B.Com. Hons. in Accounting
2nd Semester
BCOMHFINGE201: Money Market
Unit-5: Recent Developments in Money market

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Integration of Unorganised Sector with the Organised Sector:

The money market is one of the most important segment of the Indian financial system. Money market is a wholesale debt market for low risk highly liquidate short term instrument. This market is dominated mostly by government banks and financial institutions. Money market is the term designed to include the financial institution which handle the purchase, sale, and transfer of short term credit instruments.

Money market plays a vital role in developing the Indian economy it refers lending and borrowing money to banks at short term purpose within one year. Money market regulated by the Reserve Bank Of India and it is providing the money to trade and industry it helps in implementing monetary policy. The most active part of the money market is the market for overnight call and term money between banks and institutions the term short term means generally period up to one year and nearly substitutes to money is used to denote any financial assets which can be quickly converted into money with minimum transaction cost.

Money market intermediaries supply only short term funds to individual and corporate customer they consist of commercial banks, co-operative banks.

While the need for long term financing is met by the capital or financial markets, money market is a mechanism which deals with lending and borrowing of short term funds. Post reforms period in India has witnessed tremendous growth of the Indian money markets. Banks and other financial institutions have been able to meet the high expectations of short term funding of important sectors like the industry, services and agriculture. Functioning under the regulation and control of the Reserve Bank of India (RBI), the Indian money markets have also exhibited the required maturity and resilience over the past about two decades.

Decision of the government to allow the private sector banks to operate has provided much needed healthy competition in the money markets, resulting in fair amount of improvement in their functioning.

Widening the Call Money:

Call money is money loaned by a bank that must be repaid on demand. Unlike a term loan, which has a set maturity and payment schedule, call money does not have to follow a fixed schedule, nor does the lender have to provide any notice of repayment. Brokerages use call money as a short-term source of funding to maintain margin accounts for the benefit of their customers who wish to leverage their investments. The funds can move quickly between lenders and brokerage firms.

For banks, call money is the most liquid asset after cash. Dealing in call money gives banks the opportunity to earn interest on surplus balance sheet funds. On the counterparty side, brokerages know that they are taking on risk by using funds that can be called at any time, so they typically use call money for transactions that will be resolved quickly. If the bank recalls the funds, then the broker can issue a margin call, which will typically result in the automatic sale of securities in a client's account (to convert the securities to cash) in order to make the repayment to the bank. Margin rates, or the interest charged on the loans used to purchase securities, vary based on the call money rate set by banks.

An interbank call money market is a short-term money market which allows for large financial institutions, such as banks, mutual funds and corporations, to borrow and lend money at interbank rates. The loans in the call money market are very short, usually lasting no longer than a week and are often used to help banks meet reserve requirements.

The interbank call money market is a term used to refer comprehensively to a call money market for institutions. It is not exclusively used only by banks. Interbank call money market customers can include banks, mutual funds, large corporations and insurance companies.

Entities transacting within the interbank call money market seek short term loans. Loans typically have duration of one week or less. Banks often use the interbank call money market to meet reserve requirements. Other entities use short term loans from the interbank call money market to manage various liquidity needs. Loans in the interbank call money market are typically transacted based on the London Interbank Offer Rate (LIBOR). Loans are transacted globally. The interbank call money market can include global participants with transactions across multiple currencies.

Various types of interbank money markets exist globally. The interbank call money market offers liquidity for a broader range of participants. An interbank money market can also be exclusively focused on banking entities. Interbank money markets typically involve short terms loans transacted across various currencies with multiple international participants. The interbank money markets are sources of short terms funds for banks and participants in the financial markets. Financial entities utilize these loan sources and rely on them when managing their capital and liquidity requirements. A lack of market lending in these market types was a factor in the 2008 financial crisis.

Introduction of Innovative Instruments:

Recently the Indian companies in the Financial Markets are using some innovative financial instruments. These included the following financial instruments:

1) Triple Option Convertible Debentures (TOCD):
   - First Issued by Reliance Power Limited with an issue size of Rs. 2,172 Cr.
   - There was no outflow of interest for first five years.
   - Equity increase was in phases.
   - No put option to investors and no takeover threat.
   - Reduced dependence on the financial institutions.
   - The expenses for floating the issue was just 2.62% of the issue size which was very less when compared to the 10-12% for a general public issue.
2) Deep Discount Bonds:
   - The investor got a tax advantage and could eliminate the re-investment risk.
   - From the issuer's point of view also, the issue cost was saved as it involved no immediate service cost and lower effective cost. The refinancing risk was also eliminated.
3) Floating Rate Notes:
   - First issued by Tata Sons with a floor rate of 12.5% and a cap of 15.5% and a reference rate of 364 T-Bill yield, which was 9.85% at the time of issue.
   - The investors would get a minimum return of the floor rate and the maximum return was the cap rate. They would get higher than floor rate depending upon the fluctuations in the reference rate.
4) Zero Coupon Bonds:

- It did not involve any annual interest on the bonds. But it had a higher maturity value on the initial investment for a particular time period.

5) Convertible and Zero Coupon Convertible Bonds:
    - Similar to the zero coupon bonds except that the effective interest was lower because of the convertibility.
6) Secured Premium Notes (SPNS):
    - First issued by TISCO in July, 1992.
    - These financial instruments were secured against the assets of the company but the investors had to pay a premium over the market price for these types of instruments.
7) Equity with Differential Voting Rights:
    - Issued by Tata Motors, in which the shares were classified as "Ordinary Shares" and "A Ordinary Shares".
    - The ordinary shares were issued at Rs. 340 per share, had a voting right of one vote per share.
    - On the other hand, the A ordinary shares were issued at Rs. 305 per share but the voting rights were limited to one vote for every 10 shares. In addition, they were paid extra dividend of five percentage points.

Offering Of Market Rates of Interest

In a regulated market interest rate is predetermined by the monetry authority of the country (the Central Bank). But in a deregulated environment, interest rate is market determined. This is true in case of Indian banks after deregulation was introduced in 1992.

Apart from banks and regulated money market, there are a lot of private players, who lend at a very high rate of interest in the open market. This is true particularly in case of rural areas, when crops fail and money lenders lend at a high rate of interest.

Thus in an open economy, interest is determined by demand for and supply of money.

Interest rates vary according to:

- the government's directives to the central bank to accomplish the government's goals
- the currency of the principal sum lent or borrowed
- the term to maturity of the investment
- the perceived default probability of the borrower
- supply and demand in the market

Promotion of Bill Culture:

1. Financing post-sale operations against bill of exchange is always considered beneficial from the bankers' point of view since bills represent the receivables stage of the operating cycle of a commercial activity, short term in tenor, self liquidating in nature, provide credit enhancement through acceptance by the drawee, a third party, and offer liquidity to the bank through re-discounting window. However, in the Indian Banking scenario, for decades now, Cash Credit/Overdraft continues to be the preponderant style of working capital funding. While Cash Credit constitutes about 70% of the total bank credit, bill finance is barely at around 10% of total bank credit. Further, bill financing is historically associated with movement of tangible goods and did not cover in its ambit the various types of activities in the services sector, though they arose out of commercial transactions. Services sector is transforming the economic profile of the country and is poised to register tremendous growth and contribute significantly to the overall economy in terms of wealth creation. It is against this backdrop that the Reserve Bank of India constituted a Working Group in December 1999

to examine the possibility of strengthening the existing bill discounting mechanism and extend its scope to services sector in view of the latter's growing importance.

2. The terms of reference of the Group are: -

a. To examine the feasibility and suggest measures to strengthen the existing bill discounting mechanism as an instrument for facilitating financing, in particular trade and services sectors, including discounting of Trade bills against letters of credit opened by banks.

b. To examine the role and scope for introducing 'Bankers' Acceptance' facility.

c. To examine all critical and relevant issues including the necessary safeguards to be put in place before extending Bills discounting to new areas like services and introduction of 'Bankers' Acceptance' facility.

d. Any necessary changes in the existing legal/regulatory frame work that may be needed.

e. Any other issue relevant/incidental to the subject which the Group considers necessary.

3. The Group had extensive interactive meetings with trade associations/ Chambers of Commerce. The Group, through separate structured questionnaire, elicited the views of customers and bankers on various issues pertaining to bill finance. It also had the benefit of the suggestions of banks at a meeting held under the aegis of Indian Banks' Association (IBA) and had the benefit of the views of IBA as well in this regard. Thus based on the responses received to the questionnaire, the views that emerged during interaction with the trade associations, corporates and banks and the findings of the sub-groups, the Group finalised its report.

Money Market Mutual Funds

Money market mutual fund (MMMF) is short-run liquid investments with high credit rating. It aims to provide investors with a low risk-low return haven to invest in easily accessible cash and cash-equivalent assets.

How do Money Market Mutual Funds work?

Money market mutual funds (MMMF) are used to manage the short-run cash needs. It is an open-ended scheme in the debt fund category which deals only in cash or cash equivalents. These securities have an average maturity of one-year; that is why these are termed as market instruments.

The fund manager invests in high quality, liquid instruments like Treasury Bills (T-Bills), Repurchase Agreements (Repos), Commercial Papers and Certificate of Deposits. This fund aims to earn interest for the unitholders without leading to a fall in funds' Net Asset Value (NAV).

Money market fund can be compared with savings account which comprises of cheque facility, the facility to redeem without lock-in period and electronic money transfer.

Who should Invest in Money Market Mutual Funds?

Money market fund seeks to provide the highest degree of short-term income via maintaining a well-diversified portfolio of money market instruments. Investors having a short-term investment horizon of up to 1 year can invest in these funds.

Those investors with surplus cash in savings bank account and low-risk appetite can invest in money market funds. These funds will give you higher returns than the savings bank account. The investors could include corporate as well as retail investors.

However, if you have a medium to long-term investment horizon, then money market fund won't be an ideal option. Instead, you may go for dynamic bond funds or balanced funds which may give you relatively higher returns. Similarly, don't think of money market funds unless you have short-term surplus cash which you don't need urgently.

Things to Consider as an Investor to invest money in Mutual Funds

a. Risk

These funds suffer from interest rate risk, credit risk and reinvestment risk. In interest rate risk, the prices of underlying asset increase as interest rates decline and decrease as interest rates rise. The fund manager may invest in risky securities which have a higher probability of default to deliver higher returns.

b. Return

A Money Market Fund might give you more return than a savings account. However, there are no guaranteed returns. The Net Asset Value (NAV) fluctuates with changes in overall interest rate regime. A fall in interest rates may increase the prices of an underlying asset and deliver good returns.

c. Costs

Expense ratio refers to the fees charged by Money Market Funds to manage your portfolio. Until recently, SEBI had prescribed the maximum limit as 2.25%. An ideal fund is one which keeps its expense ratio at lower levels. As the asset under management (AUM) increases, the scheme tends to reduce the cost of operations.

d. Investment Horizon

Money Market Funds are suitable for very short-term to short-term investment horizons .i.e. 3 months to 1 year. For medium-term horizons, you need to invest in dynamic bond funds.

e. Financial Goals

In case you have to make EMI payments or invest extra cash while maintaining liquidity, you can use money market funds. A small portion of your portfolio can be invested in these for diversification.

f. Tax on Gains

Investing in debt funds provides you capital gains which are taxable. The tax rate depends on the holding period i.e. for how long you stay invested in the fund. You make a Short-term Capital Gain (STCG) when you stay invested for a period of lesser than 3 years.

Adoption of Suitable Monetary Policy:

What is meant by Monetary Policy?

Monetary policy refers to the policy of the central bank – ie Reserve Bank of India – in matters of interest rates, money supply and availability of credit. It is through the monetary policy, RBI controls inflation in the country. RBI uses various monetary instruments like REPO rate, Reverse RERO rate, SLR, CRR etc to achieve its purpose. (This is explained well in one of our earlier articles – basics of economy concepts).

In short, Monetary policy refers to the use of monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy.

What are the main goals/objectives of Monetary Policy of India?

According to RBI Governor Dr. D. Subba Rao, "The objectives of monetary policy in India are price stability and growth. These are pursued through ensuring credit availability with stability in the external value of rupee and overall financial stability."

Following are the main objectives of monetary policy:

i. To Regulate Money Supply in the Economy:

The main aim of the monetary policy of the Reserve Bank was to control the money supply in such a manner as to expand it to meet the needs of economic growth and at the same time contract it to curb inflation. In other words monetary policy aimed at expanding and contracting money supply according to the needs of the economy.

ii. To Attain Price Stability:

Another major objective of monetary policy in India is to maintain price stability in the country. It implies Control over inflation. Price level, is affected by money supply. Monetary policy regulates money supply to maintain price stability.

iii. To promote Economic Growth:

An important objective of monetary policy is to make available necessary supply of money and credit for the economic growth of the country. Those sectors which are quite significant for the economic growth are provided with adequate availability of credit.

iv. To Promote saving and Investment:

By regulating the rate of interest and checking inflation, monetary policy promotes saving and investment. Higher rates of interest promote saving and investment.

v. To Control Business Cycles:

Boom and depression are the main phases of business cycle. Monetary policy puts a check on boom and depression. In period of boom, credit is contracted, so as to reduce money supply and thus check inflation. In period of depression, credit is expanded, so as to increase money supply and thus promote aggregate demand in the economy.

vi. To Promote Exports and Substitute Imports:

By providing concessional loans to export oriented and import substitution units, monetary policy encourages such industries and thus help to improve the position of balance of payments.

vii. To Manage Aggregate Demand:

Monetary authority tries to keep the aggregate demand in balance with aggregate supply of goods and services. If aggregate demand is to be increased than credit is expanded and the interest rate is lowered down. Because of low interest rate, more people take loan to buy goods and services and hence aggregate demand increases and vice-verse.

viii. To Ensure more Credit for Priority Sector:

Monetary policy aims at providing more funds to priority sector by lowering interest rates for these sectors. Priority sector includes agriculture, small- scale industry, weaker sections of society, etc.

ix. To Promote Employment:

By providing concessional loans to productive sectors, small and medium entrepreneurs, special loan schemes for unemployed youth, monetary policy promotes employment.

x. To Develop Infrastructure:

Monetary policy aims at developing infrastructure. It provides concessional funds for developing infrastructure.

xi. To Regulate and Expand Banking:

RBI regulates the banking system of the economy. RBI has expanded banking to all parts of the country. Through monetary policy, RBI issues directives to different banks for setting up rural branches for promoting agricultural credit.

What are the main elements of the monetary policy of India?

Following are the main elements of the monetary policy of India:

i. It regulates the stocks and the growth rate of money supply.

ii. It regulates the entire banking system of the economy.

iii. It determines the allocation of loans among different sectors.

iv. It provides incentives to promote savings and to raise the savings-income ratio.

v. It ensures adequate availability of credit for growth and tries to achieve price stability.

What are the Monetary Policy Instruments (MPI)?

There are several direct and indirect instruments that are used for implementing monetary policy.

1. Repo Rate: The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).
2. Reverse Repo Rate: The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.
3. Liquidity Adjustment Facility (LAF): The LAF consists of overnight as well as term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under fine-tuning variable rate repo auctions of range of tenors. The aim of term repo is to help develop the inter-bank term money market, which in turn can set market-based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy. The Reserve Bank also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.
4. Marginal Standing Facility (MSF): A facility under which scheduled commercial banks can borrow an additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.
5. Corridor: The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.
6. Bank Rate: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.
7. Cash Reserve Ratio (CRR): The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such percent of its Net demand and time liabilities (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India.
8. Statutory Liquidity Ratio (SLR): The share of NDTL that a bank is required to maintain in safe and liquid assets, such as unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.
9. Open Market Operations (OMOs): These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.
10. Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through the sale of short-dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.

What is The Monetary Policy Process (MPP)?

- The Monetary Policy Committee (MPC) determines the policy interest rate required to achieve the inflation target.
- The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating the monetary policy. Views of key stakeholders in the economy and

analytical work of the Reserve Bank contribute to the process for arriving at the decision on the policy repo rate.

- The Financial Markets Operations Department (FMOD) operationalises the monetary policy, mainly through day-to-day liquidity management operations.
- The Financial Market Committee (FMC) meets daily to review the liquidity conditions so as to ensure that the operating target of monetary policy (weighted average lending rate) is kept close to the policy repo rate. This parameter is also known as weighted average call money rate (WACR).

Role of Discount and Finance House of India (DFHI)

RBI set up the Dis-count and Finance House of India (DFHI) jointly with public sector banks and the all-India financial institutions. DFHI was incorporated in March 1988 and it commenced operation in April 1988. The main objective of this money market institution is to facilitate smoothening of the short-term liquid-ity imbalances by developing an active secondary market for the money market instruments. Its authorized capital is Rs. 250 crores.

DFHI participates in transactions in all the market segments, it borrows and lends in the call, notice and term money market, purchases and sells treasury bills sold at auctions, commercial bills, CDs and CPs. DFHI quotes its daily bid (buying) and offer (selling) rates for money market instruments to develop an active secondary market for all these.

Roles:

It's establishment is the result of long drawn needs-

- to bring equilibrium of liquidity in Indian banking system.
- To impart liquidity to the instruments of money market prevalent in economy.
- Primary dealer in economy and function on commercial basis.
- It deals in all kind of instruments in money market without any upper ceiling.
- Operating in two ways as borrower and lender.
- It's objective is to provide liquidity and stability in financial market.
- Now it's new name is SBI DFHI after giving it's holding to SBI arm SBI gilts limited by RBI

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