company has receivables of Rs 1 lacs with credit period 6 months. It will not be able to liquidate its receivables before 6 months. The company is in need of funds. It can issue commercial papers in form of unsecured promissory notes at discount of 10% on face value of Rs 1 lacs to be matured after 6 months. The company has strong credit rating and finds buyers easily. The company is able to liquidate its receivables immediately and the buyer is able to earn interest of Rs 10K over a period of 6 months. They yield higher returns as compared to T-Bills as they are less secure in comparison to these bills; however chances of default are almost negligible but are not zero risk instruments. Commercial paper being an instrument not backed by any collateral, only firms with high

quality credit ratings will find buyers easily without offering any substantial discounts. They are issued by corporates to impart flexibility in raising working capital resources at market determined rates. Commercial Papers are actively traded in the secondary market since they are issued in the form of promissory notes and are freely transferable in demat form.

- ***Certificate of Deposit:*** It is a short term borrowing more like a bank term deposit account. It is a promissory note issued by a bank in form of a certificate entitling the bearer to receive interest. The certificate bears the maturity date, the fixed rate of interest and the value. It can be issued in any denomination. They are stamped and transferred by endorsement. Its term generally ranges from three months to five years and restricts the holders to withdraw funds on demand. However, on payment of certain penalty the money can be withdrawn on demand also. The returns on certificate of deposits are higher than T-Bills because it assumes higher level of risk. While buying Certificate of Deposit, return method should be seen. Returns can be based on Annual Percentage Yield (APY) or Annual Percentage Rate (APR). In APY, interest earned is based on compounded interest calculation. However, in APR method, simple interest calculation is done to generate the return. Accordingly, if the interest is paid annually, equal return is generated by both APY and APR methods. However, if interest is paid more than once in a year, it is beneficial to opt APY over APR.
- ***Banker's Acceptance:*** It is a short term credit investment created by a non financial firm and guaranteed by a bank to make payment. It is simply a bill of exchange drawn by a person and accepted by a bank. It is a buyer's promise to pay to the seller a certain specified amount at certain date. The same is guaranteed by the banker of the buyer in exchange for a claim on the goods as collateral. The person drawing the bill must have a good credit rating otherwise the Banker's Acceptance will not be tradable. The most common term for these instruments is 90 days. However, they can very from 30 days to180 days. For corporations, it acts as a negotiable time draft for financing imports, exports and other transactions in goods and is highly useful when the credit worthiness of the foreign trade party is unknown. The seller need not hold it until maturity and can sell off the same in secondary market at discount from the face value to liquidate its receivables.

An individual player cannot invest in majority of the Money Market Instruments, hence for retail market, money market instruments are repackaged into Money Market Funds. A money market fund is an investment fund that invests in low risk and low return bucket of securities viz money market instruments. It is like a mutual fund, except the fact mutual funds cater to capital market and money market funds cater to money market. Money Market funds can be categorized as taxable funds or non taxable funds.



Having understood, two modes of investment in money market viz Direct Investment in Money Market Instruments & Investment in Money Market Funds, lets move forward to understand functioning of money market account.

Money Market Account: It can be opened at any bank in the similar fashion as a savings account. However, it is less liquid as compared to regular savings account. It is a low risk account where the money parked by the investor is used by the bank for investing in money market instruments and interest is earned by the account holder for allowing bank to make such investment. Interest is usually compounded daily and paid monthly. There are two types of money market accounts:

- *Money Market Transactional Account:* By opening such type of account, the account holder can enter into transactions also besides investments, although the numbers of transactions are limited.
- *Money Market Investor Account:* By opening such type of account, the account holder can only do the investments with no transactions.

Money Market Index: To decide how much and where to invest in money market an investor will refer to the Money Market Index. It provides information about the prevailing market rates. There are various methods of identifying Money Market Index like:

- *Smart Money Market Index*- It is a composite index based on intra day price pattern of the money market instruments.
- *Salomon Smith Barney's World Money Market Index*- Money market instruments are evaluated in various world currencies and a weighted average is calculated. This helps in determining the index.
- *Banker's Acceptance Rate*- As discussed above, Banker's Acceptance is a money market instrument. The prevailing market rate of this instrument i.e. the rate at which the banker's acceptance is traded in secondary market, is also used as a money market index.
- *LIBOR/MIBOR*- London Inter Bank Offered Rate/ Mumbai Inter Bank Offered Rate also serves as good money market index. This is the interest rate at which banks borrow funds from other banks.

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