# SECURITIES LAWS AND COMPLIANCES
## PART A — SECURITIES LAWS
## STUDY III - MONEY MARKET
### LEARNING OBJECTIVES
The Study will enable the students to understand
- Concept of money market
- Difference between money market and capital market
- Call money market and Short-term Deposit market
- Various money market instruments
- Types & features of Government Securities
- Bill Rediscounting
- Money Market Mutual funds
- Concept & features of Treasury bills
- Guidelines for issuance of Commercial Paper.

### INTRODUCTION
Money market is a very important segment of the Indian financial system. It is the market for dealing in monetary assets of short-term nature. Short-term funds up to one year and financial assets that are close substitutes for money are dealt in the money market. Money market instruments have the characteristics of liquidity (quick conversion into money), minimum transaction cost and no loss in value. Excess funds are deployed in the money market, which in turn are availed of to meet temporary shortages of cash and other obligations. Money market provides access to providers and users of short-term funds to fulfill their borrowings and investment requirements at an efficient market clearing price. It performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity and in the process, facilitating the conduct of monetary policy. Short-term surpluses and deficits are evened out. The money market is the major mechanism through which the Reserve Bank influences liquidity and the general level of interest rates. The Bank's interventions to influence liquidity serve as a signaling-device for other segments of the financial system.

The money market is a wholesale debt market for low-risk, highly liquid, short term instruments. Funds are available in this market for periods ranging from a single day upto a year. Mostly government, banks and financial institutions dominate this market. It is a formal financial market that deals with short-term fund management.

Though there are a few types of players in money market, the role and the level of participation by each type of player differs greatly.

Government is an active player in the money market and in most economies, it constitutes the biggest borrower of this market. Both, Government Securities or G-Secs and Treasury-Bills or T-Bills are securities issued by RBI on behalf of the Government of India to meet the latter’s borrowing for financing fiscal

deficit. Apart from functioning as a merchant banker to the government, the central bank also regulates the money market and issues guidelines to govern the money market operations.

Another dominant player in the money market is the banking industry. Banks mobilize deposits and utilize the same for credit accommodation. However, banks are not allowed to use the entire amount for extending credit. In order to promote certain prudential norms for healthy banking practices, most of the developed economies require all banks to maintain minimum liquid and cash reserves. As such, banks are required to ensure that these reserve requirements are met before directing on their credit plans. If banks fall short of these statutory reserve requirements, they can raise the same from the money market since it is a short-term deficit.

Moreover, financial institutions also undertake lending and borrowing of short-term funds. Due to the large volumes these FIs transact in, they do have a significant impact on the money market.

Corporates also transact in the money market mostly to raise short-term funds for meeting their working capital requirements.

Other institutional players like mutual funds (MFs), Foreign institutional investors (FIIs) etc. also transact in money market. However, the level of participation of these players varies largely depending on the regulations. For instance, the level of participation of the FIIs in the Indian money market is restricted to investment in government securities only.

## I. FEATURES OF MONEY MARKET

The money market is a wholesale market. The volumes are very large and generally transactions are settled on a daily basis. Trading in the money market is conducted over the telephone, followed by written confirmation from both the borrowers and lenders.

There are a large number of participants in the money market: commercial banks, mutual funds, investment institutions, financial institutions and finally the Reserve Bank of India. The bank's operations ensure that the liquidity and short-term interest rates are maintained at levels consistent with the objective of maintaining price and exchange rate stability. The Central bank occupies a strategic position in the money market. The money market can obtain funds from the central bank either by borrowing or through sale of securities. The bank influences liquidity and interest rates by open market operations, REPO transactions changes in Bank Rate, Cash Reserve Requirements and by regulating access to its accommodation. A well-developed money market contributes to an effective implementation of the monetary policy. It provides:

1. A balancing mechanism for short-term surpluses and deficiencies.
2. A focal point of central bank intervention for influencing liquidity in the economy, and
3. A reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable price or cost.

## II. MONEY MARKET Vs. CAPITAL MARKET

The money market possesses different operational features as compared

to capital market. It deals with raising and deployment of funds for short duration while the capital market deals with long-term funding. The money market provides the institutional source for providing working capital to the industry, while the capital market offers long-term capital for financing fixed assets.

The money market operates as a wholesale market and has a number of inter- related sub-markets such as the call market, the bill market, the treasury bill market, the commercial paper market, the certificate of deposits market etc. The volume of transaction in money market is very large and varied and skilled professional operators are required to ensure successful operations. Due to its flexibility, money market trading is mostly done on telephone with written confirmation from both borrowers and lenders being sent immediately thereafter. The transactions are supposed to be on “same day settlement” basis.

As stated earlier, commercial banks, financial intermediaries, large corporates and the Reserve Bank of India (RBI) are the major constituents of Indian Money Market. RBI as the residual source of funds in the country plays a key role and holds strategic importance in the money market. RBI is able to expand or contract the liquidity in the market through different instruments such as Statutory Liquidity Ratio (SLR), Current Liquidity Ratio (CLR) etc. Thus RBI policy controls the availability and the cost of credit in the economy.

## III. GROWTH OF MONEY MARKET

The organisation and structure of the money market has undergone a sea change in the last decade in India. This was accompanied by a growth in quantitative terms also.

Upto 1987 the money market consisted of 6 facets:

1. Call Money Market;
2. Inter Bank Term Deposit/Loan Market;
3. The Participation Certificate Market;
4. Commercial Bills Market;
5. Treasury Bills Market; and
6. Inter-corporate Market

The market had 3 main deficiencies:

1. It had a very narrow base with RBI, Banks, LIC and UTI as the only participants lending funds while the borrowers were large in number;
2. There were few money market instruments. The participation certificate became extinct during 1980s;
3. The interest rates were not market determined but were controlled by either RBI or by a voluntary agreement between the participants through the Indian Banks Association (IBA).

To set right these deficiencies the Chakravarthy Committee (1985) and the Vaghul Committee (1987) offered many useful suggestions and their implementation has widened and deepened the market considerably by increasing the number of participants and instruments and introducing market determined rates as compared to the then existing administered

interest rates.

An additional feature was the creation of an active secondary market for money market instrument to have greater liquidity. For this purpose the Discount and Finance House of India Limited (DFHI) was formed as an autonomous financial intermediary in April, 1988 to smoothen the short-term liquidity imbalances and to develop an active secondary market for the instruments of the money market. The DFHI plays the role of a market maker in money market instruments. In the relaxation of the regulatory framework and the arrival of the new instruments and the new players, DFHI occupies a key role in ushering in a more active de-regulated money market.

## IV. STRUCTURE AND INSTITUTIONAL DEVELOPMENT

The following diagram depicts the important segments and inter-relation in the money market:

| | | | | | | |
|---|---|---|---|---|---|---|
| Bankers' Acceptances Market | ↔ | Commercial paper Market | ↔ | Treasury bill Market | ↔ | Call money Market |
| \| | | \| | | \| | | \| |
| \| | | \| | | \| | | \| |
| \| | | \| | | \| | | \| |
| M O N E Y M A R K E T | | | | | | |

The Indian Money Market consists of both organised and unorganised segments. In the unorganised segment interest rates are much higher than in the organised segment.

The organised segment consists of the Reserve Bank of India, State Bank of ndia with its associate Banks, Public Sector Banks, Private Sector Commercial Banks including Foreign Banks, Regional Rural Banks, Non-Scheduled Commercial Banks, apart from Non-banking Financial Intermediaries such as LIC, GIC, UTI etc.

The unorganised segment essentially consists of indigenous bankers, money lenders and other non-bank financial intermediaries such as Chit Funds. For these institutions there is no clear cut demarcation between short-term and long-term and between a genuine trade bill and mere financial accommodation. The share of the unorganised sector in providing trade finance has greatly diminished after the Bank Nationalisation and expansion of Nationalised Banks reach into the length and breadth of the country.

## V. MONEY MARKET INSTRUMENTS

Just as any other financial market, money market also involves transfer of funds in exchange of financial assets and due to the nature of the money market, the instruments used in it represent short-term claims. It is important to note that the money market instruments do not include any equities. Money market instruments mainly include Government securities, securities issued by Banking sector and securities issued by private sector. A brief discussion of

various money market instruments has been given below:

1. Government Securities

All funds raised by the government from the money market are through the issue of securities by the RBI. Thus, T-Bills and Government dated securities are all issued by the RBI on behalf of the government.

Government securities(G-secs) are sovereign securities which are issued by the Reserve Bank of India on behalf of Government of India,in lieu of the Central Government's market borrowing programme. The term Government Securities includes: Central Government Securities, State Government Securities, and Treasury bills. Being risk free securities, they set the benchmark for the interest rates of the other money market instruments.

The Central Government borrows funds to finance its 'fiscal deficit'. The market borrowing of the Central Government is raised through the issue of dated securities and 364 days treasury bills either by auction or by floatation of loans.

In addition to the above, treasury bills of 91 days are issued for managing the temporary cash mismatches of the Government. These do not form part of the borrowing programme of the Central Government.

**Types of Government Securities**

Government Securities are of the following types:

**Dated Securities**

Dated Securities are generally fixed maturity and fixed coupon securities usually carrying semi-annual coupon. These are called dated securities because these are identified by their date of maturity and the coupon, e.g., 11.03% GOI 2012 is a Central Government security maturing in 2012, which carries a coupon of 11.03% payable half yearly. The key features of these securities are:

a. They are issued at face value.
b. Coupon or interest rate is fixed at the time of issuance, and remains constant till redemption of the security.
c. The tenor of the security is also fixed.
d. Interest/Coupon payment is made on a half yearly basis on its face value.
e. The security is redeemed at par (face value) on its maturity date.

**Zero Coupon bonds**

Zero Coupon bonds are bonds issued at discount to face value and redeemed at par. These were issued first on January 19, 1994 and were followed by two subsequent issues in 1994-95 and 1995-96 respectively. The key features of these securities are:

a. They are issued at a discount to the face value.
b. The tenor of the security is fixed.
c. The securities do not carry any coupon or interest rate. The difference between the issue price (discounted price) and face value is the return on this security.
d. The security is redeemed at par (face value) on its maturity date.

**Partly Paid Stock**

Partly Paid Stock is stock where payment of principal amount is made in

installments over a given time frame. It meets the needs of investors with regular flow of funds and the need of Government when it does not need funds immediately. The first issue of such stock of eight year maturity was made on November 15, 1994 for Rs. 2000 crore. Such stocks have been issued a few more times thereafter. The key features of these securities are:

a. They are issued at face value, but this amount is paid in installments over a specified period.
b. Coupon or interest rate is fixed at the time of issuance, and remains constant till redemption of the security.
c. The tenor of the security is also fixed.
d. Interest/Coupon payment is made on a half yearly basis on its face value.
e. The security is redeemed at par (face value) on its maturity date.

**Floating Rate Bonds**

Floating Rate Bonds are bonds with variable interest rate with a fixed percentage over a benchmark rate. There may be a cap and a floor rate attached thereby fixing a maximum and minimum interest rate payable on it. Floating rate bonds of four year maturity were first issued on September 29, 1995, followed by another issue on December 5, 1995. Recently RBI issued a floating rate bond, the coupon of which is benchmarked against average yield on 364 Days Treasury Bills for last six months. The coupon is reset every six months. The key features of these securities are:

a. They are issued at face value.
b. Coupon or interest rate is fixed as a percentage over a predefined benchmark rate at the time of issuance. The benchmark rate may be Treasury bill rate, bank rate etc.
c. Though the benchmark does not change, the rate of interest may vary according to the change in the benchmark rate till redemption of the security.
d. The tenor of the security is also fixed.
e. Interest/Coupon payment is made on a half yearly basis on its face value.
f. The security is redeemed at par (face value) on its maturity date.

**Bonds with Call/Put Option**

First time in the history of Government Securities market RBI issued a bond with call and put option this year. This bond is due for redemption in 2012 and carries a coupon of 6.72%. However the bond has call and put option after five years i.e. in year 2007. In other words it means that holder of bond can sell back (put option) bond to Government in 2007 or Government can buy back (call option) bond from holder in 2007. This bond has been priced in line with 5 year bonds.

**Capital Indexed Bonds**

Capital Indexed Bonds are bonds where interest rate is a fixed percentage over the wholesale price index. These provide investors with an effective hedge against inflation. These bonds were floated on December 29, 1997 on tap basis. They were of five year maturity with a coupon rate of 6 per cent over the wholesale price index. The principal redemption is linked to the Wholesale Price Index. The key features of these securities are:

a. They are issued at face value.
b. Coupon or interest rate is fixed as a percentage over the wholesale price index at the time of issuance. Therefore the actual amount of interest paid varies according to the change in the Wholesale Price Index.
c. The tenor of the security is fixed.
d. Interest/Coupon payment is made on a half yearly basis on its face value.
e. The principal redemption is linked to the Wholesale Price Index.

**Features of Government Securities**

**i. Nomenclature**

The coupon rate and year of maturity identifies the government security.
*Example:* 12.25% GOI 2008 indicates the following:
12.25% is the coupon rate, GOI denotes Government of India, which is the borrower, 2008 is the year of maturity.

**ii. Eligibility**

All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations, Nepal Rashtra bank and even individuals are eligible to purchase Government Securities.

**iii. Availability**

Government securities are highly liquid instruments available both in the primary and secondary market. They can be purchased from Primary Dealers. PNB Gilts Ltd., is a leading Primary Dealer in the government securities market, and is actively involved in the trading of government securities.

**iv. Forms of Issuance of Government Securities**

Banks, Primary Dealers and Financial Institutions have been allowed to hold these securities with the Public Debt Office of Reserve Bank of India in dematerialized form in accounts known as Subsidiary General Ledger (SGL) Accounts. Entities having a Gilt Account with Banks or Primary Dealers can hold these securities with them in dematerialized form.
In addition government securities can also be held in dematerialized form in demat accounts maintained with the Depository Participants of NSDL.

**v. Minimum Amount**

In terms of RBI regulations, government dated securities can be purchased for a minimum amount of Rs. 10,000/-only.Treasury bills can be purchased for a minimum amount of Rs. 25,000/- only and in multiples thereof. State Government Securities can be purchased for a minimum amount of Rs 1,000/- only.

**vi. Repayment**

Government securities are repaid at par on the expiry of their tenor. The different repayment methods are as follows:

i. For SGL account holders, the maturity proceeds would be credited to their current accounts with the Reserve Bank of India.
ii. For Gilt Account Holders, the Bank/Primary Dealers, would receive the maturity proceeds and they would pay the Gilt Account Holders.

iii. For entities having a demat acount with NSDL,the maturity proceeds would be collected by their DP's and they in turn would pay the demat Account Holders.

**vii. Day Count**

For government dated securities and state government securities the day count is taken as 360 days for a year and 30 days for every completed month. However for Treasury bills it is 365 days for a year.

Example: A client purchases 7.40% GOI 2012 for face value of Rs. 10 lacs @ Rs.101.80, i.e. the client pays Rs.101.80 for every unit of government security having a face value of Rs. 100/- The settlement is due on October 3, 2002. What is the amount to be paid by the client?

The security is 7.40% GOI 2012 for which the interest payment dates are 3rd May, and 3rd November every year.

The last interest payment date for the current year is 3rd May 2002. The calculation would be made as follows:

Face value of Rs. 10 lacs.@ Rs.101.80%.

Therefore the principal amount payable is Rs.10 lacs ´ 101.80% =10,18,000

Last interest payment date was May 3, 2002 and settlement date is October 3, 2002. Therefore the interest has to be paid for 150 days (including 3rd May, and excluding October 3, 2002). (28 days of May, including 3rd May, up to 30th May + 30 days of June, July, August and September + 2 days of October). Since the settlement is on October 3, 2002, that date is excluded.

| | | |
|---|---|---|
| Interest Payable = | 10 lacs X 7.40% X 150 | = Rs. 30833.33 |
| | 360 X 100 | |

Total amount payable by client =10,18,000+30833.33=Rs. 10,48,833.33

**Benefits of Investing in Government Securities**

i. No tax deducted at source
ii. Additional Income Tax benefit u/s 80L of the Income Tax Act for Individuals
iii. Qualifies for SLR purpose
iv. Zero default risk being sovereign paper
v. Highly liquid
vi. Transparency in transactions and simplified settlement procedures through CSGL/NSDL

**Methods of Issuance of Government Securities**

Government securities are issued by various methods, which are as follows:

**a. Auctions**

Auctions for government securities are either yield based or price based. In an yield based auction, the Reserve Bank of India announces the issue size (or notified amount) and the tenor of the paper to be auctioned. The bidders submit bids in terms of the yield at which they are ready to buy the security. In a price based auction, the Reserve Bank of India announces the issue size (or notified amount), the tenor of the paper to be auctioned, as well as the coupon rate. The bidders submit bids in terms of the price. This method of auction is normally used in case of reissue of existing

government securities.

*Method of auction:* There are following two methods of auction:

i. *Uniform price Based or Dutch Auction* procedure is used in auctions of dated government securities. The bids are accepted at the same prices as decided in the cut off.

ii. *Multiple/variable Price Based or French Auction* procedure is used in auctions of Government dated securities and treasury bills. Bids are accepted at different prices/yields quoted in the individual bids.

   *Bids:* Bids are to be submitted in terms of yields to maturity/prices as announced at the time of auction.

   *Cut off yield* is the rate at which bids are accepted. Bids at yields higher than the cut-off yield is rejected and those lower than the cut-off are accepted. The cut-off yield is set as the coupon rate for the security. Bidders who have bid at lower than the cut-off yield pay a premium on the security, since the auction is a multiple price auction.

   *Cut off price:* It is the minimum price accepted for the security. Bids at prices lower than the cut-off are rejected and at higher than the cut-off are accepted. Coupon rate for the security remains unchanged. Bidders who have bid at higher than the cut-off price pay a premium on the security, thereby getting a lower yield. Price based auctions lead to finer price discovery than yield based auctions.

   *Notified amount:* The amount of security to be issued is 'notified' prior to the auction date, for information of the public.

The Reserve Bank of India (RBI) may participate as a non-competitor in the auctions. The unsubscribed portion devolves on RBI or on the Primary Dealers if the auction has been underwritten by PDs. The devolvement is at the cut-off price/ yield.

Underwriting in Auctions. For the purpose of auctions, bids are invited from the Primary Dealers one day before the auction wherein they indicate the amount to be underwritten by them and the underwriting fee expected by them. The auction committee of Reserve Bank of India examines the bids and based on the market conditions, takes a decision in respect of the amount to be underwritten and the fee to be paid to the underwriters. Underwriting fee is paid at the rates bid by PDs, for the underwriting which has been accepted. In case of the auction being fully subscribed, the underwriters do not have to subscribe to the issue necessarily unless they have bid for it. If there is a devolvement, the successful bids put in by the Primary Dealers are set-off against the amount underwritten by them while deciding the amount of devolvement.

**b. On-tap issue**

This is a reissue of existing Government securities having pre-determined yields/ prices by Reserve Bank of India. After the initial primary auction of a security, the issue remains open to further subscription by the investors as and when considered appropriate by RBI. The period for which the issue is kept open may be time specific or volume specific. The coupon rate, the interest dates and the date of maturity remain the same as determined in

the initial primary auction. Reserve Bank of India may sell government securities through on tap issue at lower or higher prices than the prevailing market prices. Such an action on the part of the Reserve Bank of India leads to a realignment of the market prices of government securities. Tap stock provides an opportunity to unsuccessful bidders in auctions to acquire the security at the market determined rate.

c. **Fixed coupon issue**
   Government Securities may also be issued for a notified amount at a fixed coupon. Most State Development Loans or State Government Securities are issued on this basis.
d. **Private Placement**
   The Central Government may also privately place government securities with Reserve Bank of India. This is usually done when the Ways and Means Advance (WMA) is near the sanctioned limit and the market conditions are not conducive to an issue. The issue is priced at market related yields. Reserve Bank of India may later offload these securities to the market through Open Market Operations (OMO).
   After having auctioned a loan whereby the coupon rate has been arrived at and if still the government feels the need for funds for similar tenure, it may privately place an amount with the Reserve Bank of India. RBI in turn may decide upon further selling of the security so purchased under the Open Market Operations window albeit at a different yield.
e. **Open Market Operations (OMO)**
   Government securities that are privately placed with the Reserve Bank of India are sold in the market through open market operations of the Reserve Bank of India. The yield at which these securities are sold may differ from the yield at which they were privately placed with Reserve Bank of India. Open market operations are used by the Reserve Bank of India to infuse or suck liquidity from the system. Whenever the Reserve Bank of India wishes to infuse the liquidity in the system, it purchases government securities from the market, and whenever it wishes to suck out the liquidity from the system, it sells government securities in the market.

2. **Money at Call and Short Notice**
   Money at call is outright money. Money at short notice is for a maturity of or up to 14 days. Money for higher maturity is known as inter-bank deposits. The participants are banks and all India financial institutions as permitted by RBI. From April 1991, corporates with minimum lendable resources of Rs.20 crores for transaction have also been permitted to lend in the market through the DFHI. Mumbai is the single most important centre and other centres are Kolkata, Delhi, Chennai, Ahmedabad and Bangalore.
   The market is an over-the-telephone market. Non-bank participants act as lenders only. Banks borrow for a variety of reasons to maintain their CRR, to meet heavy payments (e.g. withdrawals by customers for payment of taxes), to adjust their maturity mismatch etc. There are days of heavy borrowings on these occasion. Consequently, depending upon supply, interest rates show wide fluctuations. Corporate treasury management is

not as sophisticated as in industrialised countries and through the cash credit system transfer their liquidity management to their banker who in turn resort to the call money market.

3. **Bills Rediscountin**

   Bill-financing seller drawing a bill of exchange and the buyer accepting it, thereafter the seller discounting it with, say, a bank, is an important device for fund raising in advanced countries. The bills are liquidated on maturity. Hundies (an indigenous form of bill of exchange) have been popular in India, too. But there has been a general reluctance on the part of buyers to commit themselves to payments on maturity. Hence, bill finance has not been popular, official incentives and coercions notwithstanding. In case of borrowers having working capital limits of Rs.5 crores and above, at least 25% of the aggregate limits for financing inland credit sales should be by way of bill finance. In addition, banks have a facility to rediscount the bills with the RBI and other approved institutions like LIC, GIC, UTI, ICICI, IFCI, DFHI etc.

4. **Inter-Bank Participation (IBP)**

   This instrument emerged in the ‘70s but became almost defunct in the ‘80s. Vaghul Committee suggested its revival for the purpose of removing imbalances which effected the maturity mix of banks assets. Two types of IBP are allowed to be issued by banks as per RBI guidelines:

   a. on risk sharing basis
   b. without risk sharing

   These instruments are used by Scheduled Commercial Banks other than Regional Rural Banks. IBP with sharing is issued for 91 to 180 days in respect of advances classified under health-code status. In connection with corporate lending, the lender bank shares the losses with borrower banks. The rate of interest is mutually determined by the issuing bank and the participating bank.

   IBP without risk sharing can have a tenor of 90 days only. The issuing banks show participation as borrowing, while the participating banks show it as advances to banks. The IBP scheme is advantageous as it is more flexible for access compare to the regular consortium tie up.

   However, IBP has not become very popular because it is not transferable and there is absence of the ceiling on interest rate. Further, there is no provision for pre-matured redemption/advance payment of the certificate after a minimum lock-in period.

5. **Money Market Mutual Funds (MMMFs)**

   When savers switch their savings from banks to capital markets in search of higher returns and capital appreciation, there arises the institution of mutual funds - collecting small savings of a large number of savers, and investing them in capital market instruments, using their professional expertise, superior capability and economies of scale. They seek to provide safety, liquidity and return. Money market is an avenue for obtaining higher returns on short term funds. But the operators are large institutions and deals are in large amounts for beyond the capacity of money. The concept

of a mutual fund in relation to a capital market can naturally be extended to money market. Hence, the coming up of money market mutual funds. The concept has been worked in the USA and other advanced countries. MMMFs industry is very well developed in USA. In the 1980s, the capital markets were in an uncertain phase yields on the US Government short term securities were high, but the minimum amounts required by them were high. For example $10,000 to buy a treasury bill. In the circumstances, MMMFs industry developed quite fast. Historically, the MMMFs was introduced in 1971 by Bruce Bent and Henry Brown of the Wall street.

In India, the decision to promote MMMFs was announced by RBI while unveiling its credit policy in April, 1991. A task force on MMMFs was set up under the chairmanship of D Basu in September, 1991. It was required to evolve guidelines, for establishing these funds, devise formats of negotiable instruments to be used, investment policies, etc. Its recommendations formed the basis of the guidelines issued by RBI in April, 1992.

SEBI revised the guidelines on MMMFs on 28th March, 1994 relating to maximum permissible investments as a percentage of total resources mobilised, subject to the prescribed limits and durations. These guidelines were applicable to MMMFs until the first week of March, 2000. On 7th March, 2000 the RBI withdrew these guidelines and it was notified by SEBI in its Circular No.MFD/CIR/1/189/2000 dated 10th April, 2000 that the MMMF schemes like any other mutual fund schemes, would exclusively be governed by SEBI (Mutual Funds) Regulations, 1996

6. **Call Money Market and Short-term Deposit Market**

The formation and operations of Discount and Finance House of India (DFHI) led to enhanced activities in this market segment. DFHI was allowed to borrow, lend and also arrange funds. With a view to improve the equilibrium of the market without steep raise in the rates, the interest rates in the call money market was partly freed by the announcement of RBI that DFHI would operate outside the purview of the provisions of the ceiling rates fixed by the Indian Banks Association

The inter bank rates both on call money and short-term deposits were freed and deregulated from May, 1989. In May, 1990 GIC, IDBI, NABARD etc. were included as participants for the purpose of lending in the market and bring about great integration among the different segments of the market. In October, 1990 participants in the Commercial Bill market were also similarly permitted as lenders. Again in April, 1991, Institutions and mutual funds with bulk lendable resources were allowed access by RBI to the call money market through DFHI. All bank subsidiaries were allowed to set up money market mutual funds.

A minimum size of Rs. 20 crores for each transaction was stipulated while permitting the participation of the corporates in the call money market. Additionally, the lender was required to offer an undertaking that he had no outstandings against loans taken from the banking sector. The borrowers were essentially the banks. In this scenario the DFHI plays a vital role in stabilising the call and short-term deposit rates through larger turnover and

smaller spread. Private mutual funds were also allowed to participate in the market as lenders from April, 1995.

DFHI ascertains from the prospective lenders and borrowers the money available and needed and exchanges a deal settlement advise with them indicating the negotiated interest rates applicable to them. When DFHI borrows, a call deposit receipt is issued to the lender against a cheque drawn on RBI for the amount lent. If DFHI lends, it issues to the RBI a cheque representing the amount lent to the borrower against the call deposit receipt.

The call rates are very volatile as they are determined by the interaction of demand and supply of funds in the market. This volatility mainly arises out of the conditionalities regarding the maintenance of Cash Reserve Ratio (CRR) by the banks. When banks borrow large amounts during tight liquidity periods to fulfil their CRR requirements, the rates are pushed up and after these needs are met the rates come down. During busy season (October-March) there will be a great demand for credit in the market and consequently the interest rates are higher.

Two call rates exist in India, i.e. Inter-bank call rate and the lending rate of DFHI. In 1989 when the rates were first deregulated there was an initial upsurge, but the market flattened at an average rate of around 10 to 15% and this continued till 1990. In 1991 in the wake of a financial crisis in the market, the rates went up to 38%. After the CRR and the SLR were slashed and loan resources increased as a follow up of the Narasimham's Committee Report, the call rates came down steeply to 5 to 6% in 1993. Again in 1994 there was sharp increase to around 100%. The DFHI rate has also been fluctuating like the inter bank rate and is slightly higher than the latter.

The following are the additional factors contributing to the volatility:

1. periodical large borrowings to meet CRR requirements of banks.
2. certain banks operate excessive credit beyond their permissible limits to meet structural disequilibrium of resources versus needs.
3. call rates increase steeply when institutional lenders and corporates withdraw huge amounts for tax payments etc.
4. call rates go up also when there is less-liquidity in the money market investments for want of buyers for Government securities, units, public sector bonds etc. in which funds are invested.

RBI has made efforts to reduce the volatility by different measures and brought about stability in the rates. There is now a compulsion for banks to match liquidity with maturity. RBI uses CRR as a critical variable in the operation of the call money market.

**7. Treasury Bills**

Treasury Bills are money market instruments to finance the short term requirements of the Government of India. These are discounted securities and thus are issued at a discount to face value. The return to the investor is the difference between the maturity value and issue price.

In the short term, the lowest risk category instruments are the treasury bills.

RBI issues these at a prefixed day and a fixed amount.
These are four types of treasury bills.

a. 14-day Tbill-maturity is in 14 days. Its auction is on every Friday of every week. The notified amount for this auction is Rs. 100 crores.
b. 91-day Tbill-maturity is in 91 days. Its auction is on every Friday of every week. The notified amount for this auction is Rs. 100 crores.
c. 182-day Tbill-maturity is in 182 days. Its auction is on every alternate Wednesday (which is not a reporting week). The notified amount for this auction is Rs. 100 crores.
d. 364-Day Tbill-maturity is in 364 days. Its auction is on every alternate Wednesday (which is a reporting week). The notified amount for this auction is Rs. 500 crores.

A considerable part of the government's borrowings happen through Tbills of various maturities. Based on the bids received at the auctions, RBI decides the cut off yield and accepts all bids below this yield.
The usual investors in these instruments are banks who invest not only to part their short-term surpluses but also since it forms part of their SLR investments, insurance companies and FIs. FIIs so far have not been allowed to invest in this instrument.
These T-bills which are issued at a discount can be traded in the market. Most of the time, unless the investor requests specifically, they are issued not as securities but as entries in the Subsidiary General Ledger (SGL) which is maintained by RBI. The transactions cost on Tbill are non-existent and trading is considerably high in each bill, immediately after its issue and immediately before its redemption.
The yield on T-bills is dependent on the rates prevalent on other investment avenues open for investors. Low yield on T-bills, generally a result of high liquidity in banking system as indicated by low call rates, would divert the funds from this market to other markets. This would be particularly so, if banks already hold the minimum stipulated amount (SLR) in government paper.

**Benefits of Investment in Treasury Bills**

a. No tax deducted at source
b. Zero default risk being sovereign paper
c. Highly liquid money market instrument
d. Better returns especially in the short term
e. Transparency
f. Simplified settlement
g. High degree of tradeability and active secondary market facilitates meeting unplanned fund requirements.

**Features of Treasury Bills**

**a. Form**

The treasury bills are issued in the form of promissory note in physical form or by credit to Subsidiary General Ledger (SGL) account or Gilt account in dematerialised form.

**b. Minimum Amount of Bids**

Bids for treasury bills are to be made for a minimum amount of Rs 25000/- only and in multiples thereof.

c. **Eligibility**
All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations, Nepal Rashtra bank and even individuals are eligible to bid and purchase Treasury bills.

d. **Repayment**
The treasury bills are repaid at par on the expiry of their tenor at the office of the Reserve Bank of India.

e. **Availability**
All the treasury Bills are highly liquid instruments available both in the primary and secondary market.

f. **Day Count**
For treasury bills the day count is taken as 365 days for a year.

g. **Yield Calculation**
The yield of a Treasury Bill is calculated as per the following formula:

$$Y = \frac{(100-P) \times 365 \times 100}{P \times D}$$

| | |
|---|---|
| Wherein | Y = Discounted yield |
| | P = Price |
| | D = Days to maturity |

*Example*
A cooperative bank wishes to buy 91 Days Treasury Bill Maturing on Dec. 6, 2006 on Oct. 12, 2006. The rate quoted by seller is Rs. 99.1489 per Rs. 100 face values. The YTM can be calculated as following:
The days to maturity of Treasury bill are 55 (October – 20 days, November – 30 days and December – 5 days)
YTM = (100-99.1489) x 365 x 100/(99.1489*55) = 5.70%
Similarly if the YTM is quoted by the seller price can be calculated by inputting the price in above formula

**Primary Market**

In the primary market, treasury bills are issued by auction technique.
Salient Features of the Auction Technique:

a. The auction of treasury bills is done only at Reserve Bank of India, Mumbai.
b. Bids are to be submitted on NDS by 2:30 PM on Wednesday. If Wednesday happens to be a holiday then bids are to submitted on Tuesday.
c. Bids are submitted in terms of price per Rs 100. For example, a bid for 91-day Treasury bill auction could be for Rs 97.50.

d. Auction committee of Reserve Bank of India decides the cut-off price and results are announced on the same day.
e. Bids above the cut-off price receive full allotment; bids at cut-off price may receive full or partial allotment and bids below the cut-off price are rejected.

**Types of Auctions**

There are two types of auction for treasury bills:

— *Multiple Price Based or French Auction:* Under this method, all bids equal to or above the cut-off price are accepted. However, the bidder has to obtain the treasury bills at the price quoted by him. This method is followed in the case of 364 days treasury bills and is valid only for competitive bidders.

— *Uniform Price Based or Dutch Auction:* Under this system, all the bids equal to or above the cut-off price are accepted at the cut- off level. However, unlike the Multiple Price based method, the bidder obtains the treasury bills at the cut-off price and not the price quoted by him. This method is applicable in the case of 91 days treasury bills only. The system of Dutch auction has been done away with by the RBI wef 08.12.2002 for the 91 day treasury T Bill.

**Secondary Market & Palyers**

The major participants in the secondary market are scheduled banks, financial Institutions, Primary dealers, mutual funds, insurance companies and corporate treasuries. Other entities like cooperative and regional rural banks, educational and religious trusts etc. have also begun investing their short term funds in treasury bills.

The major advantages of dealing in treasury bill secondary market are: Market related yields, ideal matching for funds management particularly for short-term tenors of less than 15 days, Transparency in operations as the transactions would be put through Reserve Bank of India's SGL or Client's Gilt account only, two way quotes offered by primary dealers for purchase and sale of treasury bills and certainty in terms of availability, entry and exit.

**Treasury Bills - An Effective Cash Management Product**

Treasury Bills are very useful instruments to deploy short term surpluses depending upon the availability and requirement. Even funds which are kept in current accounts can be deployed in treasury bills to maximise returns. Banks do not pay any interest on fixed deposits of less than 15 days, or balances maintained in current accounts, whereas treasury bills can be purchased for any number of days depending on the requirements. This helps in deployment of idle funds for very short periods as well. Further, since every week there is a 91 days treasury bills maturing and every fortnight a 364 days treasury bills maturing, one can purchase treasury bills of different maturities as per requirements so as to match with the respective outflow of funds. At times when the liquidity in the economy is tight, the returns on treasury bills are much higher as compared to bank deposits even for longer term. Besides, better yields and availability for very short tenors, another important advantage of treasury bills over bank

deposits is that the surplus cash can be invested depending upon the staggered requirements.

**Example**

Suppose party A has a surplus cash of Rs. 200 crore to be deployed in a project. However, it does not require the funds at one go but requires them at different points of time as detailed below:

| | |
|---|---|
| Funds Available as on 1.1.2006 | Rs. 200 crore |
| Deployment in a project | Rs. 200 crore |
| As per the requirements | |
| 06.1.2006 | Rs. 50 crore |
| 13.1.2006 | Rs. 20 crore |
| 02.2.2006 | Rs. 30 crore |
| 08.2.2006 | Rs. 100 crore |

Out of the above funds and the requirement schedule, the party has following two options for effective cash management of funds:

*Option I*

Invest the cash not required within 15 days in bank deposits

The party can invest a total of Rs. 130 crore only, since the balance Rs. 70 crores is required within the first 15 days. Assuming a rate of return of 6% paid on bank deposits for a period of 31 to 45 days, the interest earned by the company works out to Rs. 76 lacs approximately.

Option II

Invest in Treasury Bills of various maturities depending on the funds requirements

The party can invest the entire Rs. 200 crore in treasury bills as treasury bills of even less than 15 days maturity are also available. The return to the party by this deal works out to around Rs. 125 lacs, assuming returns on Treasury Bills in the range of 8% to 9% for the above periods.

Portfolio Management Strategies

Strategies for managing a portfolio can broadly be classified as active or passive strategies:

*Buy And Hold:* A buy and hold strategy can be described as a passive strategy since the Treasury bills once purchased, would be held till its maturity. The salient features of this strategy are:

a. Return is fixed or locked in at the time of investment itself.
b. The exposure to price variations due to secondary market fluctuations is eliminated.
c. There is no risk of default on maturity.

**Buy and Trade**

This strategy can also be described as an active market strategy. The returns on this strategy are higher than the buy and hold strategy as the yield can be optimised by actively trading the treasury bills in the secondary market before maturity.

8. **Certificates of Deposits**

Certificates of Deposit (CDs) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. The guidelines for issue of CDs incorporating all the amendments issued till date are given below.

**Eligibility**

CDs can be issued by (i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI.

**Aggregate Amount**

Banks have the freedom to issue CDs depending on their requirements. A FI may issue CDs within the overall umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

**Minimum Size of Issue and Denominations**

Minimum amount of a CD should be Rs.1 lakh i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs. 1 lakh and in the multiples of Rs. 1 lakh thereafter. CDs can be issued to individuals, corporations, companies, trusts, funds, associations, etc. Non-Resident Indians (NRIs) may also subscribe to CDs, but only on non-repatriable basis which should be clearly stated on the Certificate. Such CDs cannot be endorsed to another NRI in the secondary market.

**Maturity**

The maturity period of CDs issued by banks should be not less than 15 days and not more than one year. The FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue.

**Discount/Coupon Rate**

CDs may be issued at a discount on face value. Banks/FIs are also allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market based. The issuing bank/FI is free to determine the discount/coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark.

**Reserve Requirements**

Banks have to maintain the appropriate reserve requirements, i.e., cash reserve ratio (CRR) and statutory liquidity ratio (SLR), on the issue price of the CDs.

**Transferability**

Physical CDs are freely transferable by endorsement and delivery. Demat CDs can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for the CDs. Banks/FIs cannot grant

loans against CDs. Furthermore, they cannot buy-back their own CDs before maturity.

**Format of CDs**

Banks/FIs should issue CDs only in the dematerialised form. However, according to the Depositories Act, 1996, investors have the option to seek certificate in physical form.

Accordingly, if investor insists on physical certificate, the bank/FI may inform to Monetary Policy Department, Reserve Bank of India, Central Office, Fort, Mumbai - 400 001 about such instances separately. Further, issuance of CD will attract stamp duty. There will be no grace period for repayment of CDs. If the maturity date happens to be holiday, the issuing bank should make payment on the immediate preceding working day. Banks/FIs may, therefore, so fix the period of deposit that the maturity date does not coincide with a holiday to avoid loss of discount / interest rate.

**Security Aspect**

Since physical CDs are freely transferable by endorsement and delivery, it will be necessary for banks to see that the certificates are printed on good quality security paper and necessary precautions are taken to guard against tempering with the document. They should be signed by two or more authorized signatories.

**Payment of Certificate**

Since CDs are transferable, the physical certificate may be presented for payment by the last holder. The question of liability on account of any defect in the chain of endorsements may arise. It is, therefore, desirable that banks take necessary precautions and make payment only by a crossed cheque. Those who deal in these CDs may also be suitably cautioned. The holders of dematted CDs will approach their respective depository participants (DPs) and have to give transfer/delivery instructions to transfer the demat security represented by the specific ISIN to the ‘CD Redemption Account’ maintained by the issuer. The holder should also communicate to the issuer by a letter/fax enclosing the copy of the delivery instruction it had given to its DP and intimate the place at which the payment is requested to facilitate prompt payment. Upon receipt of the Demat credit of CDs in the “CD Redemption Account”, the issuer, on maturity date, would arrange to repay to holder/transferor by way of Banker’s cheque/high value cheque, etc.

**Issue of Duplicate Certificates**

In case of the loss of physical CD certificates, duplicate certificates can be issued after compliance of the following:

a. A notice is required to be given in at least one local newspaper,
b. Lapse of a reasonable period (say 15 days) from the date of the notice in the newspaper; and
c. Execution of an indemnity bond by the investor to the satisfaction of the issuer of CD.

The duplicate certificate should only be issued in physical form. No fresh stamping is,required as a duplicate certificate is issued against the original

lost CD. The duplicate CD should clearly state that the CD is a Duplicate one stating the original value date, due date, and the date of issue (as "Duplicate issued on_____").

**Accounting**

Banks/FIs may account the issue price under the Head "CDs issued" and show it under deposits. Accounting entries towards discount will be made as in the case of "cash certificates". Banks/FIs should maintain a register of CDs issued with complete particulars.

9. **Inter-Corporate Deposits**

Apart from CPs, corporates also have access to another market called the inter corporate deposits (ICD) market. An ICD is an unsecured loan extended by one corporate to another. Existing mainly as a refuge for low rated corporates, this market allows funds surplus corporates to lend to other corporates. Also the better-rated corporates can borrow from the banking system and lend in this market. As the cost of funds for a corporate in much higher than a bank, the rates in this market are higher than those in the other markets. ICDs are unsecured, and hence the risk inherent in high. The ICD market is not well organised with very little information available publicly about transaction details.

10. **Commercial Bills**

Commercial bills are basically negotiable instruments accepted by buyers for goods or services obtained by them on credit. Such bills being bills of exchange can be kept upto the due date and encashed by the seller or may be endorsed to a third party in payment of dues owing to the latter. But the most common method is that the seller who gets the accepted bills of exchange discounts it with the Bank or financial institution or a bill discounting house and collects the money (less the interest charged for the discounting).

The volume of bills both inland and foreign, which are discounted accounted for about 20% of the total scheduled commercial bank credit. Over the years this percentage is coming down. The Reserve Bank has been attempting to develop a market for commercial bills. The bill market scheme was introduced in 1942 and a new scheme called Bill Rediscount Scheme with several new features was introduced in November, 1970. Under the latter scheme the RBI rediscount bills at the bank rates or at rates specified by it at its discretion. Since the rediscounting facility has been made restrictive, it is generally available on a discretionary basis. The difficulties which stand in the way of bill market development are, the incidence of stamp duty, shortage of stamp paper, reluctance of buyers to accept bills, predominance of cash credit system of lending and the administrative work involved in handling documents of title to goods. To be freely negotiable and marketable, the bills should be first class bills i.e. those accepted by companies having good reputation. Alternatively,the bills accepted by companies should be co-accepted by banks as a kind of guarantee. In the absence of these criteria, bill market has not developed in India as the volume of first class bills is very small.

## 11. Commercial Paper

Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. CP, as a privately placed instrument, was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Subsequently, primary dealers, satellite dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Guidelines for issue of CP are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. The guidelines for issue of CP incorporating all the amendments issued till date is given below:

In these guidelines, unless the context otherwise requires:

a. "banks" or "banking company" means a banking company as defined in clause (c) of Section 5 of the Banking Regulation Act,1949 (10 of 1949) or a "corresponding new bank", "State Bank of India" or "subsidiary bank" as defined in clause (da), clause (nc) and clause (nd) respectively thereof and includes a "co-operative bank" as defined in clause (cci) of Section 5 read with Section 56 of that Act.
b. "scheduled bank" means a bank included in the Second Schedule of the Reserve Bank of India Act,
c. 1934."All-India Financial Institutions (FIs)" means those financial institutions which have been permitted specifically by the Reserve Bank of India to raise resources by way of Term Money, Term Deposits, Certificates of Deposit, Commercial Paper and Inter-Corporate Deposits, where applicable, within umbrella limit.
d. "Primary Dealer" means a non-banking financial company which holds a valid letter of authorization as a Primary Dealer issued by the Reserve Bank, in terms of the "Guidelines for Primary Dealers in Government Securities Market" dated March 29, 1995, as amended from time to time.
e. "corporate" or "company" means a company as defined in Section 451(aa) of the Reserve Bank of India Act, 1934 but does not include a company which is being wound up under any law for the time being in force.
f. "non-banking company" means a company other than banking company.
g. "non-banking financial company" means a company as defined in Section 451(f) of the Reserve Bank of India Act, 1934.
h. "working capital limit" means the aggregate limits, including those by way of purchase/discount of bills sanctioned by one or more banks/FIs for meeting the working capital requirements.
i. "Tangible net worth" means the paid-up capital plus free reserves (including balances in the share premium account, capital and debentures redemption reserves and any other reserve not being created for repayment of any future liability or for depreciation in assets or for bad debts or reserve created by revaluation of assets) as per the latest audited balance sheet of the company, as reduced by the amount

of accumulated balance of loss, balance of deferred revenue expenditure, as also other intangible assets.

**Issue of Commercial Paper**

Corporates and primary dealers (PDs), and the all-India financial institutions (FIs) that have been permitted to raise short-term resources under the umbrella limit fixed by Reserve Bank of India are eligible to issue CP.

A corporate would be eligible to issue CP provided:

a. the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore;
b. company has been sanctioned working capital limit by bank/s or all-India financial institution/s; and
c. the borrowal account of the company is classified as a Standard Asset by the financing bank/s / institution/s.

**Rating Requirement**

All eligible participants shall obtain the credit rating for issuance of Commercial Paper from either the Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agencies as may be specified by the Reserve Bank of India from time to time, for the purpose. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies. The issuers shall ensure at the time of issuance of CP that the rating so obtained is current and has not fallen due for review.

**Maturity**

CP can be issued for maturities between a minimum of 7 days and a maximum up to one year from the date of issue. The maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.

**Denominations**

CP can be issued in denominations of Rs.5 lakh or multiples thereof. Amount invested by a single investor should not be less than Rs.5 lakh (face value).

**Limits and the Amount of Issue of CP**

CP can be issued as a "stand alone" product. The aggregate amount of CP from an issuer shall be within the limit as approved by its Board of Directors or the quantum indicated by the Credit Rating Agency for the specified rating, whichever is lower. Banks and FIs will, however, have the flexibility to fix working capital limits duly taking into account the resource pattern of companies financing including CPs. An FI can issue CP within the overall umbrella limit fixed by the RBI i.e., issue of CP together with other instruments viz., term money borrowings, term deposits, certificates of deposit and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet. The total amount of CP proposed to be issued should be raised within a period of two weeks

from the date on which the issuer opens the issue for subscription. CP may be issued on a single date or in parts on different dates provided that in the latter case, each CP shall have the same maturity date.

**Issuing & Paying Agent (IPA)**

Only a scheduled bank can act as an IPA for issuance of CP.

**Investment in CP**

CP may be issued to and held by individuals, banking companies, other corporate bodies registered or incorporated in India and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs). However, investment by FIIs would be within the limits set for their investments by Securities and Exchange Board of India (SEBI).

**Mode of Issuance**

CP can be issued either in the form of a promissory note or in a dematerialized form through any of the depositories approved by and registered with SEBI. CP will be issued at a discount to face value as may be determined by the issuer. No issuer shall have the issue of CP underwritten or co-accepted.

**Preference for Dematerialisation**

While option is available to both issuers and subscribers to issue/hold CP in dematerialised or physical form, issuers and subscribers are encouraged to prefer exclusive reliance on dematerialized form of issue/holding. However, with effect from June 30, 2001, banks, FIs and PDs are required to make fresh investments and hold CP only in dematerialised form.

**Payment of CP**

The initial investor in CP shall pay the discounted value of the CP by means of a crossed account payee cheque to the account of the issuer through IPA. On maturity of CP, when the CP is held in physical form, the holder of the CP shall present the instrument for payment to the issuer through the IPA. However, when the CP is held in demat form, the holder of the CP will have to get it redeemed through the depository and receive payment from the IPA.

**Stand-by Facility**

In view of CP being a 'stand alone' product, it would not be obligatory in any manner on the part of the banks and FIs to provide stand-by facility to the issuers of CP. Banks and FIs have, however, the flexibility to provide for a CP issue, credit enhancement by way of stand-by assistance/credit, back-stop facility etc. based on their commercial judgement, subject to prudential norms as applicable and with specific approval of their Boards.

Non-bank entities including corporates may also provide unconditional and irrevocable guarantee for credit enhancement for CP issue provided:

i. the issuer fulfils the eligibility criteria prescribed for issuance of CP;
ii. the guarantor has a credit rating at least one notch higher than the issuer given by an approved credit rating agency; and
iii. the offer document for CP properly discloses the net worth of the guarantor company, the names of the companies to which the guarantor has issued similar guarantees, the extent of the guarantees offered by

the guarantor company, and the conditions under which the guarantee will be invoked.

**Procedure for Issuance**

Every issuer must appoint an Issuing and Paying Agent (IPA) for issuance of CP. The issuer should disclose to the potential investors its financial position as per the standard market practice. After the exchange of deal confirmation between the investor and the issuer, issuing company shall issue physical certificates to the investor or arrange for crediting the CP to the investor's account with a depository. Investors shall be given a copy of IPA certificate to the effect that the issuer has a valid agreement with the IPA and documents are in order.

**Role and Responsibilities**

The role and responsibilities of issuer, IPA and credit rating agency (CRA) are set out below:

a. **Issuer**

With the simplification in the procedures for CP issuance, issuers would now have more flexibility. Issuers would, however, have to ensure that the guidelines and procedures laid down for CP issuance are strictly adhered to.

b. **Issuing and Paying Agent (IPA)**

Only a Scheduled Bank can act as an IPA for issuance of CP.

i. IPA would ensure that issuer has the minimum credit rating as stipulated by the RBI and amount mobilised through issuance of CP is within the quantum indicated by CRA for the specified rating or as approved by its Board of Directors, whichever is lower.
ii. IPA has to verify all the documents submitted by the issuer viz., copy of board resolution, signatures of authorised executants (when CP in physical form) and issue a certificate that documents are in order. It should also certify that it has a valid agreement with the issuer.
iii. Certified copies of original documents verified by the IPA should be held in the custody of IPA.
iv. Every CP issue should be reported to Chief General manager, RBI.
v. IPAs which are NDS member, should report the details of CP issue on NDS platform within two days from the date of completion of the issue.
vi. Further all scheduled banks, acting as an IPA, will continue to report CP issuance details as hitherto within three days from the date of completion of the issue, incorporating details as per Schedule II till NDS reporting stabilizes to the satisfaction of RBI.

c. **Credit Rating Agency (CRA)**

i. Code of Conduct prescribed by the SEBI for CRAs for undertaking rating of capital market instruments shall be applicable to them (CRAs) for rating CP.
ii. Further, the credit rating agency would henceforth have the discretion to determine the validity period of the rating depending upon its perception about the strength of the issuer. Accordingly, CRA shall at

the time of rating, clearly indicate the date when the rating is due for review.

iii. While the CRAs can decide the validity period of credit rating, they would have to closely monitor the rating assigned to issuers vis-a-vis their track record at regular intervals and would be required to make their revision in the ratings of public through their publications and website.

**Documentation Procedure**

Fixed Income Money Market and Derivatives Association of India (FIMMDA) may prescribe, in consultation with the RBI, for operational flexibility and smooth functioning of CP market, any standardised procedure and documentation that are to be followed by the participants, in consonance with the international best practices. For this Issuer/IPAs are required to refer to the detailed guidelines issued in this regard. Violation of these guidelines will attract penalties and may also include debarring of the entity from the CP market.

**Defaults in CP market**

In order to monitor defaults in redemption of CP, scheduled banks which act as IPAs, are advised to immediately report, on occurrence, full particulars of defaults in repayment of CPs, Reserve Bank of India.

**Non-applicability of Certain Other Directions**

Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 does not apply to any non-banking financial company (NBFC) insofar as it relates to acceptance of deposit by issuance of CP, in accordance with the Guidelines.

**12. Gilt-edged (Government) Securities**

These securities are issued by Governments such as Central and State Governments, Semi-Government Authorities, City Corporations, Municipalities, Port Trust, State Electricity Boards, Metropolitan Authorities, Housing Boards and Large Financial Institutions. They are held by RBI and are eligible to be reckoned for the purpose of SLR of the banks. Though they are long dated securities, they are in great demand as banks have to buy/sell them for maintaining the level of Net Demand and Time Liabilities (NDTL) as on the last day (Friday) of the second preceding fortnight. Being a security issued by the sovereign government, they are considered the most secured financial instruments which guarantees both safety of the capital and the income.

Considering their liquidity and safety, the rate of interest is lower but it is payable half-yearly. These securities are issued by the Public Debt Office (PDO) of the RBI. Unlike T-Bills they are not auctioned, their issues are notified a few days before opening for subscription and offer is kept open for two to three days. The budgeted amount is collected through a number of trenches over the period of a year. This helps avoidance of flooding of the market with securities. The issues are mostly mopped up by institutional investors. When these securities are announced for issue RBI suspends the sale of existing loans till the closure of the subscription to the new

issues of gilt-edged securities. The government has a right to retain excess subscriptions upto 10% over and above the notified limit. Applications for the securities are received at the offices of the RBI and SBI generally during the slack season, when there is no acute demand for funds outside. The process of issue and redemption of bill rated securities is a continuous one. Because of their continuous availability they are called tap-stocks. In most cases redemptions on the stipulated date will be meager as redemption can take place from time to time, as and when the investor opts for it. Redemption can also take place in the form of exchange or conversion of the existing securities for new ones. Grooming of the market and switching are the other operations resorted to by RBI. While grooming means acquiring securities nearing maturity to facilitate redemption and making available a variety of loans to broaden the gilt-edged market. On the other hand, switching means purchasing one security against the sale of another security instead of outright sale of the new one. These are called open operations in the secondary market.

When RBI refunds cash or issues new securities it is called primary market operations in Government securities. RBI buys the securities mostly in switch operations and rarely for cash. The purchase is made by RBI from out of the surplus funds of IDBI, Exim Bank and NABARD under special arrangements. Switch operations are helpful to the banks and financial institutions in improving the yields on their investments in Government Securities. The RBI fixes annual quota based on the size of each bank for its switch transactions.

As the buyers are banks, insurance companies and Employees Provident Funds which are statutorily required to invest in Gilt-edged Securities, the market for them continues to be captive in nature. A buy-back service is offered by RBI for the Government Securities at prices quoted in the rate lists that RBI publishes from time to time. These rates help the banks to obtain the yield in alignment with the coupon rates of the new Central Securities. The facility to substitute one security for another in their portfolio of SLR is provided by RBI to the banks.

No forward market exists for transactions in the securities but the repo transactions exist in the inter-bank market offering an opportunity to place odd amounts of cash for any period of time and in any eligible security. The risk of default is reduced as the investment is fully collateralised.

Banks opt for repo transactions in Government securities to avail three benefits:

a. The borrowing by a bank in the call money market increases its CRR and SLR liabilities. But when a repo transaction is undertaken it is shown in the bank books as an outright sale of securities and hence not reflected in the level of Net Demand and Time Liabilities (NDTL). The CRR and SLR liabilities therefore, are unaffected.
b. Some times to make speculative profits, banks sell or buy repos but this is risky in as much as the price movements may not go as expected.
c. Some banks manage to sell and buy SLR securities as part of liquidity

adjustments, taking into account the rates they would get through the repo and the new coupon rate that they expect and how soon they can realise it.

For short term Government Securities there is no attractive and effective secondary market as such securities (other than T- Bills) are not issued regularly. As and when they are issued their yields are fixed at below market rates. Consequently, profits can rarely be made either through switch transactions or occasional ready forwards. As the budget deficits are generally large requiring massive financing, open market operations in the primary market dominate the scene limiting the short-term operations in the secondary market. However, in the recent past, secondary market is being actively developed by different means for Government securities.

**LESSON ROUND-UP**

- Money market is a very important segment of the Indian financial system. It is the market for dealing in monetary assets of short-term nature.
- There are a large number of participants in the money market: commercial banks, mutual funds, investment institutions, financial institutions and the Regulatory Authority.
- The money market possesses different operational features as compared to capital market. It deals with raising and deployment of funds for short duration while the capital market deals with long-term funding.
- The money market operates as a wholesale market and has a number of inter- related sub-markets such as the call market, the bill market, the treasury bill market, the commercial paper market, the certificate of deposits market etc.
- Money market instruments mainly include Government securities, securities issued by Banking sector and securities issued by private sector. • All funds raised by the government from the money market are through the issue of securities by the RBI.
- Methods of Issuance of Government Securities are (a) Auctions (b) On-tap issue (c) Fixed coupon issue(d) Private Placement(e) Open Market Operations (OMO)
- Money at call is outright money. Money at short notice is for a maturity of or up to 14 days.
- Treasury Bills are money market instruments to finance the short term requirements of the Government of India.
- Certificates of Deposit (CDs) is a negotiable money market instrument and is issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period.
- Commercial bills are basically negotiable instruments accepted by buyers for goods or services obtained by them on credit.
- Commercial Paper (CP) is an unsecured money market instrument

issued in the form of a promissory note. CP, as a privately placed instrument, was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.

- Gilt-edged (Government) Securities are issued by Governments such as Central and State Governments, Semi-Government Authorities, City Corporations, Municipalities, Port Trust, State Electricity Boards, Metropolitan Authorities, Housing Boards and Large Financial Institutions.