

A Study on Indian Money Market, Capital Market and Banking Legislations

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Abstract--- Money market consists of financial institutions and dealers in money or credit who wish 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. 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 bankers acceptances are bought and sold. The money market is a key component of the financial system as it is the fulcrum of monetary operations conducted by the central bank in its pursuit of monetary policy objectives. It is a market for short-term funds with maturity ranging from overnight to one year and includes financial instruments that are deemed to be close substitutes of money. The capital market and in particular the stock exchange is referred to as the barometer of the company's Government policy is so moulded that creation of wealth through products and services is facilitated and surpluses and profits are channelized into productive uses through capital market operations. The banks and financial institutions are playing a vital role for purchase and sale of securities for capital market.

I. INTRODUCTION

THE Money market refers to the market where borrowers and lenders exchange short term funds to solve their liquidity needs. Money market instruments are generally financial claims that have low default risk, maturities under one year and high marketability. The capital market is a market for financial investments that are direct or indirect claim to capital (Gant 1988). It is wider than the securities market and embraces all forms of lending and borrowing whether or not evidenced by the creation of a negotiable financial instrument. The capital market comprises the complex of Institutions and mechanisms through which intermediate term funds and long term funds are pooled and made available to business, Government and individuals.

II. OBJECTIVES OF THE STUDY

The study defines the following objectives:

- (1) To understand the features and components of Indian money market
- (2) To understand the features and components of Indian capital market
- (3) To understand the banking legislations in India
- (4) To find out the draw backs and difficulties and also analyzing the remedial measures.

III. STRUCTURE OF MONEY MARKET

The structure of money market can be divided into two parts, viz., organized and unorganized. Organized structure includes, Reserve bank of India, DFHI (Discount and Finance House of India), Commercial Banks (Public Sector Banks, SBI & its Associates, Cooperative banks, Private sector banks and Foreign banks), Development bank IDBI, IFCI, ICICI, NABARD, LIC, GIC, UTI etc.

The unorganized structure includes: Indigenous banks, Money lenders, Chits & Nidhis, Co-operative Sector (State and central cooperative banks, Primary urban banks, Primary Agri. credit societies, State, Central and Primary Land development banks)

IV. FUNCTIONS OF MONEY MARKET

The money market performs three broad functions.

- (a) It provides an equilibrating mechanism for demand and supply of short-term funds. It enables borrowers and lenders of short term funds to fulfil their borrowing and investment requirements at an efficient market clearing price.
- (b) It provides an avenue for central bank intervention in influencing both quantum and cost of liquidity in the financial system, thereby transmitting monetary policy impulses to the real economy.
- (c) The objective of monetary management by the central bank is to align money market rates with the key policy rate. As excessive money market volatility could deliver confusing signals about the stance of monetary policy, it is critical to ensure orderly market behaviour, from the point of view of both monetary and financial stability.

V. FEATURES OF MONEY MARKET IN INDIA

It is a market purely for short-term funds or financial assets called near money. It deals with financial assets having a maturity period less than one year only. In Money Market, transactions can be done through oral communication, relevant document and written communication. Transactions have to be conducted without the help of brokers. It is not single

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homogeneous market, it comprises of several sub market like call money market, acceptance bill market. The players in the money market include Commercial Banks, Acceptance Houses and NBFC (Non-Banking Financial Companies).

VI. IMPORTANCE OF MONEY MARKET

(A) Development of trade and industry. (B) Development of capital market. (C) Smooth functioning of commercial banks. (D) Effective central bank control. (E) Formulation of suitable monetary policy. (F) Non-inflationary source of finance to government.

VII. COMPOSITION OF MONEY MARKET

Money Market consists of a number of sub-markets which collectively constitute the money market. They are (A) Call Money Market, (B) Commercial Bills Market, (C) Acceptance Market, and (D) Treasury bill Market.

VIII. MONEY MARKET INSTRUMENTS

Investment in money market is done through money market instruments. Common Money Market Instruments are as follows: (A) Treasury Bills (T-Bills), (B) Central Government Securities (Gilt-edged Securities) (C) State Government and Public Sector Instruments, (D) Municipal Bonds, (E) Commercial Papers, (F) Certificates of deposits, (G) Bills Rediscounting, (H) Call/Notice Money Market (I) Repurchase Agreements (Repos) (J) Inter Bank Participation, (K) Bank deposits, (L) Term Money (M) Corporate Debentures and Bonds, (N) Bankers' Acceptance (O) Fringe Market

Let us Understand Important Money Market Instruments in Detail

a. Treasury Bills (T-Bills)

Treasury Bills, are the safest money market instruments, 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.

b. Repurchase Agreements

Repurchase transactions, are called Repo or Reverse Repo 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. The lender or buyer in a Repo is entitled to receive compensation for use of funds provided to the counterparty. Effectively the seller of the security borrows money for a period of time (Repo period) at a particular rate of interest mutually agreed with the buyer of the security who has lend the funds to the seller. The rate of interest agreed upon is called the Repo rate.

c. 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 1 to 270 days and for financing of accounts receivables, inventories and meeting short term liabilities. Say, for example, a company has receivables of ` 1 lakh with credit period 6 months. It will not be able to liquidate its receivables before 6 months. The company is in need of funds. The company may issue commercial papers. 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. Commercial paper being an instrument not backed by any collateral, only firms with high quality credit ratings will find buyers easily without offering any substantial discounts.

d. 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.

e. Bankers' 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

f. *Commercial Bills*

Purchase and discounting of commercial bills is a way by which banks provide funds for working capital required by commerce, trade and industry. The financial instrument trading in the bills market is the bill of exchange. It is a written instrument containing unconditional order signed by the maker, directing to pay a certain amount of money to a particular person, or to the bearer of the instrument. It is a negotiable self-liquidating instrument with low degree of risk. Its liquidity is exceeded only by T-bills, call loans and cash, in that order. The spread between the face value of the bill and ready cash paid is the discount rate. Till the bill matures, the banks can use the same process of discounting to get ready cash. The eligibility criterion is that the bill should arise out of a genuine trade transaction and the maturity period should fall within 90 days from the date of discounting.

g. *Term Money*

RBI has permitted some of the Financial Institutions like IDBI, ICICI, IFCI, HBI, SIDBI, NABARD, EXIM-Bank etc. to borrow from the market for a period of 3 months and up to a period of not more than 6 months within the stipulated limits. The rate of interest on the term money is determined between the parties by mutual negotiation. The investment in term money is unsecured and the limits are fixed by RBI. The term money is accepted by their institutions at a discounted value. On the due date the payment will be equal to the face value of the instrument, which for all purpose consists of term deposit receipt.

h. *Bank Deposits*

The banks are permitted to keep deposits with other banks for a period of 15 days and above. The rate of interest of such deposits is freely determined by the two banks between themselves through negotiations. These deposits are not reckoned for the purpose of cash reserve ratio (CRR) requirements. Like the call/notice money transactions, the transactions relating to the bank deposit is evidenced by way of deposit receipt. These deposits are not transferable, but they could be prematurely closed at the discretion of the lender and Bankers' Acceptance:

i. *Call Money Market*

Call money refers to that transaction which is received or delivered by the participants in the call money market and where the funds are returnable next day. The call money transactions are also referred to as overnight funds. Notice money on the other hand is a transaction where the participants will take time to receive or deliver for more than two days but generally for a maximum of fourteen days. In both the cases the transaction is unsecured. Therefore, as a prudential measure, a counter-party exposure limits are listed according to which the lender lends money. In short, resorting to the call/notice money transactions reflect temporary mismatch of funds during the short period of one to fourteen days. The participants, who have surplus, lend their money to shed the mismatch for the relative period. The participants, who are short of funds, would borrow funds for the relative period. The rate at which the funds will be deployed or borrowed will be determined on the basis of the market

conditions at a given point of time. When the market is highly liquid, the funds would be easily available whereas the funds will be difficult to obtain in a tight money market conditions.

IX. DEFINITION OF CAPITAL MARKET

It is a place where people buy and sell financial instruments such as equity or debt. It is a mechanism to facilitate the exchange of financial assets. The capital market includes primary and secondary markets. Examples of secondary markets in India include BSE& NSE which constitute majority of the capital market transactions.

Significance of Capital Markets: It understands that well-functioning stock market may help the development process in an economy through the following channels:

- (a) Growth of savings.
- (b) Efficient allocation of investment resources.
- (c) Better utilization of the existing resources.

X. CAPITAL MARKET INSTRUMENTS AND PARTICIPANTS

The capital market is a place where long term funds are borrowed and lent. Capital Market Instruments include Equity, Preference shares, Debenture/ Bonds, ADRs/ GDRs and Derivatives. In the equity segment: we have equity shares, preference shares, convertible preference shares, non-convertible preference shares, etc. In the debt segment: we have debentures, zero coupon bonds, deep discount bonds, etc. Section 85 of the Companies Act, 1956 permits public limited companies (having share capital) to have two kinds of shares namely-Equity and Preference. Apart from the traditional securities, we have lot of innovative (eg. Sweat Equity Shares) and Hybrid Instruments which are coming up in the market.

Foreign institutional investors have emerged as major players on the Indian bourses. NSE has an upper hand over its reveal BSE in terms of volumes not only in the equity markets but also in the derivatives market. It has been a long journey for the Indian capital market. Now the capital market is organized, fairly integrated, mature, more global and modernized. The Indian equity market is one of the best in the world in terms of technology. Advances in computer and communications technology coming together on Internet are shattering geographic boundaries and enlarging the investor class. Internet trading has become a global phenomenon. The Indian stock markets are now getting integrated with global markets.

XI. BANKING LEGISLATIONS IN INDIA

Evolution of Legislative Regulation of Banking in India: In the very early phase of commercial banking in India, the regulatory framework was somewhat diffused and the Presidency Banks were regulated and governed by their Royal Charter, the East India Company and the Government of India of that time. Though the Company law was introduced in India way back in 1850, it did not apply to the banking companies. The banking crisis of 1913, however, had revealed several weaknesses in the Indian banking system, such as the low proportion of liquid assets of the banks and connected lending practices, resulting in large-scale bank failures.

The recommendations of the Indian Central Banking Enquiry Committee (1929-31), which looked into the issue of bank failures, paved the way for legislation for banking regulation in the country. Though the RBI, as part of its monetary management mandate, had, from the very beginning, been vested with the powers, under the RBI Act, 1934, to regulate the volume and cost of bank credit in the economy through the instruments of general credit control, it was not until 1949 that a comprehensive enactment, applicable only to the banking sector, came into Existence. Prior to 1949, the banking companies, in common with other companies, were governed by the Indian Companies Act, 1913, which itself was a comprehensive re-enactment of the earlier company law of 1850. This Act, however, contained a few provisions especially applicable to banks.

There were also a few ad hoc enactments, such as the Banking Companies (Inspection) Ordinance, 1946, and the Banking Companies (Restriction of Branches) Act, 1946, covering specific regulatory aspects. In this backdrop, in March 1949, a special legislation, called the Banking Companies Act, 1949, applicable exclusively to the banking companies, was passed; this Act was renamed as the Banking Regulation Act from March 1966. The Act vested in the Reserve Bank the responsibility relating to licensing of banks, branch expansion, and liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation.

It is interesting to note that till March 1966, the Reserve Bank had practically no role in relation to the functioning of the urban co-operative banks. However, by the enactment of the Banking Laws (Application to Co-operative Societies) Act, 1965, certain provisions of the Banking Regulation Act, regarding the matters relating to banking business, were extended to the urban co-operative banks also. Thus, for the first time in 1966, the urban co-operative banks too came within the regulatory purview of the RBI.

Legal Framework – Financial Sector in India

Umbrella Acts: Reserve Bank of India Act, 1934: governs the Reserve Bank Functions Banking Regulation Act, 1949: governs the financial sector Acts Governing Specific Functions: Public Debt Act, 1944/Government Securities Act (Proposed): Governs government debt market. Indian Coinage Act, 1906: Governs currency and coins Foreign Exchange Regulation Act, 1973/Foreign Exchange Management Act, 1999: Governs trade and foreign exchange market Acts governing Banking Operations Companies Act, 1956:Governs banks as companies Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980:Relates to nationalization of banks, Bankers' Books Evidence Act, Banking Secrecy Act, Negotiable Instruments Act, 1881,Acts governing Individual Institutions, State Bank of India Act, 1954,The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003,The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act,1993,National Bank for Agriculture and Rural Development Act, National Housing Bank Act, Deposit Insurance and Credit Guarantee Corporation Act

Findings and Recommendations

Regulation and supervision of the financial system has received renewed focus in recent years in the context of the phenomenal expansion of the financial sector, technology-enabled innovations in financial products and deepening of global integration. The strategic importance of the banks in the financial system make it imperative for the central bank—historically, the lender of the last resort and the supervisor of the banking system—to pursue financial stability as an important macroeconomic objective, although, in India, there are separate institutions (*viz.*, the SEBI and the IRDA) to oversee the functioning of individual segments of the financial system. A number of initiatives have been taken by the Reserve Bank in reorienting the supervisory and regulatory framework and aligning it with the international best practices, while providing sufficient flexibility to the financial institutions to respond to the growing competition and taking advantage of the business opportunities unfolded by technological advancements.

Narasimham Committee II made a range of recommendations for improving the vigour of the banking system (capital adequacy, asset quality, nonperforming assets, *etc.*) as also for strengthening the supervisory systems.

The Committee observed that the issue of 'autonomous status' for the Board for Financial Supervision (BFS) of the Reserve Bank should be considered to segregate the regulatory and supervisory functions of the apex bank. The Committee made specific recommendations to restructure the BFS and to set up a separate Board for Financial Regulation and Supervision (BFRS). The committee also highlighted the need for a review of banking sector laws, such as, the RBI Act, the Banking Regulation Act, the Nationalization Act and the State Bank of India Act. The recommendations made by the Committee are being progressively implemented.

Following the recommendations of the Narasimham Committee II and more recently in the context of the Basel II Accord, the Reserve Bank has taken several measures to strengthen its regulatory and supervisory framework with a view to ensuring a sound, efficient and vibrant financial system in the country. The measures to contain the level of nonperforming assets (NPAs) include the setting up of Debt Recovery Tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions, LokAdalats (people's courts) and Asset

Reconstruction Companies and Corporate Debt Restructuring (CDR) mechanisms: In order to ensure the functioning of institutions and markets on the basis of informed decisions, the Reserve Bank has issued guidelines to banks to enhance the level of transparency and disclosures with regard to their financial position. Bank regulation is increasingly getting risk based with the realization that the traditional supervisory practices were out of step with the sophisticated risk management techniques. The International Convergence of Capital Measurement and Capital Standards: A Revised Framework (popularly known as Basel II) has brought regulation and risk management to the centre stage.

Basel II rests on three pillars: minimum capital requirements, supervisory review process and market discipline. India has decided that all the commercial banks would have to be Basel II compliant by adopting, at a minimum, the Standardized Approach for credit risk and Basic Indicator Approach for operational risk under Pillar 1. As regards the supervisory review process (Pillar 2), the role of supervisors is to evaluate whether or not the banks are assessing their capital requirements properly in relation to their risks and if necessary the supervisors may intervene to mandate a higher capital requirement. Basel III framework introduces a paradigm shift in capital and liquidity standards, which was constructed and agreed to in relatively record time. Basel III proposals have two main objectives:

To strengthen global capital and liquidity regulations with the goal of promoting and a more resilient banking sector.

To improve the banking sector ability to absorb shocks arising from financial and economic stress, this, in turn, would reduce the risk of a spill over from the financial sector to the real economy. To achieve these objectives, the Basel III proposals are broken down into three parts on the basis of the main areas they address: Capital reform (including quality and quantity of capital, complete risk coverage, leverage ratio and the introduction of capital conservation buffers, and a counter cyclical capital buffer); Liquidity reform (short term and long term ratios); and other elements relating to general improvements to the stability of the financial system)

XII. CONCLUSION

The Indian regulatory regime for the banking sector has come a long way over the past six decades. The current regulatory dispensation is ownership neutral, non-discriminatory and provides a level playing field for the market participants. There is considerable scope for improvements in the regulatory systems in India and we have been pursuing a policy of constant improvements through a participative and consultative approach with market participants. The policy outcomes so far, in terms of contribution to growth, price stability, financial stability, efficiency and robustness of banking sector have been significant by all standards of measurements, but the search of excellence, in the RBI's mission, is an unending journey.

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