[Academic Script]

Money market in India

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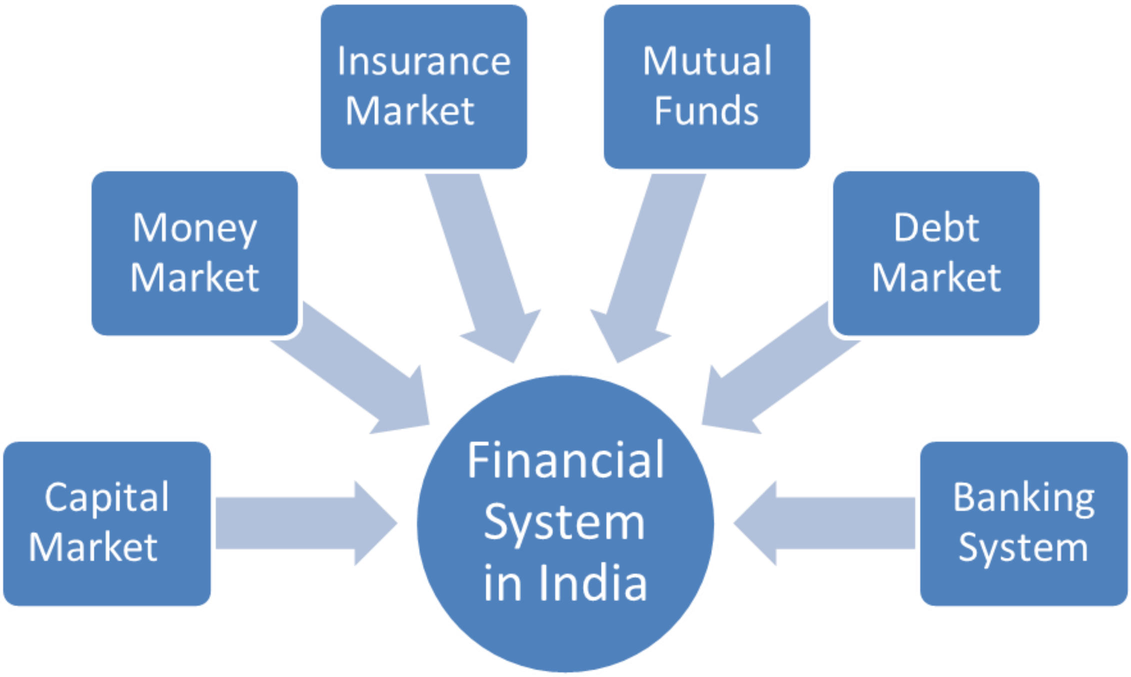
Academic Script

1. Money market

In this unit, we are going to learn about money market in India. Let us first understand the structure of the financial system in India. It consists of capital market, money market, insurance market, debt market, mutual funds and banking system.



Let us first understand the meaning of money market:

A money market is a segment of the financial market in which financial instruments with high liquidity and very short maturities are been traded. The participants use the money market as a means for borrowing and lending in the short term, from several days to just under a year. In India, both RBI and SEBI regulate Money Market.

Do you know what is the structure of money market in India?

Indian Money Market

- **Unorganized Sector**
  - Moneylenders
  - Indigenous Bankers
  - Non- Banking Financial Companies (NBFCs)
- **Organized sector**
  - Call Money / Notice Money / Term Money Market
  - Commercial Papers (CPs)
  - Certificate Of Deposits (CDs)
  - Treasury Bills (T – Bills)
  - Repo and Reverse Repo rate
  - Money Market Mutual Funds (MMMFs)
  - Bankers Acceptance

Indian money market is divided into organized and unorganized segments. Unorganized market is old Indigenous market mainly made of indigenous bankers, money lenders etc.

Organized market is that part which comes under the regulatory purview of RBI and SEBI. The nature of the money market transactions is such that they are large in amount and high in volume.

Thus, the entire market is dominated by small number of large players.

2. Unorganized Money Market

The economy on one hand performs through organised sector and on other hand in rural areas there is continuance of unorganised, informal and indigenous sector. The unorganised money market mostly finances short-term financial needs of farmers and small businessmen. The main constituents of unorganised money market are:-

1) Indigenous Bankers (IBs)

Indigenous bankers are individuals or private firms who give loans and thereby operate as banks. IBs accept deposits as well as lend money. They mostly operate in urban areas, especially in western and southern regions of the country. The volume of their credit operations is however not known. Further, their lending operations are completely unsupervised and unregulated. Over the years, the significance of IBs has declined due to growing organised banking sector.

2) Money Lenders (MLs)

They are those whose primary business is money lending. Money lending in India is very popular both in urban and rural areas. Interest rates are generally high. Large amount of loans are given for unproductive purposes. The operations of money lenders are prompt, informal and flexible. The borrowers are mostly poor farmers, artisans, petty traders and manual workers. Over the years the role of money lenders has declined due to the growing importance of organised banking sector.

3) Non - Banking Financial Companies (NBFCs)

They consist of :-

1. Chit Funds

Chit funds are savings institutions. It has regular members who make periodic subscriptions to the fund. The beneficiary may be selected by drawing of lots. Chit fund is more popular in Kerala and Tamilnadu. RBI has no control over the lending activities of chit funds.

2. Nidhis

Nidhis operate as a kind of mutual benefit for their members only. The loans are given to members at a reasonable rate of interest. Nidhis operate particularly in South India.

3. Loan or Finance Companies

Loan companies are found in all parts of the country. Their total capital consists of borrowings, deposits and owned funds. They give loans to retailers, wholesalers, artisans and self -employed persons. They offer a high rate of interest along with other incentives to attract deposits. They charge high rate of interest varying from 36% to 48% p.a.

4. Finance Brokers

They are found in all major urban markets specially in cloth, grain and commodity markets. They act as middlemen between lenders and borrowers. They charge commission for their services.

Now let us understand in detail the Structure of Organized Money Market in India

The organized money market in India is not a single market but is a conglomeration of markets of various instruments.

Like,

1. Call Money / Notice Money / Term Money Market

Call Money, Notice Money and Term Money markets are sub-markets of the Indian Money Market. These refer to the markets for very short term funds.

Call Money refers to the borrowing or lending of funds for 1 day. Notice Money refers to the borrowing and lending of funds for 2-14 days.

Term money refers to borrowing and lending of funds for a period of more than 14 days.

2. Treasury Bills (T – Bills)

Treasury Bills are one of the safest money market instruments as Central Government issues them. They are zero-risk instruments, and hence returns are not that attractive. T-Bills are circulated by both primary as well as the secondary markets. They come with the maturities of 3-month, 6-month and 1-year. The Central Government issues T-Bills at a price less than their face value and the difference between the buy price and the maturity value is the interest earned by the buyer of the instrument.

T-bills are been bought by bidding process through auctions. At present, the Government of India issues three types of treasury bills through auctions namely, 91-day, 182-day and 364-day.

3. Commercial Bills

Commercial Bills are issued by financial institutions. Commercial bills market is basically a market of instruments similar to Bill of Exchange. The participants of commercial bill market in India are banks and financial institutions but this market is not yet developed.

4. Certificate of Deposits (CDs)

Certificate of Deposit (CD) refers to a money market instruments, which is negotiable and equivalent to a promissory note.

Certificate of Deposit is like a promissory note issued by a bank in form of a certificate entitling the bearer to receive interest. It is similar to bank term deposit account. The certificate bears the maturity date, fixed rate of interest and the value. These certificates are available in the tenure of 3 months to 5 years. The returns on certificate of deposits are higher than T-Bills because they carry higher level of risk.

5. Commercial Papers (CP)

Commercial Paper (CP) is yet another money market instrument in India, which was first introduced in 1990 to enable the highly rated corporates to diversify their resources for short terms fund requirements.

Commercial Paper is the short terms unsecured promissory note issued by corporate and financial institutions at a discounted value on face value. They come with fixed maturity period ranging from 1 day to 270 days. These are issued for the purpose of financing of accounts receivables, inventories and meeting short terms liabilities. The return on commercial papers is higher as compared to T-Bills so as the risk as they are less secure in comparison to these bills. It is easy to find buyers for the firms with high credit ratings. These securities are actively traded in secondary market.

6. Money Market Mutual Funds (MMMFs)

Money Market Mutual Funds (MMMFs) were introduced by RBI in 1992 but since 2000, they are brought under the purview of the SEBI. They provide additional short-term avenue to individual investors.

7. The Repo / Reverse Repo Market

Repurchase Agreements, which are also called as Repo or Reverse Repo, are short term loans that buyers and sellers agree upon for selling and repurchasing. Repo or Reverse Repo transactions can be done only between the parties approved by RBI and allowed only between RBI-approved securities such as state and central government securities, T-Bills, PSU bonds and corporate bonds.

They are usually used for overnight borrowing. Repurchase agreements are sold by sellers with a promise of purchasing them back at a given price and on a given date in future. On the flip side, the buyer will also purchase the securities and other instruments with a promise of selling them back to the seller.

Concept of Repo Rate and Reverse Repo RateRepo (Repurchase) Rate:

Repo (repurchase agreement) was introduced in December 1992. Repo means selling a security under an agreement to repurchase it at a predetermined date and rate. Repo transactions are affected between banks and financial institutions and among bank themselves, RBI also undertake Repo. Repo rate also known as Repurchase rate is the rate at whichbanks borrow funds from the RBI to meet short-term requirements. RBI charges someinterest rate on the cash borrowed by banks. This interest rate is called repo rate. If the RBIwants to make it more expensive for the banks to borrow money, it increases the repo rate;similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate.

Reverse Repo Rate:

In 1996, Reverse Repo was introduced. Reverse Repo means buying a security on a spot basis with a commitment to resell on a forward basis. Reverse Repo transactions are affected with scheduled commercial banks and primary dealers.

Reverse Repo rate is the rate at which Reserve Bank of India (RBI) borrows money from banks. This is the exact opposite of repo rate. RBI uses this tool whenit feels there is too much money floating in the banking system. If the reverse repo rate isincreased, it means the RBI will borrow money from the bank by offering lucrative rate ofinterest. Banks feel comfortable lending money to RBI since their money would be in safehands and with a good interest.

It is also a tool, whichcan be used by the RBI to drain excessmoney out of the banking system.

8. Bankers Acceptance

Bankers Acceptance is like a short term investment plan created by non-financial firm, backed by a guarantee from the bank. Its like a bill of exchange stating a buyers promise to pay to the seller a certain specified amount at a certain date. In addition, the bank guarantees that the buyer will pay the seller at a future date. Firm with strong credit rating can draw such bill. These securities come with the maturities between 30 and 180 days and the most common term for these instruments is 90 days. Companies use these negotiable time drafts to finance imports, exports and other trade.

Call money market The call money market deals in short term finance repayable on demand, with a maturityperiod varying from one day to 14 days.

Commercial banks, both Indian and foreign, co-operative banks, Discount and Finance House of India Ltd.(DFHI), Securities Trading Corporation of India (STCI) participate as both lenders and borrowers and Life Insurance Corporation of India (LIC), Unit Trust of India(UTI), National Bank for Agriculture and Rural Development (NABARD)can participate only as lenders. The interest rate paid on call money loans, known as the call rate, is highly volatile. It is the most sensitive section of the money market and the changes in the demand for and supply of call loans are promptly reflected in call rates.

There are now two call rates in India: the Interbank call rate and the lending rate of DFHI. The ceilings on the call rate and inter-bank term money rate were dropped, with effect from May 1, 1989. The Indian call money market has been transformed into a pure inter-bank market during 2006–07. The major call money markets are in Mumbai, Kolkata, Delhi, Chennai, Ahmedabad.

3. Various functions or role of Money Markets

Due to short maturity term, the instruments of money market are liquid and can be converted to cash easily and thus are able to address the need of the short term surplus fund of the lenders and short term borrowing requirements of the borrowers.

Thus, the major function of the money markets is to cater to the short term financial needs of the economy. The other functions are:

I. Money Markets help in effective implementation of the RBI’s monetary policy
II. Money markets help to maintain demand and supply equilibrium with regard to short term funds

III. They cater to the short term fund requirement of the governments
IV. They help in maintaining liquidity in the economy
V. Determine short-term interest rates Participants in the call money market are scheduled commercial banks, non-scheduled commercial banks, foreign banks, state, district and urban, cooperative banks, Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI). The DFHI and STCI borrow as well as lend, like banks and primary dealers, in the call market. At one time, only a few large banks, particularly foreign banks, operated in the call money market.

4. Role of Discount and Finance House of India (DFHI)

It was established in 1988 by RBI and is jointly owned by RBI, public sector banks and all India financial institutions, which have contributed to its paid up capital.

DFHI plays important role in developing an active secondary market in Money Market Instruments. From 1996, it has been assigned status of a Primary Dealer (PD). It deals in treasury bills, commercial bills, CDs, CPs, short term deposits, call money market and government securities.

5. Role of STCI in Money Market

STCI Finance Ltd. (formerly known as Securities Trading Corporation of India Limited), is a systematically important non-deposit taking NBFC registered with Reserve Bank of India. Presently STCI Finance Ltd is classified as a loan NBFC.

As the leading Primary Dealer in the country, the Company was a market maker in government securities, corporate bonds and money market instruments apart from carrying out proprietary trading in equity both in the cash & derivatives (F&O) segment. The Company's other lines of activities included trading in interest rate swaps - both for hedging and market making. The Company enjoyed a successful track record of achieving profits during consecutive years spanning nearly a decade. It had the distinction of achieving secondary market turnover of more than Rs.2.00 lakh crore in sovereign paper.

6. Summary

Let us summarizes today what we have learnt about money market. There are two kinds of markets where borrowing and lending of money takes place between fund scarce and fund surplus individuals and groups

The markets catering the need of short term funds are called Money Markets while the markets that cater to the need of long term funds are called Capital Markets.

Thus, money market is that segment of financial markets where borrowing and lending of the short-term funds takes place. The maturity of the money market instruments is one day to one year. In our country, Money Market are regulated by both RBI and SEBI.

It's the place where large financial institutions, dealers and government participate and meet out their short-term cash needs. They usually borrow and lend money with the help of instruments or securities to generate liquidity. Due to highly liquid nature of securities and their short-term maturities, money market is treated as safe place.

The Reserve Bank of India (RBI) plays a key role of regulator and controller of money market. The intervention of RBI is varied – curbing crisis situations by reducing key policy rates or curbing inflationary situations by rising key policy rates such as Repo, Reverse Repo, CRR etc.

The most common money market instruments are Treasury Bills, Certificate of Deposits, Commercial Papers, Repurchase Agreements and Bankers Acceptance.