Money Markets

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Money market may be defined as a centre in which financial institutions congregate for the purpose of dealing in monetary assets. Only short term monetary assets (i.e. assets of less than one year maturity) or financial assets that are near substitutes of money (assets that are easily convertible into money at minimum transaction cost) are dealt in money markets. The presence of an active and vibrant money market is an essential pre-requisite for the growth and development of an economy. Money Market is the market for short-term funds, generally ranging from overnight to a year. It helps in meeting the short-term and very short-term requirements of banks, financial institutions, firms, companies and also the Government.

Features of money market:

a. This is not one market but collection markets where liquid assets like call money, notice money, repose, term money, treasury bills, commercial bills, certificate of deposits, commercial papers, inter-bank participation certificates, inter-corporate deposits, swaps futures, options, etc. Are dealt.
b. Usually money markets tend to concentrate at certain places. London and New York are places for international money markets. In India, money markets are at Mumbai, Delhi, Calcutta etc.
c. The markets are impersonal and pure competition exists.
d. Since the competition is pure, price differentials get adjusted through demand and supply adjustments.
e. Due to flexible regulatory framework, new products are being introduced continuously.
f. This is a wholesale market with relatively few players, yet the volume of these markets is very large.
g. Indian Money market is divided into organised and unorganised money markets.
h. Demand for money in the market is seasonal due to predominance of agriculture.
i. Organised bill market in India is very low.

Rigidities in the Indian Money Market:

a. Markets are not integrated;
b. High volatility;
c. Interest rates are not properly aligned;
d. Powers are restricted;

e. Limited instruments;
f. Players do not alternate between borrowing and lending;
g. Reserve requirements;
h. Lack of transparency;
i. Seasonal shortage of funds due to predominance of agriculture.
j. Organised bill market is low. Further, commercials bills are associated with heavy stamp duties.
k. Commercial transactions are mainly in cash.

Capital market Vs. Money market:

	Basis	**Capital Market**	**Money Market**
1	Classification	Primary Market and Secondary Market	No such classification
2	Type of Funds	Long term funds	Short term Funds
3	Number of Instruments	Shares and debentures	Many like Call money, ICDs', CPs', Treasury Bills etc.
4	Players	General investors, FIIs', brokers, Registrars, Underwriters, Bankers, Corporate investors, etc.	Banks, R B I, Govt., PF Funds, PSUs', FIs', large corporates etc.
5	Support	Supports capital	Supports working capital.
6	Value	Each instrument is of low value.	Each instrument is of high value
7	Default Risk	Risk of default is high as it is of long term.	Risk of default is less as it is of short term
8	Role	Role of capital market includes putting capital to work,	Basic role is liquidity adjustment
9	Relation with central bank.	Not closely related with central bank.	Closely and directly linked with the Central Bank of the country in fixing interest rates.

Institutions operating in money market: Main institutions are: Govt., RBI, Scheduled Commercial Banks, F Is', S T C I, D F H I, P S Us', N B F Cs', P Fs', Pension Funds, M M M Fs', Co-op. Societies, Large Corporates, etc. Operate in organised sector. In unorganised sector, money lenders, indigenous bankers, nidhis, chit funds etc. Operate. The size of unorganised market is also fairly large. Brokers are not permitted in money market.

Discount & Finance House of India Ltd. (D F H I): D F H I was set up by R B I jointly with public sector banks and all India financial institutions to deal in short term money market instruments.

a. Participates in interbank call money, notice money and term deposit markets as lender and borrower and accounts for over 10% of its business.
b. Deals in T bills in secondary market by offering 2 way quotes as RBI sells them only on fortnightly basis and purchases them back only on maturity.
c. It also deals in rediscounting of commercial bills.
d. Provides Repo facility to banks.
e. Deals in Commercial Papers, Certificate of Deposits and Government securities.

Instruments: Money market instruments are characterised by short duration (from overnight to max. One year), large volume, and deregulated interest rates. Institutions with surplus funds lend and with short of funds borrow to comply with S L R & C R R requirements. Banks invest in T Bills, G O I and State Govt. Bonds and PSU bonds to fulfil their S L R requirements.

a. **Call Money & Notice Money:** The core of Indian money market is the interbank call money market. Call money market is centralised in Mumbai with branches at Delhi, Calcutta, etc. Current and expected interest rates of call money market form the basis for the rates of other markets and also of Govt. Securities. Call money is also known as overnight money. This is the most liquid form of short term monies.

   The maturity period of call loans vary from 1 to 14 days. If the duration of call money is more than one day, it is called notice money. Players in this market are limited and include commercial banks, Co-op. Banks and primary dealers who can lend and as well as borrow. Financial Institutions, mutual funds promoted by banks, large corporates and private mutual funds can only lend monies in this market but cannot borrow. The interest paid on call loans are known as the call rates. The call rate is expected to freely reflect the day-to-day lack of funds. These rates vary from day-to-day and within the day, often from hour-to-hour. High rates indicate the tightness of liquidity in the financial system while low rates indicate an easy liquidity position in the market.

In India, call money is lent mainly to even out the short-term mismatches of assets and liabilities and to meet CRR requirement of banks. The short-term mismatches arise due to variation in maturities i.e. the deposits mobilized are deployed by the bank at a longer maturity to earn more returns and duration of withdrawal of deposits by customers vary. Thus, the banks borrow from call money markets to meet short-term maturity mismatches and to fulfil SLR and CRR requirements.

b. **Interbank Term Money (ITM):** Initially only commercial banks are allowed to participate in this market but now even Development Financial Institutions are allowed to participate. Maturity period varies from 3 to 6 months within the limits specified by RBI. Interest rates are market driven. This market is likely to grow due to declining trend in spreads in lending, volatility in call markets, integration forex and money markets etc.

c. **Interbank Participation Certificate (IBPC):** These are short term instruments to even out the short term liquidity in the bank. The primary objective is to provide some degree of flexibility in the credit portfolio of banks. It can be issued by a scheduled commercial bank and can be subscribed by any commercial bank.

IBPCs' can be issued against the base of underlying standard advances. During the currency of the participation, the aggregate amount of participation should be covered by the outstanding balance in account.

There are **two types** of IBPCs', **with risk to the lender and without risk to the lender.** Under **'with risk participation'**, the issuing bank will reduce the amount of participation from the advances outstanding and participating bank will show the participation as part of its advances. Aggregate amount of IBPCs' in any account should not exceed 40% of outstanding amount at the time of issue. The interest rate on IBPC is freely determined in the market. The certificates are neither transferable nor prematurely redeemable by the issuing bank. The duration of the category of certificates is from 91 days to 180 days. In case of **without risk participation**, the issuing bank will show as borrowing from bank and the lending bank will show as advances to bank. Duration of this type of IBPC is restricted to less than 90 days.

Interest rates are market driven. IBPCs' are neither transferable nor prematurely redeemable. IBPCs' help both banks to reorganise their advances.

d. **Inter Corporate Deposits (ICD):** ICDs' operate outside the purview of regulatory framework. This provides an opportunity for large corporate to park their temporary short term surplus funds at market determined interest rates. The instruments are mostly of 90 days duration. Rate of interest on these deposits is less than bank rates. However, as the regulatory framework is absent, there were many defaults.

   This market depends mostly on personal contacts and brokers play a great role. List of borrowers and lenders are kept confidential to protect the rate of interest. It is expected that appropriate regulations are framed regarding operation of these, so that the product can benefits of the product can be fully utilised.

e. **Certificate of Deposit (C D):** Certificate of Deposits are negotiable (transferrable by endorsement and delivery) term deposits accepted by bank from bulk depositors. C Ds' can be issued by all scheduled banks except RRBs' and Co-op Banks. C Ds' are issued at discount to face value at market driven rates for periods ranging from 3 months to one year. Minimum value of C D is Rs. 5 lacs and thereafter it can be in multiples of Rs. 1 lac. C Ds' can be negotiated after 30 days from the date of issue by the holder. C Ds' are subject to stamp duty and banks can consider the value of C Ds' for reserve requirements. Banks are prohibited from issuing loans against C Ds' as it amounts to buyback of their own C Ds'. Effective yield on a C D can be calculated by the formula:

   E = [(FV-SV) * 365 or 12 * 100] / (SV * DAYS or MONTHS)

   To the above rate, issue expenses etc. If any, are to be added.

f. **Commercial Paper (C P):** This product has first started in America and Europe. RBI has liberalised the terms of C P issue and its operation based on Vaghul committee report. This provides the cheapest source of funds for corporates.

   C P is an unsecured debt instrument in the form of a Pronote issued by highly rated borrowers for tenors of 15 days to 1 year. These are usually issued at a discount to face value and the rate of discount is determined by market forces. The C Ps' are directly issued by corporate themselves or through a bank dealer. Amount raised through C Ps' is reduced from the working capital limits of the bank. Since this is the cheapest source of funds for Corporates, these are sought by them on a continuous basis. The funds raised are utilised for redemption of existing C P liabilities also.

C P issues are governed by RBI regulations. Prior approval of R B I is required to issue CPs' and also for their rollovers. The company should also fulfil appropriate credit rating, net worth and fund based working capital requirements. CPs' are to be issued within 2 weeks from the date of opening the issue. CP issues cannot be underwritten. Minimum value of C P is Rs. 25 lacs and thereafter in multiples of Rs. 5 lacs. C Ps' can be issued to a maximum of 100% requirement of fund based working capital facilities. C Ps' are subject to stamp duty and besides the issuer has also to incur agency fee and issuing and paying agents fee.

Commercial Paper Vs. Commercial Bills: CPs' are unsecured and discounted pronotes whereas commercial Bills are based on genuine sale transactions which can be against D / A or D / P.

g. **Treasury Bills:** Popularly referred as T Bills, are short term pronotes issued by Government of India (G O I) at a discount to face value for periods ranging from 14 days to 365 days. Government issues these bills to tide over short term liquidity crunch it faces at times. T bills can be of 14 days, 28 days, 91 days and 364 days duration. These provide an outlet to banks for effective dealing of their surplus funds and to manage their dynamic asset liabilities. The amount and rate of discount is determined on the basis of bids for 91 days T bills. Return on T bills will be generally low but risk wise these are almost 100% secured. In case of other T Bills it is decided on the basis of R B I's discriminatory price auctions. For T Bills, a year is taken as 364 days. There will not be TDS on the interest payable on T Bills.

T Bills are classified as Tap (adhoc) and Auction (Regular) T Bills apart from the classification based on duration.

Tap (adhoc) bills are issued for subscription by State Governments, Semi Government Departments and foreign Central banks. Others are not allowed to buy these T Bills.

14 days T Bills are available on tap. Other features are:

a. Sold for a minimum amount of Rs. 1.00 lac and in multiples thereof.

b. Not transferrable.
c. Issued in book entry form only.
d. Discount rates are set at quarterly intervals.
e. Re-discounting is done at 50 points above the rate of their issue.
f. On rediscounting they stand extinguished.

Effective yield is calculated by the formula:

E = [(FV-SV) * 365 or 12 * 100] / (SV * DAYS or MONTHS)

Regular or auction T bills can be purchased by any person, firm company, BOI, SG, Non Govt. PF Funds, including general public. 14 days and 91 days T bills are issued in denominations of Rs. 25000 and 182 & 364 days T bills are issued in Rs. 1.00 lac denomination and multiples thereof. R B I does not buy 182 date treasury bills before their mature date. However these can be sold in secondary market and can be transferred by endorsement and delivery since they are pronotes. 364 days T Bills are also sold by G O I in the same way as 182 days T Bills. T Bills are approved securities for the purpose of SLR.

h. **Commercial Bills:** Bill financing is one of the types of working capital finance. Commercial bill is an instrument drawn by seller on the purchaser. Commercial banks can discount the bills drawn by their customers based on genuine commercial transactions. Accommodation bills should not be financed. The bills are self liquidating upon receipt of payment on due date from the purchaser of goods. Banks can seek refinance on the bills on which they provided advances from other banks / institutions. Commercial bills are exempted from stamp duty. Discount is collected upfront on advances made on the basis bills by banks. It is calculated by the formula:

D = (FV * Rt. Of Int. * No. Of months) / (100 * 12)

Since the discount is charged upfront, the effective discount to borrower will be:

ED = [(FV-SV) * 365 or 12 * 100] / (SV * DAYS or Months)

Advantages of Bill market:

a. Bill finance is better than cash credit as these are self liquidating on due date.
b. Bills provide greater liquidity to the holder as they are negotiable instruments and can be transferred by endorsement and delivery.

c. Bills are useful to banks as they can depend on them instead of call monies.
d. Interest on commercial bills is higher than T Bills and hence are more attractive to bankers.
e. To borrowers, the cost of bill finance is lower than cash credit.
f. Bill market will make the monetary control measures of the RBI more effective.

Money Market instruments like Swaps, Options and futures in rupees are presently not being traded.

Recent Developments in Money Markets: Recent developments in money markets are:

a. **Debt securitisation:** Debt securitisation refers to converting retail loans into whole sale loan and their reconverting into retail loans. This method is mostly used by finance companies to raise funds against financial assets such as loan receivables, mortgage backed receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors, etc. and thus beneficial to such financial intermediaries to support their lending volumes. Assets generating steady cash flows are packaged together and against this assets pool market securities can be issued. Investors are usually cash-rich institutional investors like mutual funds and insurance companies. The experiment has already been initiated in India by the Housing Development Finance Corporation (HDFC) by selling a part of its loan to the Infrastructure Leasing and Financial Services Ltd. (ILFS) and has therefore become a pacesetter for other kinds of debt securitisation as well.
Securitisation consists of three steps:
    i. **Origination:** A borrower seeks a loan from finance company, bank, housing company or a financial institution. On the basis of credit worthiness repayment schedule is structured over the life of the loan.
    ii. **Pooling:** Many similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special Purpose Vehicle), which acts as a trustee for the investor. Once the assets are transferred they are held in the organizers portfolios.
    iii. **Securitisation:** It is the SPV's job to structure and issue the securities on the basis of asset pool. The securities carry coupon and an expected maturity, which can be asset base or mortgage

based. These are generally sold to investors through merchant bankers. The investors interested in this type of securities are generally institutional investors like mutual fund, insurance companies etc. The originator usually keeps the spread available (i.e. difference) between yield from secured asset and interest paid to investors.

Generally the process of securitisation is without recourse i.e. the investor bears the credit risk of default and the issuer is under an obligation to pay to investors only if the cash flows are received by issuer from the collateral.

b. **Money market mutual funds (MMMFs):** MMMFs are primarily intended for individual investors including NRIs who may invest on a non–repatriable basis. MMMFs would be free to determine the minimum size of the investment by a single investor. There is no guaranteed minimum rate of return. The minimum lock in period would be 46 days.
c. **Repo & Reverse Repo agreements:** The term Repurchase Agreement (Repo) and Reverse Repurchase Agreement (Reverse Repo) refer to a type of transaction in which money market participant raises funds by selling securities and simultaneously agreeing to repurchase the same after a specified time generally at a specified price, which typically includes interest at an agreed upon rate. Such a transaction is called a Repo when viewed from the perspective of the seller of securities (the party acquiring funds) and Reverse Repo when described from the point of view of the supplier of funds. Thus, whether a given agreement is termed a Repo or a Reverse Repo depends largely on which party initiated the transaction. Generally repo–transactions are for short periods ranging from overnight to a maximum period of 1 year. The interest on such transactions is market determined and built in the structure of the Repo. Participants are commercial banks, Financial Institutions, DFHI, brokers etc. Presently Repo transactions are permitted only in T Bills. Banks use these products to comply with CRR and SLR requirements.
d. **Ready Forward (RF) contracts:** Ready forward (RF) transactions are structured to suit the requirements of both borrower and lender and have therefore, become extremely popular mode of raising / investing short term funds. The borrower has advantage of raising funds against its securities without altering its assets mix while lender finds a safe avenue giving attractive returns. Moreover, the funds management for both borrower and lender is improved as the date of reversal of transaction is known in advance.

Questions:

1. Write a short note on commercial paper.
2. Write a short note on Treasury bills.
3. Explain briefly 'Call Money' in the context of financial market.
4. Distinguish between Money market and Capital Market.
5. Write a short note on Inter Bank Participation Certificate.
6. What are a Repo and a Reverse Repo?
7. Write a short note on Debt Securitisation.
8. What are interest rate risk, reinvestment risk, default risk, & what are the types of risks involved investments of G-Sec.? *(Part of the answer covered in Forex Chapter.)*

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