Financial Institutions and Markets

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Lecture - 36
Call Money Market - I

So, after the discussion on the different financial institutions which exist in India which includes; commercial banks, mutual funds, insurance companies, then non banking financial companies, credit rating agencies, venture capitals, then we have the merchant banks etcetera. The other part of the discussion on this course it is basically the market; and if you see that whenever we define the market the market is divided into different parts.

Mostly, if you divide the market on the basis of the assets which are; traded in that market, or the term to maturity of that particular asset in that particular system, the market is divided it broadly into two categories; one is your long term market, one is short term market. But whenever you talk about specific categories the market on the basis of different financial institutions and as well as maturity then we have categorized them in this way.

We have money market, we have a debt market, long term debt market, that we can say. Then we have the stock market, then we have the derivatives market, then we have the foreign exchange market. So, these are the different markets which exist in the system. And every market has their own segments some markets are both primary and secondary segments. And now the major objective of our discussion is to see that how the market works.

What are the different issues which are related to this particular type of markets? And how these markets in this particular market the trading takes place? Who are those major participants; participants in this market? What are those different types of markets within that particular market? So, these are the different questions we will address whenever we discuss about the different markets. So, before going to discuss in detail let us first start the discussion on the money market.

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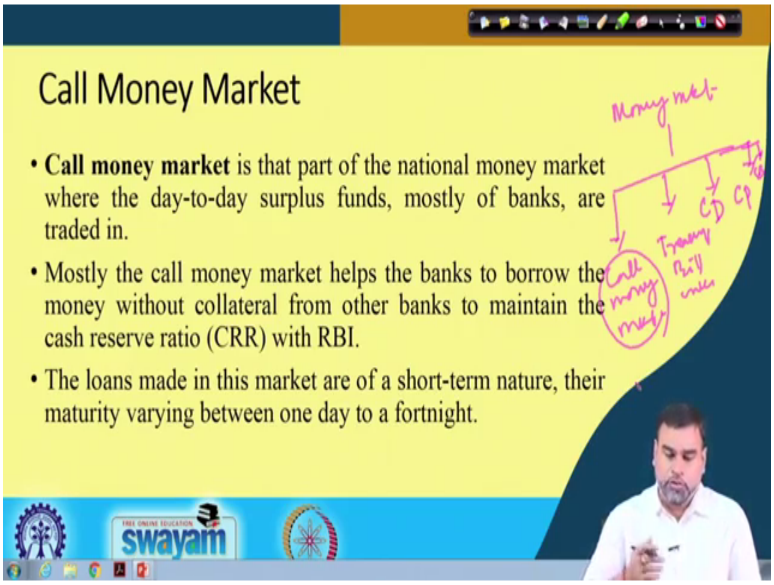

So, if you go by the money market already if you know the money market is divided into different parts. Because money market deals with the short term securities; mostly the maturity period in the money market is maximum up to 1 year. The whatever instruments are traded in the money market this maturity period can go from one day to one year. one day means this is a overnight basis that market and the trading can take place or it can go up to maximum one year.

So, the money market is mostly divided into various parts; one is your different types of money market we have, we have a call money market mostly all are short term in is these are the short term market only. We have a treasury bill market, then we have the markets for certificate of deposits, then we have the markets for the commercial papers, we have also a market for the commercial bills. So, these are the different type of market which exists in Indian system.

So, our objective is to discuss one by one; what is that market is? Or what kind of market it is? Who are those participants in this market? And how the market works? And what are those different instruments which are traded in this market? So, we can start the discussion with the call money market which is one of the most one of the important markets in the economic system; which plays a significant role in the monetary policy process.

So, first of all let us see what do you mean by the call money market. So, whenever you talk about call money market; here mostly the call money market is a day to day market it is a overnight market. And whatever surplus funds are available in a particular day these are transacted in this market. And mostly the transactions or the trading takes place between the banks. The common investors are common retail investors do not participate in the call money market in the overnight basis.

Mostly the market is confined to the banks or it we can call that it is a interbank market. So, the one bank can borrow from another bank, one bank can lend to another bank on the basis of their requirements. So, that is why the call money market basis basically is applicable for the Commercial Banks or banks which are operating in the financial system. And the basic necessity or use of the call money market is; it helps the banks to borrow the money without any collateral.

Call money market for trading in the call money market banks do not have to give any collateral. The money is borrowed for one day, or for overnight basis from another bank on the basis of the requirement of that particular bank. And the bank does not have to pay any collateral to another bank from which they take the loan. And mostly the loans are taken to maintain this CRR, the cash reserve ratio. You know what do you mean by cash reserve ratio?

The cash reserve ratio is basically nothing, but the percentage of the deposit which are parked with or which are deposited with RBI. And depending upon the deposits if the CRR is laid 7 percent depending upon the deposit base this CRR basically changes. So, mostly the banks use the borrowings and lending activities in the money market mostly; the call money market to maintain that CRR with the reserve bank of India. Because that money fluctuates over the days; so once the deposit changes the CRR will change.

So, because of that if the bank has bank has to maintain that CRR they can borrow the money from another bank they can deposit that money and one bank which has the surplus they can lend the money to the another bank. So, this is the major utility of the call money market which tells that the to maintain the CRR bank uses that. The loans which are made in this market are very short term; already I told you that whenever you talk about call money market this maturity period of varying from one day to fortnight.

The call money; money market instruments one day to one year, but whenever we are confining ourselves to the call money market. The maturity period can vary between one day to one fortnight that means; 15 days. So, this is what basically the concept of the or the definition of the call money market or the nature of the call money market which exist in the financial system. Before we go to discuss about the participation and other issues related to call money market; Let us see how the call money market in US is defined.

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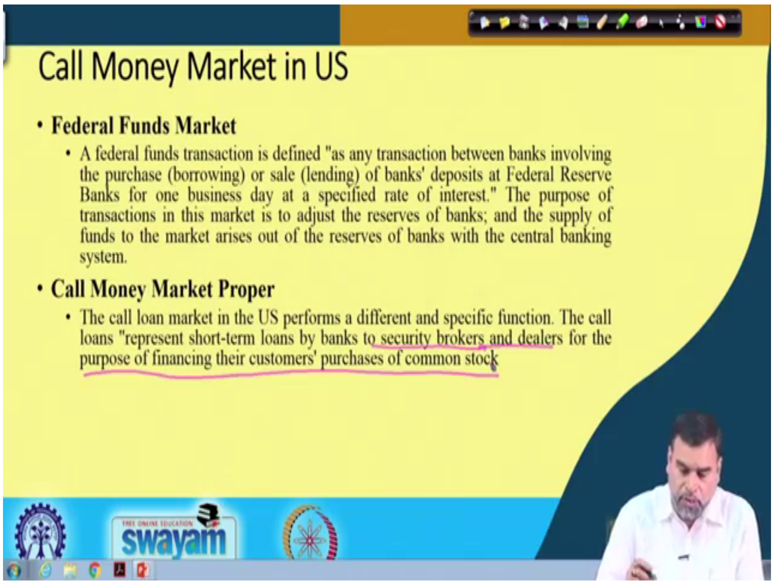

Whenever you talk about the call money market in US; there are two types of market which work in the US system. One is they call it the federal funds market and another one is call money market proper. So, whenever you talk about the federal funds market; the objective of the federal funds market is different and the objective of the call money market proper is different. Then what do you mean by the federal funds market what it does?

So, the federal fund market is basically deals with the federal fund transactions. What do you mean by the federal funds transactions? The federal funds transaction is basically what it is the transaction is defined as many any transaction between banks involving the purchase or selling of bank deposits at Federal Reserve Bank for one business day at a specified rate of interest. The purpose of transaction this market is to adjust the reserves of the banks the same thing what CRR we are talking about.

And the supply of the fonts to the market arises out of the reserves of the banks with the central banking system. That means, mostly this any whatever transactions any purchase and sale of the bank deposits happens at the federal reserve banks for one business day that is basically called the federal funds market. And again that basically depends upon the reserves whatever the Commercial Banks have to maintain with this federal bank Federal Reserve Bank; that is what basically the federal fund market is.

But whenever we talk about the call money market proper it has a different kind of objective. So, the objective of the call money market proper is to provide the short term loans by the banks to the security brokers. If you see when remember this loans are given to the security brokers and dealers for the purpose of financing their customer purchases of the common stocks. If anybody wanted to invest in the stock market and they want to borrow from their broker or from the dealer. Then the dealer can borrow from the market or from the bank to provide that particular loan.

So, which is not existing in India, but this particular market is existing in US where any kind of transactions if any retail investor wanted to do. So, they can invest by borrowing the money from the broker also. And if broker has not enough money with them then the broker can borrow with a certain interest from the different banks. And that particular market is called they call money market proper in the US context. So, this is the way the money market in US is defined. So, let us see how the market is categorized in the context of UK.

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So, whenever you talk about UK; the Commercial Banks one of the UK bank or UK money market is call money market is divided into two parts second categorized into two parts. One is clearing banks loans to discount houses and another one is the interbank call market. Whenever we are discussing or we are explaining about the clearing banks loans to discount houses; how it is defined? The Commercial Banks give loans to discount houses on the call basis.

These loans are normally payable when demanded and mostly they are the secured loans. And how it is secured they are secured by the treasury bills; that means, the bills which are issued by the government and other bills of exchange which is used as a collateral. So, the loans are given to the discount houses who basically discounting the finances or providing the finances. And this particular loans whenever they take from the Commercial Banks so the loans are basically is the secured loans.

That means, there is the collateral against that and what kind of collateral they give? They give the collateral in terms of the treasury bills and other bills of exchange whatever they have. So, that is basically clearing banks loans to discount houses and these loans are given to discount houses only by the Commercial Banks. And whenever we talk about the interbank call market they are the lending borrowing between the banks merchant banks, the overseas banks, foreign banks. That means, it is a interbank market it is more or less synonymous with the Indian context; where our operation works with the interbank transactions.

So, our call money market is interbank market and here also we have seen the interbank call market which exist in UK, which is basically always do the business within the different banks which are operating or which are working in that particular system. So, that is why these are two types of call money market which exist in the UK also. Like us you have two types of call money market which operate in the UK market. So, let us now go to the Indian context that how in India the call money market works.

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In India already I told you that the banks basically do the transactions in the call money market. And they demand the money for some specific reasons either; there is a large payments in day, as large remittances which has happened in that particular day, or to maintain the CRR the liquidity with RBI. So, these are the basic purpose that one bank borrows from another bank and one bank lends to another bank. Who has the surplus they provide the lending and the particular bank who are the deficit they always go for the barrowings.

Who are the participants in this particular market in India? Already I told you the major participants in this particular market is the Commercial Banks. All type of Commercial Banks; Scheduled, Non-Scheduled, Foreign banks, State, District or One Cooperative Banks, Discount House and we have the STCI Security Trading Corporation of India which was again established by the RBI. They also do the transactions in the foreign this kind of call money market.

So, these are the major players who are basically. And mostly we can say this particular bank is a interbank lending market this is a interbank lending market which is more or less synonymous with the interbank market in UK. So, these are the major participants which basically are available in this particular call money market in India.

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Then if you see the concept of the primary dealers; what started in mostly the primary dealers are in India we have a concept called primary dealers. And mostly the primary dealers are the Commercial Banks. and there are some standalone companies or standalone financial institutions they also got the status of the primary dealer. And they also do the transactions in the call money market; which are those?.

You have ICICI Securities Primary Dealership Limited, Morgan Stanley India Primary Dealer Private Limited, Nomura Fixed Income Securities Private Limited, SBI DFHI, STCI, already I told you. Goldman Sachs Capital Market Private Limited, Bank of America, Bank of Baroda, Canara Bank, these are the banks. And apart from the banks there are some standalone companies who also got the license from RBI to do the transactions in the call money market.

So, these are already I told you this; ICICI Securities, Morgan Stanley, Nomura, SBI, DFHI, then you have the STCI. It was previously called DFHI now the SBI has taken over the FSI so the major sponsor of the DFHI is the State Bank of India that is how it is called the SBI DFHI; Discount Found Finance House. This is what totally sponsored by the state bank of India now.

There are some Foreign Banks which also participate like HSBI Hong Kong and Shanghai Banking Corporation, you have JP Morgan, you have Standard Charted, you have Deutsche Bank all these banks also participate in this call money market in Indian context apart from our own public sector banks which also got the primary dealership to operate in this particular system.

Non banking institutions other than PDS are not permitted in the call money market or it is also called the notice money market in the Indian context. So, that is why mostly this there are some institutions which are got the license because, but mostly this banks is or this particular market is confined to the banks; that is why it is called the interbank lending market in the context of India.

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Then we can move into how basically this trading takes place in this particular market. So, whatever transactions which happen in this particular market they always happen between the two different parties maybe in the over the counter market. But they are all reported to the electronic platform called the negotiated dealing system.

This transactions takes place in the OTC market, but even if the transactions which are happening in the over the counter market these are required to be reported on the FIMMDA platform within 15 minutes of the trade. And the how the trading takes place? And what are those ways the trading takes place? How much amount of the trading takes place both lending and borrowing activities? So, the those things will be reported to the FIMMDA trade trading platform within 15 days of the trade whatever is happening in the OTC market.

That basically is the regulation always there with respect to the trading in this particular call money market. There are some restrictions there are some kind of regulations in terms of borrowing and lending activities in terms of the market participants. Already we have seen there are mostly the major type of investors or major type of participants in these segments are basically we have the schedules Commercial Banks Cooperative Banks and the primary dealers and some of the banks are also primary dealers.

So, if the it is a scheduled Commercial Banks there are two activities one is borrowing another one is lending. So, whenever it is coming we are coming to the borrowing how much maximum borrowing the scheduled Commercial Banks can make from the call money market. So, if you see on a fortnightly average basis; the borrowing outstanding should not exceed the 100 percent of the capital funds; whatever the bank halts.

The capital fund means; it is the sum of the tire one, and tire two capital already you know what is tire one tire one is nothing the owners own equity capital And tire two capital is nothing, but the sovereign a depths and other kind of capital whatever the bank has. So, this on fortnightly basis whatever capital the bank has it should not exceed the 100 percent of that on an average. Someday it may be more some days it may be less what in the fortnightly average basis it should not exceed the 100 percent of the latest audited balance it.

However, the banks are allowed to borrow a maximum of maximum of 125 percent of their capital funds on any day during a fortnight. Because on an average it should be 100 percent, but for a day may be maximum they can go up to 125 percent. But in the 15 days average; this should if a one day they are 125 other day maybe 70 percent other day maybe 60 percent that is the different issue, but on an average it should not exceed 100 percent.

But in a single day if they need they can go up to 125 percent if they are the Commercial Banks in terms of the borrowings In terms of the lending if you see it should not exceed the 25 percent of their capital. Any single Commercial Banks cannot lend more than 25 percent of their capital funds on fortnightly basis average. But they are allowed to lend maximum of 50 percent on a single day during that particular fortnight.

In a single day they can some days they can go out to 50, but on an average 25 percent will be maintained in fortnight basis. So, that actually in terms of the lending activities and for your information this major lender in this particular system is SBI, which participates in the system little bit late at 1970, but they act as the major lender in the call money market in comparison to the other banks which are operating in the financial system.

But whenever we are coming to the Cooperative Banks. It little bit different there are conditions or there are criteria is little bit different. For Cooperative Banks the outstanding borrowings of state Cooperative Banks destroyed Central Cooperative Banks urban Cooperative Banks etcetera on a on a daily basis should not exceed 2 percent of their aggregate deposits as at end march of the previous financial year.

Here for the Commercial Banks it is related to their capital, but whenever we are talking about the Cooperative Banks is a related to their aggregate deposits. It should not exceed daily basis it should not exceed the 2 percent of their aggregate deposits, if it is a corporative. What type of cooperative bank it may be? But the aggregate deposits what 2 percent of the aggregate deposits only can be taken as the borrowing and for lending no limit.

But generally the Cooperative Banks do not lend they do not have enough money to lend they only borrow. So, because of that the limit is not given in terms of the lending activities of the Cooperative Banks, but in terms of the borrowing activities it is 2 percent of the total deposits whatever they have.

But for PD's the criteria is a little bit totally different, if either the bank is a primary dealer or the standalone primary dealers whatever we have; for them for in every fortnight up to 225 percent of their net owned funds that means; equity. 225 percent of their owners equity can be given a can be taken as borrowings equity means it is only the tier one capital related to tier one capital, but it is basically one or security net owned funds whatever they have.

So, net owned funds will be 225 percent of the net owned funds on an average un fortnightly basis can be given as the borrowings. And whenever we are coming back to the lending in the lending activities the PD's are allowed to lend on an average on a reporting fortnightly up to 25 percent of their net owned funds. So, in terms of borrowing you they can go up to 225 percent on an average on a fortnightly basis.

So, whenever we are going for the lending activities they can go up to the 25 percent of their a net owned funds. So, these are the restrictions are imposed by Reserve Bank of India for the conduct of the or the functioning of the call money market in the Indian system. So, they have some restrictions in terms of the borrowing activities and they have some restrictions in terms of the lending activities.

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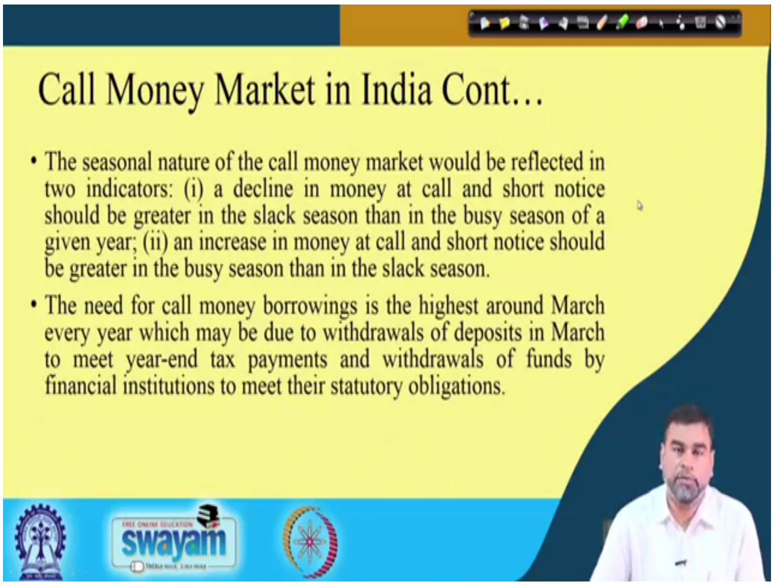

Then we will see that what are those factors which basically affect the demand for the call loans in the call money market. the call money market demand and supply can be driven by the seasonal factors. It is observed that there is a decline in the money at call and short notice market in the decline in money at call and short notice market should be greater in the slack season than in the busy season.

And an increase in the money at call and not the short notice market should be greater in the busy season than the slack season. In the slack season the demand for call loans will be less because availability to the money to the Commercial Banks will be higher because the demand for the food loan non food loan is relatively less whenever we are talking about the slack season. But those things are quite higher in the busy season. So, that is why categorically these two time periods if you observe this has a lot of impact on the operations of the call money market.

The need for call money borrowings is the highest around March every year which may be due to the withdrawals of the deposits. In March to bid the yearend tax payments and the withdrawals of the fonts by financial institutions to meet their statutory obligations because our financially or ends with March 31st. It is observed that huge withdrawal generally takes place in the month of March from the commercial banks.

Either to pay the tax or to meet their financial obligations whatever they have. So, because of that this kind of fluctuations always arise between two different periods on the basis of the demand for that particular money in that particular time. So, that is why there is a seasonal fluctuation we have always observed in the call money market.

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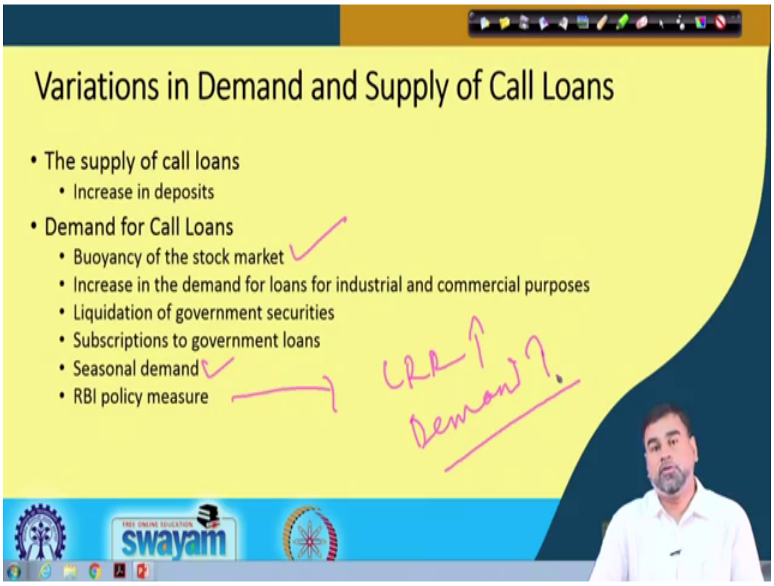

So, if you summarize there are certain factors which are affect the demand for call loans. And there are certain factors which affect the supply of the call loans. Obviously, this supply is only from one source that is the deposit. If the deposit more than the supply can be more, if the deposit will be less the supply can be less because that is the only source of raising the capital for the source of the resources whatever the Commercial Banks have.

So, through the deposit the supply side basically always changes. And whenever the demand side factor we will see; we have discussed about the seasonal factors. And there are other factors if you see because the markets are highly integrated. So, any kind of bouncy or any it is observed that the stock market is booming then the demand for money will increase. So, if the demand for money will increase then automatically what will happen the demand for call loan will increase because there are lot of demand for the borrowings from the from the Commercial Banks.

So, because of that the Commercial Banks has to fulfill that particular demand and then by that time there is a kind of deficit to fulfillment of the CRR. Then finally, they will borrow from another bank to meet that kind of requirements. Increase in the demand for loans for industrial and commercial purpose. If any kind of development which has taken place there are some enough growth opportunities are available in the industrial and commercial sector.

And then demand for industrial loans may increase the demand for industrial loan will increase. Then; obviously, same thing the demand for call loans also will be increasing so that time it is a huge demand to get this call loans from the call money market. Liquidation of the government securities if they have the government securities and government securities are liquidated then; obviously, it will have the demand for the call loans.

Subscription to the government loans if government basically is going for any kind of loans that also will affect the demand for call loans in this particular system then policy measures. Seasonal demand already we have discussed then another factor is the policy measure. So, what is that policy measure we are talking about? The policy measure means for example, the CRR has increased so; obviously, the CRR will increase then they available to the money to the Commercial Banks is already less.

So, depending upon that already we have provided the loan or committed to the loan then they have to borrow the from other bank by that the demand will increase. So, the flow or the Reserve Bank of India has increased the repo rate or declines the repo rate. So, once the repo rate will increase it will have the impact on the call loans, why? Because the normal lending activities of the Commercial Banks or the following activities of the Commercial Banks gets affected.

If the borrowing and lending activities of the Commercial Banks get affected then automatically it will have the impact of on the demand for and supply of the call loans in that particular time gap. So, these are the some of the factors which the affect the demand and supply of the call loans in the particular system and accordingly the interest rate in the call money market also change.

So, how this interest rate is getting effected in the; call money market? What are those factors behind that? Why the call money rates are quite volatile in the market? And is there any other segment? Which is the available related to this particular segment? Which are the major rates which are popularly used in this particular market? So, those questions are those issues we will be discussing in the next class.

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Please go through these particular references for this particular session.

Thank you.