Chapter 1

# The Financial System in India

The economic development of any country depends upon the existence of a well organised financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promote the well-being and standard of living of the people of a country. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system. The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilise the savings in the form of money and monetary assets and invest them to productive ventures. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development.

## FUNCTIONS OF THE FINANCIAL SYSTEM

### 1. Provision of liquidity

The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. The term liquidity refers to cash or money and other assets which can be converted into cash readily without loss of value and time. Hence, all activities in a financial system are related to liquidity — either provision of liquidity or trading in liquidity. In fact, in India the RBI has been vested with the monopoly power of issuing coins and currency notes. Commercial banks can also create cash (deposit) in the form of 'credit creation' and other financial institutions also deal in monetary assets. Over supply of money is also dangerous to the economy. In India, the RBI is the leader of the financial system and hence it has to control the money supply and creation of credit by banks and regulate all the financial institutions in the country in the best interest of the nation. It has to shoulder the responsibility of developing a sound financial system by strengthening the institutional structure and by promoting savings and investment in the country.

**2. Mobilisation of savings**

Another important activity of the financial system is to mobilise savings and channelise them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of savings into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

**3. Size Transformation function**

Generally, the savings of millions of small investors are in the nature of a small unit of capital which cannot find any fruitful avenue for investment unless it is transformed into a perceptible size of credit unit. Banks and other financial intermediaries perform this size transformation function by collecting deposits from a vast majority of small customers and giving them as loan of a sizeable quantity. Thus, this size transformation function is considered to be one of the very important functions of the financial system.

**4. Maturity transformation function**

Another function of the financial system is the maturity transformation function. The financial intermediaries accept deposits from public in different maturities according to their liquidity preference and lend them to the borrowers in different maturities according to their need and promote the economic activities of a country.

**5. Risk transformation function**

Most of the small investors are risk-averse with their small holding of savings. So, they hesitate to invest directly in stock market. On the other hand, the financial intermediaries collect the savings from individual savers and distribute them over different investment units with their high knowledge and expertise. Thus, the risks of individual investors get distributed. This risk transformation function promotes industrial development. Moreover, various risk mitigating tools are available in the financial system like hedging, insurance, use of derivatives, etc.

## FINANCIAL CONCEPTS

An understanding of the financial system requires an understanding of the following important concepts:

(i) Financial assets.

(ii) Financial intermediaries.

(iii) Financial markets.

(iv) Financial rates of return.

(v) Financial instruments.

## FINANCIAL ASSETS

In any financial transaction, there should be a creation or transfer of financial asset. Hence, the basic product of any financial system is the financial asset. A financial asset is one which is used for production or consumption or for further creation of assets. For instance, A, buys equity shares and these shares are financial assets since they earn income in future.

In this context, one must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning income. For example, X purchases land and buildings, or gold and silver. These are physical assets since they cannot be used for further production. Many physical assets are useful for consumption only.

It is interesting to note that the objective of investment decides the nature of the asset. For instance, if a building is bought for residence purposes, it becomes a physical asset. If the same is bought for hiring, it becomes a financial asset.

### Classification of financial assets

Financial assets can be classified differently under different circumstances. One such classification is:

(i) Marketable assets

(ii) Non-marketable assets

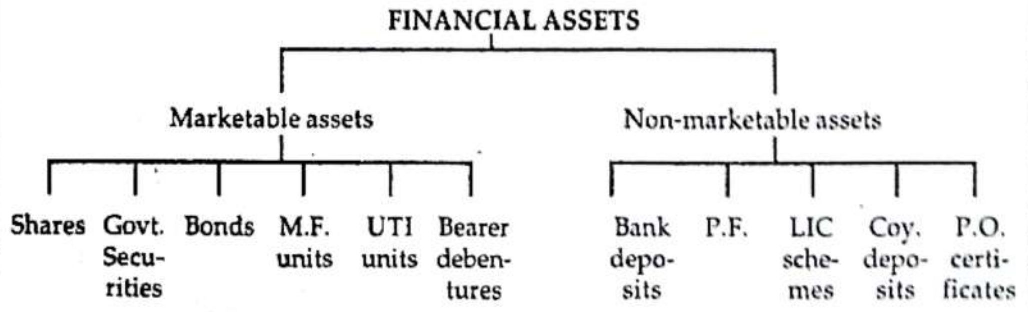
### Marketable assets

Marketable assets are those which can be easily transferred from one person to another without much hindrance. Examples: Shares of Listed Companies, Government Securities, Bonds of Public Sector Undertakings, etc.

### Non-marketable assets

On the other hand, if the assets cannot be transferred easily, they come under this category. Examples: Bank Deposits, Provident Funds, Pension Funds, National Savings Certificates, Insurance Policies, etc. This classification is shown in the following chart.

CHART 1.1



**Cash asset**

In India, all coins and currency notes are issued by the RBI and the Ministry of Finance, Government of India. Besides, commercial banks can also create money by means of creating credit. When loans are sanctioned, liquid cash is not granted. Instead, an account is opened in the borrower's name and a deposit is created. It is also a kind of money asset.

**Debt asset**

Debt asset is issued by a variety of organisations for the purpose of raising their debt capital. Debt capital entails a fixed repayment schedule with regard to interest and principal. There are different ways of raising debt capital. Example: issue of debentures, raising of term loans, working capital advance, etc.

**Stock asset**

Stock is issued by business organisations for the purpose of raising their fixed capital. There are two types of stock-namely equity and preference. Equity shareholders are the real owners of the business and they enjoy the fruits of ownership and at the same time they bear the risks as well. Preference shareholders, on the other hand get a fixed rate of dividend (as in the case of debt asset) and at the same time they retain some characteristics of equity.

## FINANCIAL INTERMEDIARIES

The term financial intermediary includes all kinds of organisations which intermediate and facilitate financial transactions of both individuals and corporate customers. Thus, it refers to all kinds of financial institutions and investing institutions which facilitate financial transactions in financial markets. They may be in the organised sector or in the unorganised sector as shown in Chart 1.2 displayed in page 8. They may also be classified into two:

(i) Capital market intermediaries.

(ii) Money market intermediaries.

**Capital market intermediaries**

These intermediaries mainly provide long-term funds to individuals and corporate customers. They consist of term lending institutions like financial corporations and investing institutions like LIC.

**Money market intermediaries**

Money market intermediaries supply only short-term funds to individuals and corporate customers. They consist of commercial banks, co-operative banks, etc.

## FINANCIAL MARKETS

Generally speaking, there is no specific place or location to indicate a financial market. Wherever a financial transaction takes place, it is deemed to have taken place in the financial market. Hence, financial markets are pervasive in nature since, financial transactions are themselves very pervasive throughout the economic system. For instance, issue of equity shares, granting of loan by term lending institutions, deposit of money into a bank, purchase of debentures, sale of shares and so on.

However, financial markets can be referred to as those centres and arrangements which facilitate buying and selling of financial assets, claims and services. Sometimes, we do find the existence of a specific place or location for a financial market as in the case of stock exchange.

### Classification of financial markets

The classification of financial markets in India is shown in Chart 1.3 displayed in page 9.

### Unorganised markets

In these markets, there are a number of moneylenders, indigenous bankers, traders, etc., who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds, etc., whose activities are not controlled by the RBI. Recently, the RBI has taken steps to bring private finance companies and chit funds under its strict control by issuing non-banking financial companies (Reserve Bank) Directions, 1998. The RBI has already taken some steps to bring the unorganised sector under the organised fold. They have not been successful. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardised.

### Organised markets

In the organised markets, there are standardised rules and regulations governing their financial dealings. There is also a high degree of institutionalisation and instrumentalisation. These markets are subject to strict supervision and control by the RBI or other regulatory bodies.

These organised markets can be further classified into two. They are:

(i) Capital market.

(ii) Money market.

CHART 1.2

FINANCIAL INTERMEDIARIES IN INDIA

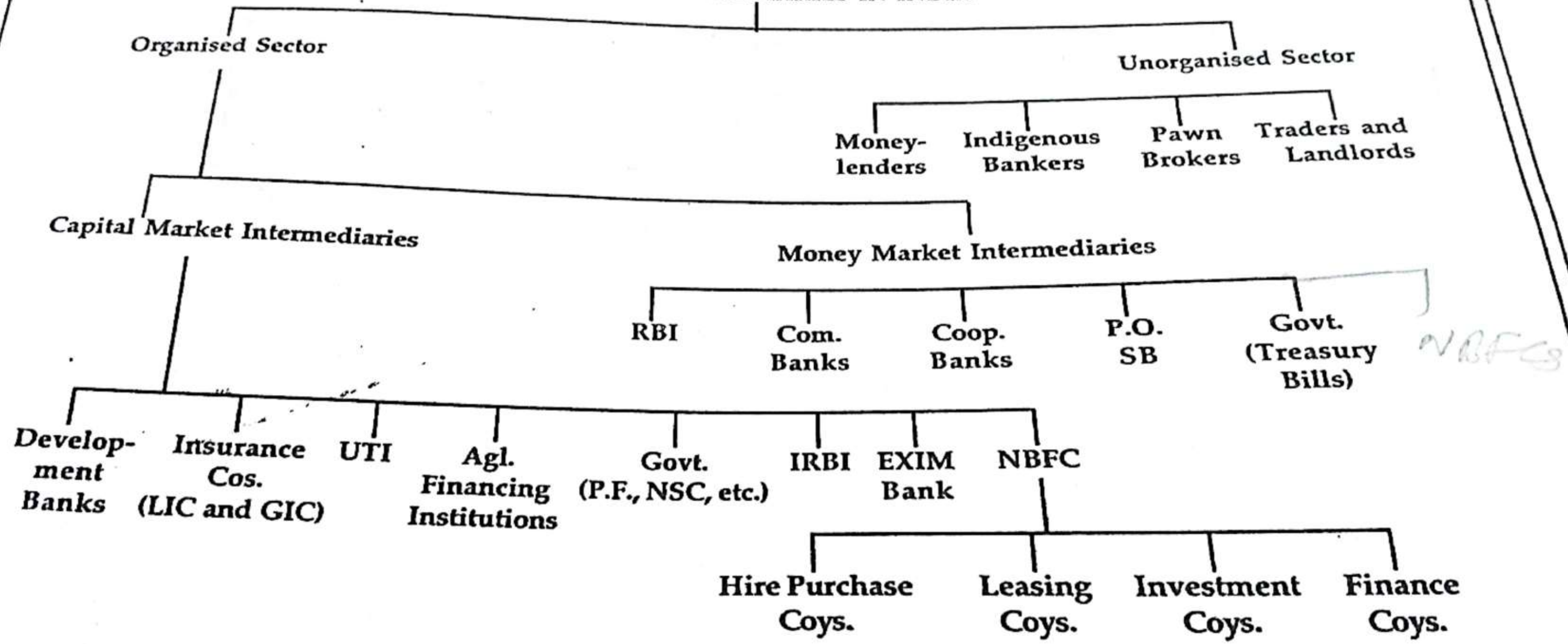
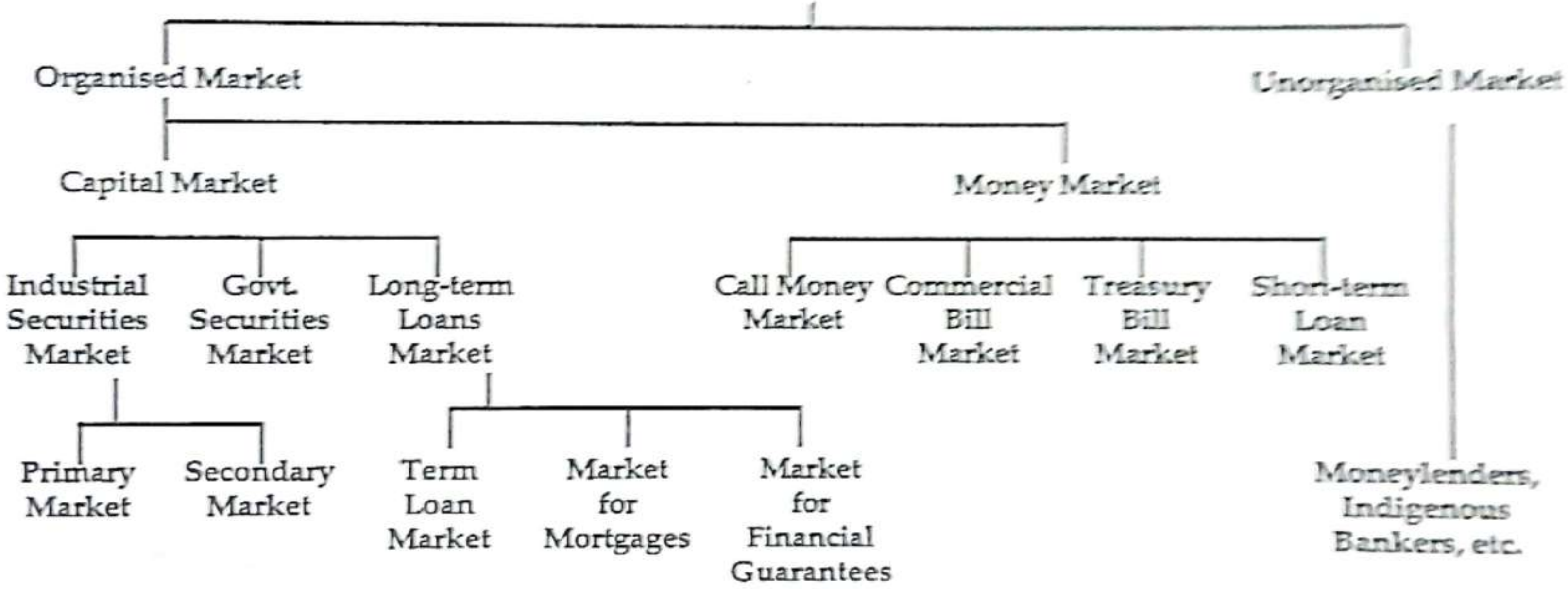


CHART 1.3

CLASSIFICATION OF FINANCIAL MARKETS



**Capital market**

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long-term securities which have a maturity period of above one year. Capital market may be further divided into three namely:

(i) Industrial securities market.

(ii) Government securities market, and

(iii) Long-term loans market.

**(i) Industrial securities market**

As the very name implies, it is a market for industrial securities namely: (i) Equity shares or ordinary shares, (ii) Preference shares, and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are:

(i) Primary market or New issue market.

(ii) Secondary market or Stock exchange.

**Primary market**

Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, primary market facilitates capital formation.

There are three ways by which a company may raise capital in a primary market. They are:

(i) Public issue.

(ii) Rights issue.

(iii) Private placement.

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

**Secondary market**

Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the Stock Exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognised by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act, 1956. The Bombay Stock Exchange is the principal stock exchange in India which sets the tone of the other stock markets.

### (ii) Government securities market

It is otherwise called Gilt-edged securities market. It is a market where Government Securities are traded. In India, there are many kinds of Government securities — short-term and long-term. Long-term securities are traded in this market while short-term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi-government authorities like City Corporations, Port Trusts, etc. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

Government Securities are issued in denominations of ₹ 100. Interest is payable half-yearly and they carry tax exemptions also. The role of brokers in marketing these securities is practically very limited and the major participant in this market is the 'commercial banks' because they hold a very substantial portion of these securities to satisfy their SLR requirements.

The secondary market for these securities is narrow since, most of the institutional investors tend to retain these securities until maturity.

The Government Securities are in many forms. These are generally:

(i) Stock certificates or inscribed stock.

(ii) Promissory notes.

(iii) Bearer bonds which can be discounted.

Government Securities are sold through the Public Debt Office of the RBI while Treasury Bills (short-term securities) are sold through auctions.

Government Securities offer a good source of raising inexpensive finance for the Government exchequer and the interest on these securities influences the prices and yields in this market. Hence, this market also plays a vital role in monetary management.

### STRIPS – Separate Trading of Registered Interest and Principal of Securities

With a view to improve liquidity and widening the investor base of the Government Securities market, stripping and reconstitution of Government Securities have been permitted under the Government Securities Act, 2006. Stripping is nothing but the process of separating a standard coupon leaving bond into its constituent interest and principal components. For example, stripping a 15-year security would yield 30 coupon securities (generally coupon payments are made on Jan 2 and July 2) maturing on the respective coupon dates and one principal security representing the principal amount maturing on the redemption date of the 15-year security. All the 30 coupon securities and the principal security would thereafter become zero coupon bonds. The reverse of stripping in called reconstitution. That is, when all the coupon STRIPS and the principal STRIPS are reassembled into the original Government Security, it is called reconstitution.

The special feature of STRIPS is that the coupon STRIPS of the same date, though from different stocks are exchangeable since they are identical by their maturity dates. STRIPS provide additional instruments to institutional investors for their asset-liability management. Again, STRIPS have zero investment risk (discounted instruments with no periodic interest payment). Stripping/Reconstitution can be done at the option of the holder at any time from the date of issues of a Government Security till its maturity. The minimum amount of securities that needs to the submitted for Stripping/Reconstitution will be ₹ 1 crore (Face vaule) and multiples thereof.

**(iii) Long-term loans market**

Development banks and commercial banks play a significant role in this market by supplying long-term loans to corporate customers. Long-term loans market may further be classified into:

(i) Term loans market.

(ii) Mortgages market.

(iii) Financial guarantees market.

**Term loans market**

In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply long-term and medium-term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India. Institutions like IRBI, IFCI, and other state financial corporations come under this category. These institutions meet the growing and varied long-term financial requirements of industries by supplying long-term loans. They also help in identifying investment opportunities, encourage new entrepreneurs and support modernisation efforts.

**Mortgages market**

The mortgages market refers to those centres which supply mortgage loan mainly to individual customers. A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one. Again, it may be a first charge or second charge. Equitable mortgage is created by a mere deposit of title deeds to properties as security, whereas in the case of a legal mortgage the title in the property is legally transferred to the lender by the borrower. Legal mortgage is less risky.

Similarly, in the first charge, the mortgager transfers his interest in the specific property to the mortgagee as security. When the property in question is already mortgaged once to another creditor, it becomes a second charge when it is subsequently mortgaged to somebody else. The mortgagee can also further transfer his interest in the mortgaged property to another. In such a case, it is called a sub-mortgage.

The mortgage market may have primary market as well as secondary market. The primary market consists of original extension of credit and secondary market has sales and resales of existing mortgages at prevailing prices.

In India, residential mortgages are the most common ones. The Housing and Urban Development Corporation (HUDCO) and the LIC play a dominant role in financing residential projects. Besides, the Land Development Banks provide cheap mortgage loans for the development of lands, purchase of equipment, etc. These development banks raise finance through the sale of debentures which are treated as trustee securities.

**Financial guarantees market**

A guarantee Market is a centre where finance is provided against the guarantee of a reputed person in the financial circle. Guarantee is a contract to discharge the liability of a third party in case of his default. Guarantee acts as a security from the creditor's point of view. In case the borrower fails to repay the loan, the liability falls on the shoulders of the guarantor. Hence, the guarantor must be known to both the borrower and the lender and he must have the means to discharge his liability.

Though there are many types of guarantees, the common forms are: (i) Performance guarantee, and (ii) Financial guarantee. Performance guarantees cover the payment of earnest money, retention money, advance payments, non-completion of contracts, etc. On the other hand, financial guarantees cover only financial contracts.

In India, the market for financial guarantees is well organised. The financial guarantees in India relate to:

(i) Deferred payments for imports and exports.

(ii) Medium and long-term loans raised abroad.

(iii) Loans advanced by banks and other financial institutions.

These guarantees are provided mainly by commercial banks, development banks, Governments, both Central and States and other specialised guarantee institutions like ECGC (Export Credit Guarantee Corporation) and DICGC (Deposit Insurance and Credit Guarantee Corporation). This guarantee financial service is available to both individual and corporate customers. For a smooth functioning of any financial system, this guarantee service is absolutely essential.

## IMPORTANCE OF CAPITAL MARKET

Absence of capital market acts as a deterrent factor to capital formation and economic growth. Resources would remain idle if finances are not funneled through the capital market. The importance of capital market can be briefly summarised as follows:

(i) The capital market serves as an important source for the productive use of the economy's savings. It mobilises the savings of the people for further investment and thus, avoids their wastage in unproductive uses.

(ii) It provides incentives to saving and facilitates capital formation by offering suitable rates of interest as the price of capital.

(iii) It provides an avenue for investors, particularly the household sector to invest in financial assets which are more productive than physical assets.

(iv) It facilitates increase in production and productivity in the economy and thus, enhances the economic welfare of the society. Thus, it facilitates 'the movement of stream of command over capital to the point of highest yield' towards those who can apply them productively and profitably to enhance the national income in the aggregate.

(v) The operations of different institutions in the capital market induce economic growth. They give quantitative and qualitative directions to the flow of funds and bring about rational allocation of scarce resources.

(vi) A healthy capital market consisting of expert intermediaries promotes stability in values of securities representing capital funds.

(vii) Moreover, it serves as an important source for technological upgradation in the industrial sector by utilising the funds invested by the public.

Thus, a capital market serves as an important link between those who save and those who aspire to invest their savings.

## MONEY MARKET

Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it is a market for purely short-term funds. The money market may be subdivided into four. They are:

(i) Call money market.

(ii) Commercial bills market.

(iii) Treasury bills market.

(iv) Short-term loan market.

**Call money market**

The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Mumbai, Kolkata, Chennai, Delhi, Ahmedabad, etc. The special feature of this market is that the interest rate varies from day-to-day and even from hour-to-hour and centre-to-centre. It is very sensitive to changes in demand and supply of call loans.

**Commercial bills market**

It is a market for bills of exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill, promising to pay at a later date the amount specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

In India, the bill market is underdeveloped. The RBI has taken many steps to develop a sound bill market. The RBI has enlarged the list of participants in the bill market. The Discount and Finance House of India was set-up in 1988 to promote secondary market in bills. In spite of all these, the growth of the bill market is slow in India. There are no specialised agencies for discounting bills. The commercial banks play a significant role in this market.

**Treasury bills market**

It is a market for treasury bills which have 'short-term' maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because its repayment is guaranteed by the Government. It is an important instrument for short-term borrowing of the Government. There are two types of treasury bills namely: (i) Ordinary or Regular and (ii) *ad hoc* treasury bills popularly known as *'ad hocs'*.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short-term financial needs. *Ad hoc* treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only. *Ad hocs* are not marketable in India but holders of these bills can sell them back to RBI. Treasury bills have a maturity period of 91 days or 182 days or 364 days only. Financial intermediaries can park their temporary surpluses in these instruments and earn income.

**Short-term loan market**

It is a market where short-term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short-term loans in the form of cash credit and overdraft. Overdraft facility is mainly given to business people, whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But, cash credit is for a period of one year and it is sanctioned in a separate account.

## FOREIGN EXCHANGE MARKET

The term foreign exchange refers to the process of converting home currencies into foreign currencies and vice versa. According to Dr. Paul Einzing, 'Foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another'.

The market where foreign exchange transactions take place is called a foreign exchange market. It does not refer to a marketplace in the physical sense of the term. In fact, it consists of a number of dealers, banks and brokers engaged in the business of buying and selling foreign exchange. It also includes the central bank of each country and the treasury authorities who enter into this market as controlling authorities. Those engaged in the foreign exchange business are controlled by the Foreign Exchange Maintenance Act (FEMA).

**Functions**

The most important functions of this market are:

(i) To make necessary arrangements to transfer purchasing power from one country to another.

(ii) To provide adequate credit facilities for the promotion of foreign trade.

(iii) To cover foreign exchange risks by providing hedging facilities.

In India, the foreign exchange business has a three-tiered structure consisting of:

(i) Trading between banks and their commercial customers.

(ii) Trading between banks through authorised brokers.

(iii) Trading with banks abroad.

Brokers play a significant role in the foreign exchange market in India. Apart from authorised dealers, the RBI has permitted licensed hotels and individuals (known as Authorised Money Changers) to deal in foreign exchange business. The FEMA helps to smoothen the flow of foreign currency and to prevent any misuse of foreign exchange which is a scarce commodity.

## FINANCIAL RATES OF RETURN

Most households in India still prefer to invest on physical assets like land, buildings, gold, silver, etc. But, studies have shown that investment in financial assets like equities in capital market fetches more return than investments on gold. It is imperative that one should have some basic knowledge about the rate of return on financial assets also.

The return on Government Securities and bonds are comparatively less than on corporate securities due to lower risk involved therein. The Government and the RBI determine the interest rates on Government Securities. Thus, the interest rates are administered and controlled. The peculiar feature of the interest rate structure is that the interest rates do not reflect the free market forces. They do not reflect the scarcity value of capital in the country also. Most of these rates are fixed on an ad hoc basis depending upon the credit and monetary policy of the Government.

Generally, the interest rate policy of the Government is designed to achieve the following:

(i) To enable the Government to borrow comparatively at cheaper rate.

(ii) To ensure stability in the macroeconomic system.

(iii) To support certain sectors through preferential lending rates.

(iv) To mobilise substantial savings in the economy.

The interest rate structure for bank deposits and bank credits is also influenced by the RBI. Normally, interest is a reward for risk undertaken through investment and at the same time it is a return for abstaining from consumption. The interest rate structure should allocate scarce capital between alternative uses. Unfortunately, in India the administered interest rate policy of the Government fails to perform the role of allocating scarce resources between alternative uses.

### Recent trends

With a view to bring the interest rates nearer to the free market rates, the Government has taken the following steps:

(i) The interest rates on company deposits are freed.

(ii) The interest rates on 364 days Treasury Bills are determined by auctions and they are expected to reflect the free market rates.

(iii) The coupon rates on Government loans have been revised upwards so as to be market-oriented.

(iv) The interest rates on debentures are allowed to be fixed by companies depending upon the market rates.

(v) The maximum rates of interest payable on bank deposits (fixed) are freed for all deposits.

Thus, all attempts are being taken to adopt a realistic interest rate policy so as to give a positive return in real terms adjusted for inflation. The proper functioning of any financial system requires a good interest rate structure.

## FINANCIAL INSTRUMENTS

Financial instruments refer to those documents which represent financial claims on assets. As discussed earlier, financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples: Bill of Exchange, Promissory Note, Treasury Bill, Government Bond, Deposit Receipt, Share, Debenture, etc. The innovative instruments introduced in India have been discussed later in the chapter 'Financial Services'.

Financial instruments can also be called financial securities. Financial securities can be classified into:

(i) Primary or direct securities.

(ii) Secondary or indirect securities.

### Primary securities

These are securities directly issued by the ultimate investors to the ultimate savers, e.g., shares and debentures issued directly to the public.

### Secondary securities

These are securities issued by some intermediaries called financial intermediaries to the ultimate savers, e.g., Unit Trust of India and Mutual Funds issue securities in the form of units to the public and the money pooled is invested in companies.

Again these securities may be classified on the basis of duration as follows:

(i) Short-term securities.

(ii) Medium-term securities.

(iii) Long-term securities.

Short-term securities are those which mature within a period of one year, e.g., Bill of Exchange, Treasury Bill, etc. Medium-term securities are those which have a maturity period ranging between one to five years, e.g., Debentures maturing within a period of five years. Long-term securities are those which have a maturity period of more than five years, e.g., Government Bonds maturing after ten years.

### Characteristic features of financial instruments

Generally speaking, financial instruments possess the following characteristic features:

(i) Most of the instruments can be easily transferred from one hand to another without many cumbersome formalities.

(ii) They have a ready market, i.e., they can be bought and sold frequently and thus, trading in these securities is made possible.

(iii) They possess liquidity, i.e., some instruments can be converted into cash readily. For instance, a bill of exchange can be converted into cash readily by means of discounting and rediscounting.

(iv) Most of the securities possess security value, i.e., they can be given as security for the purpose of raising loans.

(v) Some securities enjoy tax status, i.e., investments in these securities are exempted from Income Tax, Wealth Tax, etc., subject to certain limits, e.g., Public Sector Tax Free Bonds, Magnum Tax Saving Certificates.

(vi) They carry risk in the sense that there is uncertainty with regard to payment of principal or interest or dividend as the case may be.

(vii) These instruments facilitate futures trading so as to cover risks due to price fluctuations, interest rate fluctuations, etc.

(viii) These instruments involve less handling costs since expenses involved in buying and selling these securities are generally much less.

(ix) The return on these instruments is directly in proportion to the risk undertaken.

(x) These instruments may be short-term or medium-term or long-term depending upon the maturity period of these instruments.

## DEVELOPMENT OF FINANCIAL SYSTEM IN INDIA

Some serious attention was paid to the development of a sound financial system in India only after the launching of the planning era in the country. At the time of Independence in 1947, there was no strong financial institutional mechanism in the country. There was absence of issuing institutions and non-participation of intermediary financial institutions. The industrial sector also had no access to the savings of the community. The capital market was very primitive and shy. The private as well as the unorganised sector played a key role in the provision of 'liquidity'. On the whole, chaotic conditions prevailed in the system.

With the adoption of the theory of mixed economy, the development of the financial system took a different turn so as to fulfil the socio-economic and political objectives. The Government started creating new financial institutions to supply finance both for agricultural and industrial development and it also progressively started nationalising some important financial institutions so that the flow of finance might be in the right direction.

### Nationalisation of Financial Institutions

As stated earlier, the RBI is the leader of the financial system. But, it was established as a private institution in 1935. It was nationalised in 1948. It was followed by the nationalisation of the Imperial Bank of India in 1956 by renaming it as State Bank of India. In the same year, 245 Life Insurance Companies were brought under Government control by merging all of them into a single corporation called Life Insurance Corporation of India. Another significant development in our financial system was the nationalisation of 14 major commercial banks in 1969. Again, six banks were nationalised in 1980. This process was then extended to General Insurance Companies which were reorganised under the name of General Insurance Corporation of India. Thus, the important financial institutions were brought under public control.

### Starting of Unit Trust of India

Another landmark in the history of development of our financial system is the establishment of new financial institutions to strengthen our system and to supply institutional credit to industries.

The Unit Trust of India was established in 1964 as a public sector institution to collect the savings of the people and make them available for productive ventures. It is the oldest and largest mutual fund in India. It is governed by its own statutes and regulations. However, since 1994, the schemes of UTI have to be approved by the SEBI. It has introduced a number of open-ended and close-ended schemes. It also provides repurchase facility of units of the various income schemes after a minimum lock-in period of one year. Some of the unit schemes of UTI are linked with stock exchanges. Its investment is confined to both corporate and non-corporate sectors. In recent years, it has established the following subsidiaries:

(i) The UTI Bank Ltd., in April 1994.

(ii) The UTI Investor Service Ltd., to act as UTI's own Registrar and Transfer agency.

(iii) The UTI Security Exchange Ltd.,

### Establishment of Development Banks

Many development banks were started not only to extend credit facilities to financial institutions but also to render advisory services. These banks are multipurpose institutions which provide medium and long-term credit to industrial undertakings, discover investment projects, undertake the preparation of project reports, provide technical advice and managerial services and assist in the management of industrial units. These institutions are intended to develop backward regions as well as small and new entrepreneurs.

The Industrial Finance Corporation of India (IFCI) was set-up in 1948 with the object of 'making medium and long-term credits more readily available to industrial concerns in India, particularly under circumstances where normal banking accommodation is inappropriate or recourse to capital issue method is impracticable'. At the regional level, State Financial Corporations were established under the State Financial Corporation Act, 1951 with a view of providing medium and long-term finance to medium and small industries. It was followed by the establishment of the Industrial Credit and Investment Corporation of India (ICICI) in 1955 to develop large and medium industries in private sector, on the initiative of the World Bank. It adopted a more dynamic and modern approach in industrial financing. Subsequently, the Government of India set-up the Refinance Corporation of India (RCI) in 1958 with a view of providing refinance facilities to banks against term loans granted by them to medium and small units. Later on it was merged with the Industrial Development Bank of India.

The Industrial Development Bank of India (IDBI) was established on July 1, 1964 as a wholly-owned subsidiary of the RBI. The ownership of IDBI was then transferred to the Central Government with effect from February 16, 1976. The IDBI was the apex institution in the area of development banking and as such it had to coordinate the activities of all the other financial institutions. However, it has been converted into a commercial bank and so it has lost the status of a development bank now. At the State level, the State Industrial Development Corporations (SIDCO)/State Industrial Investment Corporations were created to meet the financial requirements of the States and to promote regional development.

In 1971, the IDBI and LIC jointly set-up the Industrial Reconstruction Corporation of India (IRCI) with the main objective of reconstruction and rehabilitation of sick industrial undertakings. The IRCI was converted into a statutory corporation in March 1985 and renamed as the Industrial Reconstruction Bank of India (IRBI). In 1997, the IRBI has to be completely restructured since it itself has become sick due to financing of sick industries. Now, it is converted into a limited company with a new name of Industrial Investment Bank of India (IIBI). Its objective is to finance only expansion, diversification, modernisation, etc., of industries and thus it has become a development bank.

The Small Industries Development Bank of India (SIDBI) was set-up as a wholly-owned subsidiary of IDBI. It commenced operations on April 2, 1990. The SIDBI has taken over the responsibility of administrating the Small Industries Development Fund and the National Equity Fund.

**Institution for Financing Agriculture**

In 1963, the RBI set-up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects such as minor irrigation, farm mechanisation, land development, horticulture, dairy development, etc. However, in July 1982, the National Bank for Agriculture and Rural Development (NABARD) was established and the ARDC was merged with it. The whole sphere of agricultural finance has been handed over to NABARD. The functions of the Agricultural Credit Department and Rural Planning and Credit Cell of the RBI have been taken over by NABARD.

### Institution for Foreign Trade

The Export and Import Bank of India (EXIM Bank) was set-up on January 1, 1982 to takeover the operations of International Finance wing of the IDBI. Its main objective is to provide financial assistance to exporters and importers. It functions as the principal financial institution for coordinating the working of other institutions engaged in financing of foreign trade. It also provides refinance facilities to other financial institutions against their export-import financing activities.

### Institution for Housing Finance

The National Housing Bank (NHB) has been set-up on July 9, 1988 as an apex institution to mobilise resources for the housing sector and to promote housing finance institutions both at regional and local levels. It provides refinance facilities to housing finance institutions and scheduled banks. It also provides guarantee and underwriting facilities to housing finance institutions. Again, it coordinates the working of all agencies connected with housing.

### Stock Holding Corporation of India Ltd. (SHCIL)

In 1987 another institution, *viz.*, Stock Holding Corporation of India Ltd. was se-up to tone up the stock and capital markets in India. Its main objective is to provide quick share transfer facilities, clearing services, depository services, support services, management information services and development services to investors both individuals and corporates. The SHCIL was set-up by seven All India financial institutions, *viz.*, IDBI, IFCI, ICICI, LIC, GIC, UTI and IRBI.

### Mutual Funds Industry

Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public and investing them in a diversified portfolio. They provide investment avenues for small investors who cannot participate in the equities of big companies. Mutual funds have been floated by some public sector banks, LIC, GIC and recently by private sector also.

## Venture Capital Institutions

Venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. Much thrust is given to new ideas or technological innovations. Indeed, it is a long-term risk capital to finance high technology projects. The IDBI venture capital fund was set-up in 1986. The IFCI has started a subsidiary to finance venture capital, *viz.*, The Risk Capital and Technology Finance Corporation (RCTC). Likewise, the ICICI and the UTI have jointly set-up the Technology Development and Information Company of India Limited (TDICI) in 1988 to provide venture capital. Similarly, many State Financial Corporations and commercial banks have started subsidiaries to provide venture capital. The Indus Venture Capital Fund and the Credit Capital Venture Fund Limited come under the private sector.

## Credit Rating Agencies

Of late, many credit rating agencies have been established to help investors to make a decision of their investment in various instruments and to protect them from risky ventures. At the same time, it has the effect of improving the competitiveness of the companies so that one can excel the other. Credit rating is now mandatory for all debt instruments. Similarly, for accepting deposits, non-banking companies have to compulsorily go for credit rating. Some of the important credit rating agencies established are:

(i) Credit Rating and Information Services of India Ltd., (CRISIL).

(ii) Investment Information and Credit Rating Agency of India Ltd., (ICRA).

(iii) Credit Analysis and Research Ltd., (CARE).

The rating is confined to fixed deposits, debentures, preference shares and short-term instruments like commercial paper. The rating of equity shares will come into effect soon. The establishment of various credit rating agencies will go a long way in stabilising the financial system in India by supplying vital credit information about corporate customers.

## Multiplicity of Financial Instruments

The expansion in size and number of financial institutions has consequently led to a considerable increase in the financial instruments also. New instruments have been introduced in the form of innovative schemes of LIC, UTI, Banks, Post Office Savings Bank Accounts, Shares and debentures of different varieties, Public Sector Bonds, National Savings Scheme, National Savings Certificates, Provident Funds, Relief Bonds, Indira Vikas Patra, etc. Thus, different types of instruments are available in the financial system so as to meet the diversified requirements of varied investors and thereby making the system more healthy and vibrant.

## Legislative Support

The Indian financial system has been well supported by suitable legislative measures taken by the Government then and there for its proper growth and smooth functioning. Though there are many enactments, some of them are very important. The Indian Companies Act was passed in 1956 with a view of regulating the functioning of companies from birth to death. It mainly aims at giving more protection to investors since there is a diversity of ownership and management in companies. It was a follow-up to the Capital Issues Control Act passed in 1947. Again, in 1956, the Securities Contracts (Regulation) Act was passed to prevent undesirable transactions in securities. It mainly regulates the business of trading in the stock exchanges. This act permitted only recognised stock exchanges to function.

To ensure the proper functioning of the economic system and to prevent concentration of economic power in the hands of a few, the Monopolies and Restrictive Trade Practices Act was passed in 1970. In 1973, the Foreign Exchange Regulations Act was enacted to regulate the foreign exchange dealings and to control Indian investments abroad and vice versa.

The Capital Issues Control Act was replaced by setting up of the Securities Exchange Board of India. Its main objective is to protect the interest of investors by suitably regulating the dealings in the stock market and money market so as to achieve efficient and fair trading in these markets. When the Government adopted the New Economic Policy, many of these acts were amended so as to remove many unwanted controls. Banks and financial institutions have been permitted to become members of the stock market in India. They have been permitted to float mutual funds, undertake leasing business, carry-out factoring services, etc.

Besides the above, the Indian Contract Act, The Negotiable Instruments Act, The Law of Limitation Act, The Banking Regulations Act, The Stamp Act, etc., deserve a special mention. When the financial system grows, the necessity of regulating it also grows side-by-side by means of bringing suitable legislations. These legislative measures have reorganised the Indian financing system to a greater extent and have restored confidence in the minds of the investing public as well.

However, to avoid overlap in certain key areas between SEBI and other bodies such as Company Law Board, RBI, etc., it is necessary to classify the respective jurisdictions. At present, the jurisdiction is divided between the RBI (money, market, repos, debt market) and SEBI. It would be advisable to consolidate the securities laws into one comprehensive legislation on the lines of the British Financial Services and Market Act, 2000.

## Financial Sector Legislative Reforms Commission (FSLRC)

The Central Government has very recently constituted the Financial Sector Legislative Reforms Commission (FSLRC) under the chairmanship of former Justice B.N. Srikrishna to rewrite and harmonise the various financial sector legislations, rules and regulations. There are over 60 acts and multiple rules and regulations and many of them have become archaic. Moreover, large number of amendments made in these acts over time have increased the ambiguity and complexity of the system.

## FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

The financial system plays a significant role in the process of economic development of a country. The financial system comprises of a network of commercial banks, Non-banking companies, development banks and other financial and investment institutions offer a varieties of financial products and services to suit to the varied requirements of different categories of people. Since they function in a fairly developed capital and money markets, they play a crucial role in spurring economic growth in the following ways:

**(i) Mobilising savings:** The financial system mobilises the savings of the people by offering appropriate incentives and by deepening and widening the financial structure. In other words, the financial system creates varieties of forms of savings so that savings can take place according to the varying asset preferences of different classes of savers. In the absence of the financial system, all savings would remain idle in the hands of the savers and they would not have flown into productive ventures.

**(ii) Promoting investments:** For the economic growth of any nation, investment is absolutely essential. This investment has to flow from the financial system. In fact, the level of investment determines the increase in output of goods and services and incomes in the country. The financial system collects the savings and channels them into investment which contributes positively towards economic development.

**(iii) Encouraging investment in financial assets:** The dynamic role of the financial system in the economic development is that it encourages savings to flow into financial assets (money and monetary assets) as against physical assets (land, gold and other goods and services). The investments in physical assets are speculative and would breed inflation. On the other hand, investment in financial assets are non-inflationary in nature and would aid growth in the economy. The larger the proportion of the financial assets, the greater is the scope for economic growth in the long-run.

**(iv) Allocating savings on the basis of national priorites:** Above all, the financial system allocates the savings in a more efficient manner so that the scarce capital may be more efficiently utilised among the various alternative investments. In other words, it gives preference to certain sectors, from the social and economic point of view, on the basis of national priorities.

**(v) Creating credit:** Large financial resources are needed for the economic development of a nation. These resources are supplied by the financial system not only in the form of liquid cash but also in the form of 'created money' or 'deposit money' by creating credit and thereby making available large resources to finance trade, production, distribution, etc. Thus, it accelerates economic growth by facilitating the transactions of trade, production and distribution on a large-scale.

**(vi) Providing a spectrum of financial assets:** The financial system provides a spectrum of financial assets so as to meet the varied requirements and preferences of households. Thus, it enables them to choose their asset portfolios in such a way as to achieve a preferred mix of return, liquidity and risk. Thus, it contributes to the economic development of a country.

**(vii) Financing trade, industry and agriculture:** All the financial institutions operating in a financial system take all efforts to ensure that no worthwhile project – be it in trade or agriculture or industry – suffers due to lack of funds. Thus, they promote industrial and agricultural development which have a greater say on the economic development of a country.

**(viii) Encouraging entrepreneurial talents:** The financial insitutions encourage the managerial and entrepreneurial talents in the economy by promoting the spirit of enterprise and risk-taking capacity. They also furnish the necessary technical consultancy services to the entrepreneurs so that they may succeed in their innovative ventures.

**(ix) Providing financial services:** Sophistication and innovations have started appearing in the arena of financial intermediations as well. The financial instituions play a very dynamic role in the economic development of a country not only as a provider of finance, but also as a departmental store of finance by offering varieties of innovative financial products and services to meet the ever-increasing demands of their clients both corporates and individuals.

**(x) Developing backward areas:** The integral policy of the national development plans of every country concentrates on the development of relatively less developed areas called backward areas. The financial institutions provide a package of services, infrastructure and incentives conducive to a healthy growth of industries in such backward areas and thus, they contribute for the uniform development of all regions in a country.

## WEAKNESSES OF INDIAN FINANCIAL SYSTEM

After the introduction of planning, rapid industrialisation has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing requirements of the Government and the industries, many innovative financial instruments have been introduced. Besides, there has been a mushroom growth of financial intermediaries to meet the ever-growing financial requirements of different types of customers. Hence, the Indian financial system is more developed and integrated today than what it was 50 years ago. Yet, it suffers from some weaknesses as listed below:

**(i) Lack of coordination between different financial institutions:** There are a large number of financial intermediaries. Most of the vital financial institutions are owned by the Government. At the same time, the Government is also the controlling authority of these institutions. In these circumstances, the problem of coordination arises. As there is multiplicity of institutions in the Indian financial system, there is lack of coordination in the working of these institutions.

**(ii) Monopolistic market structures:** In India, some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance, a major share of life insurance business is in the hands of LIC. The UTI has more or less monopolised the mutual fund industry. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement or lack of effort in mobilising savings of the public and so on. Ultimately, it would retard the development of the financial system of the country itself.

**(iii) Dominance of development banks in industrial financing:** The development banks constitute the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the financial institutions created by the Government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds from their sponsors. As such, they fail to mobilise the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country. For industries abroad, institutional finance has been a result of institutionalisation of personal savings through media like banks, LIC, pension and provident funds, Unit Trusts and so on. But they play a less significant role in Indian financial system, as far as industrial financing is concerned. However, in recent times attempts are being made to raise funds from the public through the issue of bonds, units, debentures and so on. It will go a long way in forging a link between the normal channels of savings and the distributing mechanism.

**(iv) Inactive and erratic capital market:** The important function of any capital market is to promote economic development through mobilisation of savings and their distribution to productive ventures. As far as industrial finance in India is concerned, corporate customers are able to raise their financial resources through development banks. So, they need not go to the capital market. Moreover, they don't resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.

(v) **Imprudent financial practice:** The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So, there is a preponderance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. To make matters worse, when corporate enterprises face any financial crisis, these financial institutions permit a greater use of debt than is warranted. It is against the traditional concept of a sound capital structure.

However, in recent times, all efforts have been taken to activate the capital market. Integration is also taking place between different financial institutions. For instance, the Unit Linked Insurance Schemes of the UTI are being offered to the public in collaboration with the LIC. Similarly, the refinance and rediscounting facilities provided by the IDBI aim at integration. Thus, the Indian financial system has become a developed one.

## QUESTIONS

### I. Objective type Questions

#### 1. Fill in the blanks:

1. __________ assets are mostly useful for consumption.
2. The market for new issues is called __________ market.
3. Loan against the security of immovable property is called __________ loan.
4. __________ guarantee cover the payment of earnest money, retention money and advance payments.
5. The SHCIL was set-up in the year __________.

[Key: 1. Physical, 2. Primary, 3. Mortgage, 4. Performance, 5. 1987]

#### 2. Choose the best answer from the following:

1. The following one is a financial asset:
   (a) Gold (b) Silver
   (c) Share (d) Land
2. Which one of the following is a cash asset?
   (a) Deposit created out of loans (b) Share
   (c) Bond (d) Post office certificate.
3. The component of a capital market is:
   (a) Treasury bill market (b) Government securities market
   (c) Commercial bill market (d) (a) and (b) together.

4. The money market instrument is:
   (a) Bond
   (b) Debenture
   (c) Stock certificate
   (d) Certificate of deposit.
5. Government Bond is a:
   (a) Short-term security
   (b) Long-term security
   (c) Medium-term security
   (d) Either short-term or long-term security.

   [Key: 1. (c), 2. (a), 3. (b), 4. (d), 5. (b)]

**3. State whether the following statements are TRUE or FALSE:**

1. Building bought for hiring is a financial asset.
2. LIC is primarily a money market intermediary.
3. Companies can raise capital in a primary market only through Rights Issue.
4. The most liquid financial market is the call money market.
5. A promissory note issued by the Government is called Treasury Bill.

   [Key: 1. True, 2. False, 3. False, 4. True, 5. True]

**II. Short Answer Type Questions:**

1. Distinguish between a physical asset and a financial asset.
2. Classify financial assets giving examples.
3. What is a money market?
4. What is a capital market?
5. Distinguish between a primary market and a secondary market.
6. What is performance guarantee?
7. State the functions of a foreign exchange market.
8. What do you mean by indirect securities? Give an example.
9. What is venture capital financing?
10. What is STRIPS?

**III. Answer the following in a paragraph:**

1. What is a capital market? What are its major constituents?
2. Write a brief note on the financial guarantees market operating in India.
3. What are financial instruments? What are their characteristic features?
4. What legislative measures have been taken by the Government to support the Indian financial system?
5. Classify financial assets and bring out their features.
6. Distinguish between stripping and reconstitution.

**IV. Essay type questions:**

1. Classify the various financial intermediaries functioning in the Indian financial system and bring out their features.
2. Show the classification of Indian financial markets in the form of a chart and explain the features of each market.
3. What do you mean by financial rate of return? What are the basic objectives of the interest rate policy of the Government and what steps have been taken by the Government in this direction?
4. Trace out the development of the financial system in India.
5. "In spite of suitable legislative measures, the Indian financial system remains weak". Comment.
6. Discuss the role of the financial system in the economic development of a country.

Chapter 2

# Money Market

Money market is a market for short-term loans or financial assets. It is a market for the lending and borrowing of short-term funds. As the name implies, it does not actually deal in cash or money. But it actually deals with near substitutes for money or near money like trade bills, promissory notes and Government papers drawn for a short period not exceeding one year. These short-term instruments can be converted into cash readily without any loss and at low transaction cost.

Money market is the centre for dealing mainly in short-term money assets. It meets the short-term requirements of borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus funds at the disposal of financial institutions and individuals are borrowed by individuals, institutions and also the Government.

The money market does not refer to a particular place where short-term funds are dealt with. It includes all individuals, institutions and intermediaries dealing with short-term funds. The transactions between borrowers, lenders and middlemen take place through telephone, telegraph, mail and agents. No personal contact or presence of the two parties is essential for negotiations in a money market. However, a geographical name may be given to a money market according to its location. For example, the London money market operates from Lambard Street and the New York money market operates from Wall Street. But, they attract funds from all over the world to be lent to borrowers from all over the globe. Similarly, the Mumbai money market is the centre for short-term loanable funds of not only Mumbai, but also the whole of India.

## DEFINITION

According to Crowther, 'The money market is the collective name given to the various firms and institutions that deal in the various grades of near money'.

The RBI defines the money market as, 'a market for short-term financial assets that are close substitutes for money, facilitates the exchange of money for new financial claims in the primary market as also for financial claims, already issued, in the secondary market'.

## MONEY MARKET VS. CAPITAL MARKET

In this context, it is imperative that one should know the distinction between a money market and a capital market. The distinction is briefly shown in the following table:

| Money Market | Capital Market |
|---|---|
| (i) It is a market for short-term loanable funds for a period of not exceeding one year. | (i) It is a market for long-term funds exceeding a period one year. |
| (ii) This market supplies funds for financing current business operations, working capital require-ments of industries and short period requirements of the Government. | (ii) This market supplies funds for financing the fixed capital requirements of trade and commerce as well as the long-term requirements of the Government. |
| (iii) The instruments that are dealt in a money market are bills of exchange, treasury bills, commercial papers, certificate of deposit, etc. | (iii) This market deals in instruments like shares, debentures, Government bonds, etc. |
| (iv) Each single money market instrument is of large amount. A TB is of minimum for one lakh. Each CD or CP is for a minimum of ₹ 25 lakh. | (iv) Each single capital market instrument is of small amount. Each share value is ₹ 10. Each debenture value is ₹ 100. |
| (v) The Central bank and Commercial banks are the major institutions in the money market. | (v) Development banks and insurance companies play a dominant role in the capital market. |
| (vi) Money market instruments generally do not have secondary markets. | (vi) Capital market instruments generally have secondary markets. |
| (vii) Transactions mostly take place over-the-phone and there is no formal place. | (vii) Transactions take place at a formal place, *viz.*, stock exchange. |
| (viii) Transactions have to be conducted without the help of brokers. | (viii) Transactions have to be conducted only through authorised dealers. |

## FEATURES OF A MONEY MARKET

The following are the general features of a money market:

(i) It is a market purely for short-term funds or financial assets called near money.

(ii) It deals with financial assets having a maturity period up-to one year only.

(iii) It deals with only those assets which can be converted into cash readily without loss and with minimum transaction cost.

(iv) Generally, transactions take place through phone, i.e., oral communication. Relevant documents and written communications can be exchanged subsequently. There is no formal place like stock exchange as in the case of a capital market.

(v) Transactions have to be conducted without the help of brokers.

(vi) It is not a single homogeneous market. It comprises of several submarkets, each specialising in a particular type of financing, e.g., Call money market, Acceptance market, Bill market and so on.

(vii) The components of a money market are the Central Bank, Commercial Banks, Non-banking financial companies, discount houses and acceptance houses. Commercial banks generally play a dominant role in this market.

### Objectives

The following are the important objectives of a money market:

(i) To provide a parking place to employ short-term surplus funds.

(ii) To provide room for overcoming short-term deficits.

(iii) To enable the central bank to influence and regulate liquidity in the economy through its intervention in this market.

(iv) To provide a reasonable access to users of short-term funds to meet their requirements quickly, adequately and at reasonable costs.

## CHARACTERISTIC FEATURES OF A DEVELOPED MONEY MARKET

In order to fulfil the above objectives, the money market should be fully developed and efficient. In every country of the world, some type of money market exists. Some of them are highly developed while others are not well developed. Prof. S.N. Sen has described certain essential features of a developed money market. They are as follows:

### (i) Highly organised banking system

The commercial banks are the nerve centre of the whole money market. They are the principal suppliers of short-term funds. Their policies regarding loans and advances have greater impact on the entire money market. The commercial banks serve as vital link between the central bank and the various segments of the money market. Consequently, a well developed money market and a highly organised banking system co-exist. In an underdeveloped money market, the commercial banking system is not fully developed.

**(ii) Presence of a central bank**

The central bank acts as the banker's bank. It keeps their cash reserves and provides them financial accommodation in difficulties by discounting their eligible securities. In other words, it enables the commercial banks and other institutions to convert their assets into cash in times of financial crisis. Through its open market operations, the central bank absorbs surplus cash during off-seasons and provides additional liquidity in the busy seasons. Thus, the central bank is the leader, guide and controller of the money market. In an underdeveloped money market, the central bank is in its infancy and not in a position to influence and control the money market.

**(iii) Availability of proper credit instruments**

It is necessary for the existence of a developed money market a continuous availability of readily acceptable negotiable securities such as bills of exchange, treasury bills, etc., in the market. There should be a number of dealers in the money market to transact in these securities. Availability of negotiable securities and the presence of dealers and brokers in large numbers to transact in these securities are needed for the existence of a developed money market. There is absence of adequate and proper credit instruments as well as dealers to deal in these instruments in an underdeveloped money market.

**(iv) Existence of sub-markets**

The number of sub-markets determines the development of a money market. The larger the number of sub-markets, the broader and more developed will be the structure of money market. The several sub-markets together make a coherent money market. In an underdeveloped money market, the various sub-markets, particularly the bill market, are absent. Even if sub-markets exist, there is no co-ordination between them. Consequently, different money rates prevail in the sub-markets and they remain unconnected with one another.

**(v) 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 also from foreign countries. The London, New York and Paris money markets attract funds from all over the world. The underdeveloped money markets are starved of funds.

**(vi) Existence of secondary market**

There should be an active secondary market in these instruments.

**(vii) Demand and supply of funds**

There should be a large demand and supply of short-term funds. It presupposes the existence of a large domestic and foreign trade. Besides, it should have adequate amount of liquidity in the form of large amounts maturing within a short period.

**Other factors**

Besides the above, other factors also contribute to the development of a money market. Rapid industrial development leading to the emergence of stock exchanges, large volume of international trade leading to the system of bills of exchange, political stability, favourable conditions for foreign investment, price stabilisation, etc., are the other factors that facilitate the development of money market in the country.

London money market is a highly developed money market because it satisfies all requirements of a developed money market.

If any one or more of these factors are absent, then the money market is called an underdeveloped one.

## IMPORTANCE OF MONEY MARKET

A developed money market plays an important role in the financial system of a country by supplying short-term funds adequately and quickly to trade and industry. The money market is an integral part of a country's economy. Therefore, a developed money market is highly indispensable for the rapid development of the economy. A developed money market helps the smooth functioning of the financial system in any economy in the following ways:

**(i) Development of trade and industry**

Money market is an important source of financing trade and industry. The money market, through discounting operations and commercial papers, finances the short-term working capital requirements of trade and industry and facilitates the development of industry and trade both — national and international.

**(ii) Development of capital market**

The short-term rates of interest and the conditions that prevail in the money market influence the long-term interest as well as the resource mobilisation in capital market. Hence, the development of capital market depends upon the existence of a developed money market.

**(iii) Smooth functioning of commercial banks**

The money market provides the commercial banks with facilities for temporarily employing their surplus funds in easily realisable assets. The banks can get back the funds quickly, in times of need, by resorting to the money market. The commercial banks gain immensely by economising their cash balances in hand and at the same time meeting the demand for large withdrawal of their depositors. It also enables commercial banks to meet their statutory requirements of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) by utilising the money market mechanism.

**(iv) Effective central bank control**

A developed money market helps the effective functioning of a central bank. It facilitates effective implementation of the monetary policy of a central bank. The central bank, through the money market, pumps new money into the economy in slump and siphons it off in boom. The central bank, thus, regulates the flow of money so as to promote economic growth with stability.

**(v) Formulation of suitable monetary policy**

Conditions prevailing in a money market serve as a true indicator of the monetary state of an economy. Hence, it serves as a guide to the Government in formulating and revising the monetary policy then and there depending upon the monetary conditions prevailing in the market.

**(vi) Non-inflationary source of finance to government**

A developed money market helps the Government to raise short-term funds through the treasury bills floated in the market. In the absence of a developed money market, the Government would be forced to print and issue more money or borrow from the central bank. Both ways would lead to an increase in prices and the consequent inflationary trend in the economy.

## COMPOSITION OF MONEY MARKET

As stated earlier, the money market is not a single homogeneous market. It consists of a number of sub-markets which collectively constitute the money market. There should be competition within each sub-market as well as between different sub-markets. The following are the main sub-markets of a money market:

(i) Call money market.

(ii) Commercial bills market or discount market.

(iii) Acceptance market.

(iv) Treasury bill market.

## CALL MONEY MARKET

The call money market refers to the market for extremely short period loans, say one day to fourteen days. These loans are repayable on demand at the option of either the lender or the borrower. As stated earlier, these loans are given to brokers and dealers in stock exchange. Similarly, banks with 'surplus funds' lend to other banks with 'deficit funds' in the call money market. Thus, it provides an equilibrating mechanism for evening out short-term surpluses and deficits. Moreover, commercial banks can quickly borrow from the call market to meet their statutory liquidity requirements. They can also maximise their profits easily by investing their surplus funds in the call market during the period when call rates are high and volatile.

### Operations in call market

Borrowers and lenders in a call market contact each other over telephone. Hence, it is basically over-the-telephone market. After negotiations over the phone, the borrowers and lenders arrive at a deal specifying the amount of loan and the rate of interest. After the deal is over, the lender issues FBL cheque in favour of the borrower. The borrower in turn issues call money borrowing receipt. When the loan is repaid with interest, the lender returns the duly discharged receipt.

Instead of negotiating the deal directly, it can be routed through the Discount and Finance House of India (DFHI). The borrowers and lenders inform the DFHI about their fund requirement and availability at a specified rate of interest. Once the deal is confirmed, the Deal Settlement Advice is exchanged. In case the DFHI borrows, it issues a call deposit receipt to the lender and receives RBI cheque for the money borrowed. The reverse is taking place in the case of lendings by the DFHI. The duly discharged call deposit receipt is surrendered at the time of settlement. Call loans can be renewed up-to a maximum period of 14 days only and such renewals are recorded on the back of the deposit receipt by the borrower.

### Call loan market transactions and participants

In India, call loans are given for the following purposes:

(i) To commercial banks to meet large payments, and large remittances, to maintain liquidity with the RBI and so on.

(ii) To the stock brokers and speculators to deal in stock exchanges and bullion markets.

(iii) To the bill market for meeting matured bills.

(iv) To the Discount and Finance House of India and the Securities Trading Corporation of India to activate the call market.

(v) To individuals of very high status for trade purposes to save interest on OD or cash credit.

The participants in this market can be classified into two categories, *viz.:*

(i) Those permitted to act as both lenders and borrowers of call loans.

(ii) Those permitted to act only as lenders in the market.

The first category includes all Commercial banks, Cooperative banks, DFHI and STCI. In the second category, LIC, UTI, GIC, IDBI, NABARD, Specified mutual funds, etc., are included. They can only lend and they cannot borrow in the call market.

### Advantages

In India, commercial banks play a dominant role in the call loan market. They used to borrow and lend among themselves and such loans are called inter-bank loans. They are very popular in India. So, many advantages are available to commercial banks. They are as follows:

#### (i) High liquidity

Money lent in a call market can be called back at any time when needed. So, it is highly liquid. It enables commercial banks to meet large sudden payments and remittances by making a call on the market.

#### (ii) High profitability

Banks can earn high profits by lending their surplus funds to the call market when call rates are high and volatile. It offers a profitable parking place for employing the surplus funds of banks temporarily.

#### (iii) Maintenance of SLR

Call market enables commercial banks to maintain their statutory reserve requirements. Generally, banks borrow on a large-scale every reporting Friday to meet their SLR requirements. In the absence of call market, banks have to maintain idle cash to meet their reserve requirements. It will tell upon their profitability.

#### (iv) Safe and cheap

Though call loans are not secured, they are safe since the participants have a strong financial standing. It is cheap in the sense brokers have been prohibited from operating in the call market. Hence, banks need not pay brokerage on call money transactions.

#### (v) Assistance to central bank operations

Call money market is the most sensitive part of any financial system. Changes in demand and supply of funds are quickly reflected in call money rates and it gives an indication to the central bank to adopt an appropriate monetary policy. Moreover, the existence of an efficient call market helps the central bank to carry-out its open market operations effectively and successfully.

### Drawbacks

The call market in India suffers from the following drawbacks:

#### (i) Uneven development

The call money market in India is confined to only big industrial and commercial centres like Mumbai, Kolkata, Chennai, Delhi, Bengaluru and Ahmedabad. Generally, call markets are associated with stock exchanges. Hence, the market is not evenly developed.

### (ii) Lack of integration

The call markets in different centres are not fully integrated. Besides, a large number of local call markets exist without any integration.

### (iii) Volatility in call money rates

Another drawback is the volatile nature of the call money rates. Call rates vary to a greater extent in different centres in different seasons on different days within a fortnight. The rates vary between 12 per cent and 85 per cent. One cannot believe 85 per cent being charged on call loans.

## COMMERCIAL BILLS MARKET OR DISCOUNT MARKET

A commercial bill is one which arises out of a genuine trade transaction, i.e., credit transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the amount due. The buyer accepts it immediately agreeing to pay the amount mentioned therein after a certain specified date. Thus, a bill of exchange contains a written order from the creditor to the debtor, to pay a certain sum, to a certain person, after a certain period. A bill of exchange is a 'self-liquidating' paper and negotiable. It is drawn always for a short period ranging between 3 months and 6 months.

### Definition

Section 5 of the Negotiable Instruments Act defines a bill of exchange as follows:

'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'.

### Types of bills

Many types of bills are in circulation in a bill market. They can be broadly classified as follows:

(i) Demand and usance bills.

(ii) Clean bills and documentary bills.

(iii) Inland and foreign bills.

(iv) Export bills and import bills.

(v) Indigenous bills.

(vi) Accommodation bills and supply bills.

### Demand and usance bills

Demand bills are otherwise called sight bills. These bills are payable immediately as soon as they are presented to the drawee. No time of payment is specified and hence they are payable at sight.

Usance bills are called time bills. These bills are payable immediately after the expiry of time period mentioned in the bills. The period varies according to the established trade custom or usage prevailing in the country.

**Clean bills and documentary bills**

When bills have to be accompanied by documents of title to goods like Railway receipt, Lorry receipt, Bill of Lading, etc., the bills are called documentary bills. These bills can be further classified into D/A bills and D/P bills. In the case of D/A bills, the documents accompanying bills have to be delivered to the drawee immediately after his acceptance of the bill. Thus, a D/A bill becomes a clean bill immediately after acceptance. Generally, D/A bills are drawn on parties who have a good financial standing.

On the other hand, the documents have to be handed over to the drawee only against payment in the case of D/P bills. The documents will be retained by the banker till the payment of such 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 those drawn upon a person resident in India and are payable in India. Foreign bills are drawn outside India and they may be payable either in India or outside India. They may be drawn upon a person resident in India also. Foreign bills have their origin outside India. They also include bills drawn in India but made payable outside India.

**Export bills and import bills**

Export bills are those drawn by Indian exporters on importers outside India and import bills are drawn on Indian importers in India by exporters outside India.

**Indigenous bills**

Indigenous bills are those drawn and accepted according to native custom or usage of trade. These bills are popular among indigenous bankers only. In India, they are called 'hundis'. The hundis are known by various names such as 'Shahjog', 'Namjog', 'Jokhani', 'Termainjog', 'Darshani', 'Dhanijog' and so on.

**Accommodation bills and supply bills**

If bills do not arise out of genuine trade transactions, they are called accommodation bills. They are known as 'kite bills' or 'wind bills'. Two parties draw bills on each other purely for the purpose of mutual financial accommodation. These bills are discounted with bankers and the proceeds are shared among themselves. On the due dates, they are paid.

Supply bills are those drawn by suppliers or contractors on the Government departments for the goods supplied by them. These bills are neither accepted by the departments nor accompanied by documents of title to goods. So, they are not considered as negotiable instruments. These bills are useful only for the purpose of getting advances from commercial banks by creating a charge on these bills.

### Operations in bill market

From the operations point of view, the bill market can be classified into two, viz.:

(i) Discount market.

(ii) Acceptance market.

### Discount market

Discount market refers to the market where short-term genuine trade bills are discounted by financial intermediaries like commercial banks. When credit sales are effected, the seller draws a bill on the buyer who accepts it promising to pay the specified sum at the specified period. The seller has to wait until the maturity of the bill for getting payment. But, the presence of a bill market enables him to get payment immediately. The seller can ensure payment immediately by discounting the bill with some financial intermediary by paying a small amount of money called 'Discount rate'. On the date of maturity, the intermediary claims the amount of the bill from the person who has accepted the bill.

In some countries, there are some financial intermediaries who specialise in the field of discounting. For instance, in London Money Market there are specialised institutions called Discount Houses which specialise only in the field of discounting bills. Such institutions are conspicuously absent in India. Hence, commercial banks in India have to undertake the work of discounting. However, the DFHI has been established to activate this market.

### Acceptance market

The acceptance market refers to the market where short-term genuine trade bills are accepted by financial intermediaries. All trade bills cannot be discounted easily because the parties to the bills may not be financially sound. In case such bills are accepted by financial intermediaries like banks, the bills earn a good name and reputation and such bills can be readily discounted anywhere. In London, there are specialist firms called acceptance houses which accept bills drawn by traders and impart greater marketability to such bills. However, their importance has declined in recent times. In India, there are no acceptance houses. The commercial banks undertake the acceptance business to some extent.

**Advantages or Importance**

Commercial bill market is an important source of short-term funds for trade and industry. It provides liquidity and activates the money market. In India, commercial banks play a significant role in this market due to the following advantages:

**(i) Liquidity**

Bills are highly liquid assets. In times of necessity, bills can be converted into cash readily by rediscounting them with the central bank.

**(ii) Self-liquidating and negotiable asset**

Bills are self-liquidating in character since they have a fixed tenure. Moreover, they are negotiable instruments and hence they can be transferred freely by a mere delivery or by endorsement and delivery.

**(iii) Certainty of payment**

Bills are drawn and accepted by business people. Generally, business-people are used to keep their words and the use of bills imposes a strict financial discipline on them. Hence, bills would be honoured on the due date.

**(iv) Ideal investment**

Bills are for periods not exceeding 6 months. They represent advances for a definite period. This enables financial institutions to invest their surplus funds profitably by selecting bills of different maturities. For instance, commercial banks can invest their funds on bills in such a way that the maturity of these bills may coincide with the maturity of their fixed deposits.

**(v) Simple legal remedy**

In case the bills are dishonoured, the legal remedy is simple. Such dishonoured bills have to be simply noted and protested and the whole amount should be debited to the customer's accounts.

**(vi) High and quick yield**

The financial institutions earn a high and quick yield. The discount is deducted at the time of discounting itself, whereas in the case of other loans and advances, interest is payable only when it is due. The discount rate is also comparatively high.

**(vii) Central bank control**

The central bank can easily influence the money market by manipulating the bank rate or the rediscounting rate. Suitable monetary policy can be taken by adjusting the bank rate depending upon the monetary conditions prevailing in the market.

**Drawbacks**

In spite of these merits, the bill market has not been well developed in India. The reasons for the slow growth are the following:

**(i) Absence of bill culture**

Business-people in India prefer OD and cash credit to bill financing. Therefore, banks usually accept bills for the conversion of cash credits and overdrafts of their customers. Hence, bills are not popular.

**(ii) Absence of rediscounting among banks**

There is no practice of rediscounting of bills among banks who need funds and those who have surplus funds. In order to enlarge the rediscounting facility, the RBI has permitted financial institutions like LIC, UTI, GIC and ICICI to rediscount genuine eligible trade bills of commercial banks. Even then, bill financing is not popular.

**(iii) Stamp buty**

Stamp duty discourages the use of bills. Moreover, stamp papers of required denomination are not available.

**(iv) Absence of secondary market**

There is no active secondary market for bills. Rediscounting facility is available in important centres and that too it is restricted to the apex level financial institutions. Hence, the size of the bill market has been curtailed to a large extent.

**(v) Difficulty in ascertaining genuine trade bills**

The financial institutions have to verify the bills so as to ascertain whether they are genuine trade bills and not accommodation bills. For this purpose, invoices have to be scrutinised carefully. It involves additional work.

**(vi) Limited foreign trade**

In many developed countries, bill markets have been established mainly for financing foreign trade. Unfortunately, in India, foreign trade as a percentage to national income remains small and it is reflected in the bill market also.

**(vii) Absence of acceptance services**

There are no discount houses or acceptance houses in India. Hence, specialised services are not available in the field of discounting or acceptance.

**(viii) Attitude of banks**

Banks are shy of rediscounting bills even with the central bank. They have a tendency to hold the bills till maturity and hence it affects the velocity of circulation of bills. Again, banks prefer to purchase bills instead of discounting them.

## BILL MARKET SCHEME

A well organised bill market is essential for the smooth working of the credit system, progress of commercial banking as well as linking up the various credit agencies effectively to the central bank of a country. Realising its importance, the Central Banking Enquiry Committee emphasised the need for developing a bill market in India as early as 1931. But, it did not develop even after the establishment of the Reserve Bank due to several reasons.

In January 1952, for the first time, the Reserve Bank introduced a Bill Market Scheme.

Under Section 17(4) of the Reserve Bank of India Act, the bank undertook to make advances to scheduled banks against the security of usance promissory notes or trade bills having a maturity of 90 days and bearing two signatures, of which one will be that of a scheduled bank.

This facility was originally restricted to banks having deposits of more than ₹ 10 crore. The minimum value of each bill was fixed at ₹ 1 lakh and the minimum amount of advance was ₹ 25 lakh for a bank. The scheme was introduced on an experimental basis for a period of 4 years. Later on the recommendations of the Shroff Committee, the scheme was extended to all scheduled banks. The minimum amount of each bill was reduced to ₹ 50,000 and the minimum limit of advance for a bank was reduced to ₹ 10 lakh.

In 1957, on the recommendations of the Export Promotion Committee, the Reserve Bank of India, extended the scheme to include export bills in order to enable scheduled banks to provide finance to exports on a liberal scale. The extension of the bill market scheme to export bills has been continued further year-after-year.

### New bill market scheme 1970

The 1952 Bill Market Scheme remained a partial success. It was criticised that it did not develop a good bill market in India. The scheme appears to be a device for extending credit for banks during busy seasons. It is not based on genuine trade bills but on the conversion of loans and advances by scheduled banks into usance bills.

The Deheja Committee set in motion the introduction of a new bill market. The report brought out the abuses of cash credit system and suggested the use of bill financing and for the supervision of the end-use of funds lent by commercial banks.

A study group was appointed by the Reserve Bank in February 1970, under the chairmanship of Shri. M. Narasimham to go into the question of enlarging the use of the bill of exchange as an instrument for providing credit and creation of a bill market in India. The group submitted the report in June 1970. Following its recommendations, the Reserve Bank announced a new bill market scheme under Section 17(2)(a) of the Reserve Bank of India Act in November 1970.

(i) All eligible scheduled banks are eligible to offer bills of exchange for rediscount.

(ii) The bills of exchange should be a genuine trade bill and should have arisen out of the sale of goods. Accommodation bills are not eligible for this purpose.

(iii) The bill should not have a maturity time of more than 120 days and when it is offered to the Reserve Bank for rediscount its maturity should not exceed 90 days.

(iv) The bill should have at least two good signatures, one of which should be that of a licensed scheduled bank.

(v) The minimum amount of bill should be ₹ 5,000 and on one occasion, the value of bill offered for rediscount should not be less than ₹ 50,000.

In 1971, the Reserve Bank simplified the procedure for rediscounting the bills. To avoid delays and reduce the work involved in physically delivering and redelivering the bills to and from the bank, it was decided to dispense with the actual lodgement of bills, each of the face value of ₹ 2 lakh and below.

The minimum amount of a bill eligible for rediscount with the bank was reduced to ₹ 1,000. The facility which was available only in Mumbai, Kolkata, Chennai and New Delhi, was extended to Kanpur and Bengaluru.

In April 1972, the bills drawn on and accepted by the Industrial Credit and Investment Corporation of India Limited on behalf of the purchasers were covered by the scheme provided they are presented to the Reserve Bank by an eligible scheduled bank.

In 1973, the minimum value of a bill for the purpose of actual lodgement with the Reserve Bank was raised from ₹ 2 lakh to ₹ 10 lakh.

The New Bill Market Scheme has opened vistas of development of a full-fledged bill market in India. Certain criticisms are levelled against the working of the scheme. The unorganised money market has not been drawn within its fold. Most of the bills presented for rediscount relate to trade and not agriculture. The period of the bill admitted under the scheme is inadequate. The procedure followed for determining the eligibility of the bank for the purpose of rediscounting is far from satisfactory.

The Reserve Bank has been making constant efforts for the orderly development of a bill market. However, it will take a long time to have a bill market of the type found in advanced countries.

## TREASURY BILL MARKET

Just like commercial bills which represent commercial debt, treasury bills represent short-term borrowings of the Government. Treasury bill market refers to the market where treasury bills are bought and sold. Treasury bills are very popular and enjoy a higher degree of liquidity since they are issued by the Government.

### Meaning and features

A treasury bill is nothing but a promissory note issued by the Government under discount for a specified period stated therein. The Government promises to pay the specified amount mentioned therein to the bearer of the instrument on the due date. The period does not exceed a period of one year. It is purely a finance bill since it does not arise out of any trade transaction. It does not require any 'grading' or 'endorsement' or 'acceptance' since it is a claim against the Government.

Treasury bills are issued only by the RBI on behalf of the Government. Treasury bills are issued for meeting temporary Government deficits. The treasury bill rate or the rate of discount is fixed by the RBI from time-to-time. It is the lowest one in the entire structure of interest rates in the country because of short-term maturity and high degree of liquidity and security.

### Types of treasury bills

In India, there are two types of treasury bills, viz., (i) Ordinary or regular and (ii) 'Ad hoc' known as 'ad hocs'. Ordinary treasury bills are issued to the public and other financial institutions for meeting the short-term financial requirements of the Central Government. These bills are freely marketable and they can be bought and sold at any time and they have secondary market also.

On the other hand, 'Ad hocs' are always issued in favour of the RBI only. They are not sold through tender or auction. They are purchased by the RBI and the RBI is authorised to issue currency notes against them. They are not marketable in India. However, the holders of these bills can always sell them back to the RBI. Ad hocs serve the Government in the following ways:

(i) They replenish cash balances of the Central Government. Just like State Governments get advance (ways and means advances) from the RBI, the Central Government can raise finance through these ad hocs.

(ii) They also provide an investment medium for investing the temporary surpluses of State Governments, Semi-government departments and foreign central banks.

On the basis of periodicity, treasury bills may be classified into three. They are:

(i) 91 days treasury bills,

(ii) 182 days treasury bills, and

(iii) 364 days treasury bills.

Ninety-one days treasury bills are issued at a fixed discount rate of 4 per cent as well as through auctions. 364 days treasury bills do not carry any fixed rate. The discount rate on these bills are quoted in auction by the participants and accepted by the authorities. Such a rate is called cut-off rate. In the same way, the rate is fixed for 91 days treasury bills sold through auction. 91 days treasury bills (tap basis) can be rediscounted with the RBI at any time after 14 days of their purchase. Before 14 days, a penal rate is charged.

**Operations and participants**

The RBI holds 91 days Treasury Bills (TBs) and they are issued on tap basis throughout the week. However, 364 days TBs are sold through auction which is conducted once in a fortnight. The date of auction and the last date of submission of tenders are notified by the RBI through a press release. Investors can submit more than one bid also. On the next working day of the date of auction, the accepted bids with the prices are displayed. The successful bidders have to collect letters of acceptance from the RBI and deposit the same along with a cheque for the amount due on RBI within 24 hours of the announcement of auction results.

Institutional investors like commercial banks, DFHI, STCI, etc., maintain a Subsidiary General Ledger (SGL) account with the RBI. Purchases and sales of TBs are automatically recorded in this account. Investors who do not have SGL account can purchase and sell TBs through DFHI. The DFHI does this function on behalf of investors with the help of SGL transfer forms. The DFHI is actively participating in the auctions of TBs. It is playing a significant role in the secondary market also by quoting daily buying and selling rates. It also gives buyback and sellback facilities for periods up to 14 days at an agreed rate of interest to institutional investors. The establishment of the DFHI has imparted greater liquidity in the TB market.

The participants in this market are the following:

(i) RBI and SBI.

(ii) Commercial banks.

(iii) State Governments.

(iv) DFHI.

(v) STCI.

(vi) Financial institutions like LIC, GIC, UTI, IDBI, ICICI, IFCI, NABARD, etc.

(vii) Corporate customers.

(viii) Public.

Though many participants are there, in actual practice, this market is in the hands of the banking sector. It accouns for nearly 90 per cent of the annual sale of TBs.

**Importance or merits**

**(i) Safety**

Investments in TBs are highly safe since the payment of interest and repayment of principal are assured by the Government. They carry zero default risk since they are issued by the RBI for and on behalf of the Central Government.

**(ii) Liquidity**

Investments in TBs are also highly liquid because they can be converted into cash at any time at the option of the investors. The DFHI announces daily buying and selling rates for TBs. They can be discounted with the RBI and further refinance facility is available from the RBI against TBs. Hence, there is a ready market for TBs.

**(iii) Ideal short-term investment**

Idle cash can be profitably invested for a very short period in TBs. TBs are available on tap throughout the week at specified rates. Financial institutions can employ their surplus funds on any day. The yield on TBs is also assured.

**(iv) Ideal fund management**

TBs are available on tap as well as through periodical auctions. They are also available in the secondary market. Fund managers of financial institutions build-up a portfolio of TBs in such a way that the dates of maturities of TBs may be matched with the dates of payment of their liabilities like deposits of short-term maturities. Thus, TBs help financial managers to manage the funds effectively and profitably.

**(v) Statutory liquidity requirement**

As per the RBI directives, commercial banks have to maintain SLR (Statutory Liquidity Ratio) and for measuring this ratio investments in TBs are taken into account. TBs are eligible securities for SLR purposes. Moreover, to maintain CRR (Cash Reserve Ratio). TBs are very helpful. They can be readily converted into cash and thereby CRR can be maintained.

### (vi) Source of short-term funds

The Government can raise short-term funds for meeting its temporary budget deficits through the issue of TBs. It is a source of cheap finance to the Government since the discount rates are very low.

### (vii) Non-Inflationary monetary tool

TBs enable the Central Government to support its monetary policy in the economy. For instance, excess liquidity, if any, in the economy can be absorbed through the issue of TBs. Moreover, TBs are subscribed by investors other than the RBI. Hence, they cannot be monetised and their issue does not lead to any inflationary pressure at all.

### (viii) Hedging facility

TBs can be used as a hedge against heavy interest rate fluctuations in the call loan market. When the call rates are very high, money can be raised quickly against TBs and invested in the call money market and vice versa. TBs can be used in ready forward transactions.

### Defects

### (i) Poor yield

The yield from TBs is the lowest. Long-term Government securities fetch more interest and hence subscriptions for TBs are on the decline in recent times.

### (ii) Absence of competitive bids

Though TBs are sold through auction in order to ensure market rates for the investors, in actual practice, competitive bids are conspicuously absent. The RBI is compelled to accept these non-competitive bids. Hence, adequate return is not available. It makes TBs unpopular.

### (iii) Absence of active trading

Generally, the investors hold TBs till maturity and they do not come for circulation. Hence, active trading in TBs is adversely affected.

## MONEY MARKET INSTRUMENTS

A variety of instruments are available in a developed money market. In India, till 1986, only a few instruments were available. They were:

(i) Treasury bills in the treasury market.

(ii) Money at call and short notice in the call loan market.

(iii) Commercial bills, and promissory notes in the bill market.

Now, in addition to the above, the following new instruments are available:

(i) Commercial papers.

(ii) Certificate of Deposit.

(iii) Inter-bank participation certificates.

(iv) Repo Instruments.

The new instruments are discussed below:

## COMMERCIAL PAPERS

### Introduction

During the 1980s, a wave of financial liberalisation and innovation in financial instruments swept across the world. A basic feature of the many innovations is the trend towards securitisation, i.e., raising money direct from the investors in the form of negotiable securities as a substitute for bank credit. The companies found it cheaper to borrow directly from public by way of short-term paper. The cost of fund is cheaper for the companies as it involved lower information and transaction cost. This also suits the interest of many investors as it provides them with a wide spectrum of financial instruments to choose from and in placing their funds at reasonably high rates of return. Commercial paper is a new instrument used for financing working capital requirements of corporate enterprises.

### What is a commercial paper?

A commercial paper is an unsecured promissory note issued with a fixed maturity by a company approved by RBI, negotiable by endorsement and delivery, issued in bearer form and issued at such discount on the face value as may be determined by the issuing company.

### Participants

### Issuers

All private sector company, public sector units, non-banking company, etc.

### Investors

Individuals, banks, corporates and also NRIs. Usually banks, large corporate bodies and public sector units with investible funds participate in CP market.

### Features of commercial paper

1. Commercial paper is a short-term money market instrument comprising usance promissory note with a fixed maturity.
2. It is a certificate evidencing an unsecured corporate debt of short-term maturity.

3. Commercial paper is issued at a discount to face value basis but it can also be issued in interest-bearing form.
4. The issuer promises to pay the buyer some fixed amount on some future period but pledges no assets, only his liquidity and established earning power, to guarantee that promise.
5. Commercial paper can be issued directly by a company to investors or through banks/merchant bankers.

**Advantages of commercial paper**

**(i) Simplicity**

The advantage of commercial paper lies in its simplicity. It involves hardly any documentation between the issuer and investor.

**(ii) Flexibility**

The issuer can issue commercial paper with the maturities tailored to match the cash flow of the company.

**(iii) Diversification**

A well rated company can diversify its source of finance from banks to short-term money markets at somewhat cheaper cost.

**(iv) Easy to raise long-term capital**

The companies which are able to raise funds through commercial paper become better known in the financial world and are thereby placed in a more favourable position for raising such long-term capital as they may, from time-to-time, require. Thus, there is an inbuilt incentive for companies to remain financially strong.

**(v) High returns**

The commercial paper provides investors with higher returns than they could get from the banking system.

**(vi) Movement of funds**

Commercial paper facilitates securitisation of loans resulting in creation of a secondary market for the paper and efficient movement of funds providing cash surplus to cash deficit entities.

**Commercial paper market in other countries**

The roots of commercial paper can be traced way back to the early nineteenth century when the firms in the USA began selling open market paper as a substitute for bank loan needed for short-term requirements but it developed only in 1920s. The development of consumer finance companies in the 1920s and the high cost of bank credit resulting from the incidence of compulsory reserve requirements in the 1960s contributed to the popularity of commercial paper in the USA. Today, the US commercial paper market is the largest in the world. The outstanding amount at the end of 1990 in the US commercial paper market stood at $ 557.8 billion. The commercial paper issues in the US are exempted from Security Exchange Commission registration and from requirement of issue of prospectus so long as proceeds are used to finance current transactions and the paper's maturity is less than 270 days.

Most of the commercial paper market in Europe is modelled on the lines of the US market. In UK, the Sterling Commercial Paper Market was launched in May 1986. In UK, the borrower must be listed on the stock exchange and he must have met assets of at least $ 50 million. However, rating by credit agencies is not required. The maturities of commercial paper must be between 7 and 364 days. The commercial paper is exempted from stamp duty.

In France, commercial papers were thought of as a flexible alternative to bank loans. The commercial paper was introduced in December 1985. Commercial paper can be issued only by non-bank French companies and subsidiaries of foreign companies. The paper are in bearer form. It can be either issued by dealers or placed directly. The maturity ranges from ten days to seven years. Rating by credit agencies is essential. To protect investors, law contains fairly extensive disclosure requirements and requires publication of regular financial statements by issuers. The outstanding amount at the end of 1990 in France commercial paper market was $ 31 billion.

The Canadian commercial paper market was launched in 1950s. The commercial paper is generally used for terms of 30 days to 365 days although terms such as overnight are available. The commercial paper issued by Canadian companies is normally secured by pledge of assets. The outstanding amount at the end of 1990 in the Canadian market was $ 26.8 billion.

In Japan, the Yen commercial paper market was opened in November 1987. The commercial paper issues carry maturities from two weeks to nine months. Japan stands second in the commercial paper market in the world with an outstanding amount of $ 117.3 billion in 1990.

In 1980s, many other countries launched commercial paper market, notably Sweden (early 1980s), Spain (1982), Hong Kong (1982), Singapore (1984) and Norway (1984).

**Commercial paper in India**

In India, on the recommendations of the Vaghul Working Group, the RBI announced on 27th March, 1989 that commercial paper will be introduced soon in Indian money market. The recommendations of the Vaghul Working Group on introduction of commercial paper in Indian money market are as follows:

1. There is a need to have limited introduction of commercial paper. It should be carefully planned and the eligibility criteria for the issuer

should be sufficiently rigorous to ensure that the commercial paper market develops on healthy lines.

2. Initially, access to the commercial paper market should be restricted to rated companies having a net worth of ₹ 5 crore and above with good dividend payment record.
3. The commercial paper market should function within the overall discipline of CAS. The RBI would have to administer the entry on the market, the amount of each issue and the total quantum that can be raised in a year.
4. No restriction be placed on the participants in the commercial paper market except by way of minimum size of the note. The size of any single issue should not be less than ₹ 1 crore and the size of each lot should not be less than ₹ 5 lakh.
5. Commercial paper should be excluded from the stipulations on unsecured advances in the case of banks.
6. Commercial paper would not be tied to any specific transaction and the maturity period may be 7 days and above but not exceeding six months, backed up if necessary by a revolving underwriting facility of less than three years.
7. The issuing company should have a net worth of not less than ₹ 5 crore, a debt-equity ratio of not more than 1.5, a current ratio of more than 1.33, a debt servicing ratio closer to 2, and be listed on the stock exchange.
8. The interest rate on commercial paper would be market-dominated and the paper could be issued at a discount to face value or could be interest-bearing.
9. Commercial paper should not be subject to stamp duty at the time of issue as well as at the time of transfer by endorsement and delivery.

On the recommendations of the Vaghul Working Group, the RBI announced on 27th March, 1989 that commercial paper will be introduced soon in Indian money market. Detailed guidelines were issued in December 1989, through non-banking companies (Acceptance of Deposits through Commercial Paper) Direction, 1989 and finally the commercial papers were introduced in India from 1st January, 1990.

**RBI Guidelines on commercial paper issue**

The important guidelines are:

1. A company can issue commercial paper only if it has:
   (i) A tangible net worth of not less than ₹ 10 crore as per the latest balance sheet;

(ii) Minimum current ratio of 1.33:1;

(iii) A fund-based working capital limit of ₹ 25 crore or more;

(iv) A debt servicing ratio closer to 2;

(v) The company is listed on a stock exchange;

(vi) Subject to CAS discipline;

(vii) It is classified under Health Code No. 1 by the financing banks;

(viii) The issuing company would need to obtain P1 from CRISIL.

2. Commercial paper shall be issued in multiples of ₹ 25 lakh but the minimum amount to be invested by a single investor shall be ₹ 1 crore.

3. The commercial paper shall be issued for a minimum maturity period of 7 days and the maximum period of 6 months from the date of issue. There will be no grace period on maturity.

4. The aggregate amount shall not exceed 20 per cent of the issuer's fund-based working capital.

5. The commercial paper is issued in the form of usance promissory notes, negotiable by endorsement and delivery. The rate of discount could be freely determined by the issuing company. The issuing company has to bear all flotation cost, including stamp duty, dealers' fee and credit rating agency fee.

6. The issue of commercial paper cannot be underwritten or coopted in any manner. However, commercial banks can provide standby facility for redemption of the paper on the maturity date.

7. Investment in commercial paper can be made by any person or banks or corporate bodies registered or incorporated in India and unincorporated bodies too. Non-Resident Indians can invest in commercial paper on non-repatriation basis.

8. The companies issuing commercial paper would be required to ensure that the relevant provisions of the various statutes such as Companies Act, 1956, the IT Act, 1961 and the Negotiable Instruments Act, 1981 are complied with.

**Procedure and timeframe for issue of commercial paper**

1. Application to RBI through financing bank or leader of consortium bank for working capital facilities together with a certificate from credit rating agency.

2. RBI to communicate in writing their decision on the amount of commercial paper to be issued to the leader bank.

3. Issue of commercial paper to be completed within 2 weeks from the date of approval of RBI through private placement.

4. The issue may be spread over 2 weeks on different dates but all such commercial papers shall bear the same maturity date.

5. Issuing company to advise RBI through the bank/leader of the bank, the amount of actual issue of commercial paper within 3 days of completion of the issue.

**Implications of commercial paper**

The issue of commercial paper is an important step in disinter-mediation bringing a large number of borrowers as well as investors in touch with each other, without the intervention of the banking system as financial intermediary. The borrowers can get at least 20 per cent of their working capital requirements directly from market at rates which may be more advantageous than borrowing through a bank. The first-class borrowers have the prestige of joining the elitist commercial paper club with the approval of CRISIL, the banking system and the RBI. However, RBI has presently stipulated that the working capital limits of the banks will be reduced to the extent of issue of commercial paper. Industrialists have already made a plea that the issue of commercial paper should be outside the scheme of bank finance and other guidelines such as recommendation of banks and approval of RBI should be waived. RBI has not accepted the plea at present as commercial paper is a unsecured borrowing and not related to a trade transaction. The main aim of the RBI is to ensure that commercial paper develops a sound money market instrument. So, in the initial stages emphasis should be on the quality rather than quantity.

**Implications on bank**

The impact of issue of commercial paper on commercial banks would be of two dimensions. One is that the banks themselves can invest in commercial paper and show this as short-term investment. The second aspect is that the banks are likely to lose interest on working capital loan which has been hitherto lent to the companies, which have, now started borrowing through commercial paper.

Further, the larger companies might avail of the cheap funds available in the market during the slack season worsening the bank's surplus fund position, but come to the banking system for borrowing during the busy season when funds are costly. This would mean the banks are the losers with a clear impact on profitability.

However, the banks stand to gain by charging higher interest rate on reinstated portion especially if it is done during busy season and by way of service charges for providing standby facilities and issuing and paying commission. Further, when large borrowers are able to borrow directly from the market, banks will correspondingly be freed from the pressure on resources.

**Impact on the economy**

The process of disintermediation is taking place in the free economies all over the world. With the introduction of CP, financial disintermediation has been gaining momentum in the Indian economy. If CPs are allowed to free play, large companies as well as banks would learn to operate in a competitive atmosphere with more efficiency. This would result in greater excellence in the services of banks as well as management of finance by companies.

**Recent trends**

RBI has liberalised the terms of issues of CP from May 30, 1991. According to the liberalised terms, proposal by eligible companies for the issues of CP would not require the approval of RBI. Such companies would have to submit the proposal to the financing bank which provided working capital facility either as a sole bank or as a leader of the consortium. The bank, on being satisfied of the compliance of the norms would take the proposal on record before the issue of commercial paper.

RBI has further relaxed the rules in June 1992. The minimum working capital limit required by a company to issue CP has been reduced to ₹ 5 crore. The ceiling on amount of which can be raised through CP has been raised to 75 per cent of working capital. A closely held company has also been permitted to borrow through CPs provided all the criteria are met. The minimum rating required from CRISIL has been lowered to P2 from P1 while minimum rating needed from ICRA is A2 instead of A1.

According to the RBI monetary policy for the second half of 1994-95, the standby facility by banks for CP has been abolished. When CPs are issued, banks will have to effect a prorata reduction in the cash credit limit and it will be no longer necessary for banks to restore the cash credit limit to meet the liability on maturity of CPs. This will impart a measure of independence to CP as a money market instrument.

**Future of commercial paper in India**

Corporate enterprises requiring burgeoning funds to meet their expanding needs find it easier and cheaper to raise funds from market by issuing commercial paper. Further, it provides greater degree of flexibility in business finance to the issuing company in as much as it can decide the quantum of CP and its maturity on the basis of its future cash flows. CPs have made a good start. Since the inception of CPs in India in January 1990, 23 companies have issued CPs worth ₹ 419.4 crore till June 1991. The total issues amounted to ₹ 9,000 crore in June 1994. The outstanding amount of CPs stood at ₹ 44,171 crore on March 31, 2000 and increased to ₹ 68,721 crore on June 30, 2009.

However, the secondary market is virtually non-existent. Only commercial banks pick up these papers and hold till maturity. No secondary market is allowed to develop on any significant scale. Further, trading is cumbersome as procedural requirements are onerous. The stamp duty payable by banks subscribing to commercial paper from the primary market is lower than which is charged to non-banking entities like primary dealer, corporates and non-banking finance companies. As a result, the entities prefer to buy

CPs from banks instead of directly subscribing to them. The structural rigidities such as rating requirements, timing of issue, terms of issue, maturity range, denominational range and interest rate stand in the way of developing commercial paper market. The removal of stringent conditions and imposing of such regulatory measures justifiable to issuers, investors and dealers will improve the potentiality of CP as a source of corporate financing.

## CERTIFICATE OF DEPOSIT (CD)

Certificate of Deposits are short-term deposit instruments issued by banks and financial institutions to raise large sums of money.

CDs are issued in the form of usance promissory notes. They are negotiable and are in marketable form bearing specific face value and maturity. The CDs are transferable from one party to another. Due to their negotiable nature, they are also known as negotiable certificate of deposit.

### Issuers

The issuers of certificate of deposits are commercial banks, financial institutions, etc.

### Subscribers

CDs are available for subscription by individuals, corporations, trusts, associations and NRIs.

### Features of certificate of deposit

1. Document of title to time deposit.
2. Unsecured negotiable pronotes.
3. Freely transferable by endorsement and delivery.
4. Issued at discount to face value.
5. Repayable on a fixed date without grace days.
6. Subject to stamp duty like the usance promissory notes.

The banks in the USA in 1960s introduced CDs which are freely negotiable and marketable any time before maturity. The CDs were issued by big banks in the USA in units of $ 1 million at face value bearing fixed interest with a maturity generally ranging from 1 to 6 months. Banks sold CDs direct to investors or through dealers who subsequently traded this instrument in secondary market. The American banks issued for the first time dollar CDs in London in 1966. The Bank of England gave permission to around 40 banks to make CD issue.

The feasibility of introducing CDs in India was examined by the Tambe Working Group in 1982 which did not, however, favour the introduction of this instrument. The matter was again studied in 1987 by the Vaghul Working Group on the Money Market. The Vaghul Group recognised that CP would be attractive both to the banker and investor in that the bank is not required to encash the deposit prematurely while the investor can liquify the instrument before its maturity in the secondary market.

On the recommendations of the Vaghul Committee, the RBI formulated a scheme in June 1989 permitting scheduled commercial banks (excluding RRBs) to issue CDs. In terms of the scheme, CDs can be issued by scheduled commercial banks at a discount on face value and the discount rates are market-determined. The RBI has issued detailed guidelines for the issue of CDs and, with the changes introduced subsequently, the scheme for CDs has been liberalised.

**RBI guidelines**

1. The denomination of CDs could be in multiples of ₹ 5 lakh subject to a minimum size of an issue to a single investor being ₹ 25 lakh. The CDs above ₹ 25 lakh will be in multiples of ₹ 5 lakh. The amount relates to face value (not maturity value) of CDs issued.
2. The CDs are short-term deposit instruments with maturity period ranging from 3 months to one year. The banks can issue at their discretion, the CDs for any number of months/days beyond the minimum usance period of three months and within the maximum usance of one year.
3. CDs can be issued to individuals, corporations, companies, trust funds, associations, etc. Non-Resident Indians (NRIs) can also subscribe to CDs but only on a non-repartiation basis.
4. CDs are freely transferable by endorsement and delivery but only after 45 days of the date of issue to the primary investor. As such, the maturity period of CDs available in the market can be anywhere between 1 day and 320 days.
5. They are issued in the form of usance promissory notes payable on a fixed date without days of grace. CDs are subject to payment of stamp duty like the usance promissory notes.
6. Banks have to maintain CRR and SLR on the issue price of CDs and report them as deposits to the RBI. Banks are neither permitted to grant loans against CDs nor to buy them back prematurely.
7. From October 17, 1992, the limit for issue of CDs by scheduled commercial banks (excluding Regional Rural Banks) has been raised from 7 per cent to 10 per cent of the fortnightly aggregate deposits in 1989-90. The ceilings on outstanding of CDs at any point of time are prescribed by the Reserve Bank of India for each bank. Banks are advised by the RBI to ensure that the individual bankwise limits prescribed for issue of CDs are not exceeded at any time.

At present, the total permissible limits for issue of certificates of deposits (CDs) by the banking system amounts to ₹ 15,038 crore, equivalent to 10 per cent of the fortnightly average outstanding aggregate deposits in 1989-90. The outstanding amount of CDs issued by 50 scheduled commercial banks as on February 5, 1993 amounted to ₹ 10,261 crore and formed 70.4 per cent of the limits set for these banks for issue of CDs. To enable banks to mobilise deposits on competitive terms, it has been decided to enhance the limits for issue of CDs. Accordingly, with effect from April 17, 1993, scheduled commercial banks (excluding Regional Rural Banks) can issue CDs equivalent to 10 per cent of the fortnightly average outstanding aggregate deposits in 1991-92. Consequently, the aggregate limits for issue of CDs by eligible banks would increase from ₹ 15,038 crore to ₹ 20,552 crore.

8. Three financial institutions, *viz.*, Industrial Development Bank of India, Industrial Credit and Investment Corporation of India and Industrial Finance Corporation of India, were permitted to issue CDs with a maturity period of more than one year up to three years with an initial aggregate limit of ₹ 1,000 crore (enhanced to ₹ 1,350 crore in May 1992). Effective from July 29, 1992, the Industrial Reconstruction Bank of India has also been permitted to issue CDs up to a limit of ₹ 100 crore.

## Advantages

1. Certificate of deposits are the most convenient instruments to depositors as they enable their short-term surpluses to earn higher return.
2. CDs also offer maximum liquidity as they are transferable by endorsement and delivery. The holder can resell his certificate to another.
3. From the point of view of issuing bank, it is a vehicle to raise resources in times of need and improve their lending capacity. The CDs are fixed term deposits which cannot be withdrawn until the redemption date.
4. This is an ideal instrument for banks with short-term surplus funds to invest at attractive rates.

## Impediments

The scheme of CDs has been in operation for almost six years now. It is yet to gain ground and its usage is confined only to a few corporations and banks. The number of issuing banks has been 51 in March 1992-93 and the amount outstanding has been ₹ 9,803 crore. The number of issuing banks and the amount outstanding have declined to 48 and ₹ 5,571 crore respectively. The reasons for the slow growth are the following:

**1. Stamp duty**

The CDs are subject to stamp duty applicable to usance pronotes. Besides, the cost involved which is anywhere between 0.5 per cent and 1 per cent p.a. which makes the CDs less attractive, there are practical problems such as non-availability of stamps of required denomination, the time involved in getting the CDs stamped due to procedural delays at the stamp office, etc.

There is, therefore, an immediate need for revamping stamp duty on CDs if this instrument is to become popular.

**2. Development of secondary market**

There is a need for developing an active and liquid secondary market for CDs. The Discount and Finance House of India Ltd., (DFHI) has been designated to trade in the CDs in the secondary market.

In spite of DFHI intending to trade in CDs for which it is publishing its daily discount rates in the press and also individually approaching the issuing banks, the secondary market in this instrument has yet to gather momentum. Some of the inhibiting factors in this regard are as follows:

(i) Since CD holders have received highly attractive returns on their holdings, they are reluctant to disinvest them for a better trade-off;

(ii) CD holders particularly those outside Mumbai, may not be aware of the trading in CDs by DFHI and its dealing procedure;

(iii) Banks are not investing in CDs since this instrument has no fiscal advantage nor does the holding bank has the benefit of netting off the holding as an eligible asset from its DTL;

(iv) Some banks have reportedly not yet issued the proper scrips to CD holders;

(v) Limited size of the primary market and holdings confined to a few holders at selected centres are the other reasons.

The following steps can be taken to activate the secondary market:

(a) DFHI may intensify its efforts in making banks and through them the CD holders, aware of its trading in CDs and its dealing procedure.

(b) Banks may advise their CD holders about the opportunities for disinvesting their holdings for a better trade-off.

(c) Once some merchant banks create money market funds after obtaining the RBI's approval, they will be able to actively trade in money market instruments including CDs and commercial paper.

(d) Banks/merchant banks offering investment services to their clients may create trading opportunities in CDs.

(e) RBI may examine selective relaxation of the ceiling on CDs outstanding for individual banks and reduction in the minimum size of the deposit to broadbase the CD holders, in order to improve the

• Window of time in which investors of a hedge fund or other closely-held investment vehicle are not allowed to redeem or sell. The LIP helps



portfolio managers avoid liquidity problems while capital is put to work in sometimes illiquid investments.

size of the primary market, which will hopefully provide a fillip to the secondary market.

(f) In order to eliminate the hassle of moving CDs from upcountry centres to Mumbai to facilitate trading with DFHI, the issuing banks may hold the CDs in safe custody duly discharged by the CD holders at their respective Mumbai branches which could handle the sale transactions on behalf of and as and when desired by their clients, with DFHI by tendering the CDs, to DFHI, and also, if required, pay the proceeds of CDs on maturity to the holders on behalf of the issuing branches. In due course, RBI may consider permitting banks to act as depository agencies in CDs on behalf of investors dispensing with the issue of actual certificates so that sales and purchases of CDs are effected through internal book-keeping in banks, thus obviating the need for physical movement of certificates.

(g) In order that the banks have some incentive to invest in CDs, these holdings may be permitted as an eligible asset for netting off from their respective DTL. In some countries like Singapore and Malaysia, CDs below 1 year are even treated as an eligible asset to a specified extent, for the purpose of SLR. As a result, banks at these centres actively invest in CDs and also trade in the secondary market.

### 3. Lock-in period

The minimum lock-in period of 45 days is yet another problem.

Removal of this stipulation may go a long way in popularising CD scheme.

## INTER-BANK PARTICIPATION CERTIFICATE

The Governor of the Reserve Bank of India while dealing with credit policy measures in October 1988, had informed the bank Chiefs about a proposal to authorise banks to fund their short-term needs from within the system through issuance of inter-bank participations. This announcement by the RBI was in line with the recommendations made by the Working Group on the money market. Inter-bank participation certificate provides them an additional instrument for even out short-term liquidity within the perimeter of the banking system, particularly at times when there are imbalances affecting the maturity mix of assets in bankers' books.

Since then the regular guidelines applicable to inter-bank Participations have been brought out by the RBI, the salient features thereof may be briefly set out as given hereafter:

(i) The objective is to provide a certain element of liquidity to the portfolio of banks particularly in the credit segment support of funds to tide over, situations arising from lags in the funds flow of the borrowers.

(ii) The scheme is confined to scheduled commercial banks only and the period of participation is restricted to minimum 91 days and maximum 180 days.

(iii) Participations permitted are of two types namely with and without risk to the lender. The without risk type of participation is confined to a tenure of 90 days only.

(iv) Originally a ceiling interest rate of 12.5 per cent per annum was prescribed for the lent funds under 'without risk' participation and this was removed later on along with removal of ceilings of inter-bank call rate and the interest rate for rediscounting of bills.

(v) Banks are permitted to issue participations under the 'with risk' nomenclature for the advance classified under Health Code-1 status and the aggregate amount of such participations in any account should not exceed 40 per cent of the outstandings in the account at the time of issue.

(vi) The distinction between 'with risk' and 'without risk' sharing arrangements in so far as the borrower bank is concerned, is that under 'with risk' participation the issuing bank will reduce the amount of the participation from the advances outstanding while the participating bank will show the participation as part of its advances, whereas under the 'without risk' sharing arrangement the issuing bank will show the participation as a borrowing while the participating bank will show it as advances to banks. In the latter case, the participation is treated as part of the net demand and time liabilities and net bank balances for purposes of statutory reserve requirements.

**Advantages of the scheme**

(i) The scheme benefits the issuing and participating banks to the extent that it provides access to funds against advances comparatively with less cumbersome procedure than through regular consortium tie-up.

(ii) It also facilitates banks having surplus funds on their hands to build up and earn more on their assets over a certain period than with the earlier time-consuming and procedurally complicated tie-ups with other banks. At the same time, those banks who are in need of funds can take advantage of the market if they have an overlent position for a short while.

**Suggestions**

(i) The scheme may be enlarged so as to admit term lending financial institutions and organisations like LIC, UTI and GIC as participants. In that case, the market may turnout to be more broad-based and competitive.

(ii) The scheme may incorporate provisions for redemption earlier than due date.

(iii) It may be stipulated that the rate of interest on lending to the issuing bank should not exceed 0.5 per cent the interest rate at which the issuing bank has lent to its borrower.

(iv) A second tier transferability may be permitted to create more appeal for the scheme.

(v) There can be also a provision to extend the tenure of participation beyond the present permitted time limits by another 30 days if the lender and borrower banks so agree.

## REPO INSTRUMENTS

Repo stands for repurchase. Under Repo transaction, the borrower parts with securities to the lender with an agreement to repurchase them at the end of the fixed period at a specified price. At the end of the period, the borrower will repurchase the securities at the predetermined price. The difference between the purchase price and the original price is the cost for the borrower. This cost of borrowing is called 'Repo Rate' which is little cheaper than pure borrowing.

A transaction is called a Repo when viewed from the perspective of the seller of the securities and Reverse Repo when described from the point of view of the suppliers of funds. Thus, whether a given agreement is termed a Repo or Reverse Repo depends largely on which party initiated the transaction.

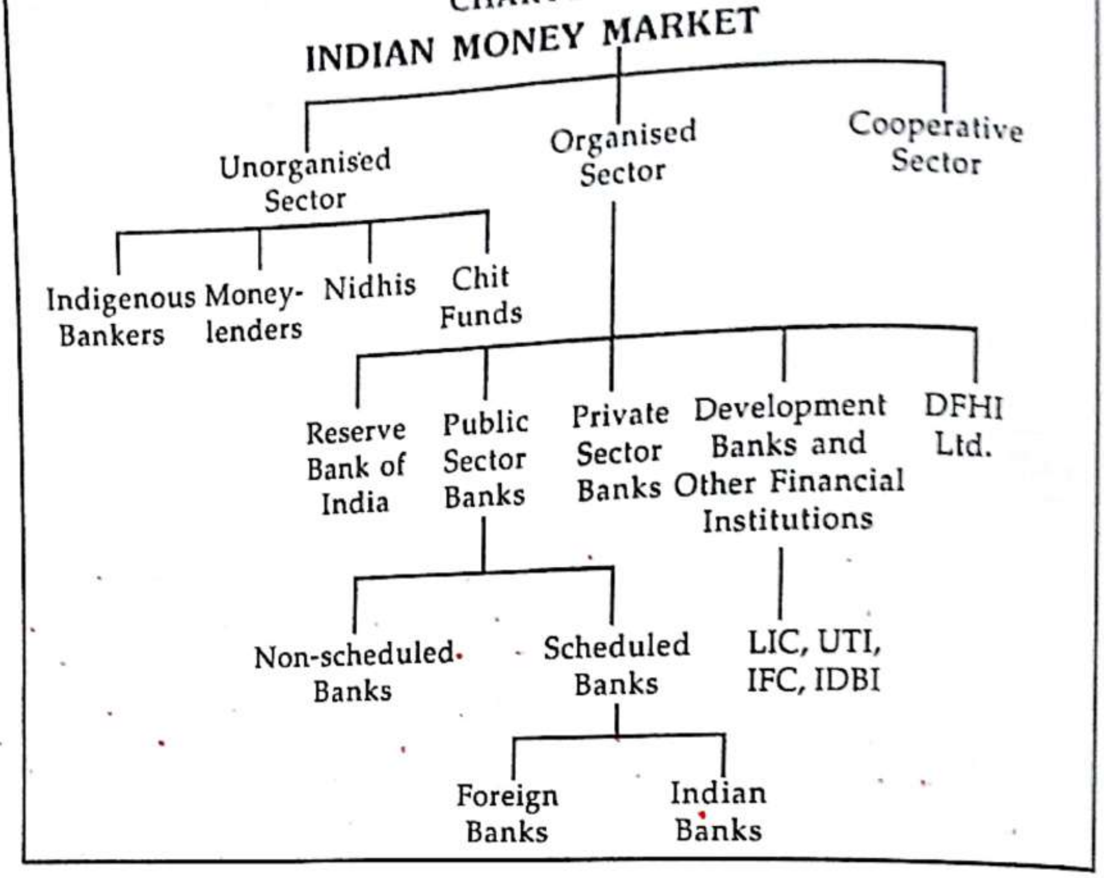
Repo transactions are conducted in the money market to manipulate short-term interest rate and manage liquidity levels. In India, Repos are normally conducted for a period of 3 days. The eligible securities for the purpose are decided by RBI. These securities are usually government promissory notes, treasury bills and public sector bonds.

When the RBI announces a fixed rate Repo, for certain number of days/period it conveys its intention to market at the desirable level of short-term interest rate. When RBI conducts 'Repos', the short-term interest rate in the money market may not go below the RBI Repo rate. If the interest is lower in other markets such as foreign exchange market, treasury bills market, holders of funds may go for Repos with RBI. Thus, Repo transactions ensure stability in short-term interest rates in the money market. In case, the RBI wants to inject fresh funds in the market, it will conduct 'Reverse Repo' transactions with primary dealers against Government securities.

## STRUCTURE OF INDIAN MONEY MARKET

The structure of Indian money market is displayed in the Chart 2.1.

CHART 2.1




As shown in the chart, the Indian money market is highly disintegrated and unorganised. There are two sectors, *viz.*, organised and unorganised. In between these two, there exists the cooperative sector. The cooperative sector is also subject to strict control and supervision and hence it can very well be included under the organised sector.

In the organised sector, the RBI, public sector banks, private sector banks, development banks and other financial institutions play a dominant role. The RBI is the nerve centre of the monetary system of our country and it is the leader of the Indian money market. Commercial banks form the nucleus of the Indian money market. At the same time, the unorganised sector exists side-by-side with the organised sector. This sector remains outside the purview of the RBI even today. It makes the Indian money market an underdeveloped one.

## FEATURES OR DEFICIENCIES OF INDIAN MONEY MARKET

The features or the deficiencies of the Indian money market are the following:

### (i) Existence of Unorganised Sector

The Indian money market consists of organised and unorganised sectors. The organised sector comprises of the Reserve Bank, the State Bank of India and its subsidiaries, private sector banks and foreign banks. Life Insurance Corporation of India, Unit Trust of India, Industrial Finance Corporation, State Financial Corporations also participate in the operations of the money market as lenders. The unorganised sector comprises of indigenous bankers. A substantially higher rate of interest prevails in the unorganised market. The indigenous banks follow their own rules of banking and finance. Many attempts were made by RBI to bring the indigenous bankers under its direct control. These efforts have not been successful. They have not accepted the conditions prescribed by RBI. The indigenous bankers are now slowly coming under the organised banking system by availing of the rediscounting facilities from RBI.

### (ii) Absence of integration

The Indian money market was divided into several sections with each section being loosely connected with other sections. The organised banking system and the unorganised banking system did not have any contact between them remaining completely aloof from each other. With the setting up of the Reserve Bank of India and the passing of the Banking Regulations Act, 1949, the conditions have improved. The RBI effectively controls the affairs of the organised sector and it has become an important part of the Indian money market.

### (iii) Diversity in money rates of interest

There exists wide diversity in the money rates of interest in the money market. The immobility of funds from one section to another contributes to the diversity in interest rates. At present, the wide divergence does not exit. The different rates of interest get adjusted to the changes in the bank rate. Still, the situation cannot be said to be identical with that found in the developed money market. Moreover, the money rates of interest also differ between different regions or centres. This leads to fluctuations in security prices. This is due to the difficulty of making cheap and quick remittance of funds from one financial centre to the others. The Reserve Bank of India has rationalised the system of remittance of funds between different parts of the country so as to equalise the money rates throughout the country.

### (iv) Seasonal stringency of funds

The demand for money in Indian money market is of seasonal in nature. During the busy season from October to April, money is needed for financing the marketing of agricultural products, seasonal industries such as sugar, gur, etc., and to some extent coal. From the end of April, the demand for money begins to decrease till the end of October. Consequently, the money rates fluctuate from one period to another. RBI attempts to lessen the fluctuation in money rates by increasing the money supply during busy season and withdrawing the same during lean season.

**(v) Absence of bill market**

The bill market in Indian money market is in its infancy. The market for Government and semi-government securities is narrow. The investors in government securities are limited to institutional investors comprising RBI, LIC, commercial banks, etc. Transactions in the inter-bank call money market constitute the core of the Indian money market. The commercial banks had substantial recourse to RBI for financial accommodation. The market for bill of exchange and treasury bills is little developed. The Reserve Bank of India has taken steps to develop genuine bill market in India.

**(vi) No contact with foreign money markets**

The Indian money market is an insular one with little contact with money market in other countries. There is large movement of capital between money markets in Western countries. The Indian money market does not attract any foreign funds as developed money markets do.

**(vii) Limited instruments**

The supply of money market instruments like bills, TBs, etc., is very limited and inadequate considering the varied requirements of short-term funds. In fact, in a developed money market, there should be well diversified mix of money market instruments so as to meet the varied requirements of borrowers and lenders.

**(viii) Limited secondary market**

The secondary market is very limited in the case of money market instruments. Practically speaking, it is restricted to rediscounting of commercial and treasury bills. In India, people generally prefer cash credit and OD to bill financing. Hence, the primary market is also limited. Similarly, due to low yield, the market for TBs is also restricted. In India, banks have a tendency to hold these bills till maturity, thus preventing an active trade in these bills.

**(ix) Limited participants**

Again, the participants in the Indian money market are also limited. Entry into the market is strictly regulated. In fact, there are a larger number of borrowers but a few lenders. Hence, the market is not very active, broad and vibrant.

## RECENT DEVELOPMENTS

In recent years, the money market is undergoing structural changes in India. Many steps have been taken to transform the restricted and narrow market to an active and broad market. Some important measures adopted in this direction are the following:

### (i) Integration of unorganised sector with the organised sector

The process of integration of the unorganised money market with the organised sector has already started. This is being done by means of bringing the institutions in the unorganised sector within the orbit of control and regulation exercised by the RBI. These institutions are now slowly coming under the organised sector by subjecting themselves to the control of RBI and availing of the rediscounting facilities from the RBI.

Again, at present, commercial banks have been asked to extend their network of branches in rural areas and this has enlarged the 'monetised sector' in the economy by restricting the activities of the unorganised sector.

### (ii) Widening of call money market

In recent times, many steps have been taken to widen the call market. LIC, GIC, IDBI, UTI, specified mutual funds have been permitted to enter into this market as lenders only. The DFHI and STCI have been permitted to operate both as lenders and borrowers. This increase in the number of participants has definitely widened the call market making it more active.

### (iii) Introduction of innovative instruments

New innovations have been introduced in the structure and instrument traded in the money market. 182 days treasury bills have been introduced since November 1986 on the recommendations of Chakraborty Committee. Again 364 days TBs with higher yields have been introduced from April 1992. These bills are sold through periodical auctions at varying rates of interest so as to enable the investors to get market rates of interest.

Moreover, new instruments such as certificate of deposit, commercial paper and inter-bank participation certificate have been introduced and necessary guidelines have been issued for their operation. Thus, all attempts have been taken to provide a well diversified mix of money market instruments so as to make the market very active.

Recently, schemes for the development of secondary market in commercial paper and for trading in CDs and PCs have been initiated by the RBI.

### (iv) Offering of market rates of interest

In order to popularise money market instruments, the ceiling on interest rate has been abolished. Call money rate, bill discounting rate, inter-bank rate, etc., have been freed from May 1, 1989. TBs are issued through auction so as to fetch market rates of interest. Thus, today Indian money market offers full scope for the play of market forces in determining the rates of interest.

### (v) Promotion of bill culture

All attempts are being taken to discourage cash credit and OD system of financing and to popularise bill financing. Exemption from stamp duty is given on rediscounting of derivative usance promissory notes arising out of genuine trade bill transactions with a view to promoting bill culture in the country.

### (vi) Entry of Money Market Mutual Funds (MMMFs)

Certain private sector mutual funds and subsidiaries of commercial banks have been recently permitted to deal in money market instruments. This has been done with a view to expanding the money market and also for developing secondary market for money market instruments. These funds can invest in money market instruments. They can also lend to call market. Frequent realisation of interest and redemption of fund at short notice are the special features of this fund.

### (vii) Setting up of credit rating agencies

The Credit Rating Information Services of India Ltd., (CRISIL) provides, credit ratings for raising funds through money market instruments like commercial papers. Of late, credit information agencies like Investment Information and Credit Rating Agency of India (IICRA), Credit Analysis and Research Limited (CARE), etc., have been established to provide credit information through financial analysis of leading companies and industrial sectors. All these measures have strengthened the Indian money market by paving way for safe and liquid short-term investments.

### (viii) Adoption of suitable monetary policy

In recent times, the RBI is adopting a more realistic and appropriate monetary policy so as to increase the resources in the money market and make it more active than before. For instance, the CRR has been brought down from 15 per cent in 1995 to 12 per cent in July 1996. Again it was brought down to 5 per cent in April 2009. These successive reductions have helped to increase the resources available in the money market.

### (ix) Establishment of DFHI

The Discount and Finance House of India was established in 1988 to activate the money market and to promote a secondary market in all money market. It deals in all money market instruments as market maker. In view of its importance, it has been discussed in detail subsequently.

### (x) Setting up of Securities Trading Corporation of India Ltd., (STCI)

The RBI has set up the STCI in May 1994 with an authorised capital of ₹ 500 crore. Its main objective is to provide a secondary market in government securities. As far as money market is concerned, its operations are mostly confined to treasury bills and money at call and short notice. The STCI has enlarged the treasury bill market and the call market and provided an active secondary market for treasury bills.

### (xi) Introduction of Non-Cumulative Debentures (NCDs)

The RBI has issued directions regulating the issue of NCDs of maturity upto one year which are money market instruments. NCDs cannot be issued for maturity less than 90 days and cannot have call/put options that are exercisable within 90 days from the date of issue.

In view of these recent developments, the money market in India can no longer be called an underdeveloped one. In terms of organised relationship and specialisation of functions, the Indian money market is considered a developed one.

## DISCOUNT AND FINANCE HOUSE OF INDIA (DFHI)

The Discount and Finance House of India (DFHI) has been set-up as a specialised money market institution with the objective of providing liquidity to money market instruments and to develop a secondary market.

The working group on money market suggested the setting up of DFHI in 1987. In pursuance of the recommendations of the working group, the Reserve Bank set up jointly with public sector banks and financial institutions, the Discount and Finance House of India Limited. The DFHI was incorporated under the Indian Companies Act, 1956 and commenced its operations in April 1988.

It is a joint-stock company and is jointly owned by RBI, the public sector banks and the all India financial institutions which have contributed its paid-up capital of ₹ 150 crore. The main objective of establishing DFHI has been to strengthen the short-term money market and make short-term resources available to the institutions. It shall generate the bill culture and bill discipline amongst the banks, financial institutions and the Central and State Government undertakings. In addition, refinance facility with the RBI and a line of credit of ₹ 100 crore from public sector banks on a consortium basis are the main sources of its funds. The option of borrowing in the call money market and on short-term basis is also open to the DFHI. However, the total amount of credit that the DFHI can borrow either from RBI or from its consortium lenders is limited to ten times its net worth.

### Functions

The main functions of DFHI are as follows:

1. To discount, rediscount, buy, sell, underwrite or acquire and sell marketable securities and negotiable instruments including treasury bills, trade bills, bills of exchange, promissory notes, commercial bills and commercial papers.
2. To undertake buyback arrangements in trade and treasury bills as well as securities of local authorities, public sector institutions, Government and commercial and non-commercial houses.

3. To carry on business as a lender, borrower, broker or as a broking house in the inter-bank call money market.
4. To promote and support company funds, trusts and such other organisations for the development of short-term money market.
5. To advise Governments, banks, financial institutions or business houses in evolving schemes for growth, development and expansion of the money market.

Although the DFHI is empowered to undertake a wide range of business, it will, in its initial stages deal mainly with the 182 days treasury bills and selectively repurchase and resell the bills only from/to banks for short period up to 14 days at a predetermined prices. As regards short-term commercial bills, the aim of the DFHI is to provide liquidity to commercial bills which have already been rediscounted by banks and financial institutions, thus giving them access to liquid funds.

The operations of DFHI are aimed at imparting greater flexibility to banks in their fund management. Corporate bodies and other institutions will also find it attractive to invest their short-term surplus funds in treasury bills and secondary market will be created by the presence of DFHI.

The DFHI participates in the call, notice and term markets as a borrower and as a lender. It also purchases and sells treasury bills at the auctions, commercial bills, commercial papers and certificate of deposits. All transactions are done through exchange of cheques drawn on the RBI to facilitate same day settlement.

**Call, notice and term money**

In order to provide some flexibility in the money market, the DFHI has been allowed with effect from July 28, 1988 to participate in the call and notice money market both as a lender and as a borrower. The DFHI borrows in markets for lending as also to fund its other assets such as treasury bills and commercial bills. It also lends funds realised through the sale of money market assets. The minimum amount of transaction is generally one crore. However, in respect of cooperative banks, the minimum amount per transaction is ₹ 50 lakh for dealings in notice and term money. The DFHI's average daily lending in the call money market has grown significantly over the years — from ₹ 82 crore in 1988-89 to ₹ 242 crore in 1989-90 to ₹ 800 crore in 1991-92. The DFHI has been effectively pooling the lenders' supplies to meet the borrowers' requirements. Despite such commendable performance, even after five years of its existence, the market share of DFHI in the call money operations is still less than 15 per cent.

**Treasury bills**

The DFHI's operations in 182 days treasury bills are aimed at imparting greater flexibility to banks in their funds management. When the inter-bank call money market is tight, banks holding 182 days TBs have an advantage in raising funds at lower cost against the collateral of these bills, through the DFHI. When the conditions are easy in the call money market, banks having surplus funds can enter into buying arrangements in 182 days TBs with the DFHI for comparatively better returns. With its dealing in 182 days TBs, the DFHI has been playing a vital role in developing a secondary market for these bills.

Besides sale and purchase of 182 days treasury bills on outright basis, the DFHI also provides repo facility (selling TBs with an assurance to buy them back or buying bills with an assurance of selling back to the holder after a fixed duration) to banks, select financial institutions and public sector undertakings, up to a period of 14 days at negotiated interest rates. For banks, 'repo' facility provides the flexibility for maintenance of Cash Reserve Ratio and Statutory Liquidity Requirements.

**Commercial bills**

With a view of providing liquidity to commercial bills discounted by scheduled commercial banks, the DFHI provides rediscounting facilities to banks through purchase of Derivative Usance Promissory Notes (DPNs) drawn in favour of the DFHI by banks. The DPNs are then sold by them to investors such as financial institutions, approved State Cooperative Banks and Urban Cooperative Banks duly endorsed in their favour. In case the investors are in need of funds, they can sell these DPNs to the DFHI at quoted bid rediscount rates. On maturity, the holder will have to present the DPN duly discharged to the drawer (bank) for the payment of maturity proceeds. The DFHI daily quotes its bid and offer rediscount rates. The DPNs are generally drawn for a minimum amount of ₹ 50 lakh for the usance period of 15 to 90 days.

**Performance**

During the period of eighteen years, the DFHI has grown into an effective organisation. It is playing a vital role in call money market, government securities and bills market. Its resources form about 10 to 15 per cent of the total money market funds. However, the operations of the DFHI is subject to a number of constraints such as paucity of funds, competition from primary dealers, weak inter-bank transactions, presence of few large players in the market and too much dependence on the RBI. Despite the limitations, the DFHI is making concerned efforts to expand its operations to provide additional liquidity in the market.

## QUESTIONS

### I. Objective type questions

#### 1. Fill in the blanks:

1. The market for extremely short period loans is called ________.
2. ________ are drawn by contractors on the government departments for the goods supplied to them.
3. The bill which does not require any acceptance is called ________.
4. ________ has been set-up mainly to provide a secondary market in government securities.
5. The Discount and Finance House of India was set-up in the year ________

[**Key:** 1. Call money market, 2. Supply bills, 3. Treasury bill, 4. STCI, 5. 1987]

#### 2. Choose the best answer from the following:

1. The market for short-term loans is known as:

   (a) Call money market (b) Treasury bill market

   (c) Money market (d) Acceptance market

2. Bills drawn and accepted payable after three months are called:

   (a) Indigenous bills (b) Usance bills

   (c) Clean bills (d) Supply bills

3. The market which helps commercial banks to maintain their SLR requirements is:

   (a) Call loan market (b) Discount market

   (c) Acceptance market (d) Commercial bill market

4. The certificate which evidences an unsecured corporate debt of short-term maturity is:

   (a) Short-term loan certificate (b) Certificate of deposit

   (c) Inter-bank participation certificate (d) Commercial paper

5. The major player in the Indian money market is:

   (a) Cooperative banks (b) Indigenous banks

   (c) Commercial banks (d) Reserve Bank of India

[**Key:** 1. (c), 2. (b), 3. (a), 4. (d), 5. (c)]

#### 3. State whether the following statements are TRUE or FALSE:

1. Money market supplies funds for financing working capital requirements of industries.
2. 'Ad hoc' treasury bills are always issued in favour of the RBI only.