

# **Money Market And Instruments**

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## **Introduction:**

Money market means market where money or its equivalent can be traded. Money is synonym of liquidity. Money market consists of financial institutions and dealers in Money or credit who wishes to generate liquidity. It is better known as a place where large Institutions and government manage their short term cash needs. For generation of liquidity, short term borrowing and lending is done by these financial institutions and dealers.

## **Benefits and Functions of Money Market**

Money markets exist to facilitate efficient transfer of short-term funds between holders and borrowers of cash assets. For the lender/investor, it provides a good return on their funds. For the borrower, it enables rapid and relatively inexpensive acquisition of cash to cover short-term liabilities. One of the primary functions of money market is to provide focal point for RBI's intervention for influencing liquidity and general levels of interest rates in the economy. RBI being the main constituent in the money market aims at ensuring that liquidity and short term interest rates are consistent with the monetary policy objectives.

Money market functions are transfer of large sums of money transfer from parties with surplus funds to parties with a deficit allow governments to raise funds help to implement monetary policy determine short-term interest rates

## **Money Market & Capital Market**

Money Market is a place for short term lending and borrowing, typically within a year. It deals in short term debt financing and investments. On the other hand, Capital Market refers to stock market, which refers to trading in shares and bonds of companies on recognized stock exchanges. Individual players cannot invest in money market as the value of

investments is large, on the other hand, in capital market, anybody can make investments through a broker. Stock Market is associated with high risk and high return as against money market which is more secure. Further, in case of money market, deals are transacted on phone or through electronic systems as against capital market where trading is through recognized stock exchanges.

### **Maturity Period**

The money market deals in the lending and borrowing of short-term finance (i.e., for one year or less), while the capital market deals in the lending **and** borrowing of long-term finance (i.e., for more than one year).

### **Credit Instruments**

The main credit instruments of the money-market are call money, collateral loans, acceptances, bills of exchange. On the other hand, the main instruments used in the capital market are stocks, shares, debentures, bonds, securities of the government.

### **Nature of Credit Instruments**

The credit instruments dealt with in the capital market are more heterogeneous than those in money market. Some homogeneity of credit instruments is needed for the operation of financial markets. Too much diversity creates problems for the investors.

### **Institutions**

Important institutions operating in the' money market are central banks, commercial banks, acceptance houses, nonbank financial institutions, bill brokers, etc. Important institutions of the capital market are stock exchanges, commercial banks and nonbank institutions, such as insurance companies, mortgage banks, building societies, etc.

### **Purpose of Loan**

The money market meets the short-term credit needs of business; it provides working capital to the industrialists. The capital market, on the other hand, caters the long-term credit needs of the industrialists and provides fixed capital to buy land, machinery, etc.

### **Risk**

The degree of risk is small in the money market. The risk is much greater in capital market. The maturity of one year or less gives little time for a default to occur, so the risk is

minimized. Risk varies both in degree and nature throughout the capital market.

### **Basic Role**

The basic role of money market is that of liquidity adjustment. The basic role of capital market is that of putting capital to work, preferably to long-term, secure and productive employment. Relation with Central Bank

The money market is closely and directly linked with central bank of the country. The capital market feels central bank's influence, but mainly indirectly and through the money market.

### **Market Regulation**

In the money market, commercial banks are closely regulated. In the capital market, the institutions are not much regulated.

### **Money Market - Futures and Options**

Active trading in money market futures and options occurs on number of commodity exchanges. They function in the similar manner like any other futures and options.

### **Discount and Accrual Instruments**

There are two types of instruments in the fixed income market that pay the interest at maturity, instead of paying it as coupons. Discount instruments, like repurchase agreements, are issued at a discount of the face value, and their maturity value is the face value. Accrual instruments are issued at the face value and mature at the face value plus interest

### **Common Money Market Instruments**

Certificate of deposit — Time deposit, commonly offered to consumers by banks, thrift institutions, and credit unions.

Repurchase agreements — Short-term loans—normally for less than two weeks and frequently for one day—arranged by selling securities to an investor with an agreement to repurchase them at a fixed price on a fixed date.

Commercial paper - Unsecured promissory

notes with a fixed maturity of one to 270 days; usually sold at a discount from face value.

Eurodollar deposit- Deposits made in U.S. dollars at a bank or bank branch located outside the United States.

Federal agency short-term securities - Short-term securities issued by government sponsored enterprises such as the Farm, the Federal Home Loan Banks and the Federal National Mortgage Association.

Federal funds - Interest-bearing deposits held by banks and other depository institutions at the Federal Reserve; these are immediately available funds that institutions borrow or lend, usually on an overnight basis. They are lent for the federal funds rate.

Municipal notes - Short-term notes issued by municipalities in anticipation of tax receipts or other revenues.

Treasury bills - Short-term debt obligations of a national government that are issued to mature in three to twelve months.

Money funds - Pooled short maturity, high quality investments which buy money market securities on behalf of retail or institutional investors.

Foreign Exchange Swaps - Exchanging a set of currencies in spot date and the reversal of the exchange of currencies at a predetermined time in the future.

Short-lived mortgage- and asset-backed securities

### Money Market Instruments

Investment in money market is done through money market instruments. Money market instrument meets short term requirements of the borrowers and provides liquidity to the lenders. Common Money Market Instruments are as follows:

**Treasury Bills (T-Bills)**

Treasury Bills, one of the safest money market instruments, are short term borrowing instruments of the Central Government of the Country issued through the Central Bank (RBI in India). They are zero risk instruments, and hence the returns are not so attractive. It is available both in primary market as well as secondary market. It is a promise to pay a said sum after a specified period. T-bills are short-term securities that mature in one year or less from their issue date. They are issued with three-month, six-month and one-year maturity periods. The Central Government issues T- Bills at a price less than their face value (par value). They are issued with a promise to pay full face value on maturity. So, when the T-Bills mature, the government pays the holder its face value. The difference between the purchase price and the maturity value is the interest income earned by the purchaser of the instrument. T-Bills are issued through a bidding process at auctions. The bid can be prepared either competitively or non-competitively. In the second type of bidding, return required is not specified and the one determined at the auction is received on maturity. Whereas, in case of competitive bidding, the return required on maturity is specified in the bid. In case the return specified is too high then the T-Bill might not be issued to the bidder.

At present, the Government of India issues three types of treasury bills through auctions, namely, 91-day, 182-day and 364-day. There are no treasury bills issued by State Governments. Treasury bills are available for a minimum amount of Rs.25K and in its multiples. While 91-day T-bills are auctioned every week on Wednesdays, 182-day and 364-day T-bills are auctioned every alternate week on Wednesdays. T-bills auctions are held on the Negotiated Dealing System (NDS) and the members electronically submit their bids on the system. NDS is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. RBI issues these instruments to absorb liquidity from the market by contracting the money supply. In banking terms, this is called Reverse Repurchase (Reverse Repo). On the other hand, when RBI purchases back these instruments at a specified date mentioned at the time of transaction, liquidity is infused in the market. This is called Repo (Repurchase) transaction.

**Repurchase Agreements**

Repurchase transactions, called Repo or Reverse Repo are transactions or short term loans in which two parties agree to sell and repurchase the same security. They are usually used for overnight borrowing. Repo/Reverse Repo transactions can be done only between the parties approved by RBI and in RBI approved securities viz. GOI and State Government Securities, T-Bills, PSU Bonds, FI Bonds, Corporate Bonds etc. Under repurchase agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date at a predetermined price. Such a transaction is called a Repo when viewed from the perspective of the seller of the securities and Reverse Repo when viewed from the perspective of the buyer of the securities. Thus, whether a given agreement is termed as a Repo or Reverse Repo depends on which party initiated the transaction.

**Commercial Papers**

Commercial paper is a low-cost alternative to bank loans. It is a short term unsecured promissory note issued by corporate and financial institutions at a discounted value on face value. They are usually issued with fixed maturity between one to 270 days and for financing of accounts receivables, inventories and meeting short term liabilities. Say, for example, a company has receivables of Rs 1 lacs with credit period 6 months. It will not be able to liquidate its receivables before 6 months. The company is in need of funds. It can issue commercial papers in form of unsecured promissory notes at discount of 10% on face value of Rs 1 lacs to be matured after 6 months. The company has strong credit rating and finds buyers easily. The company is able to liquidate its receivables Immediately and the buyer is able to earn interest of Rs 10K over a period of 6 months. They yield higher returns as compared to T-Bills as they are less secure in comparison to these bills; however chances of default are almost negligible but are not zero risk instruments.

**Certificate of Deposit**

It is a short term borrowing more like a bank term deposit account. It is a promissory note issued by a bank in form of a certificate entitling the bearer to receive interest. The certificate bears the maturity date, the fixed rate of interest and the value. It can

be issued in any denomination. They are stamped and transferred by endorsement. Its term generally ranges from three months to five years and restricts the holders to withdraw funds on demand. However, on payment of certain penalty the money can be withdrawn on demand also. The returns on certificate of deposits are higher than T-Bills because it assumes higher level of risk. While buying Certificate of Deposit, return method should be seen. Returns can be based on Annual Percentage Yield (APY) or Annual Percentage Rate (APR). In APY, interest earned is based on compounded interest calculation. However, in APR method, simple interest calculation is done to generate the return. Accordingly, if the interest is paid annually, equal return is generated by both APY and APR methods. However, if interest is paid more than once in a year, it is beneficial to opt APY over APR.

**Banker's Acceptance**

It is a short term credit investment created by a non financial firm and guaranteed by a bank to make payment. It is simply a bill of exchange drawn by a person and accepted by a bank. It is a buyer's promise to pay to the seller a certain specified amount at certain date. The same is guaranteed by the banker of the buyer in exchange for a claim on the goods as collateral. The person drawing the bill must have a good credit rating otherwise, the Banker's Acceptance will not be tradable. The most common term for these instruments is 90 days. However, they can vary from 30 days to 180 days. For corporations, it acts as a negotiable time draft for financing imports, exports and other transactions in goods and is highly useful when the credit worthiness of the foreign trade party is unknown. The seller need not hold it until maturity and can sell off the same in secondary market at discount from the face value to liquidate its receivables.

**Euro Dollars**

The Eurodollars are basically dollar-denominated deposits that are held in banks outside the United States. Since the Eurodollar market is free from any stringent regulations, the banks can operate at narrower margins as compared to the banks in U.S. The Eurodollars are traded at very high denominations and mature before six months. The Eurodollar market is within the reach of large institutions only and individual investors can access it only through money market funds.

## **Repos**

The Repo or the repurchase agreement is used by the government security holder when he sells the security to a lender and promises to repurchase from him overnight. Hence the Repos have terms ranging from 1 night to 30 days. They are very safe due to government backing. An individual player cannot invest in majority of the Money Market Instruments, hence for retail market, money market instruments are repackaged into Money Market Funds. A money market fund is an investment fund that invests in low risk and low return bucket of securities viz., money market instruments. It is like a mutual fund, except the fact mutual funds cater to capital market and money market funds cater to money market. Money Market funds can be categorized as taxable funds or non taxable funds. Having understood, two modes of investment in money market viz., Direct Investment in Money Market Instruments & Investment in Money Market Funds, let's move forward to understand functioning of money market account. Investment in Money Market Direct Investment in Money Market Instruments, Investment in Money Market Funds and Parking money in Money Market Account

## **Money Market Account**

It can be opened at any bank in the similar fashion as a savings account. However, it is less liquid as compared to regular savings account- It is a low risk account where the money parked by the investor is used by the bank for investing in money market instruments and interest is earned by the account holder for allowing bank to make such investment. Interest is usually compounded daily and paid monthly. There are two types of money market accounts:

### **Money Market Transactional Account**

By opening such type of account, the account holder can enter into transactions also besides investments, although the numbers of transactions are limited. **Money Market Investor Account**

By opening such type of account, the account holder can only do the investments with no transactions.

### **Money Market Index**

To decide how much and where to invest in money market an investor will refer to the Money Market Index. It provides information about the prevailing market rates. There are various methods of identifying Money Market Index like:

### **Smart Money Market Index**

It is a composite index based on intra day price pattern of the money market instruments.

### **Salomon Smith Barney's World Money Market Index**

Money market instruments are evaluated in various world currencies and a weighted average is calculated. This helps in determining the index.

### **Banker's Acceptance Rate**

As discussed above, Banker's Acceptance is a money market instrument. The prevailing market rate of this instrument i.e. the rate at which the banker's acceptance is traded in secondary market, is also used as a money market index.

### **Libor/Mibor**

London Inter Bank Offered Rate/ Mumbai Inter Bank Offered Rate also serve as good money market index. This is the interest rate at which banks borrow funds from other banks.

### **Conclusion**

Thus Money Market is part of financial market where instruments with high liquidity and very short term maturities are traded. Due to highly liquid nature of securities and their short term maturities, money market is treated as a safe place. Hence, money market is a market where short term obligations such as Treasury bills, commercial papers and banker's acceptances are bought and sold.