

 **PART FOUR** 
Financial Instruments

CHAPTER

12

CALL MONEY MARKET

INTRODUCTION

The Call/Notice money market formed the core segment of the Indian money market for many decades. The banks were the main players for a long time. The call money market plays a crucial role in liquidity management. Prior to the mid-1980s, the market participants heavily depended on the Call money market for meeting their funding requirements. The reforms in the called money market commenced in 1988 have widened the scope of the money market. As a result of various measures, new markets and new instruments have been introduced to ensure orderly market behaviour. Even then, the call money market has been playing an active role in the economy. Against the above backdrop, this chapter discusses the development in the call money market.

SEGMENTS OF THE INDIAN MONEY MARKET

The money market is the market in which short-term funds are borrowed and lent. The money market is not a single homogeneous one but is composed of several submarkets, each one dealing in different types of short-term credits. The most important components of the money market are:

- (i) Call money market;
- (ii) Acceptance market;
- (iii) Bill market;
 - (a) Treasury bills market
 - (b) Commercial bills market
 - (c) Commercial Paper market
- (iv) Repo Market
- (v) Term Money Market
- (vi) Certificate of Deposits

- (vii) Collateralized Borrowing and Lending Obligation (CBLO)
- (viii) Government securities market and
- (ix) Gilt-edged market.

CALL MONEY MARKET

The call money market, which deals in overnight funds, is a key segment of the money market in India. Funds for 2 to 14 days are termed as notice money. Various reform measures initiated in this segment have resulted in more orderly conditions and increased liquidity.

The call money market refers to the market for extremely short-period loans. Bill brokers (*i.e.*, those who buy bills) and dealers in the stock exchange require financial accommodation for short periods to finance their customers' trading on margin and their own holdings of securities and this financial accommodation is provided by the banks. The money advanced by banks to bill brokers and stock exchange dealers is lent up to seven days, but more often it is lent from day-to-day or for overnight only. These loans are commonly known as call loans or call money since the bank can call them back at the shortest possible notice. Call loans are found useful by banks for more than one reason. First of all, since they can be converted to cash at any time, they are almost like cash and banks consider their money at call and short notice as their secondary cash reserves. Secondly, unlike cash, they bring some income for the banks. The call money market, composed of commercial banks as lender and the stock exchange brokers and dealers as borrowers, has always been a very important segment of the money market.

The Indian call money market is undergoing a historic transformation. It is moving from acting as a mechanism for ensuring liquidity amongst banks to performing a more dynamic and active role in the Indian money market. The extremely volatile conditions prevailed in this market, seriously jeopardising the levels of profitability of many banks. Before the causes for this volatility are identified, it would be useful to take a quick look at the evolution of the market today.

HISTORICAL PERSPECTIVE

The Indian call money market is one of the oldest money market in India. Earlier stages of its evolution were characterised by the presence of individuals in the market as participants. Call money operations used to be the foreign exchange banks' original mainstay and the Indian banks' participation was minimal. Indian banks have been actively participating in the market only since 1956. In 1970, the monetary authorities permitted the LIC and the UTI to operate in the call money market. With their entry, the call money market no longer remained the exclusive preserve of banks and became an inter-institutional call money market. The State Bank Group entered the call money market as late as October 1970. By this time, individuals had ceased to operate in the market.

Brokers were very active in the call money market till 1977. Towards the end of 1977, the Reserve Bank suddenly stopped the participation of brokers in the call money market. At first, the brokers continued without brokerage in the hope that their role will be restored. Banks initially felt helpless without brokers and tried to persuade the Reserve Bank to allow the

participation of the brokers. Finally, despite representations by banks and brokers, the Reserve Bank insisted on eliminating brokers from the call money market.

During 1973, suddenly, the rate in the call money market shot up to 39%, reflecting acute shortage of funds, excessive credit squeeze and financial tightness everywhere. It was at this stage that the Indian Banks' Association (IBA) decided to step in and fixed a ceiling of 15% on the call money rate. This persuasive and forceful action on the part of the IBA with moral support from the Reserve Bank ensured enforcement of voluntary ceiling and self-discipline among the participants, though from time to time discipline tended to burst at critical times like yearly closing of accounts or peak season pressures. But by and large, the IBA's discipline and good sense of banks survived and the IBA was also able to bring down the ceiling progressively from 15% in December 1973 to 10% in 1978 and it worked almost in this manner for a decade.

The situation, however, began to change dramatically since the mid-1980s. Banks faced with a slower rate of deposit growth on the one hand and restrictive credit policy of the Reserve Bank on the other, experienced a growing pressure on their profitability and tight conditions prevailed in the money market. The result was that the IBA imposed ceiling on the call money rates which was observed more in breach. The lending banks, while officially sticking to the ceiling rate, sought compensation elsewhere, particularly in ready forward deals in government securities.

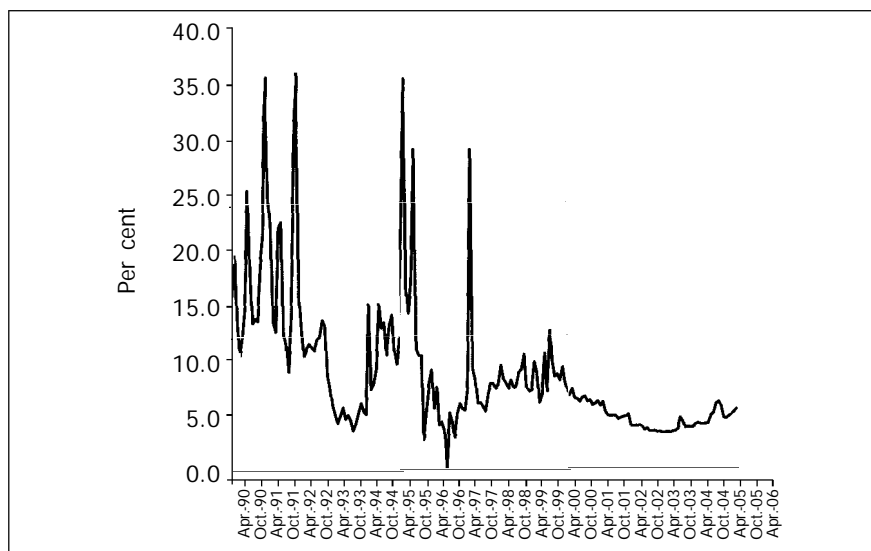
It was against this background that the Vaghul Working Group (1987) on Money markets recommended freeing of call money rates for inter-bank transactions. The Reserve Bank responded promptly, initially by exempting the operations of the DFHI in the call money market from the provisions of the ceiling rate of interest and from May 1, 1989, completely withdrawing the ceiling on interest rates on call/notice money. The Reserve Bank, in fact, went a step further and permitted other Financial Institutions (FIs) to operate in the call money market as lenders with a view to broadening the market. Establishment of the DFHI in April 1988 added a new dimension to the call money market. A large number of non-bank participants such as mutual funds, insurance companies and corporates are allowed to lend in the call/notice money market through Primary Dealers (PDS) from March 1995. The latest innovation has been the Reserve Bank's decision to permit banks to establish Money Market Mutual Funds (MMMMFs) through which cash rich corporates and even individuals could operate in the call money market.

The Indian call money market has thus undergone a virtual metamorphosis in recent years.

The call money market during the 1990s witnessed orderly conditions barring a few episodes of volatility (Chart 12.1). The call rates first came under pressure in May 1992 when they touched a peak of 35.3 per cent, essentially reflecting liquidity tightness due to high levels of statutory preemptions and withdrawal of all refinance facilities except for export credit refinance. After witnessing tranquil conditions during July 1992-December 1994, the call money market came under pressure again during 1995-96. The call rate touched a peak of around 35.0 per cent in November 1995, largely mirroring turbulence in the foreign exchange market. To stabilise the market, the Reserve Bank injected liquidity through reverse repos, enhanced banks' refinance facilities against government securities and reduced the CRR. The call rate softened to a single digit level thereafter till December 1997. However, the call rate hardened again and touched a high of around 29 per cent, in January 1998, reflecting the mopping up of money market

liquidity by the Reserve Bank to squelch the pressure in the foreign exchange market. During 1999-2000, the inter-bank call money rates ruled steady within a narrow range, excepting few bouts of volatility, primarily attributable to the unanticipated demand for reserves by commercial banks.

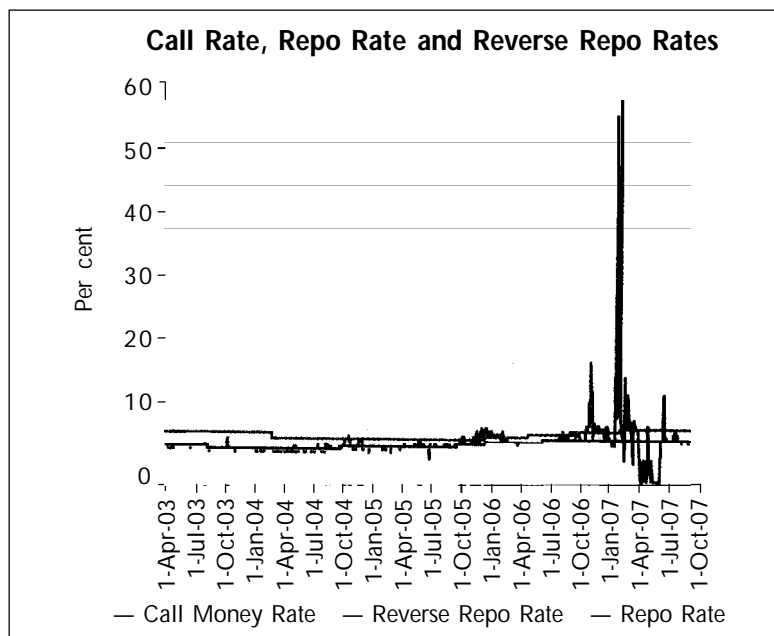
Chart 12.1: Behaviour of Call Rates (Monthly Average)



Thus, excepting a few episodes of volatility conditions in the call money market remained stable in the 1990s. The full-fledged Liquidity Adjustment Facility (LAF), which was introduced on June 5, 2000, with a view to modulating short-term liquidity under diverse market conditions, has emerged as an effective instrument to provide a corridor for the overnight call rate movement. This has resulted in stability and orderly market conditions through clear signaling (Chart 12.2). The LAF combined with strategic open market operations (OMOs) has since been used to signal the monetary stance by removing shortfalls and excesses of liquidity in the system so as to keep the short-term interest rates reasonably stable.

The level of weighted average call money borrowing rates declined from around 7.5 per cent in April 2001 to 5.7 per cent in February 2003. The LAF has also enabled a reduction in the volatility in call rates (measured by coefficient of variation) from 85.7 per cent during 1997-98 to 7.6 per cent during 2002-03 so far (April to February).

Chart 12.2: Evolution of Liquidity Adjustment Facility



During the first half of the 1990s, volumes in the call money market at Mumbai remained more or less steady. However, the turnover increased sharply and fluctuated widely during the last few years. The average daily turnover rose from ` 23,221 crore in 1999-2000 to ` 30,320 crore in 2000-01 and further to ` 35,144 crore in 2001-02, before falling to ` 21,725 crore in 2006-07. On June 19, 2008 the volume of trade in the call money market aggregated to ` 15,357.03 crore. The turnover in the call/ notice market should also be seen alongside the repo amount accepted by the Reserve Bank on a daily basis where one can observe substantial volatility. LAF has been effective in reducing the volatility in the call notice money market.

While these developments are worth a welcome, what is causing concern in the minds of the bankers is the growing volatility of the call money rates. Immediately after the withdrawal of the ceiling from May 1, 1989, particularly during the month of May 1989, the rates were less than 10 per cent for just 3 days, between 11 and 20 per cent for 12 days, between 21 and 30 per cent for 3 days and between 31 per cent and 40 per cent for 6 days. The lowest rate was 4 per cent in the first week of May and the highest rate was 40 per cent in the last complete week of that month. The trend continued in the following months and relatively steady conditions became an exception rather than the rule. Call rates eased below the repo rate between March 5.15 2007. Call rates ranged between 6.25-8.25 percent on June 19, 2008.

After years of the regime, the somewhat regimented interest rates (with a ceiling of 10 per cent), the freedom given to determine the rate without any ceiling or floor caused problems for the market participants to adjust to this new reality. The call market where oligopolistic conditions were then prevalent with few big lenders dominating the market, smaller borrowing banks were the worst sufferers and doubts were often raised whether withdrawal of the ceiling was a step in the right direction. With the entry of many FIs as lenders, the market is no longer oligopolistic today as it was then.

MONEY MARKET OPERATIONS

Call money market (Jun. 21) Volumes (` crore) 2,554.85	<i>Weighted Avg.</i> 8.12	<i>Range</i> 7.00-8.25	
Notice money market (Jun. 21) Volumes (` crore) -	<i>Weighted Avg.</i> -	<i>Range</i> —	
Term money market (Jun. 21) Volumes (` crore) 150.00	<i>Weighted Avg.</i> -	<i>Range</i> 8.40-8.40	
Liquidity adjustment facility (Jun. 23)	<i>Bids</i>	<i>Amount (` cr)</i>	<i>Rate (%)</i>
1 day repo	25	32,215.00	8.00
1 day reverse repo	Nil	NA	6.00

CALL MONEY RATES

The inter-bank call money rates zoomed to 85 per cent levels on 01-11-1995 after opening at 40.5-41.75 per cent levels. The volatility in call money rates relatively depends on the liquidity in the market. The recent interventions in the forex markets by the RBI also seem to have sucked a considerable amount of liquidity out of the market. The RBI and the Securities Trading Corporations of India (STCI) has pumped in ` 500 crore and ` 250 crore each into the call money market.

The Securities Trading Corporation of India Limited was set up in May 1994 by the Reserve Bank of India (RBI) jointly with public sector banks and all-India financial institutions for developing the market infrastructure to foster the growth of an active secondary market in Government securities and public sector bonds.

The STCI is a leading participant in the call money market. The primary function of the STCI is to regulate the call rates during volatile situation. The business of dealing in Government dated fixed income securities is somewhat risky as even a slight upward movement in yield curve could result in significant depreciation in the value of the portfolio. Similarly, a rise in call rates could significantly raise the funding costs.

The call/ notice money market essentially serves the purpose of equilibrating the short-term liquidity position of banks and other participants. The turnover in the call/notice money market depends on the amount of surplus funds available with some participants and the requirements of funds by some other participants. Over the years, the number of participants in the market has gradually increased to include banks and Primary Dealers both as lenders and borrowers, and select mutual funds, insurance companies, development financial institutions and corporate through Primary Dealers (as lenders).

The supply of and demand for funds in the market arise on account of (i) compliance with cash reserve requirement of banks as mandated by the Reserve Bank, (ii) as a funding source to build up assets, (iii) temporary surpluses that are available with lenders, (iv) foreign exchange flows and (v) seasonal factors such as festival, election, harvesting, advance tax payments, etc. Over the years, a few banks tended to be overly exposed to the call/notice money market. Such banks relied excessively on the call money market for carrying out banking operations and long-term as secretion. The Narasimham Committee II (1998) recommended that there must be clearly defined prudent limits beyond which banks should not be allowed to rely on the call/ notice money market and that access to this market should essentially be for meeting unforeseen mismatches and not as regular means of financing banks' lending operations. With the progressive regulations, asset liability management system was put in place, which kept the mismatches in cash flows in the 1-28 days bucket under check. As part of streamlining the Liquidity Adjustment Facility and improving the transmission channel of monetary policy, the phasing out of non-bank participants from the call money market commenced from May 2001. Furthermore, recognizing that building up of substantial exposure to the call/notice money market relative to the balance-sheet size by some participants on a continuous basis has the potential not only for default and the consequent systemic instability but also impeding other segments of the money markets, participants are now operations within limits on both lending and borrowing operations. Thus, the call/notice money market is evolving as a pure inter-bank market with ALM discipline for participants and prudential limits for borrowing and lending.

With the establishment of the Clearing Corporation and the enhanced liquidity in the repo market both in government and non-government securities, it is envisaged that eventually both the call market and the repo market combined with other money market instruments, would constitute an integrated market for equilibrating short-term funds for both banks and non-banks.

DEVELOPMENTS IN THE SHORT-TERM MONEY MARKET

A freely operating money market is a sensitive barometer of current conditions in the financial markets and, ideally, it should provide for market clearing of short-term surpluses and deficits. In a series of measures since 1987, a number of liberalisations have been made to develop the money market. Briefly, these are: (i) Introduction of 182-Day Treasury Bills on an auction basis. (ii) Introduction of two new money market instruments, viz., Certificates of Deposits (CD) and Commercial Paper (CP). While the CD provides for a market-determined rate of return on bulk deposits, the CP enables prime borrowers to raise short-term funds from the market. The scope and eligibility criteria in respect of these instruments have also been liberalised in successive credit policy pronouncements of the RBI. (iii) Rationalisation of the bill discount rates and stipulations as to the use of bills for credit purchases and credit sales by large bank borrowers. (iv) Introduction of two kinds of Inter-Bank Participation Certificates (IBPCs) with risk and without risk. (v) Removal of interest rate ceilings on call and notice money, inter-bank term money, inter-bank participations without risk and rediscounting of commercial bills. (vi) Setting up of the Discount and Finance House of India (DFHI) to develop an active secondary market in money market instruments, which has very recently been allowed to engage in secondary trading in government securities, and (vii) Enlarging the scope of the call money market, where, apart from the LIC and UTI, the GIC, IDBI and NABARD were allowed as lenders from May 1990, to

be followed in October that year by all institutions participating in the bills market. Steps were also taken to contain the spiralling of money market rates which remain free and have to bear the burden of equilibrating the system.

Developments in the inter-bank call money market have always been causing concern for the bankers and RBI, as the call money rates of interest during liquidity crisis has been rising to astronomical level, though official ceiling on call money rate was prescribed. This concern was posing a challenge for a long time and an effective solution was being evaded. With the new measures introduced to activate the money market, a solution to overcome the problem of liquidity crisis faced by the banks seemed to be in sight. The establishment of DFHI is expected to go a long way in bringing about equilibrium and stability in the call money operations.

The Reserve Bank of India's decision to permit private sector mutual funds to lend funds in the inter-bank call money market would help them earn higher returns. The immediate impact would be limited as an estimated ` 50 crore may flow to the call money market, but the RBI decision opens a new avenue for parking short-term funds. This is seen to a certain extent in the market.

Moreover, the announcement would also have a positive impact on a macro level as it would bring some amount of stability to the volatile call money market as the liquidity would now enter the call money market in "*consolidated bunch*" rather than from scattered sources.

While the decision to allow private sector mutual funds the access to call money market as lenders has found favour with managers of these funds, they are not expecting a huge quantum of money to flow into the call money market. Their contention is that the funds that would be diverted to the call money market would be a tiny fraction of the 25 per cent of the total corpus that a mutual fund can invest in the money market.

THE HOWS AND WHYS OF THE CALL MONEY MARKET

BOX: 12.1

The developments in the inter-bank call money market have dominated the headlines on the front pages of most newspapers. What is this market? Here is a handy primer on the market:

What is the inter-bank call market?: The inter-bank call market is part of the domestic money market from where banks borrow and lend on a daily basis. The daily turnover of funds in this market is currently estimated at ` 8,000 crore.

Who can participate in this market?: All scheduled commercial banks (private sector, public sector and cooperative banks), financial institutions (term-lending institutions, insurance companies) and mutual funds can participate in this market. Non-banking finance companies, however, are not allowed to participate in this market as yet.

Participants are split into two categories. The first comprises those who can both borrow and lend in this market, and the second, those who can lend but borrow. Only the banks can do both.

Why does a bank borrow in the call market?: Banks borrow in the call market to meet any temporary shortfall in funds on any given day. There are mainly two reasons why a bank may face such a shortfall. Banks normally lend out of the deposits that they mobilise. But there are temporary gaps, or mismatches. The call money market is used to manage these gaps.

The second reason is to meet the cash reserve ratio (CRR) which is the cash reserves it must maintain with the Reserve Bank of India, to meet daily cash needs of the banks' clientele. In India, banks have to keep 14.5 per cent of all their borrowings from the public (in the form of savings and term deposits) and other banks with the RBI. The CRR is calculated on the basis of the bank's borrowings or net time and demand liabilities (NDTL), broadly its deposit base, every alternate Friday. This day is also called the reporting Friday, on which the banks report their positions to the RBI. So, the CRR is calculated at 825 (w.e.f. for 28-05-08) per cent of the NDTL as of the last Friday.

For how long can a bank borrow these funds?: Technically, the call money market is an overnight money market. But a bank can borrow these funds for between one day upto 14 days. Normally, funds are borrowed for one day, and up to three days on weekends.

How is the rate of interest paid?: The rate of interest is calculated on a daily basis; but the rate quoted in the market is an annualised one. Once the deal is struck the funds are immediately available to the borrowing bank and the loan is returned with interest the next day. The funds are lent and paid back through a banker's pay order, which is cleared by the special high value banker's clearing cell in the RBI.

Can the RBI lend in the call market? What does intervention by the central bank mean?: The RBI is the market regulator and cannot lend or borrow funds in the call market. However, as a regulator, it can intervene in the market as it did when rates go through the roof. It intervenes in the market through two market intermediaries — the Securities Trading Corporation of India and Discount Finance House of India. The STCI lends funds against the government securities that a bank holds with an offer to sell back the security (called repurchases or repos), while the DFHI lends funds that it receives from the central bank against repos of certain securities specified as eligible for the same. The RBI also allows banks to rediscount proceeds of export bills of exchange.

Why do rates fluctuate? What does this indicate?: The rates fluctuate in the market depending on the demand and supply of money in the market. High rates indicate a tightness of liquidity in the financial system, while low rates indicate an easy liquidity position. In India, rates in the call market are prone to fluctuations and are unidirectional. This is due to the fact that it has a limited number of players whose needs are similar.

Source: RBI

ROLE OF DFHI

The Discount and Finance House of India (DFHI) entered the call money market at the end of July 1988. And, from October 1988, the DFHI was no longer subject to the provisions of the ceiling on the call/notice money set out by the IBA.

Thus, DFHI was permitted to borrow and lend and also arrange funds in the interbank call/notice market. In the October 1988 credit policy announcement, the Reserve Bank of India set out that the operations of DFHI in the call and short notice money market will not be subject to the provision of the ceiling rate fixed by the Indian Banks Association. The limited freeing of the interest rate in the call and short notice money market was expected to bring about some improvement in the equilibrating mechanism of the market without raising the rates too high.

The DFHI also played an effective role in the inter-bank call/short notice money market with the active support of banks, UTI and LIC. The lending rates generally ruled within the ceiling rate during the slack season and almost up to middle of January 1989. As the stringency for funds grew, the overnight call money rate slowly edged up and remained in the region of 11.50-13.50 per cent per annum.

To enable price discovery, interest rates in the money market were freed in 1989. In the case of call money, the rates were deregulated in stages. DFHI is thus a market leader in stabilising the call money market. The presence of DFHI in the call money market facilitates the financial sector.

Nevertheless, DFHI insists on being able to hold the reins of the market and intervening in the market to balance liquidity, especially in the overnight money market, despite resourcefully strong institutions and large public sector banks being at an advantage.

The DFHI, in close co-ordination with the RBI, works out an indicative volume of funds when the market is in need. The RBI, in turn, based on its liquidity assessment and its monetary policy stance, routes the funds through DFHI to conduct repos, even though the amount suggested by the DFHI and the amount released by the RBI has often differed.

ADVANTAGE FOR BANKS FOR HOLDING OF 182 DAYS TREASURY BILLS

The DFHI would buy and sell outright 182 Days Treasury Bills and selectively repurchase/resell the Bills only from/to banks for short periods up to 14 days at pre-determined prices. It will quote its bid and offer rates for different maturity bonds with a fine spread. Prices quoted by DFHI would depend upon the demand and supply of bills in the money market.

The presence of DFHI in the 182 Days Treasury Bill Market would help in developing considerable depth to the market and the transactions in the secondary market would turn attractive with genuine two-day operations.

Reserve and Funds Management is a key functional area in banks. SLR/CRR management could be skilfully managed if in the investment portfolio, there is a reasonable proportion of investments in Treasury Bills. Better cash management can release balances which can be invested in Treasury Bills. Banks could acquire such bills in the primary market and now in the secondary market as well. DFHI will buy and sell Treasury Bills in between auction periods and thus provide liquidity for these investments. From the reserve management angle, it is highly desirable for banks to invest in Treasury Bills. Banks can then convert the SLR surpluses which are held in the form of Treasury Bills into cash balances as and when required for meeting the CRR obligations, thus optimising the use of funds. Banks can also create a second tier in the secondary market by trading in Treasury Bills with their clients.

CONSTITUTION OF A MONEY MARKET (STABILISATION) FUND

Development of the money market on sound lines is an avowed objective of the monetary policy. To achieve this objective, it is suggested that the Reserve Bank take initiative in constituting a fund styled '*Money Market (Stabilisation) Fund*' for the orderly functioning of the call money market. For this fund, an initial non-recurring contribution can be made by the Reserve Bank and a fixed amount can be set apart annually from the profits of the banks. The fund can act as a market intervention agency to protect the interests of both lenders and borrowers and would eventually supplant the discretionary and stand-by refinance facilities from the Reserve Bank, which essentially represent created money. The objective of the fund should be to allow the call rates to fluctuate in a permissible band of, say, 6 per cent to 25 per cent. During easy conditions in the call market, funds would be invested in other money market instruments such as CPs, CDs, Commercial Bills and 182 Days Treasury Bills. In conditions of general stringency in the call money market, funds would be pumped in the call market through the DFHI and this would enable the call rates to remain in the permissible band.

The operations of the fund would bring about an effective integration of various segments of the money market and could emerge as an effective instrument of the monetary policy.

The band could be reviewed at periodical intervals to be in tune with the objectives of credit policy.

In the present self-regulatory environment, the task of administration of the fund could be left to a joint institutional committee with adequate representation from the Reserve Bank and participants of the call money market.

The Reserve Bank can take lead in introducing and popularising these risk management techniques in the Indian financial markets. The task would involve setting up of futures exchanges, framing suitable legislation and identifying supervisory and regulatory bodies to oversee these operations. This could be the Reserve Bank's contribution to the structural transformation of the financial system in India.

The Reserve Bank of India (RBI) employs two forms of interventions to cool an overheated call money market. The first and more regularly employed tool these days is that of ready forward transactions, or 'repos.' The second tool is that of Open Market Operations (OMOs). The difference between the two is that while the former provides the players liquidity only for a short period, recourse to the latter gives the players a slightly more permanent source of liquidity.

REPOS OR READY FORWARD TRANSACTIONS

Repurchase Agreements (Repo), a short-term money market instrument is used for smoothing volatility in money market rates by RBI through injection of short-term liquidity into the market, as well as absorbing excess liquidity from the system.

To put it very simply, a ready forward or a repo transaction is like collateralised lending. It is a contract between two parties wherein one bank, say A, bank, which is short of Cash, places some security, in exchange for cash, with a second bank B. The securities sold will be repurchased on an agreed-upon future date; normally, this future date is about three days from the date of 'sale.' The difference between sale and repurchase prices is the cost of borrowing.

The entire transaction thus has two legs:

LEG ONE: The first party sells the security to the second at a particular price for a particular period with an undertaking that it will purchase back the same security at a predetermined price at the end of the period.

LEG TWO: The first party repurchases the security from the second at the predetermined price. The difference between the sale rate in the first leg and the repurchase rate in the second leg is the cost to the first party and the capital gain of the second.

As per RBI rules, the minimum period of a repo transaction has to be three days. There is no cap on the maximum number of days. The RBI also has a list of securities, in which such transactions are permitted. Since a repos transaction is basically a money market transaction, the maximum period is usually 14 days.

The RBI has been intervening in the market through the Securities Trading Corporation of India (STCI) and the Discount Finance House of India (DFHI). When the inter-bank call money rates started spiraling upwards with money in short supply, both these institutions pumped in liquidity by way of repos deals with banks. The money generated was used by the banks in maintaining their cash reserve ratio (CRR) requirements.

OPEN MARKET OPERATIONS (OMOs)

The OMO route of intervention is resorted to in order to provide market participants with another source of liquidity. From time to time, the central bank announces a list of securities indicating the price at which it will sell or purchase a particular security.

Those banks holding securities in excess of their statutory requirements but strapped for cash are thus provided a window, where they can sell any security to generate liquidity. The window can also be used by those who have surplus cash and want to exchange them for securities.

CALL MONEY MARKET REFORMS

In line with the deregulation and liberalisation policies of the 1990s, call money market reforms were undertaken in the early phase of reforms. The basic objectives of the reforms were to enhance stability and efficiency in the market.

Over the years, following measures have been taken:

- The call money market reform process continued to adopt a multipronged approach.
- The number of participants in the market has been gradually increased.
- With the operationalisation of the LAF, the collateralized lending facility was phased out by October 5, 2002.
- The prudential norms were introduced with adequate safeguards to prevent problems arising out of asset-liability mismatches on bank's portfolio.
- A system of mandatory reporting of all call/notice money market deals on the Negotiated Dealing System (NDS) for members was commenced.

- The 182-day treasury bills were introduced effective November, 1986, followed subsequently by phasing out of on-tap treasury bills, introduction of auctioning system in 91-day treasury bills since January 1993, and introduction of 14-day and 364-day treasury bills. The system of *ad hoc* treasury bills (with a fixed 4.6 per cent interest rate since July 1974), which were issued by the Central Government to the Reserve Bank, was abolished effective April 1997. Currently only the 91-day and 364-day treasury bills exist.
- The Discount and Finance House of India (DFHI) was set up in April 1988, and was allowed to participate in the call notice money market both as a borrower and lender commencing from July, 1988.
- Several new financial instruments were introduced, such as inter-bank participation certificates (1988); certificates of deposit (June 1989), commercial paper (January 1990) and repos (December 1992).
- Derivative products like forward rate agreements and interest rate swaps were introduced in July 1999 to enable banks, FIs and PDs to hedge interest rate risks.
- A full-fledged Liquidity Adjustment Facility was introduced on June 5, 2000 with a view to modulating short-term liquidity under diverse market conditions.
- The Clearing Corporation was established to make the repo operation efficient, with adequate safeguards.
- The introduction of rupee derivatives, *i.e.*, Interest Rate Swaps (IRS)/Forward Rate Agreements (FRA) helped in the deepening of money market.
- Repurchase Agreements (Repo) market has been developed to smoothen volatility in money market. With the development of the repo market, since the late 1990s, the call money market has gradually been transformed into a pure inter-bank including primary dealers. The process, which was initiated in 1999, was completed in August 2005.
- A screen based negotiated quote-driven system for dealings in call/notice and term money market (NDS-CALL) developed by CCIL was launched on September 18, 2006. It accounts for 75 percent of total call-money volumes.

FUTURE SCENARIO

As India enters into this brave new world of financial liberalisation and globalisation, it is essential to place the call money market, which is the core of the Indian money market and one of its most sensitive segments, on a sound footing to ensure smooth transition. This has been achieved to a large extent.

The call/notice money market essentially serves the purpose of equilibrating the short-term liquidity position of banks and other participants. The turnover in the call/notice money market depends on the amount of surplus funds available with some participants and the requirements of funds by some other participants. Over the years, the number of participants in the market has gradually increased to include banks and Primary Dealers both as lenders and borrowers, and select mutual funds, insurance companies, development financial institutions and corporates

through primary dealers (as lenders). The supply of and demand for funds in the market rose on account of (i) compliance with case reserve requirement of banks as mandated by the Reserve Bank, (ii) as a funding source to build up assets, (iii) temporary surpluses that are available with lenders, (iv) foreign exchange flows and (v) seasonal factors such as festival, election, harvesting, advance tax payments, etc. Eventually, the call market would constitute an integrated market for equilibrating short-term funds for both banks and non-banks.

CONCLUSION

The call/notice money market, which deals in overnight funds and upto 14 days, is a key segment of the money market in India.

It is at present one of the most important short-term money market. Banks borrow from the call money market in order to meet the sudden demand for funds for payments and to obtain funds to meet any likely shortfalls in their cash reserves to meet the CRR stipulation, or in the liquid assets required to be held to meet the SLR stipulation. In India, the inter-bank call money market is the single most important source for banks for getting overnight and short-term funds. The call loans generally have a maturity of one day to a fortnight. The State Bank of India along with its subsidiaries, as also insurance companies and the UTI, are the primary lenders in the call money market. There has been a considerable growth of the market due to the participation of investment institutions like LIC, GIC, UTI and mutual funds, whose supply of funds to the market as compared to the assets of the banking system is still quite small.

In the initial phase of money market reforms in the late 1980s, considerable volatility was noticed in the call rate, resulting primarily from a free call money market while interest rates in other segments of the money market remained regulated. As a result, any fluctuation in the liquidity conditions impinged on the call money market.

A noteworthy development in the money market since 2004-05 has been the substantial migration of money market activity from the uncollateralized call money segment to the collateralized market repo and collateralised borrowing and lending obligations (CBCOs). This has helped in reducing the systematic risk in the market.

The full-fledged Liquidity Adjustment Facility (LAF), which was introduced on June 5, 2000 has emerged as an effective instrument to provide a corridor for the overnight call rate moment. In fact, LAF and market stabilization scheme (MSS) have been successful in restricting the call-money rates. Various reform measures initiated have transformed the call money market into a pure inter-bank including PDs. The process which was initiated in 1999 was completed in August 2005.

SELF ASSESSMET QUESTIONS

- (1) Discuss the evolution of Indian Call market.
- (2) Discuss the call money market reforms.
- (3) What is the role of in the call market.