# BLOCK II:
# FINANCIAL MARKETS

Unit 1 : Financial Markets

Unit 2 : Structure of Money Market; Money Market and Reserve Bank of India

Unit 3 : Types of Money Market Instruments

# Unit-1
# Financial Markets

**Unit Structure:**

1.1 Introduction
1.2 Objectives
1.3 Meaning of Financial Market
1.4 Functions of Financial Markets
1.5 Structure of Financial Market
1.6 Types of Financial Market
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## 1.1 Introduction

Every business unit requires fund for smooth running of the business. The fund requirement may be short-term as well as long-term to meet their working and fixed capital requirements from time to time. This necessitates not only the ready availability of such funds but also a transmission mechanism with the help of which the providers of funds (investors/ lenders) can interact with the borrowers/users (business units) and transfer the funds to them as and when required. The investors also need a market which provides liquidity/marketability to their investment. Financial market is a place/system which takes care of transfer of fund from the savers to the investors and also provide liquidity to such investment.

In this unit we will discuss the functions of financial market and the different types of financial markets.

## 1.2 Objectives

After going through this unit, you will be able to-

- *know* the meaning of financial market,
- *explain* the functions of financial market,
- *discuss* the various types of financial market.

## 1.3 Meaning of Financial Market

Efficient financial markets are essential for speedy economic development. A vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment. Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. The growth of the financial markets is the barometer of the growth of a country's economy.

A financial market is a place where financial instruments are exchanged or traded. The primary function of the financial markets is to facilitate the transfer of funds from surplus sector(lenders) to deficit sector(borrowers). It is one of the most important constituents of Financial System. Financial markets facilitate the flow of funds in order to finance investments by corporations, governments and individuals.

Financial markets deal in financial securities (or financial instruments) and financial services through which funds are traded. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. Financial markets exist wherever financial transactions take place. Financial transactions include issue of equity stock by a company, purchase of bonds in the secondary market, deposit of money in a bank account, transfer of fundsfrom a current account to a savings account etc.

Financial Markets are broadly classified as Money Market and Capital Market. Money market is for short term securities while capital market is for long term securities. Capital Market is further classified as Primary market and Secondary Market. Primary market deals in new issues and the secondary market is meant for trading in outstanding or existing securities.

## 1.4 Functions of Financial Markets

Financial markets provide the following major economic functions:

1) Mobilisation of fund
2) Price discovery
3) Liquidity
4) Reduction of transaction costs

**1) Mobilisation of fund:** A well designed financial system promotes growth through effective mobilisation of savings and their allocation to the most productive uses.Financial markets facilitate mobilisation

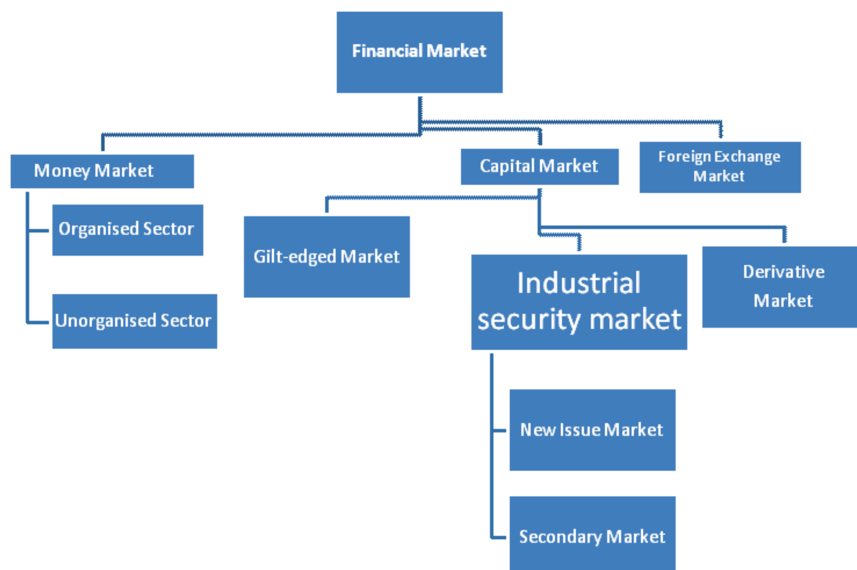
of Savings and channelizing them for most productive use. Financial markets act as a link between savers and investors. It gives the platform through which savers can transfer his savings to most appropriate investment opportunities.

2) **Price discovery:** Price of anything depends upon the demand and supply factors. Demand and supply of financial assets and securities in financial markets help in deciding the prices of various financial securities. Price discovery in financial market means that transactions between buyers and sellers of financial instruments in a financial market determine the price of the traded asset. At the same time the required return from the investment of funds is determined by the participants in a financial market. The motivation for those seeking funds (deficit units) depends on the required return that investors demand. It is these functions of financial markets that signal how the funds available from those who want to lend or invest funds will be allocated among those needing funds and raise those funds by issuing financial instruments.

3) **Liquidity:** Secondary market which is a part of capital markets provide liquidity to the securities by providing a ready market.In financial markets financial securities can be bought and sold easily so financial market provides a platform to convert securities in cash. Without liquidity, an investor would be forced to hold a financial instrument until conditions arise to sell it or the issuer is contractually obligated to pay it off. Debt instrument is liquidated when it matures, and equity instrument is until the company is either voluntarily or involuntarily liquidated. All financial markets provide some form of liquidity. However, different financial markets are characterized by the degree of liquidity.

4) **Reduction of Transaction Costs:** The function of reduction of transaction costs is performed, when financial market participants are charged and/or bear the costs of trading a financial instrument. In market economies the economic rationale for the existence of institutions and instruments is related to transaction costs, thus the surviving institutions and instruments are those that have the lowest transaction costs. Financial market provides complete information regarding price, availability and cost of various financial securities. So investors and companies do not have to spend much on getting this information as it is readily available in financial markets.

## 1.5 Structure of Financial Market




Financial Market is one of the important components of Indian Financial System. Indian Financial Market is broadly classified as Money Market and Capital Market. There are two segments in Indian money market, namely organized sector and unorganized sector. The organized sector consists of Reserve bank of India, commercial banks, financial intermediaries such as Unit Trust of India, Life Insurance Corporation of India, Cooperative Banks, Insurance companies, brokers etc. The organized sector of Indian money market directly comes under the preview of the Reserve Bank of India. The RBI is the most important constituents of Indian money market which control and regulate the money market. The unorganized sector of Indian money market consists of indigenous bankers, money lenders, traders and unregulated non-banking financial institutions. Capital market is the market for medium and long term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending term funds (medium-term and long-term funds). Capital market also known as industrial security market is further classifies as Primary or New Issue Market and Secondary or Share Market. Gilt edge Market, Foreign Exchange Market and Derivative Market are also the part of Indian Financial Market.

## 1.6 Types of Financial Market:

There are different types of market operating in the financial market such as:

- Money Market
- Capital Market
- Primary Market
- Secondary Market
- Gilt Edged Market
- Derivative Market
- Foreign Exchange Market
- Over-the-Counter Market

We shall try to understand the meaning and functions of all such markets in the following discussion.

### 1.6.1 Money Market

Money Market is that segment of the financial market where borrowing and lending of short-term funds take place. It is a market for short-term funds with maturity ranging from overnight to one year and includes financial instruments that are deemed to be close substitutes of money. Money market transactions could be both secured and unsecured, *i.e.,* without collaterals.Money market has no physical location, but is an activity conducted over the telephone and through the internet. It enables the raising of short-term funds for meeting the temporary shortages of cash and obligations and the temporary deployment of excess funds for earning returns.

The money market performs three broad functions.

1) It provides an equilibrating mechanism for demand and supply of short-term funds.
2) It enables borrowers and lenders of short- term funds to fulfil their borrowing and investment requirements at an efficient market clearing price.
3) It provides an avenue for central bank intervention in influencing both quantum and cost of liquidity in the financial system, thereby transmitting monetary policy impulses to the real economy.

The government bonds, corporate bonds and bonds issued by banks are examples of money marketinstruments. Various players in the money market are banks, financial institutions, government agencies, and at times even corporates. Money market deals with a number of instruments like treasury bills, repos (and reverse repos),commercial papers, certificates of deposits, and bill rediscountingare traded in money market and there are various sub-markets of money market like Call/Notice Money Market, Term Money Market, Treasury Bill market,etc.(These are discussed in details in the next unit).

**Check Your Progress**

Fill in the blanks:

1) Financial markets are market that deal in ——————and debt instruments.
2) The market for short term fund is called ——————.
3) _________ facilitate the transfer of funds from savers to the borrowers.

### 1.6.2 Capital Market

Capital market is the market for medium and long term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending term funds (medium-term and long-term funds).The demand for long-term funds comes mainly from industry, trade, agriculture and government.The supply of funds comes largely from individual savers, corporate savings, banks, insurance companies, specialized financial institutions and government. Adequate capital formation is indispensable for a speedy economic development. Capital market plays a significance role in capital formation. The main function of capital market is the collection of savings and their distribution for industrial development. This stimulates capital formation and hence, accelerates the process of economic development.

Various functions and significance of capital market are discussed below;

**i. Link between Savers and Investors**: The capital market functions as alink between savers and investors. It plays an important role in mobilizingthe savings and diverting them in productive investment. In this way,capital market plays a vital role in transferring the financial resourcesfrom surplus

and wasteful areas to deficit and productive areas, thusincreasing the productivity and prosperity of the country.

**ii. Promotes Saving:** With the development of capital, market,the banking and non-banking institutions provide facilities, which encourage people to save more. In the less - developed countries, in the absence of a capital market, there are very little savings and those who save often invest their savings in unproductive and wasteful directions and conspicuous consumption.

**iii. Promotes Investment:** The capital market facilitates lendingto the businessmen and the government and thus encourages investment. Itprovides facilities through banks and nonbanking financial institutions.Various financial asset s, e.g., shares, securities, bonds, etc., induce saversto lend to the government or invest in industry. With the development of financial institutions, capital becomes more mobile, interest rate falls and investment increases.

**iv. Promotes Economic Growth**: The capital market not only reflects the general condition of the economy, but also smoothens and accelerates the process of economic growth. Various institutions of the capital market, like nonbank financial intermediaries, allocate the resources rationally in accordance with the development needs of the country. The proper allocation of resources results in the expansion of trade and industry in both public and private sectors, thus promoting balanced economic growth in the country.

A sound and efficient capital market facilitates the process of capital formation and thus contributes to economic development. *Broadly capital market has two segments which are briefly discuss bellow-*

**A) Industrial Security Market:** Industrial security market refers to the market for shares and bonds of the existing companies as well as the new companies. This market is further divided in to primary market and secondary market. *Primary market or new issue market* is the market for fresh securities issued by new and existing companies.

The new issue market is used by the corporate houses for raising capital. *Secondary market or stock exchanges* are the market for second hand securities i.e., the securities which are all ready traded in the new issue market or securities which are already available in the market. The secondary market gives liquidity to the existing securities. If a company wants to trade its shares in the security market, they need to get themselves registrar with a stock

exchange for listing of their securities. Securities are allowed to trade in the secondary market only after it is get listed with the stock exchange. Capital market is discussed in detail in Block-3.

B) **Government Securities Market or Gilt-edged Market:** The term *gilt edged* means the best quality government securities. Such securities have high liquidity and low risk. This is the market where securities issued by central government and state governments are traded. Securities guaranteed by the government are also traded in this market.

As a segment of capital market, government securities market is very important as it provides a mechanism for management of public debt and open market operations to the Reserve Bank of India. Government securities market has a strong bearing on the formulation of the fiscal policy of the government of India and the monetary policy of the Reserve Bank of India. Government securities market has two segments. Treasury bill market and Government bond market. Treasury bill market (discussed in the next unit) is a source of short-term fund for the government and the government bond market is a source of long term fund for the government. Government bonds are dated securities which are floated to raise medium and long term loans in the open market. It is significant to note that generally the buyers in the government bonds markets are institutions. Individuals are found to be reluctant to invest their funds in government bonds as it carries lower interest rate, long maturity period and high face value. Institutions like commercial banks, LICI,GIC buy government bonds to build up their asset portfolio. These institutions invest in government bonds as they are required by law to invest a minimum portion of their total fund in government securities. In the supply side RBI as a manager of the public debt operates in the government bond market. At the end of the subscription period RBI holds the stocks of unsold government bonds and keep them selling on its own account.

Primary dealers are registered entities with the RBI who have the license to purchase and sell government securities. They are entities who buys government securities directly from the RBI (the RBI issues government securities on behalf of the government), aiming to resell them to other buyers. In this way, the Primary Dealers create a market for government securities.

**Check Your Progress**

**Fill in the blanks:**

1) The market for medium- and long-term fundsis called ——
2) Compared to money market the risk in capital market is …………

### 1.6.3 Foreign Exchange Market

The foreign exchange market is a market in which currencies are bought and sold against each other. In other words, foreign exchange marketis the market where the currency of one country is exchanged for the currency of another country. The market is an over the counter market.There is no single market place or an organized exchange (like a stock exchange) where traders meet and exchange currencies. According to Kindelberger, "Foreign exchange market is a place where foreign moneyis bought and sold." Foreign exchange market is the largest financial market. Foreignexchange markets were primarily developed to facilitate settlement of debtsarising out of international trade. The largest foreign exchange market isLondon followed by New York, Tokyo, Zurich and Frankfurt. The marketsare situated throughout the different time zones of the globe in such a waythat when one market is closing the other is beginning its operations. Thus,at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day.

There are two segments in the foreign exchange markets. Viz. the retail market and the wholesale market. In the retail foreign exchange market, Retail traders buy or sellcurrency for their genuine business/personal requirements. Individuals liketourists, foreign students, patients traveling to other countries for medical treatment; small companies, small exporters and importers operate in theretail foreign exchange market. Money transfer companies are also majorplayers in the retail market. The wholesale foreign exchange market is also called the inter-bank market. In the wholesale market Commercial banks are the market makers. This market serves to smoothen the excessive purchases or sales made by individual banks.

**Stop to Consider**

'Hawala Market' extensively operating in India before the economic liberalization of 1992. During the pre-liberalization period, RBI was

strictly controlling exchange rate. This created a parallel black market of foreign exchange popularly known as 'Hawala Market'. Hawala market is nothing but an illegal foreign exchange market where trading of foreign exchange takes place at a rate which is different from the rate prescribed by the RBI.

**Functions of Foreign Exchange Market**

The foreign exchange market performs the following three functions:

a) **Transfer function:** The foreign exchange market transfers purchasingpower between two countries. It is the primary function of this market.Various instruments such as telegraphic transfers, bank drafts andforeign bills are used for transferring the purchasing power.

b) **Credit function**: Another function of foreign exchange market is to providecredit for promotion of foreign trade. Foreign exchange market providecredit by discounting bills of exchange arising out of foreign trade. Billsof exchange, with maturity period of three months, are generally usedfor international payments. Credit is required for this period in order toenable the importer to take possession of goods, sell them and obtainmoney to pay off the bill.

c) **Hedging function**: The third function of foreign exchange market is tohedge foreign exchange risk. The exchange rates (price of one currencyexpressed in another currency) under free market situation can go upand down. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilitieswhich are to be met in foreign currency. Through hedging, the foreignexchange market tries to protect the interest of the persons dealing inthe market from any such unforeseen changes in the exchange rate.

**Dealers in Foreign Exchange Market**

Following are the important dealers of foreign exchange market inIndia:

**Banks**: Commercial banks operate in the foreign exchange market eitherat retail level for individual exporters and corporations or at wholesalelevel in the interbank market. The banks dealing in foreign exchangemaintain substantial foreign currency balances to serve the need of thecustomers.

These banks discount and sell foreign bills of exchange,issue bank draft, make transfer etc.

**Central Bank:** Central banks of the country intervene in the foreign

exchange market in order to maintain the exchange rate within a certainrange. The central banks also execute the policies of the government.

**Brokers:** In the foreign exchange market banks do not deal directlywith each other. The brokers bring together the buyers and sellers offoreign exchange. If a bank wants to buy or sell foreign exchange, itinforms the broker the amount. If the broker succeeds in carrying outthe transaction, he receives a commission from the selling bank.

**Acceptance Houses:**Acceptance houses also operate in foreignexchange market. They accept bills on behalf of their customers andhelps in foreign remittance.

**Check Your Progress**

1) In which year RBI launched the system of primary dealers for expanding the government securities market.
2) Who is the market maker of wholesale foreign exchange market? Commercial banks

### 1.6.4 Derivatives Market

Derivative market is the market for derivative instruments/contracts like future, forward etc. A derivative is a financial instrument whose value is derived from an underlying asset or group of assets. They are contracts between two or more parties. The value of this contract depends on changes in the value of the asset that the derivative's value is derived from.The underlier can come in many forms including, commodities, mortgages, stocks, bonds, or currency.

Derivatives can either be exchange-traded or traded over the counter (OTC).Exchange refers to the formally established stock exchange wherein securities are traded and have a defined set of rules for the participants.Whereas OTC is a dealer-oriented market of securities, which is an unorganized market where trading happens by way of phone, emails, etc.Derivatives traded on the exchange are standardized and regulated.On the other hand, OTC derivative constitutes a greater proportion of derivatives

contracts, but it carries higher counterpart risk and is unregulated.Exchange traded derivative markets have better price transparency than OTC markets. Derivative trades in OTC markets are bilateral in nature. All contract terms such as delivery quality, quantity, location, date and prices are negotiable between the two parties.Transactions can be arranged by telephone or other communication means. Prices are not reported publicly.

**Basic Derivative Instruments:** The three basic kinds of derivative securities are forwards and futures; swaps; and options.

**Forwards**

A forward contract is one in which two parties (referred to as the "counterparties" to the transaction) commit to the terms of a specified trade to be carried out on a specified date in the future. Forward contracts are bilateral or "over the counter" (OTC) contracts, i.e., they are negotiated directly between buyer and seller. On the positive side, this means they are customizable in terms of the maturity date, the specific quality (grade) to be delivered, etc. On the other hand, each party also takes on the risk of the other counterparty's default.

**Futures**

A futures contract is, in essence, a forward contract that is traded on an organized exchange rather than negotiated bilaterally. Futures contracts grew out of forward contracts in the mid-19th century. Futures contract terms (maturity dates, deliverable grade of the underlying,etc.) are standardized, and the exchange guarantees performance on the contract. Participants in futures markets are required to post "margin," which is essentially collateral against default.

**Swaps**

Swaps, like forwards, are over-the-counter contracts. In a forward, the two counterparties commit to a single trade or single exchange of cash flows. In a swap, the counterparties commit to multiple exchanges of cash flows over several dates in the future. Swaps are most common in the interest-rate derivatives market, where the typical contract has the parties exchanging one interest index for another computed on a given notional principal amount. (For example, one counter party in the swap may make floating-rate payments indexed to LIBOR, while the other makes fixed-rate payments on the same principal amount.) They are also popular in the currency market, where the swap involves an exchange of principal and currency in one exchange for principal and currency in another.

**Options**

An option is a financial security that gives the holder the right, but not the obligation, to take part in a specified trade. There are two basic kinds of options (and a great many variants on these structures). In a call option, the holder of the option has the right, but not the obligation, to buy the specified underlying asset at a price specified in the contract (called the "strike price").In a put option, the holder of the option has the right to sell the underlying asset at the specified strike price.The holder of the option is also variously referred to as the long position in the option or the buyer of the option. The other counterparty in option trade—who has an obligation to take part in the trade if the option buyer should decide to exercise his right—is called the seller or writer of the option or the short position in the option. In exchange for providing the option holder with optionality concerning the trade, the option writer receives an up-front fee called the option price or the option premium.Options trade both on organized exchanges and in the over-the-counter (OTC) market. Exchange-traded options exist on equities, equity indices, currencies, and interest rates and bonds,among others. Exchange-traded options are standardized in terms of expiry dates and strike prices.OTC options are customizable and exhibit a great deal more variety.Credit Derivatives are derivatives written on the credit risk of an underlying reference entity. By far the most popular form of credit derivative is the credit default swap or CDS. Akin to insurance against default, a CDS references a specific credit obligation issued by a specified entity (for example, a specific bond issued by Ford Motor Company). One counterpartyin the CDS contract (the "buyer of protection") makes a regular periodic payment to the other counterparty (the "seller of protection"); in exchange the protection seller agrees to pay the protection buyer any loss in value on the specified reference obligation if a "credit event" (e.g.,default) were to occur during the life of the CDS contract.

**Functions/Needs of Derivative Market**

Derivative contracts may be employed to satisfy a variety of needs and it performs various functions

i. **Transfer/Hedging of Risk**: This is the most important use of derivative which helps in transferring risk from risk-averse people to a risk-seeking investor. The risk-seeking investor can enter into a risky contrarian trade to gain short-term profits. While the risk-

averse investor can enhance the safety of their position by entering into a derivative contract.

Derivative contracts help in hedging risk against unfavourable price movements of an underlying asset. By entering into a forward contract, the buyer and seller agrees to complete the deal at a pre-decided price at some specific date in the future. Any unexpected price hikes or drop will not influence the contract value, thereby providing protection against these types of risks.

ii. **Price Discovery**: Derivative market serves as an important source of information about prices. Prices of derivative instruments such as futures and forwards can be used to determine what the market expects future spot prices to be. In most cases, the information is accurate and reliable. Thus, the futures and forwards markets are especially helpful in future as well as current price discovery mechanism.

iii. **Linked to cash markets:** Derivatives, due to their inherent nature,are linked to the underlying cash markets. With the introduction ofderivatives, the underlying market witnesses higher trading volumes because of participation by more players who would not otherwise participate for lack of an arrangement to transfer risk.

iv. **Check on speculation:** Speculation traders shift to a more controlled environment of the derivatives market. In the absence of an organised derivatives market, speculators trade in the underlying cash markets. Managing, monitoring and surveillance of the activities of various participants become extremely difficult in these kinds of mixed markets.

**Participants in the Derivative Market**

**Hedgers**

In investment decisions the investor always try to transfer the risk from one party to another. Hedge is a position taken for the purpose of reducing exposer to risk. Hedging is a market mechanism by which an investor protects erosion of asset value due to an adverse price movement. Hedgers therefore, use derivatives especially during market volatility.A hedger uses futures markets to reduce risk caused by the movements in prices of

securities, commodities, exchange rates,interest rates, indices, etc. As such, a hedger will take a position in futures market that is opposite a risk to which he or she is exposed.

**Speculators**

Speculators, in a way are the exact opposite of hedgers. Rather they are extremely high-risk seekers who anticipate future price movement in the hope of making large and quick gains. The motive here is to take maximum advantage of the price fluctuations. They play a very key role in the market by absorbing excess risk and also provide much-needed liquidity in the market when normal investors do not participate. Speculators usually trade in the futures markets to earn profit on the basis ofdifference in spot and futures prices of the underlying assets. Hedgers use the futures markets for avoiding exposure to adverse movements in the price of an asset, whereas the speculators wish to take position in the market based upon such expected movements in the price of that asset.

**Arbitrageurs**

Arbitrageurs are another important group of participants in futures markets. They take advantage of price differential oftwo markets. An arbitrageur is a trader who attempts to make profits by locking in a riskless trading by simultaneously entering into transactions in two or more markets. The arbitrage opportunities available in the different markets usually do not last long because of heavy transactions by the arbitrageurs where such opportunity arises.

### 1.6.5 Over-the-Counter Market

OTC markets are electronic networks that allow two parties to trade with each other using dealer-broker as a middle man. In Over-the-Counter (OTC) market trading of securities between two counterparties executed outside the formal stock exchange. Companies that list their securities on over-the-counter markets may not meet the requirements for listing on an exchange, and therefore turn to this alternative market to raise capital. Stocks that are traded over-the-counter usually belong to small companies that lack the resources to be listed on formal exchanges. However, stocks of many big companies are also traded over-the-counter.In OTC market prices of the securities/products are not always published to the public. Financial

products traded in OTC market include stocks, debt securities, commodities and derivatives. Derivatives represent a substantial part of over-the-counter trading, which is especially crucial in hedging risks using derivatives.Most OTC trading happens at two primary networks: OTC Markets Group and Over-the-Counter Bulletin Board (OTCBB).

The typical trading process in an OTC market is as under:

1. An investor opens an account at a brokerage firm, which is needed to execute trades in an OTC market.
2. The investor chooses a security to buy from one of the major OTC markets.
3. The investor places either a limit order or a market order. A limit order allows the investor to state the exact price they're willing to trade a security for, while a market order instructs the broker-dealer to execute the trade immediately at the best price.
4. The broker-dealer facilitates the order, either internally from its own trading accounts or externally with another broker-dealer.
5. The broker-dealer confirms the trade with the investor, and settles the trade by delivering the funds and securities to the appropriate parties.

**Check Your Progress**

1) Name two participants in the derivative market.
2) What is mean by OTC market?
3) What is derivative?

## 1.7 Summing Up

- The primary function of the financial markets is to facilitate the transfer of funds from surplus sector(lenders) to deficit sector(borrowers).
- Besides money market and capital market are the main markets of the financial market, there are different other markets in financial market.
- Money Market is that segment of the financial market where borrowing and lending of short-term funds take place.

- Capital market is the market for medium and long term funds.
- Capital market has two segments-Industrial securities market and Government securities market.
- Industrial securities market has two segments- primary market and secondary market.
- The foreign exchange market is a market in which currencies are bought and sold against each other.
- Derivative market is the market for derivative instruments/contracts like future, forward etc. A derivative is a financial instrument whose value is derived from an underlying asset or group ofassets.
- In Over-the-Counter (OTC) market trading of securities between two counterparties executed outside the formal stock exchange.

## 1.8 Model Questions

1. What is financial market? Discuss the functions performed by financial market.
2. Explain the concept of capital market.
3. Explain the concept of money market.
4. Define foreign exchange market. Also discuss the dealers in the foreign exchange market.
5. What is derivative? Discuss different types of derivative instruments.
6. Write a note on OTC market.

## 1.9 References and Suggested Readings


1. Bharati V Pathak, *The Indian financial system*. New Delhi: Pearson.
2. JaydebSarkhel and Seikh Salim,*Indian financial system*. McGraw Hill India.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# Unit-2

## Structure of Money Market; Money Market and Reserve Bank of India

**Unit Structure:**

2.1 Introduction
2.2 Objectives
2.3 Meaning and Definitions Money Market
2.4 Features of Money Market
2.5 Characteristics of a Developed Money Market
2.6 Structure of Indian Money Market
 2.6.1 Unorganised Sector of Indian Money Market
 2.6.2 Organized Sector of Indian Money Market
2.7 Unorganised Sector of Indian Money Market
2.8 Organized Sector of Indian Money Market
2.9 Defects of Indian Money Market
2.10 RBI and Indian Money Market
 2.10.1 Role of RBI in Money Market
 2.10.2 Measures/ Steps taken by RBI to develop the Indian Money Market
2.11 RBI Committees / Working Groups on Money Market
2.12 Summing Up
2.13 Model Questions
2.14 References and Suggested Readings

### 2.1 Introduction

Financial market deals in financial instruments (securities) and financial services. Financial markets are classified into two, namely, money market and capital market**.** Money market is a segment of financial market. It is a market for short term funds. It deals with all transactions in short term securities. These transactions have a maturity period of one year or less. This unit will discuss the meaning, characteristics, constituents, functions and instruments of money market. It will also discuss about the recent trends of Indian Money market as well as the importance of a developed money market in the economy.

## 2.2 Objectives

After going through this unit the learners will able to–

- *State* the meaning and definition of money market,
- *Interpret* the features of developed money market,
- *Explain* the components and structure of money market,
- *Explain* the functions of Indian money market,
- *Discuss* the characteristics and defects of Indian money market,
- *Highlight* the role played and step taken by RBI to develop the Indian Money Market.

## 2.3 Meaning and Definitions Money Market

Money market is a very important segment of financial market. It is a market for short term funds. Monetary assets of short-term nature with maturity period up to one year and financial assets that are close substitutes for money are dealt in the Money Market. Money Market instruments have the characteristics of - liquidity, minimum transaction cost and no loss in value.

It should be noted that money market does not deal in cash or money as such but simply provides a market for credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are close substitute of money. These instruments help the business units, other organisations and the Government to borrow the funds to meet their short-term requirement.

Money Market enables suppliers and users of short-term funds to fulfill their investments and borrowings requirements respectively. It performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity, surpluses and deficits. The process of money market enables the central bank to administer its monetary policy. The Money Market is one of the primary mechanism through which the Central Bank (RBI) influences liquidity and the general level of interest rates in an economy.

This is a market for borrowing and lending of short-term fund. Money market does not imply to any specific market place. Rather it refers to the whole networks of financial institutions dealing in short-term funds, which provides an outlet to lenders and a source of supply for such funds to

borrowers. Most of the money market transactions are taken place on telephone, fax or Internet. The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialized financial institutions. The Reserve Bank of India is the leader of the money market in India. Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC, GIC, UTI, etc. also operate in the Indian money market.

According to Crowther, ***"****Money market is a collective name given to various firms and institutions that deal in the various grades of near money*". Money market is not a place. It is an activity. It includes all organizations and institutions that deal in short term financial instruments. However, sometimes geographical names are given to the money market according to the location, e.g. Mumbai Money Market.

### 2.4 Features of Money Market

Following are some important features of Money Market:

1. The Money Market is a wholesale market where the volumes of transactions is very large and is settled on a daily basis.
2. Money market comprises of various sub markets like call money, Treasury bill, commercial bill etc. and each market is concerned to deal in particular type of asset. All the sub markets in money market are closely interlinked.
3. Trading in the Money Market is conducted over the telephone, followed by written confirmation through e-mails, texts from the borrowers and lenders.
4. There are a large number of participants in the Money Market such as commercial banks, mutual funds, investment institutions, and financial institutions and finally the Reserve Bank of India.
5. The Central Bank occupies a strategic position in the Money Market. The Money Market can obtain funds from the central bank either by borrowing or through sale of securities. The central bank influences liquidity and interest rates by open market operations, REPO transactions changes in Bank Rate, Cash Reserve Requirements and by regulating access to its accommodation.

6. Indian money market has a dichotomy structure consisting both organised money market and unorganised money market. The organised money market consists of commercial banks and other financial institutions controlled by RBI. The unorganised sector consist of indigenous bankers, moneylenders etc. who remains outside the control of RBI.
7. In Indian money market demand for fund is seasonal. Being an agricultural economy, during the harvesting season (October to April) demand for fund is high.
8. In Indian money market the supply of instruments such as commercial bills, treasury bills, certificates of deposits etc, is limited.
9. A well-developed Money Market contributes to an effective implementation of the monetary policy.

## 2.5 Characteristics of a Developed Money Market

A well developed and efficient money market is necessary for the development of any economy. The following are the characteristics or prerequisites of a developed and efficient money market:

1. **Highly Developed Commercial Banking System:** Commercial banks are the centre of the whole short term funds. They serve as a vital link between the central bank and the various segments of the money market. When the commercial banking system is developed or organized, the money market will be developed.
2. **Presence of a strong Central Bank:** In a developed money market, there always exists a central bank. The central bank is necessary for direction and control of money market. Central bank absorbs surplus cash during off-seasons and provides additional funds in busy seasons. This is done through open market operations. Being the bankers' bank, central bank keeps the reserves of commercial banks and provides them financial accommodation in times of need. If the central bank cannot influence the money market it means the money market is not developed. In short, without the support of a central bank, a money market cannot function.
3. **Existence of Sub-markets:** Money market is a group of various sub-markets. Each sub market deals in instruments of varied maturities. There should be large number of sub-markets. The larger the number

of sub markets, the broader and more developed will be the structure of money market. Besides, the sub-market must be interrelated and integrated with each other. If there is no co-ordination and integration among them, different interest rates will prevail in the submarkets.

4. **Availability of Credit Instruments:** The continuous availability of readily acceptable negotiable securities (near money assets) is necessary for the existence of a developed money market. In addition to variety of instruments or securities, there should be a number of dealers (participants) in the money market to transact in these securities. It is the dealers in securities who actually infuse life into the money market.

5. **Existence of Secondary Market**: There should be active secondary market in these credit instruments. The success of money market always depends on the secondary market. If the secondary market develops, then there will be active trading of the instruments.

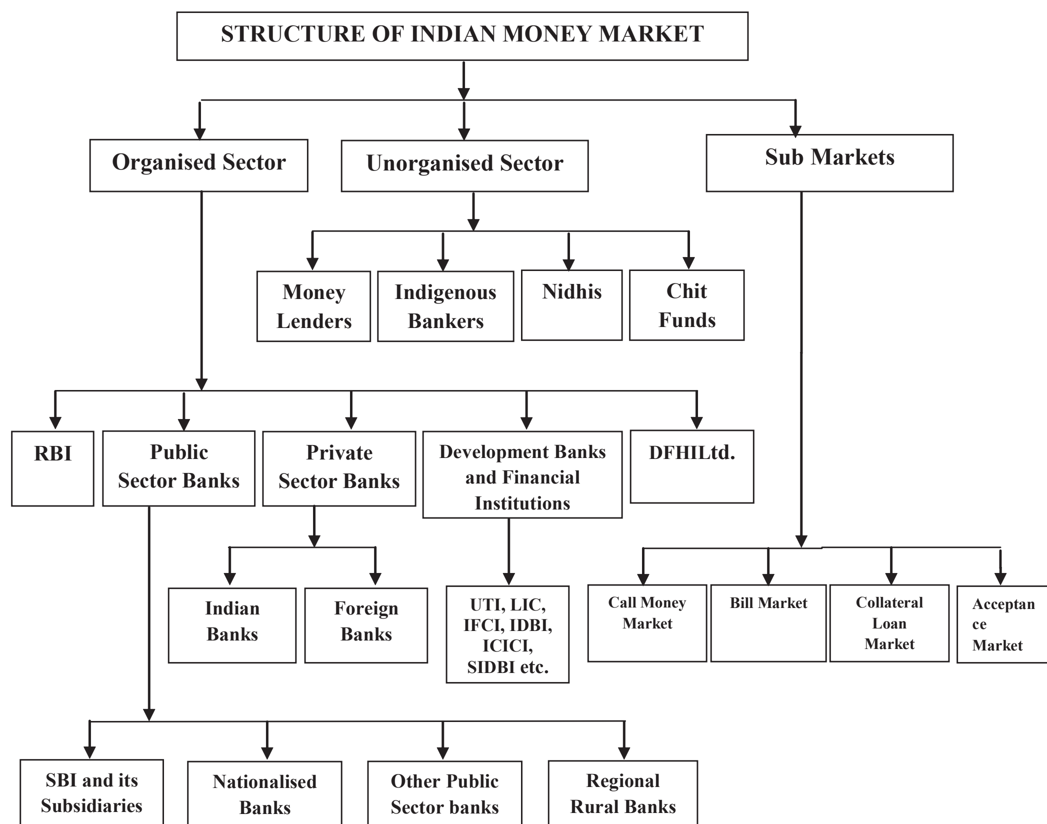
6. **Availability of Ample Resources**: There must be availability of sufficient funds to finance transactions in the sub markets. These funds may come from within the country and outside the country. Under developed money markets do not have ample funds. Thus availability of sufficient funds is essential for the smooth and efficient functioning of the money market.

7. **Demand and Supply of Funds:** Money market should have a large demand and supply of funds. This depends upon the number of participants and also the government policies in encouraging the investments in various sectors and monetary policy of RBI.

8. **Other Factors:** There are some other factors that also contribute to the development of a money market. These factors include industrial development, volume of international trade, political stability, trade cycles, foreign investment, price stabilization etc.

## 2.6 Structure of Indian Money Market

In the Indian money market RBI occupies a key role. It is the nerve centre of the monetary system of our country. It is the leader of the Indian money market. The Indian money market can be divided into two sectors- unorganized and organised.




The organized sector of Indian Money Market comes under the control of RBI. This sector comprises of RBI, SBI group of banks, public sector banks, private sector banks, development banks and other financial institutions. The unorganised sector comprises of indigenous bankers, money lenders, chit funds etc. These are outside the control of RBI.

## 2.7 Unorganised Sector of Indian Money Market

The unorganised sector of the money market is largely made up of indigenous bankers, money lenders, traders, commission agents etc., some of whom combine money lending with trade and other activities and some are purely engaged with money lending activity. Following are some players operating in the unorganized sector of Indian Money Market.

A. **Indigenous Bankers:** Indigenous bankers include those individuals and private firms which are engaged in receiving deposits and giving loans. Their activities are not at all regulated. Though with the growth of modern banking indigenous bankers received a setback but even today also it serves a huge population of India and occupies an important place in the Indian money market and play a vital role in

financing domestic trade. According to Central Banking Enquiry Committee "an indigenous banker is an individual or private firm which receives deposits, deals in hundis or engages itself in lending money". Indigenous bankers are classified into three main groups, i.e., (i) those who deals only in banking business; (ii) those who combine banking business with trade; and (iii) those who mainly associated with trade and also have limited banking business. They are known in different names in different parts of the country like Sahukars, Mahajans, Shroffs, Marwaris, Chettys etc. Gujarati Shroffs are mostly operating in Mumbai, Kolkata and in industrial and trading cities of Gujarat. The Multani or Shikarpuri Shroffs are operating mainly in Mumbai and Chennai. The Chettiars are mostly found in the South. The Marwari are mostly active in Mumbai, Kolkata, tea gardens of Assam and also in different other parts of North-East India. indigenous bankers are different from moneylenders in the sense that moneylender only lends money from his own fund but the indigenous banker lend money and also accept deposit from public.

The indigenous bankers charge high rate of interest and they are not influenced by any policy of the Reserve Bank of India.

B. **Moneylenders:** Moneylenders advanced loans to small borrowers like marginal and small farmers, agricultural labourers, artisans, factory and mine workers, low paid staffs, small traders etc. at very high rates of interest and also adopt various malpractices for manipulating loan records of these poor borrowers. The area of operation of the moneylenders is very much localised and their methods of operation is also not uniform. Broadly there are three types of moneylenders- (i) Professional moneylenders dealing solely with money lending; (ii) Itinerant moneylenders such as Kabulis and Pathans and (iii) Non-professional moneylenders.

## 2.8 Organized Sector of Indian Money Market

The Indian money market consist of two segments-organized sectors and the unorganized sector. The organized sector consists of various financial/ non-financial institutions. This sector is controlled by the central bank i.e. the Reserve Bank of India. Following are some institutions operates in organized sector of Indian money market-

A. **Reserve Bank of India: Reserve** Bank of India (RBI) is the central bank of India and most important participant of the money market. The RBI implements and monitors the monetary policy and ensures price stability while keeping in mind the objective of economic growth of the country. It regulates the activities and institutions in the money market.

   It comes under the management of the Ministry of Finance, Government of India. RBI is responsible for the issue, control, and maintaining the supply of the Indian currency, the rupee. The RBI manages the foreign exchange reserves of India.

B. **Schedule Commercial Banks:** Scheduled banks are those listed in Schedule II of the Reserve Bank of India Act of 1934 and constitute the majority of banks operating under the central bank. As per the rules, the bank's paid-up capital and raised funds must be at least Rs. 5 lakh. Scheduled Commercial Banks (SCBs) form the core of India's banking system, providing a wide array of financial services to individuals, businesses, and the government. The structure of SCBs in India is intricate, encompassing various layers, components, and functions.

   Scheduled Public Sector Banks are the banks in which the government of India owns more than 50% of the stock. As of 2022, there are *12 public sector banks* after the recent bank mergers of the total 27 public sector banks. Scheduled Private Sector Banks are the banks in which private entities have the most stakes. There are 21 private sector banks in operating in India. In India, there are 45 foreign banks. Foreign banks are which are established in some other country having business in India. Such foreign banks must abide by the rules and regulations of both their home and host countries.

C. **Co-operative Banks:** A Co-operative Bank is a Co-operative Society registered under the States Cooperative Societies Act. The Co-operative banks are also regulated by the Reserve Bank of India (RBI) and governed by the Banking Regulations Act 1949, The Banking Laws (Application to Co-operative Societies) Act, 1965. Co-operative banks play an important role in meeting the credit requirements of both the urban and rural India. Though in the bank dominated financial system, these institutions account for a

small share in the total credit they hold a significant position in credit delivery as they cater to different geographic locations and demographic categories. The wide network of co-operative banks, both rural and urban, supplements the commercial banking network for deepening financial intermediation by bringing a large number of depositors/borrowers under the formal banking network. Demographically, these institutions have enabled access to financial services to low and middle-income groups in both rural and urban areas.

D. **Corporate Houses:** Corporate houses are very important participants of money market and plays very vital role by creating demand of funds from the banks. Corporate houses issue commercial papers for raising short term funds from the money market. They also accept public deposit and indulge in inter-corporate deposit and investment.

E. **Mutual Funds:** Mutual fund is special types of investment institutions which pools the savings of investors for collective investment in a diversified portfolio of securities. It acts as financial intermediaries who collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and government bonds and equity shares of joint stock companies. It serves as a links between the investors and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns.

Money market mutual fund is set up to invest exclusively in short term money markets instruments like treasury bills, commercial paper, certificate of deposits, etc. The main objective of this fund is generation of income and provides easy liquidity. A money market fund invests in a pool of short-term, interest-bearing securities. Money market funds are most appropriate in situations where you seek to preserve the value of your investment while still earning income. After the remarkable success of mutual funds set up by the banks and financial institutions in India, the Reserve Bank of India (RBI) permitted the establishment of the Money Market Mutual Funds (MMMF) in the year 1992. The basic idea is the deployment of mutual funds' surplus funds in the money market. MMMF ensures high liquidity, adequate surety and high returns. What distinguishes

the money market mutual funds from the existing mutual funds is the difference in their investment portfolios. A money market mutual fund invariably and exclusively invests its resources in high quality money market instruments, whereas, a mutual fund largely invests in capital market securities and "parks" its surplus funds in money market instruments for short period.

F. **Insurance Companies:** Both general and life insurance companies are usual lenders in the money market. With the introduction of CBLO (Collateralized Borrowing and Lending Obligations), they have become important investors in the money market. Being cash surplus entities, they do not borrow in the money market. In between capital market instruments and money market instruments, insurance companies invest more in capital market instruments.

G. **Discount and Finance House in India (DFHI):** The DFHI equilibrated the surplus of fund and the deficit amounts of the banks. The DFHI helps in lending and borrowing of funds to the different banks as well as financial institutions. The DFHI was setup jointly by the Reserve Bank of India, public sector banks and financial institutions in the year 1988 as a sequel to Vaghul Working Group recommendations to impart liquidity to money market instruments and help the development of a secondary market in such instruments.

DFHI since its inception has been actively trading in all the money market instruments (viz. call/notice/term money, commercial bills, treasury bills, certificates of deposit and commercial paper) and its business turnover has grown progressively over the years. With effect from the year 1992-93, DFHI has been authorised to deal in dated Government securities also. In 2004, the Reserve Bank of India (RBI) transferred its total holding to SBI Giltz Limited. Its new name is SBI DFHI.

**Check Your Progress**

1. What is Money Market?
2. What are the feature of Money Market?
3. Highlight the characteristics of a develop Money Market.
4. Who controls the organised sector of Money Market?
5. Name some institution/players in organised Money Market.

### 2.9 Defects of Indian Money Market

Indian money market is relatively underdeveloped when compared with advanced markets like New York and London Money Markets. The defects of the Indian money market are as follows:

1. **Existence of Un-organised Segment**: The most important defect of the Indian money market is the existence of un-organised segment. The un-organised segment comprises of indigenous bankers, money lenders etc. This un-organised sector does not follow the rules and regulations of the RBI. Besides, a higher rate of interest prevails in the un-organised market.
2. **Lack of Integration:** Another important drawback of the Indian money market is that the money market is divided into different sections. Unfortunately, these sections are loosely connected to each other. There is no co-ordination between the organised and un-organised sectors. With the setting up of the RBI and the passing of the Banking Regulations Act, the conditions have improved.
3. **Disparities in Interest Rates**: Interest rates in different money markets and in different segments of money market still differ. Too many interest rates are prevailing in the market. For example, borrowing rates of government lending rate of commercial banks, the rates of co-operative banks and rates of financial institutions. This disparity in interest rates is due to lack of mobility of funds from one segment to another.
4. **Seasonal Diversity of Money Market**: The demand for money in Indian money market is of seasonal in nature. During the busy season from November to June, money is needed for financing the marketing of agricultural products, seasonal industries such as sugar, jaguar, etc. From July to October the demand for money is low. As a result, the money rates fluctuate from one period to another.
5. **Absence of Organized Bill Market:** A bill market refers to a mechanism where bills of exchange are purchased and discounted by banks in India. A bill market provides short term funds to businessmen. The bill market in India is not popular due to over dependence of cash transactions, high discounting rates, problem of dishonour of bills etc. The bill market in India is not well developed. There is a great paucity of sound commercial bills of

exchange in our country. As a matter of habit, Indian traders resort to hundies rather than properly drawn bill of exchange.

6. **Shortage of Funds:** In Indian money market demand for funds exceeds the supply. There is shortage of funds in Indian money market an account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy etc. There is also vast amount of black money in the country which has caused shortage of funds. However, in recent years' development of banking has improved the mobilisation of funds to some extent.

7. **Inadequate Banking Facilities**: Though the commercial banks, have been opened on a large scale, yet banking facilities are inadequate in our country. The rural areas are not covered due to poverty. Their savings are very small and mobilisation of small savings is difficult. The involvement of banking system in different scams and the failure of RBI to prevent these abuses of banking system shows that Indian banking system is not yet a well organised sector.

8. **Inefficient and Corrupt Management**: One of the major problems of Indian money market is its inefficient and corrupt management. Inefficiency is due to faulty selection, lack of training, poor performance appraisal, faulty promotions etc. For the growth and success of money market, there is need for well trained and dedicated workforce in banks. However, in India some of the bank officials are inefficient and corrupt.

9. **Limited Instruments:** The supply of short term instruments like commercial bills, treasury bills etc. are very limited and inadequate.

10. **Limited Number of Participants**: The participants in the Indian money market are limited. Entry in the money market is tightly regulated.

11. **Restricted Secondary Market:** Secondary market for money market instruments is mainly restricted to rediscounting of commercial bills and treasury bills.

12. **No Contact with Foreign Money Markets**: Indian money market has little contract with money markets in other countries.

**Stop to Consider**

The unorganised sector of the Money Market lacks proper regulations and operates outside the purview of RBI. This leads to issues such as lack of transparency, high interest rates, and exploitation of borrowers

## 2.10 RBI and Indian Money Market

**2.10.1: Role of RBI in Money Market:** Reserve Bank of India is the regulator of Indian money market. The market comes within the direct preview of the Reserve Bank regulations.RBI gives directions and guidelines regarding money supply in India and plays an active role in Money Market. It is through this market the RBI controls the liquidity position in the country. Various quantitative credit control techniques of RBI such as Open Market Operation, Repo and Reverse Repo, CRR, SLR etc, are implemented through the money market.

**Stop to Consider**

To control Inflation various monetary policy tools are used by the Reserve Bank of India. The aim of this policy is to manage the quantity of money in order to meet the needs of various sector of the economy while also increasing the rate of economic growth in India. The RBI implements most of the policies through the Money Market.

**2.10.2: Measures/ Steps taken by RBI to develop the Indian Money Market:**

The Reserve Bank of India (RBI) has taken several measures over the years to promote the development and efficiency of the money market in India. These measures are aimed at enhancing liquidity, improving market infrastructure, ensuring transparency, and facilitating better price discovery. Here are some of the key measures taken by the RBI for the development of the money market:

1. **Introduction of Treasury Bills (T-Bills):** In the 1970s, the RBI introduced T-Bills as short-term government securities to provide a risk-free instrument for investors and a tool for the government to manage its short-term borrowing requirements.

2. **Development of Call Money Market:** The RBI facilitated the development of the call money market, providing a platform for banks to borrow and lend short-term funds to meet liquidity needs. It introduced the system of daily reporting of call/notice money market transactions.

3. **Development of Certificate of Deposit (CD) Market:** In the 1980s, the RBI introduced CDs, allowing banks to raise funds through unsecured instruments. This step helped diversify banks' sources of funds.

4. **Promotion of Commercial Paper (CP):** In 1989, the RBI permitted the issuance of CP by eligible corporations, further broadening the range of money market instruments.

5. **Introduction of Repo and Reverse Repo:** The RBI introduced the repo (repurchase agreement) and reverse repo mechanisms to provide a reliable avenue for short-term borrowing and lending of funds. These operations help manage liquidity and influence short-term interest rates.

6. **Liberalization of Interest Rates:** The 1990s marked a period of liberalization of interest rates in India. The RBI has progressively moved toward a more market-determined interest rate regime. It has allowed greater flexibility in interest rate setting for money market instruments, promoting competition and efficiency.

7. **Secondary Market Development:** The RBI has taken steps to develop a vibrant secondary market for money market instruments such as treasury bills, commercial paper, and certificates of deposit. This encourages trading and liquidity in these instruments.

8. **Open Market Operations (OMO):** The RBI conducts OMOs to buy and sell government securities in the secondary market. These operations are used to manage liquidity conditions and influence interest rates.

9. **Market Stabilization Scheme (MSS):** The RBI introduced the MSS to manage excess liquidity arising from capital inflows, especially foreign exchange inflows. It involves the issuance of government securities to absorb surplus funds.

10. **Regulatory Framework:** The RBI has put in place a comprehensive regulatory framework for money market instruments.

It prescribes guidelines for the issuance, trading, and reporting of these instruments, ensuring transparency and market integrity. The RBI has continuously updated and enhanced the regulatory framework for money market instruments, ensuring transparency and market integrity. It introduced guidelines for Commercial Paper (CP) in 2017 and for T-Bills in 2020.

11. **Encouraging Money Market Mutual Funds:** The RBI has encouraged the establishment and growth of money market mutual funds (MMMFs). These funds provide retail investors with access to the money market.

12. **Financial Inclusion Initiatives:** The RBI has promoted financial inclusion by encouraging banks to extend their reach into rural and underserved areas. This widens the participation in the money market.

13. **Development of Government Securities Market:** The government securities market was developed further, and the RBI introduced reforms like the negotiated dealing system (NDS) to facilitate electronic trading and settlement of government securities.

14. **Treasury Bill Reforms:** The RBI introduced several reforms in the Treasury Bill (T-Bill) market, including the introduction of 364-day T-Bills, increasing the auction frequency, and allowing non-competitive bidding.

15. **Technology Integration:** The RBI has encouraged the use of technology for trading, settlement, and reporting of money market instruments. This enhances efficiency and reduces operational risks.

16. **Financial Inclusion Initiatives:** The RBI promoted financial inclusion by encouraging banks to extend their reach into rural and underserved areas, widening the participation in the money market.

17. **Liquidity Adjustment Facility (LAF):** The LAF, introduced in 2000, allows banks to borrow or lend funds on an overnight basis, helping them manage their liquidity requirements effectively.

18. **Credit Default Swaps (CDS):** In 2011, the RBI permitted the introduction of CDS in the money market, providing a risk management tool for market participants. The RBI has permitted the trading of credit default swaps in the money market.

19. **Marginal Standing Facility (MSF):** Introduced in 2011, the MSF allowed banks to borrow from the RBI against eligible securities at a penal rate. It provided banks with a means to meet their overnight borrowing needs during emergencies.
20. **Market Surveillance and Oversight:** The RBI conducts regular market surveillance to detect irregularities or market manipulation. It takes prompt action against entities found in violation of regulations.
21. **Communication:** The RBI maintains open communication with market participants, issuing guidelines and notifications to provide clarity on regulatory and operational matters.

These measures collectively aim to foster a well-functioning, efficient, and transparent money market in India. They support the broader monetary policy objectives of the RBI and contribute to the stability and growth of the financial system.

### 2.11 RBI Committees / Working Groups on Money Market

The Reserve Bank of India (RBI) has formed various committees and working groups over the years to review and make recommendations on different aspects of the money market in India. These committees have played a vital role in shaping the policies and regulations governing the money market. Here are some prominent RBI committees related to the money market:

- **Chakravarty Committee (1985):** This committee was set up to review the functioning of the money market and recommend measures to improve its efficiency. The committee recommended the development of a more active secondary market for government securities, the introduction of new instruments such as commercial paper and certificates of deposit, and the strengthening of the regulatory framework for the money market.
- **Working Group on Money Market (1986):** Reserve Bank of India set up a Working Group under the chairmanship of Mr. N. Vaghul in the year 1986 to examine the possibilities of enlarging the scope of Indian money market and to recommend specific measures for evolving other suitable money market instruments. The Working Group submitted its Report in January, 1987. Based on the recommendations of the committee,the following measures were initiated:

(i) The Discount and Finance House of India (DFHI) was set up in 1988.

(ii) Money Market instruments such as the 182 days Treasury bill and Certificate of Deposit were introduced 1988-89.

(iii) Commercial Paper was introduced in the year 1990.

- **Narasimham Committee-I (1991):** The Narasimham Committee-I was established in 1991 by FM Manmohan Singh to examine the functioning of banks. In August 1991, a nine-member committee was appointed to suggest reforms to the financial system. The committee submitted its recommendations and the report in December 1991 to the Parliament.
- **Narasimham Committee-II (1998):** In 1998, the Narasimham Committee-II was formed by Finance Minister P Chidambaram to intimate on the banking sector reforms. The committee submitted its recommendations to the government in April 1998. The government undertook the report and recommendations as it emphasized more human resource development, technological upgradation, and strengthening of the foundation of the banking system by structure, which was the need of the hour.
- **Working Group on Money Market (1998):** This working group was set up to study the feasibility of setting up a unified money market in India. The working group recommended that the RBI should take steps to set up a unified money market by providing a single platform for trading in short-term debt instruments.
- **Working Group on Introduction of Repo and Reverse Repo Transactions (2000):** This working group was set up to study the feasibility of introducing repo and reverse repo transactions in India. The working group recommended that the RBI should introduce repo and reverse repo transactions to help regulate the liquidity in the money market and to manage the RBI's balance sheet.
- **Working Group on Development of a Market for Short-Term Government Securities (2001):** This working group was set up to study the feasibility of developing a market for short-term government securities in India. The working group recommended that the RBI should take steps to develop a market for short-term

government securities by providing a liquid secondary market for these securities.

- **Urjit Patel Committee (2018):** This committee was set up to review the liquidity management framework of the RBI and recommend measures to improve it. The committee made several recommendations for improving the liquidity management framework, including setting up a Standing Liquidity Facility (SLF), introducing a term repo facility, and developing a market for government securities of different maturities.

These are just some of the different committees on money market of RBI. The RBI has set up several other committees and working groups to study specific aspects of the money market and recommend measures to improve its functioning. The RBI's committees and working groups have played a significant role in improving the functioning of the money market in India. Their recommendations have helped to make the money market more efficient, liquid, and resilient.

**Check Your Progress**

1. Write True or False:

   a) The Indian money market does not deal in cash or money but in promissory notes, government paper.

   b) Money market supplies funds for financing working capital of industries.

   c) 'Ad hoc' treasury bills are always issued in favour of the RBI only.

2. Fill in the gaps:

   a) The market for extremely short period is called _________.

   b) ________ are drawn by contractors on the Government Departments for the goods supplied to them. (Fill in the gap)

   c) The bill which does not require any acceptance is called ________.

d) _______ has been set up mainly to provide a secondary market in Government securities.

3. Choose the correct answer from the given alternatives:

a) The market for short term loans is called ________.

i) Call money market  ii) Treasury bill market

iii) Money market  iv) Acceptance market

b) Bills drawn and accepted payables after three months are called _______.

i) Indigenous bills  ii) Usance bills

iii) Clean bills  iv) Supply bills

c) The market which helps commercial banks to maintain their SLR requirements is _________.

i) Call loan market  ii) Discount market

iii) Acceptance market  iv) Commercial bill market

d) The certificate which evidences an unsecured corporate debt of short-term maturity is ________.

i) Short-term loan certificate

ii) Certificate of deposit

iii) Inter-bank participation certificate

iv) Commercial paper

4. Write True or False:

a) LIC and UTI can act as both lenders and borrowers of call loans in India.

b) 91 days' treasury bills do not carry any fixed rate of discount.

c) Certificate of deposit can be issued only by commercial banks.

5. The Discount and Finance House of India was set up in the year ________. (Fill in the gaps)

6. The major player in the Indian money market is/are _________.

i) Co-operative banks  ii) Indigenous banks

iii) Commercial banks  iv) Reserve Bank of India

(Choose the correct answer)

## 2.12 Summing Up

- Money market is a market for short term funds. It deals with all transactions in short term securities. Maturity period of them are one year or less.
- Money market does not imply to any specific market place.
- Central bank is the leader, guide, controller and policy maker of the banking system of a country.
- The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialized financial institutions. The Reserve Bank of India is the controller of the money market in India.
- Money market consists of a number of sub-markets. All sub-markets collectively constitute the money market.
- The Indian money market can be divided into two sectors-unorganized and organised.

## 2.13 Model Questions

1. What is Money Market? Discuss the role of money market in the Indian Financial System.
2. Give the structure of Indian money market and point out its deficiencies.
3. Discuss the role of RBI as a regulator of Indian Money Market.
4. Discuss the role of money market in the Indian Financial System.
5. What are the essential characteristics of a develop money market?
6. What steps have been taken in recent years to make the Indian money market a developed one?
7. Discuss the institutions that operates in organized sector of Indian money market.

## 2.14 References and Suggested Readings

Financial Markets and Services –By E. Gordon & Dr. K Natarajan
Indian Financial System –By Gobinda Deka
Financial Services – By M. P. Tripathy

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# Unit-3
# Types of Money Market Instruments

**Unit Structure:**


3.1 Introduction

3.2 Objectives

3.3 Money market instruments

3.4 Sub-markets of money market

3.4.1 Money at call and Short Notice

3.4.2 Commercial Bill Market

3.4.3 Acceptance Market

3.4.4 Treasury Bills Market

3.4.5 Certificates of Deposits (CD) Market

3.4.6 Commercial Paper Market

3.4.7 Collateral Loan Market

3.5 Summing Up

3.6 Model Questions

3.7 References and Suggested Readings


## 3.1 Introduction

Money market encompassing various sub-markets, each with its unique characteristics, instruments, and functions. Money market instruments are a cornerstone of the global financial system, representing a diverse range of short-term debt securities and financial tools that facilitate the borrowing and lending of funds in the short run, usually with maturities ranging from a single day to one year. These instruments are pivotal in maintaining liquidity, managing short-term financing needs, and enabling smooth monetary operations within an economy.

One of the fundamental money market instruments is Treasury Bills (T-Bills), issued by the government to raise funds and considered among the safest short-term investments. Commercial Paper (CP) is another essential instrument, unsecured and issued by corporations to meet short-term obligations. Certificates of Deposit (CDs), typically offered by banks, are time deposits with fixed maturities, attracting investors seeking low-risk avenues.

Other notable instruments include Repurchase Agreements (Repos) and Reverse Repos, where securities are sold with an agreement to repurchase at a later date at a predetermined price. Additionally, the Call Money market facilitates short-term borrowing and lending primarily among banks.

Money market instruments are crucial for investors, financial institutions, and governments in managing their liquidity, ensuring stability, and optimizing investment portfolios. Their nature, flexibility, and accessibility make them integral components of the broader financial landscape, contributing significantly to economic growth and financial well-being.

## 3.2 Objectives

After going through this unit, you will be able to-

- *know* the meaning of money market instruments,
- *explain* different money market instrument,
- *discuss* the different submarkets of money market.

## 3.3 Money Market Instruments

Money market instruments are financial instruments that help companies, corporations, and government bodies to raise short-term debt for their needs. The borrowers meet their short-term needs at a low cost and the lenders benefit from interest rates and liquidity. The main characteristic of money market instruments is that they can be easily converted to cash, thereby preserving an investor's cash requirements.

The Indian money market is a crucial segment of the broader financial system and plays a vital role in the economic development of the country. It consists of various instruments that help in short-term borrowing, lending, and liquidity management. In this comprehensive explanation, we will delve into each of these instruments, exploring their features, functions, and significance within the Indian financial landscape.

### 3.3.1 Treasury Bills (T-Bills)

When the government goes to the financial market to raise money, it does so by issuing two types of debt instruments — treasury bills and government bonds. Treasury bills are issued when the government needs money for a short period. These bills are issued only by the central government to reduce the overall fiscal deficit of a country. RBI issues the TBs on behalf of the government and honors them on the date of maturity. Treasury bills were first issued in India in 1917. They are issued at a discount to the face value and have maturities of 91 days, 182 days, and 364 days. T-Bills play a vital role in managing short-term liquidity for the government and are considered virtually risk-free, making them an attractive investment option. This is one of the safest short-term instruments in the money market. At present, treasury bills are issued in three maturities — 91-day, 182-day and 364-day. In 1997 the government also issued 14-day immediate treasury bills.

Treasury bills are issued at a discount to original value and the buyer gets the original value upon maturity. For example, a Rs 100 treasury bill can be availed of at Rs 95, but the buyer is paid Rs 100 on the maturity date.

**Features:**

a) **Investors:** Eligible participants to invest in T-Bill are the banks, insurance companies like LIC, GIC etc., NABARD and UTI, corporates and Foreign Institutional Investors (FII).

b) **Importance:** The TBs are eligible securities for maintenance of statutory liquidity ratio of banks. In addition, it is also used for the repo operation of the central bank. Corporates also park their funds in TBs because there is no risk of default.

c) **Short-Term Maturity**: T-Bills have short maturities, typically ranging from a few days to one year. Common maturities include 91 days, 182 days, and 364 days.

d) **Issued at Discount**: They are issued at a discount to the face value, and upon maturity, the government pays the holder the face value, resulting in interest earned for the holder.

e) **Backed by Government**: T-Bills are backed by the government, making them virtually risk-free. They are considered one of the safest forms of investment.

f) **Low Denomination**: T-Bills are available in low denominations, making them accessible to a wide range of investors, including individuals, financial institutions, and corporations.

g) **Liquidity**: They are highly liquid and can be sold on the secondary market before maturity, providing an easy exit option for investors.

**Advantages:**

a) **Safety**: T-Bills are considered extremely safe as they are backed by the government, making them a preferred choice for investors seeking a low-risk investment.

b) **Liquidity**: They are highly liquid, and investors can easily buy or sell them in the secondary market, providing flexibility and a quick exit if needed.

c) **Competitive Returns**: Although the returns are fixed and known upfront, they provide competitive returns compared to other low-risk investment options.

d) **Government Support**: Being issued by the government, they enjoy the implicit support and creditworthiness of the government, enhancing investor confidence.

e) **Portfolio Diversification**: T-Bills can be used to diversify an investment portfolio by adding a low-risk, fixed-income component to balance the overall risk.

**Disadvantages:**

a) **Fixed Returns**: The returns on T-Bills are fixed and relatively low compared to other investment options, limiting the potential for higher earnings.

b) **Inflation Risk**: T-Bills may not keep pace with inflation, potentially eroding purchasing power over time, especially for longer-term T-Bills.

c) **Interest Rate Risk**: Changes in interest rates can impact the market value of T-Bills if investors choose to sell them before maturity. Rising interest rates can reduce the market value of existing T-Bills.

d) **Limited to Government Issuers**: T-Bills are issued only by the government, limiting the variety of issuers compared to other fixed-income securities.

e) **Tax Implications**: The interest earned on T-Bills is taxable as per the prevailing tax laws, which can reduce the overall effective return for the investor.

### 3.3.2 Commercial Paper (CP)

Commercial Paper is a short-term, unsecured money market instrument issued by well-established corporations, financial institutions, and primary dealers. It allows companies to raise funds to meet short-term liabilities and working capital requirements. CPs have maturities ranging from 7 days to one year and are typically issued at a discount to face value and is redeemed at face value.

In India, CP made its appearance from January 1990, when the RBI issued detailed guidelines for the issue of CPs. The guidelines undergo a lot of changes now and then. Though there is no secondary market for CP, its importance is growing in the Indian money market.

**Features:**

a) **Lenders:** The buyers of CPs are other joint stock companies, public sector companies and corporations, banks etc. Insurance companies and term-lending institutions invest in long-term securities. Therefore, they seldom invest in CPs. However, non-corporate bodies, non-resident Indians (NRIs) and foreign institutional investors do invest in CPs.

b) **Unsecured Instrument**: Commercial Paper is not backed by any collateral, making it an unsecured form of borrowing. The creditworthiness of the issuing company determines its acceptance in the market.

c) **Short-Term Maturity**: CPs have a maturity ranging from 7 days to one year. The most common maturities are 30, 60, 90, and 180 days.

d) **Issued at Discount**: Companies issue CPs at a discount to the face value, and the face value is repaid to the holder at maturity, generating the interest for the holder.

e) **Denomination of CPs:** The minimum denomination for a single investor is Rs.25 lakh. Thereafter, it should be in multiples of Rs.5 lakh.

f) **Issued by Creditworthy Companies**: CPs are typically issued by large, creditworthy corporations or financial institutions to meet short-term funding needs. The networth of the issuing company (capital + reserves) should not be less than Rs.4 crore.

g) **Issued in Dematerialized Form**: Commercial Paper is issued and held in a dematerialized form to facilitate ease of trading and transfer.

**Advantages:**

a) **Cost-Effective Funding**: CPs offer a cost-effective alternative for short-term funding compared to traditional bank loans. The discount at which they are issued effectively lowers the cost of borrowing.

b) **Flexibility**: Companies can tailor the amount, timing, and maturity of the CPs according to their specific financing needs, providing flexibility in managing short-term funding requirements.

c) **High Liquidity**: CPs are highly liquid instruments. Investors can trade them in the secondary market before maturity, providing an exit option if needed.

d) **Wide Investor Base**: CPs attract a diverse range of investors, including banks, mutual funds, insurance companies, and corporate treasuries, providing a broad base for raising funds.

e) **Enhanced Credit Profile**: Successful issuance of CPs enhances the issuing company's credit profile, making it easier and cheaper to raise funds in the future.

**Disadvantages:**

a) **Credit Risk**: Since CPs are unsecured, investors bear the risk of default by the issuing company. The creditworthiness of the issuer is a critical factor.

b) **Market Risk**: Changes in interest rates and market conditions can impact the market value of CPs if investors decide to sell them before maturity.

c) **Limited to Highly Rated Entities**: CPs are typically accessible to companies with high credit ratings, limiting their availability to lesser-rated or smaller firms.

d) **Restricted Use**: CPs cannot be used for long-term financing needs, limiting their application to short-term funding requirements.

e) **Regulatory Compliance**: Issuers need to comply with regulatory requirements and guidelines set by the Reserve Bank of India, adding to administrative and compliance costs.

### 3.3.3 Certificates of Deposit (CDs)

CD is a negotiable certificate issued by a bank on the receipt of a large deposit. It is like a fixed deposit receipt issued by the bank on the receipt of a deposit. The ordinary FD receipt is neither negotiable nor transferable. CD is a negotiable certificate payable to bearer. They are unsecured and have fixed maturities, usually ranging from 7 days to one year. CDs provide a source of short-term funds for banks and often offer higher interest rates than regular savings accounts.

CDs appeared in the USA in 1961. In India, the RBI permitted banks to issue CDs from June, 1989. CDs' are meant for large deposits so that administrative expenses of the bank and the depositor are reduced. CD is a short- term security while the ordinary FD can be of either short-term or long-term security.

**Features:**

1. The issuer of CDs can be any scheduled bank other than RRBs for raising large funds. On receiving the deposit, the banks issue the negotiable receipt which can be transferred or sold in the secondary market. The investors are generally joint stock companies, institutions, high net-worth individuals or any other funds.
2. **Fixed Term**: CDs have a fixed term or maturity period, ranging from a few months to a year. The common tenure is three months. The investor agrees not to withdraw the funds before this maturity period.
3. **Issue Price:** CDs are issued at a discount to the face value. The discount is decided by market forces of demand and supply.
4. **Fixed Interest Rate**: The interest rate is fixed at the time of purchase and remains constant throughout the term of the CD. It is generally higher than the interest rate offered on savings accounts.
5. **Minimum Deposit Amount**: The minimum amount of a CD should be Rs.1 lakh, i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs.1 lakh, and in multiples of Rs.1 lakh thereafter.

6. **Penalties for Early Withdrawal**: If an investor withdraws the funds before maturity, they may incur penalties in the form of reduced interest or forfeiture of a portion of the interest earned.

7. **Safety**: CDs are generally considered safe as they are insured by the Deposit Insurance and Credit Guarantee Corporation (DICGC) for up to ₹ 5 lakhs per depositor per bank.

8. **Negotiable:** It is negotiable and can be transferred by delivery and endorsement. However, there is an initial lock in period of 30 days during which it cannot be transferred.

9. **Loan against CD:** A depositor can get loans against CDs, except for the permitted explicitly by the RBI. The issuer is given to buy back CDs before maturity at the prevailing market price. The investors could opt for accepting or rejecting the CDs purchased back offer as per wants.

10. **Maturity:** The maturity period of CDs issued by banks should not be less than 7 days and not morethan one year, from the date of issue. All India Financial Institutions can issue CDs for a period not less than 1 year and not exceeding 3 years from thedate of issue.

**Advantages:**

a) **Stable Returns**: CDs provide a guaranteed, stable return on investment, making them a popular choice for conservative investors seeking predictable earnings.

b) **Risk Mitigation**: The fixed interest rate and maturity date eliminate interest rate risk, providing security and predictability to the investor.

c) **Insurance Protection**: CDs offered by banks are covered by deposit insurance, providing protection to the investor's funds up to a specified limit.

d) **Diversification**: CDs offer a way to diversify a portfolio by adding a fixed-income component without exposing the investment to market risks.

e) **High-Interest Rates**: CDs usually offer higher interest rates compared to regular savings accounts, providing an opportunity for higher returns on idle funds.

**Disadvantages:**

a) **Liquidity Constraints**: Funds are tied up for the duration of the CD, and early withdrawal can result in penalties, making them less liquid than other forms of investments.

b) **Opportunity Cost**: If interest rates rise after purchasing a CD, the investor misses out on the opportunity to invest at the higher rates.

c) **Inflation Risk**: The fixed interest rate might not keep pace with inflation, potentially reducing the real purchasing power of the returns.

d) **Interest Taxation**: The interest earned on CDs is taxable as per the applicable tax laws, reducing the effective return for the investor.

e) **Minimum Deposit**: Some banks require a relatively high minimum deposit amount to open a CD, making it less accessible for small-scale investors.

### 3.3.4 Call Money

Call money, also referred to as 'money at call,' represents a short-term financial loan that necessitates immediate full repayment upon the lender's request. In contrast to a term loan, which has a stipulated maturity and payment plan, call money lacks a fixed timetable for repayment, and the lender isn't obligated to give prior notice for payback. Call money encompasses short-term, interest-yielding loans that the borrower must promptly settle if demanded by the lender. Call money allows banks to earn interest on their excess funds, which is known as the call money rate (call loan rate/call rate). It consists of overnight money as well as money available on short notice for up to 14 days. The call money market primarily serves to rebalance banks' and other participants' short-term liquidity positions.

**Features**

a. A call money loan is a short-term, interest-bearing loan made by one financial institution to another.

b. As it is short term in nature, it does not have regular principal and interest payments.

c. The call loan rate is the interest rate charged on a call loan.

d. Brokers use call money as a short-term source of funding to keep margin accounts open for their customers who want to leverage their investments.

e. The funds can be transferred quickly between lenders and brokerage houses. As a result, it is the second most liquid asset on a balance sheet, trailing only cash.

f. **Primary dealers** are registered entities with the RBI who have the license to purchase and sell government securities. They are entities who buys government securities directly from the RBI (the RBI issues government securities on behalf of the government), aiming to resell them to other buyers. In this way, the Primary Dealers create a market for government securities.The Primary Dealers system in the government securities market was introduced by the RBI in 1995.

The interest rate charged on loans used to purchase securities, known as margin rates, varies according to the call money rate set by banks.

### 3.3.5 Commercial Bills

When goods are sold on credit, the seller draws a bill of exchange on the buyer for the amount due. The buyer accepts it immediately. This means he agrees to pay the amount mentioned therein after a certain specified date. After accepting the bill, the buyer returns it to the seller. This bill is called trade bill. The seller may either retain the bill till maturity or due date or get it discounted from some banker and get immediate cash. When trade bills are accepted by commercial banks, they are called commercial bills. The bank discounts this bill by deducting a certain amount (discount) and balance is paid.

A bill of exchange contains a written order from the creditor (seller) to the debtor (buyer) to pay a certain sum, to a certain person after a certain period. According to Negotiable Instruments Act, 1881, a bill of exchange is 'an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument'.

**Features of Commercial Bills**

a) These are negotiable instruments.

b) These are generally issued for 30 days to 120 days. Thus these are short term credit instruments.

c) These are self-liquidating instruments with low risk.

d) These can be discounted with a bank. When a bill is discounted with a bank, the holder gets immediate cash. This means bank provides credit to the customers. The credit is repayable on maturity of the bill. In case of need for funds, the bank can rediscount the bill in the money market and get ready money.

e) These are used for settling payments in the domestic as well as foreign trade.

f) The creditor who draws the bill is called drawer and the debtor who accepts the bill is called drawee.

**Types of Commercial Bills:** Many types of bills are in circulation in a bill market. They may be broadly classified as follows:

- **Demand Bills and Time Bills**: Demand bill is payable on demand. It is payable immediately on presentation or at sight to the drawing. Demand bill is also known as sight bill. Time bill is payable at a specified future date. Time bill is also known as usance bill.
- **Clean Bills and Documentary Bills:** When bills have to be accompanied by documents of title to goods such as railway receipts, bill of lading etc. the bills are called documentary bills. When bills are drawn without accompanying any document, they are called clean bills. In such a case, documents will be directly sent to the drawee.
- **Inland and Foreign Bills:** Inland bills are bills drawn upon a person resident in India and are payable in India. Foreign bills are bills drawn outside India and they may be payable either in India or outside India.
- **Accommodation Bills and Supply Bills:** In case of accommodation bills, two parties draw bills on each other purely for the purpose of mutual financial accommodation. These bills are then discounted with the bankers and the proceeds are shared among themselves. On the due dates, the parties make payment to the bank. Accommodation bills are also known as 'wind bills' or 'kite bills'. Supply bills are those drawn by suppliers or contactors

on the Govt. departments for the goods supplied to them. These bills are not considered as negotiable instruments.

### 3.3.6 Promissory Note

The promissory note is the earliest types of bill. It is a written promise on the part of a businessman today to another a certain sum of money at an agreed future data. Usually, a promissory note falls due for payment after 90 days with three days of grace. A promissory note is drawn by the debtor and has to be accepted by the bank in which the debtor has his account, to be valid. The creditor can get it discounted from his bank till the date of recovery.

### 3.3.7 Repurchase Agreements (Repos) and Reverse Repos

The Repo Rate is the interest rate at which the Reserve Bank of India (RBI) lend money to commercial banks.Repo Rate full form is Repurchase Agreement or Repurchasing Option. Banks obtain loans from the Reserve Bank of India by selling qualifying securities.The RBI and the commercial bank would reach an agreement to repurchase the securities at a set price. The RBI regulates the repo rate based on the economic situation. The repo rate is utilized by the RBI to manage inflation and control the flow of money in the market. When the market is impacted by inflation, the RBI raises the repo rate. An increased repo rate means that banks borrowing money from the central bank during this period will have to pay more interest. This prevents banks from borrowing money, reducing the amount of money in the market and helping to negate inflation.

As the name implies, reverse repo is the inverse contract to the repo rate. The reverse repo rate is the rate at which the RBI borrows funds from the country’s commercial banks. In simple term, the reverse repo rate is the rate on commercial banks’ deposits with the central bank. It is the rate where the commercial banks in India park excess funds with the Reserve Bank of India for a short period of time.Most banking organizations choose this safer strategy to secure their funds in the event of a surplus. In other terms, the reverse repo rate is an interest rate paid on cash deposited.

The key distinction between the repo and reverse repo rates is that the repo rate earns income through lending to commercial banks, whereas the reverse repo rate earns interest on funds deposited with the Reserve Bank

of India.The differences between Repo Rate and Reverse Repo Rate are based on the lender's and borrower's perspectives. It also differs on the impact the change in rates creates. They are:

- Repo Rate and Reverse Repo Rate are contradictory. Banks borrow money from RBI at Repo Rate, and on the other hand, they lend money to RBI at Reverse Repo Rate.
- RBI uses Repo Rate as a mechanism to control inflation and Reverse Repo Rate to manage money flow.
- Repo Rate injects liquidity in the market whereas Reverse Repo Rate absorbs liquidity from the market.
- Usually, Reverse Repo Rate is lower than Repo Rate.

### 3.3.8 Banker's Acceptance (BA)

Banker's Acceptance is a time draft drawn on and accepted by a bank, representing an unconditional obligation to pay a specified amount at a future date. It states the name of the entity to which the funds need to be transferred, along with the amount and date of payment. Banker's acceptances are short-term instruments that generally come with a maturity between 30 days and 180 days. BAs are commonly used in international trade transactions, especially in cross-border trade financing.

The issuer of a banker's acceptance deposits the future payment with a bank. The bank charges a small fee and issues a time draft against the deposit, representing a guaranteed future payment by the bank. Upon acceptance from the bank, the liability transfers from the issuer of the banker's acceptance and becomes an obligation of the bank. As such, the credit rating of a banker's acceptance is generally the same as that of the bank that promised the payment.

**Stop to Consider**

The money market works based on the instruments of the money market. The treasury bill market in India is under developed as compared to treasury bill market in the U.S.A. and the U.K. In U.S.A. and U.K., the treasury bills are the most important money market instrument.

**Check Your Progress**

1. What is a key characteristic of money market instruments?
   a) Long-term maturity
   b) Easy in converting to cash
   c) High risk
   d) High denomination
2. Treasury bills are issued by:
   a) Banks
   b) Government
   c) Private corporations
   d) Foreign investors
3. Commercial Paper is typically issued by:
   a) Government agencies
   b) Banks
   c) Well-established corporations
   d) Foreign central banks
4. Certificates of Deposit (CDs) are:
   a) Always secured by collateral
   b) Unsecured short-term instruments
   c) Long-term investment options
   d) Exempt from taxation
5. Call money represents:
   a) Long-term financial loans
   b) Unsecured money market instruments
   c) Securities issued by the government
   d) Collateralized loans
6. Banker's Acceptance (BA) is commonly used in:
   a) Domestic trade transactions
   b) Long-term financing
   c) Real estate transactions
   d) International trade financing

### 3.4 Sub Markets of Money Market

Money market consists of a number of sub-markets. All sub-markets collectively constitute the money market. Each sub-market deals in a particular financial instrument. The main components or constituents or sub-markets of money market are as follows:

### 3.4.1 Call Money Market

Commercial banks borrow money without collateral from other banks to maintain a minimum cash balance known as cash reserve ratio (CRR). This interbank borrowing has led to the development of the call money market. This is the most active and sensitive part of the organized money market. It deals in one-day loans (called call loans or call money) which may or may not be renewed the next day. The participants are mostly banks. Therefore, it is also called inter-bank call money market. The borrowing side is limited exclusively to banks, which are temporarily short of funds. On the lending side, too, there are mostly banks with temporary excess of cash.

In the call money market, surplus funds of financial institutions and banks are traded. There is no demand for collateral security against call money. In India call money markets are mainly located in big industrial and commercial centres like Mumbai, Kolkata, Chennai, Delhi and Ahmadabad. Participants or players in the Call Money Market are scheduled commercial banks and RBI, Non-Scheduled commercial banks, Co-operative banks, Foreign banks, Discount and Finance House of India, Primary dealers etc.

The above players are permitted to operate both as lenders and borrowers. On the other hand participants like LIC, UTI, GIC, IDBI, NABARD, Specific mutual funds, etc. are permitted to operate as lenders.

Among banks, the State Bank of India (SBI), because of its formidable liquid position, is always on the lenders' side of the market. It acts as the 'lender of intermediate resort', whereas the RBI as the country's central bank is the 'lender of last resort'. Call rate is the rate of interest paid on call loans. The call money market operates through brokers who keen in constant touch with banks in the city and bring the borrowing and lending banks together.

### 3.4.2 Commercial Bill Market

Commercial bill market is another segment of money market. It is a market in which commercial bills (short term) are bought and sold. Commercial bills are important instruments. They are widely used in both domestic and foreign trade to discharge the business obligations (or to settle business obligations). From the operational point of view bill market can be classified as-Discount Market and Acceptance Market.

### Discount Market

When credit sale take place the seller draw a bill on the buyer who accept it promising to pay the specified sum at the specified period. For getting the payment seller has to wait until the maturity of the bill. But, the presence of bill market enables him/her to get payment against the bill immediately. The seller can ensure payment immediately by discounting the bill with some financial intermediary by paying a small amount of money called discount. On the date of maturity of the bill the intermediary claims the amount of the bill from the person who has accepted the bill. Discounting is the main process in this market. There are specialized institutions known as discount houses for discounting commercial bills accepted by reputed acceptance houses. In India, RBI has permitted the financial institutions, mutual funds, commercial banks and cooperative banks to enter in the commercial bill market.

### Acceptance Market

Acceptance Market is another component of money market. It is a market for banker's acceptance. In this market short term genuine trade bills are accepted by financial intermediaries. All trade bills cannot be discounted easily because parties to the bills may not be financially sound. If such bills are accepted by financial intermediaries like banks, it earns good reputations and can be easily discounted anywhere. In develop money market there are specialized institutions called acceptance house which accept bills drawn by traders and impart good marketability to such bills.

**Check Your Progress**

1. Name/listout the various instruments of money market in India.
2. What is 'Repo' and 'Reverse Repo'?
3. What is certificate of deposits? When did RBI permit banks to issue CDs.
4. Mention two features of treasury bills.
5. What is money at call and money at short notice.

### 3.4.3 Treasury Bills Market

Treasury bill market is a market which deals in treasury bills. In this market, treasury bills which are the short-term (i.e., 91, 182 and 364 days) liability of the Government of India. Theoretically these bills are issued to meet the short-term financial requirements of the government. Thus it represents short term borrowings of the government.But, in reality, they have become a permanent source of funds to the government. Every year, a portion of treasury bills are converted into long-term bonds. Treasury bills are of two types: ad hoc and regular.

Ad hoc treasury bills are issued to the state governments, semi- government departments and foreign central banks. They are not sold to the banks and the general public, and are not marketable.

The regular treasury bills are sold to the banks and public and are freely marketable. Both types of ad hoc and regular treasury bills are sold by Reserve Bank of India on behalf of the Central Government.

The treasury bill market in India is underdeveloped as compared to the treasury bill markets in the U.S.A. and the U.K. Indian Treasury bill market has no dealers expect the Reserve Bank of India. Besides the Reserve Bank, some treasury bills are held by commercial banks, state government and semi-government bodies. But, these treasury bills are not popular with the non-bank financial institutions, corporations, and individuals mainly because of absence of a developed treasury bill market.

**Advantages of Treasure Bill Market:**

***Advantages to the Issuer/Government*:**

- The government can raise short term funds for meeting temporary budget deficit.
- The government can absorb excess liquidity in the economy through the issue of bills in the market.
- It does not lead to inflationary pressure.

***Advantages for the Purchaser/Investor*:**

- It is a ready market for purchasers or investors.
- It is a safety instrument to invest.
- Treasury bills are eligible securities for SLR requirement.
- The market provides hedging facility.

### 3.4.4 Certificates of Deposits (CD) Market

CD market is a market which deals in Certificate of Deposits (CDs). CDs are short term deposit instruments to raise large sums of money. These are short term deposits which are transferable from one party to another. Banks and financial institutions are major issuers of CDs. These are short term negotiable instruments.

***Advantages of CD Market*:**

- It enables the depositors to earn higher return on their short term surplus.
- The market provides maximum liquidity.
- The bank can raise money in times of need. This will improve their lending capacity.
- The market provides an opportunity for banks to invest surplus funds.
- The transaction cost of CDs is lower.

### 3.4.5 Commercial Paper Market

Commercial paper (CP) market is a constituent of the unsecured money market - in whichcorporates do their fund-raising activity for theiroperational obligations. Prior to the introduction of CPs, Indian corporates had to do a lot of negotiations for borrowing their working capital from commercial banks by pledging inventory as collateral security. The introduction of CPs provided corporates a debt instrument that allowed them to raise funds in the open market with certain conditionality - like tangiblenet worth, minimal credit rating requirement and limits on borrowable amount. These are issued at a discount. Commercial papers can now be issued by primary dealers and all India financial institutions. They can be issued to (or purchased by) individuals, banks, companies and other registered Indian corporate bodies.

The Working Group on Money Market (Vaghul Committee) in 1987 suggested the introduction of the Commercial Paper (CP) in India. As per the recommendation of the committee, the RBI introduced commercial papers in January 1990. The Committee suggested the following:

- CP should be issued to investors directly or through bankers.

- The CP issuing company must have a net worth of not less than Rs. 5 crores.
- The issuing company's shares must be listed in the stock exchange.
- The minimum amount of issue should be Rs. 1 crore and the minimum denomination of Rs. 5 lakhs
- The CPs issuing cost should not exceed 1% of the amount raised.
- RBI is the sole authority to decide the size of issue and timing of issue.
- The instrument should not be subject to stamp duty at the time of issue and there should not be any tax deduction at source.
- The interest on CP shall be a market determined.
- The issuing companies should get certification of credit rating for every six months and 'A' grading enterprises may be permitted to enter the market.

### 3.4.6 Collateral Loan Market

Collateral loan market is another important sector of the money market. The collateral loan market is a market which deals with collateral loans. Collateral means anything pledged as security for repayment of a loan. Thus collateral loans are loans backed by collateral securities such as stock, bonds etc. The collateral loans are given for a few months. The collateral security is returned to the borrower when the loan is repaid. When the borrower is not able to repay the loan, the collateral becomes the property of the lender. The borrowers are generally the dealers in stocks and shares.

**Check Your Progress**

1. What does the Call Money Market primarily deal with?

   a) Short-term loans  b) Long-term loans

   c) Collateral-backed loans  d) Foreign exchange transactions

2. In the Commercial Bill Market, what is the main purpose of discounting a bill?

   a) To delay payment to the seller

b) To ensure immediate payment to the seller

c) To negotiate a lower payment amount

d) To extend the maturity period of the bill

3. What is the main advantage of Treasury Bills for the government?

    a) Absorbing excess liquidity

    b) Generating long-term funds

    c) Facilitating foreign trade

    d) Reducing inflationary pressure

4. What does the Certificates of Deposits (CD) Market primarily deal with?

    a) Short-term deposit instruments

    b) Long-term bonds

    c) Real estate transactions

    d) Foreign exchange transactions

5. Commercial Paper (CP) market is a part of which segment of the money market?

    a) Secured money market

    b) Unsecured money market

    c) Foreign exchange market

    d) Long-term financing market

6. What does the Collateral Loan Market deal with?

    a) Loans secured by tangible assets

    b) Long-term mortgages

    c) Foreign exchange transactions

    d) Unsecured personal loans

## 3.5 Summing Up

- Money market instruments facilitate short-term debt raising for various entities, ensuring low-cost borrowing for borrowers and providing interest rates and liquidity benefits for lenders.
- Money market instruments are easily convertible to cash, preserving investors' cash requirements and ensuring high liquidity.

- The Indian money market is crucial for short-term borrowing, lending, and liquidity management, playing a significant role in the country's economic development.
- T-Bills are short-term, virtually risk-free instruments issued by the government, aiding in managing short-term liquidity and attracting a wide range of investors due to their safety and ease of investment.
- CPs are unsecured, short-term instruments allowing cost-effective funding for corporations, offering flexibility and liquidity to tailor financing according to specific needs.
- CDs provide stable returns, risk mitigation, and insurance protection for investors, but they have liquidity constraints and are subject to taxation.
- The call money market involves short-term, interest-yielding loans, mainly between banks, to manage short-term liquidity positions, and it operates through brokers.
- The commercial bill market involves buying and selling short-term commercial bills, either through discounting or acceptance, aiding trade and business transactions.
- The treasury bill market deals with short-term government debt, providing a source of short-term funds for the government while offering a safety net for investors.
- The collateral loan market involves loans backed by collateral securities like stocks or bonds, providing short-term funding typically for a few months, with collateral being returned upon loan repayment or becoming the lender's property in case of default.

### 3.6 Model Questions

1. What are the key features and functions of Treasury Bills (T-Bills) in the Indian money market, and how do they contribute to managing short-term liquidity for the government and investors?
2. Discuss Commercial Paper (CP) and Certificates of Deposit (CDs) as short-term financing instruments in the Indian money market.
3. Explain the role and significance of the Call Money Market in the Indian money market.

4. Provide an in-depth overview of the Treasury Bill Market in India, including the types of treasury bills.
5. Discuss various sub markets of Indian money market.

### 3.7 References and Suggested Readings

(including possible links to online & e-contents sources)


1. Bharati V Pathak, *The Indian financial system*. New Delhi: Pearson.
2. JaydebSarkhel and Seikh Salim,*Indian financial system*. McGraw Hill India.


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