REPORT OF THE WORKING GROUP ON THE MONEY MARKET

RESERVE BANK OF INDIA
BOMBAY
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Chapter I : INTRODUCTION

The Committee to Review the Working of the Monetary System (Chairman Professor Sukhamoy Chakravarty) had *inter alia* made certain recommendations relating to the development of the money market and it was felt that a well developed money market would itself be an important monetary regulation measure. The Chakravarty Committee could not, however, examine in detail the specific reforms necessary for developing the money market.

1.2 Since a comprehensive review of the money market had not been undertaken hitherto, the Governor of the Reserve Bank of India appointed on September 5, 1986, a Working Group on the money market consisting of the following:

1.	Shri N. Vaghul, Chairman, Industrial Credit and Investment Corporation of India, Bombay.	: Chairman
2.	Shri M. J. Pherwani, Chairman, Unit Trust of India, Bombay.	: Member
3.	Shri S. Padmanabhan, Chairman, Indian Overseas Bank, Madras.	: Member
4.	Shri R. Narasimhan, General Manager (Operations), State Bank of India, Lucknow.	: Member
5.	Shri K. Sajeeve Thomas, Vice-President, Citibank, Bombay	: Member
6.	Shri V. B. Desai, Stock/Share Broker, Bombay	: Member

7. Shri S. S. Tarapore, : Member-Secretary
Adviser-in-Charge,
Credit Planning Cell,
Reserve Bank of India,
Bombay.

1.3 The terms of reference of the Working Group were:

i) To examine money market instruments and recommend specific measures for their development.

ii) To recommend the pattern of money market interest rates and to indicate whether these should be administered or determined by the market.

iii) To study the feasibility of increasing the participants in the money market.

iv) To assess the impact of changes in the cash credit system on the money market and to examine the need for developing specialised institutions such as discount houses. In this context, the inter-action between the inter-corporate market and the expanded money market could also be examined.

v) Any other issue having a bearing on the development of the money market.

The Memorandum appointing the Working Group is at Annexure I.

1.4 The Working Group was expected to submit its report by the end of December 1986, but in view of certain unforeseen problems faced by the Secretariat, the Working Group completed its task in January 1987.

1.5 At the outset of its deliberations, the Working Group had the benefit of the advice of Deputy Governor, Dr. C. Rangarajan and Executive Director Shri. A. Hasib. Dr. Rangarajan explained that the Chakravarty Committee had recommended the continuation of administered lending and deposit rates but that these rates should be responsive to developments in the economy. Dr. Rangarajan suggested that the Working Group on the money market could give specific attention to the adequacy of the present money market instruments at the short end of the market and the need to develop new instruments. Dr. Rangarajan urged the Group to examine how the money market rates could be dovetailed into the present administrative structure of overall interest rates. While recognising that any drastic reform of the money market would be contingent on reform of the overall monetary framework, the Working Group was advised to take the present monetary environment as given and to suggest improvements to tone up the efficiency of the system. The working Group also had the benefit of on-going dialogue with Dr. Rangarajan and Shri Hasib.

1.6 The Group held six meetings at Bombay. Apart from background papers prepared by the Secretariat, the Group had the benefit of perusing papers prepared by the Department of Economic Analysis and Policy of the Reserve Bank of India and the Industrial Credit and Investment Corporation of India (ICICI). From the Reserve Bank of India, Dr. S. R. K. Rao, Principal Adviser, Department of Economic Analysis and Policy, and Dr. K. K. Mukherjee, Chief Officer, Department of Banking Operations and Development, had detailed discussions with the Working Group. The Group had

the benefit of advice from Shri D. N. Ghosh, Chairman, State Bank of India and Shri. M. N. Goiporia, Chairman, Indian Banks' Association (IBA), and also met officials of the Life Insurance Corporation of India(LIC), The General Insurance Corporation of India (GIC), foreign banks and merchant bankers. The Group took the opportunity of meeting Professor J. S. G. Wilson, Professor Emeritus, University of Hull, who was in Bombay in November 1986 and Mr. Antony K. Leung, Area Head – South West Asia, Citicorp Investment Bank who was in Bombay in December 1986. A list of persons with whom the Group had discussions is furnished in Annexure II. The Working Group would like to thank all those who conveyed their views and suggestions to the Working Group.

1.7 The Secretariat for the Working Group was provided by the Credit Planning Cell. The Working Group places on record its deep appreciation of the yeoman service rendered by Shri. M. V. Raghavachari (Director) and Shri S. R. Kamath (Banking Officer). These two officers participated in all the deliberations of the Working Group and provided exemplary support all along the line in the preparation of the Group's Report. The Group also wishes to record its appreciation of the unstinted assistance provided by other members of the Credit Planning Cell.

Chapter II: PRESENT STRUCTURE OF THE MONEY MARKET

Scope of the Report

The money market is a market for short-term financial assets that are close substitutes for money. The important feature of a money market instrument is that it is liquid and can be turned over quickly at low cost and it provides an avenue for equilibrating the short-term surplus funds of lenders and the requirements of borrowers. There is strictly no demarcated distinction between the short-term money market and the long-term capital market, and in fact there are integral links between the two markets as the array of instruments in the two markets invariably form a continuum. While for the limited purpose of this Report, the Working Group has confined its attention to instruments with a maturity period upto 180 days, it should, at the outset, be made clear that this by no means constitutes an attempt to define the money market in a narrow sense.

Characteristics of Indian Money Market

2.2 The Indian money market is a restricted market with a narrow base and limited number of participants. The participants in the market are limited to banks and six all India financial institutions and the entry in the money market is tightly regulated. Even amongst the limited participants, there is a considerable amount of lopsidedness with a few predominant lenders and a large number of borrowers, and there is an absence of participants who make for an active market by alternating between lending and borrowing. The overall transactions are also small relative to the size of the economy, and form barely 3-4 per cent of the bank deposits.

2.3 The market is also characterised by paucity of instruments with the dealings being confined to money at call (overnight) and short notice (fourteen days), inter-bank deposits/loans and bills rediscounting. Participation certificates which were a feature of the market in the late seventies, have now become non-existent, while Treasury Bill transactions are confined only to banks and the Reserve Bank of India. Innovative financial instruments which have now become commonplace in the international financial markets, and which are providing an impetus to the growth of money markets in the world, are yet to find a place in the Indian money market largely because of its narrow base and strict regulation and control.

2.4 The rates of interest in the market are also tightly regulated and controlled, either by the Reserve Bank of India directly or by a voluntary agreement between the participants through the intermediation of the IBA. However, the general impression is that the various rates prescribed on the money market instruments are not strictly adhered to particularly during periods of fight liquidity.

2.5 In this context, it is not surprising that an unorganised money market has emerged on the scene. While the unorganised money market does not equilibrate the organised sector, it endeavours to meet the sectoral financing gaps in the sense that the fringe of unsatisfied borrowers in the Organised financial system seeks finance from the unorganised market. The rates of interest in the unorganised money market are market-related depending upon the demand and supply of funds, and in the very nature of its operation, the unorganised sector is characterised by interest rates markedly higher than in the organised sector.

2.6 Statement 1 shows the ceiling rates of interest and participants in money market instruments. The manner in which the market is operated in respect of each of these instruments is set out below:

Call Money

2.7 The call money market consists of overnight money and money at short notice for periods upto 14 days. The call money market essentially serves the purpose of equilibrating the short-term liquidity position of banks. A characteristic of the call money market is the existence of a few large lenders and a large number of borrowers. The absence of participants who alternate in borrowing and lending activity has, in some ways, inhibited the active development of the call money market. This market was strictly an inter-bank call market till 1971 when UTI and LIC were allowed to operate in the call money market. The participants now are commercial banks, cooperative banks, LIC and UTI. While the banks participate both as borrowers and lenders, LIC and UTI are only allowed to lend. The LIC and UTI were considered to be institutions with a sizeable short-term float which could usefully augment the supply of such funds in the call market. Again, these institutions need to hold very short-term liquid funds to meet their commitments. By maintaining a presence in the money market, particularly in the call market, the UTI is able to better meet any large repurchases from unit holders.

2.8 The rate of interest in the call money market is subject to a ceiling fixed by the IBA. Prior to December 1973, the call money rate was freely determined by the market but as the rates climbed to as high as 25-30 per cent and remained at that level, IBA considered it necessary to intervene and bring some order in the market. It was felt that high interest rates over long periods would distort the entire banking system's operations and would militate against the basic objectives of planned credit allocation under an administered structure of lending rates. Accordingly, a ceiling of 15 per cent on call money was fixed in December 1973 and in various phases this ceiling was reduced to 8.5 per cent by March 1978. With the resurgence of inflation and the sharp upward movement of the administered interest rates in 1979-80, it was felt necessary to raise the ceiling on the call money rate to 10 per cent in April 1980. The ceiling rate on call money has since then remained unchanged.

2.9 It appears to be the general experience of the banking system that the ceiling rate prescribed by the IBA is freely breached especially during periods of tight liquidity. While there is no hard evidence to indicate a direct contravention of the ceiling provisions, banks seem to have developed alternative methods to overcome the ceiling rate; the most notable one would appear to be buy-back arrangements in Government securities with markedly higher effective interest rates.

2.10 The data on the call money rates (as quoted in Bombay) during the period April 1981 to September 1986 are set out in Statement-2. During the last two years or so, there have not been significant seasonal variations in call money rates. In fact, since November 1985, the average call money rates have been quoted at the ceiling rate of 10 per cent. To some extent, this reflects the smoothening of seasonal liquidity through policy measures during the slack/busy season. In recent years, enhancement of reserve requirements have been effected during the slack season while releases of impounded cash balances have been effected in the busy season. Thus, apart from very short periods, the call money rate has been held taut at the ceiling.

2.11 The volume of business in the call money market has been on the increase. The average borrowings of banks increased from Rs. 573 crores during 1982-83 to Rs. 1,067 crores in 1985-86 (Statement-3). The proportion of borrowings from LIC and UTI has, however, declined in recent years. These institutions accounted for 42.5 per cent of call money lending in 1983-84 but in 1985-86 the share of these institutions declined to 21 per cent, partly reflecting the institutions' preference for other short-term money market instruments such as bills rediscounting.

Inter-Bank Term Deposits/Loans

2.12 In the inter-bank term deposit/loan market, the participants are commercial banks and cooperative banks. While the rates of interest in this market are not governed by any directive from RBI, the IBA has fixed ceiling rates for inter-bank transactions as under:

	Period	Ceiling Rate of Interest (Per cent per annum)
i)	15-30 days	10.5
ii)	31-60 days	11.0
iii)	Over 60 days	11.5

Here again, as in call money transactions, there are reports of breach of these provisions, especially during periods of tight liquidity.

2.13 Statement-4 sets out the volume of transactions in this market. Although the data indicate that during the recent period, there has been an increase in the volume of business done in term-deposits/loans, this appears to be, to some extent, a reflection of misclassification of data. Illustratively, money market term borrowings are reported to be of the order of Rs. 1,411 crores at the end of October 1986 of which only Rs. 216 crores is reported as having been placed by commercial banks. While cooperative banks do place funds with commercial banks, such placements by cooperative banks are unlikely to be of the order of Rs. 1,200 crores. What is perhaps conceivable is that some banks rolling over call money have erroneously reported such call money as term deposits.

Participation Certificates

2.14 Participation Certificates (PCs) as a money market instrument emerged on the scene first in 1970 but came into greater prominence from 1977. PCs were initially intended to serve as a short-term money market instrument. For the most part, however, PCs were utilised by the financial institutions for 'parking' their funds for increasingly long maturities and this instrument was not developed for evening out *inter se* liquidity between banks and/or financial institutions. The PC as it evolved represented a borrower-

lender relationship between the bank issuing the PC and the banks/institutions purchasing it and the issuing bank was bound to repay the purchaser bank/institution on maturity irrespective of the position of the borrower designated in the certificates. Thus, the PC arrangements were in no way related to the loans or advances to the borrower mentioned in the PC and there was also no risk-sharing involved. As such the basic tenet of the PC that the advances would be shared was not realised and the instrument mainly became a mechanism for obtaining additional resources rather than to share the advances as part of evening out liquidity.

2.15 In July 1979, PCs were subjected to reserve requirements and banks were asked by the Reserve Bank to bring about a lasting reduction in funds raised through PCs and to ultimately phase them out. These measures were introduced during a period when there was excessive credit expansion and a monetary restraint was considered necessary. The banks' reliance on PCs has since then been declining and at present, banks' outstanding borrowings under PCs are virtually nil. It is pertinent to note that an overwhleming proportion of PCs was from institutions and inter-bank PCs were insignificant. At its peak level in May 1979, out of a total of Rs. 646 crores, PCs from institutions amounted to Rs. 594 crores while inter-bank PCs were only Rs. 52 crores.

Bills Rediscounting

2.16 The need to encourage bill finance has been advocated on more than one occasion. The Dehejia Committee, constituted by the National Credit Council in 1968, suggested that commercial banks, industry and trade should try, where feasible and administratively convenient, to initiate and develop the practice of issue of usance bills and their acceptance for the purpose of trade credit and for securing discounting facilities against them. The Study Group chaired by Shri M. Narasimham on the Creation of Bill Market observed in 1970 that the progressive use of the bill of exchange as an instrument of credit would be advantageous not only from the point of view of imposing financial discipline on borrowers but also on lenders and it would be possible to meet the short-term liquidity requirements of banks by rediscounting these bills. The creation of a bill market would enable the banks and also the other financial institutions to invest their surplus funds profitably by selecting appropriate maturities and it would impart flexibility to the money market by evening out liquidity in the banking system and there would be more effective monetary control.

2.17 Despite the various measures taken to develop bill finance, there has not been satisfactory progress in the growth of this instrument and an active bill market has not developed. While the inland bills purchased and discounted rose from Rs. 1,575 crores in March 1978 to Rs. 3,779 crores in March 1986, the proportion of bills to total bank credit has come down in the same period from 10.5 per cent to 6.8 per cent (Statement-5).

2.18 Bill rediscounting is an important segment of the money market and this instrument provides short-term liquidity to banks in need of funds. In the initial stages of the development of the bill discounting market, the Reserve Bank provided significant support but over time the Reserve Bank reduced its support as institutions were permitted to rediscount bills. In this market, scheduled commercial banks and select financial institutions are permitted to rediscount bills of exchange presented by banks for rediscount. At present, besides scheduled commercial banks, LIC, UTI, GIC and its subsidiaries, ICICI, IRBI and ECGC are permitted to rediscount bills. The institutions are, however, not permitted to raise funds by a further round of rediscounting these bills with banks or other institutions.

2.19 The funds made available to the banking system through bill rediscounting have been increasing in the recent period though there are considerable month-to-month fluctuations (Statement-6). It can be seen that bill rediscounting has been rising rapidly from a little over Rs. 100 crores in March 1981 to over Rs. 750 crores in March 1986 and the level of such rediscounts crossed Rs. 1,000 crores in August 1986; the financial institutions account for an overwhelming proportion of bill rediscounting and banks rediscounted among themselves a little less than Rs. 170 crores in August 1986.

2.20 The rate of rediscount is governed by a directive from the Reserve Bank which has, at present, stipulated a ceiling rate of 11.5 per cent. In reality, however, this ceiling rate has become the effective rate as all transactions take place only at 11.5 per cent. The effective cost of funds raised by scheduled commercial banks through the bills rediscountign scheme is, however, lower than the effective cost of inter-bank term-deposits/loans of over 60 days as the latter are subject to reserve requirements; as such banks seeking funds through the money market find bill rediscounting very lucrative.

Treasury Bills

2.21 In well-developed money markets, Treasury Bills are normally an integral part of money market operations and this is mainly an instrument of short-term borrowing by the Government. In the Indian context, however, the Treasury Bill as a money market instrument has been largely attenuated because of certain historical developments. First, the substantial Treasury Bill creation which reflects Government deficits, has largely remained unfunded over the years and the bulk of Treasury Bills is now held by the Reserve Bank. Secondly, the discount rate on 91 Days Treasury Bills has remained unchanged at 4.6 per cent since 1974 and as such this interest rate is totally out of alignment with other short-term rates. Thirdly, until recently, these bills were freely rediscounted by the Reserve Bank. In the event, banks used the Treasury Bill market essentially for parking funds for very short periods of one to two days and given the stipulation of the cash reserve ratio as an average for a fortnight, there were very large and volatile fluctuations in investments of banks in Treasury Bills as also the banks' cash balances with the Reserve Bank (Statement-7). These violent fluctuations were entirely counter-productive and gave wrong signals for monetary management. Accordingly, measures have been taken by the Reserve Bank to reduce such volatility.

2.22 The two measures taken by the Reserve Bank in relation to 91 Days Treasury Bills were the recycling of Treasury Bills and the introduction of an additional early rediscounting fee. With the introduction of recycling of Treasury Bills (i.e., the bills rediscounted by the Reserve Bank are sold back to the banks) with effect from October 3, 1986, a dramatic shift has taken place in the Treasury Bill portfolio of the Reserve Bank. Between October 3, 1986, and December 19, 1986, the Reserve Bank's portfolio of *ad hocs* rose from Rs. 14,640 crores to Rs. 25,685 crores and the holdings of Treasury Bills purchased and discounted fell from Rs. 15,102 crores to Rs. 5,541 crores.

2.23 With effect from November 21, 1986, the Reserve Bank imposed an additional early rediscounting fee for rediscounting within 14 days of purchase. With this measure, the weekly fluctuations in Treasury Bill holdings of banks which averaged about Rs. 2,077 crores in the current financial year upto November 21, 1986, fell sharply and in subsequent weeks the fluctuations have been as low as Rs. 152 crores. It is expected that banks' holdings of 91 Days Treasury Bills will now become insignificant and this instrument would soon no longer be a money market instrument, and the "noise" created

in the monetary aggregates by the Treasury Bill operations of the banks would be eliminated.

2.24 More relevant from the view point of the money market is the nascent development of the 182 Days Treasury Bill on an auction basis. In the very nature of this new instrument, in the initial stages, the volume of funds in 182 Days Treasury Bills would be small and it is only over time that this instrument can become significant in the context of the money market. Two auctions have been held so far. At the first auction, there were 79 bids for a total amount of Rs. 738.64 crores; of this only 24 bids for a total amount of Rs. 21.99 crores was accepted; bids upto 8.75 per cent were accepted. At the second auction, there were 40 bids for a total amount of Rs. 105.55 crores; of this only two bids for a total amount of Rs. 15.50 crores was accepted; bids upto 8.50 per cent were accepted The important aspects of the newly developed instrument are the move to a flexible rate and the expected development of a secondary market and such a development could over time provide a useful money market instrument.

Inter-Corporate Market

2.25 At the present time, the inter-corporate market operates freely and outside the regulatory framework. It provides the corporate sector with an instrument for evening out short-term liquidity. Although the interest rate in this market is unregulated, the administered maximum lending rate of banks provides a floor to this market as units which enjoy surplus funds would normally reduce their cash credit outstandings rather than lend in the inter-corporate market at lower than the ceiling rate on bank advances. Precise information on the size of this market is not available but reports indicate that the interest rates in the inter-corporate market currently range between 18-20 per cent and the volume of transactions range between Rs. 800-1000 crores. In the very nature of this market, the interest rate and the amount could vary significantly over time reflecting changes in short-term corporate liquidity. While the inter-corporate market helps towards equilibrating the liquidity in the corporate sector, the risks in such lending have been such that the development of this market has been punctuated by periodic failures which have had a sobering effect on the inter-corporate market.

Chapter III : OBJECTIVES OF DEVELOPING THE MONEY MARKET

It will be useful at the outset to outline the conceptual framework within which the Working Group has framed its recommendations. The broad objectives of the money market are threefold: first, it should provide an equilibrating mechanism for evening out short-term surpluses and deficits. Secondly, the money market should provide a focal point for central bank intervention for influencing liquidity in the economy. Thirdly, it should provide reasonable access to users of short-term money to meet their requirements at a realistic price.

3.2 The third objective is particularly important from the point of view of an efficient banking system. In the existing money market with tightly administered interest rates, restricted entry and limited Reserve Bank refinance, banks having liquidity problems cannot, in the short-run, equilibrate their position by paying the price for short-term borrowings. In the absence of adequate facilities for obtaining very short-term funds, defaults in the maintenance of reserve requirements pose a real danger and banks face a dilemma of deciding between maintaining large excess liquidity or facing the consequences of defaults, both of which impinge on the profitability of banks. As such it is imperative to develop a money market which can genuinely equilibrate in the short-term and provide a viable alternative to defaults in the maintenance of reserve requirements.

3.3 These objectives are sought to be realised by a four-pronged strategy. First, the attempt would be to widen and deepen the market by a selective increase in the number of participants which would broaden the base of money market operations by ensuring adequate supply of funds. In formulating this strategy, care has been taken to ensure that there is no substantial diversion of resources from the banking system into the money market. In the Indian context, the banking system performs, apart from the traditional function of meeting the financial requirements of trade and industry, a very useful role in socio-economic development which would call for a substantial accretion to the banks' resources. Particularly in view of this, the process of broad basing the money market would have to have as its objective, generation of additional resources and not merely diversion.

3.4 Secondly, the endeavour would be to activate the existing instruments and to develop new instruments so as to have a well diversified mix of instruments suited to different requirements of borrowers and lenders. The central role of bills in an active money market hardly needs to be emphasised. In this context, the development of trade and commercial bills which is a self-liquidating instrument will have to be given an overriding importance.

3.5 Thirdly, the attempt would be to work out an orderly move away from administered interest rates to market determined interest rates. The needs of the economy

dictate that a framework of an overall administered structure will have to be continued with a significant element of cross-subsidisation, and given the overriding societal interests, directions on channelling credit to select sectors would remain integral to the system. While the overall milieu requires the continuation of administered interest rates, it is also necessary to attempt a significant degree of rationalisation and impart to the structure a degree of flexibility as already recommended by the Chakravarty Committee. In the context of a highly regulated monetary and banking system, any attempt to rapidly deregulate only one segment could create adverse repercussions on other areas of regulation. The strategy would, therefore, have to be directed towards freeing interest rates in certain segments only to the extent that it does not conflict with the basic thrust of the overall economic policy. The Group's recommendations in this regard will have to be viewed as pragmatic measures to achieve efficient money market operations rather than any preconceived bias in favour of a totally market determined interest rate structure.

3.6 The fourth element of the strategy would be to create an active secondary market through the process of establishing, where necessary, new sets of institutions which would impart sufficient liquidity into the system. The absence of an active secondary market has been a major inhibiting factor in the development of the money market in the country and it is time that this deficiency is removed.

3.7 The Working Group envisages that in the context of other vital changes in the economy, a significant element of rationalisation of the monetary and banking system would be inevitable and reform of money markets could provide an appropriate ***avant garde*** for improved monetary and banking operations. While it is recognised that continued supervision of the money market would be necessary and the phased deregulation of the market would need to be approached with caution, there should be transparency of rules rather than a predominance of discretion. The objectives should be to move towards a more efficiently operating money market which could generate a ripple effect through the monetary and banking system.

3.8 While making recommendations, the Working Group has chalked out a detailed time-bound programme which would facilitate implementation. In the area of money market institution building and instrument development, the Group has made specific recommendations and if these are accepted in principle, it should be possible to expeditiously move towards their implementation. It needs to be emphasised, however, that the recommendations of the Working Group should be viewed as an integrated package though implementation would necessarily need to be in phases.

Chapter IV: MEASURES TO IMPROVE THE OPERATION OF THE CALL MONEY MARKET

The call money market is an important segment of the money market and the Working Group is of the view that improvements in the functioning of this market are vital to the development of the money market.

Problems of the Call Money Market

4.2 The ceiling rate of interest and a virtual ban on new entrants are two major factors which have inhibited the proper development of the call money market. The cap on the call money rate has been observed more in breach and participants have resorted to various devices to circumvent this ceiling. In view of the fact that the short-term deposit rate for 15-45 days is as low as 3 per cent (as against a ceiling rate of 10 per cent for call money) there has been a spate of representations to the Reserve Bank by various institutions cogently pleading to be given entry into the call money market. The pressures for entry are generated by the fact that the LIC and UTI have been given privileged access to the call money market while a similar privilege has been denied to other institutions. The stance of the Reserve Bank has been not to accede to these requests as it would tantamount to raising the interest rate on institutional term deposits while denying higher rates on deposits from individuals. Again, a sharp increase in the interest rate paid on institutional deposits would substantially raise the cost of funds to the banking system and thereby adversely affect bank profitability.

4.3 The other aspect of this dilemma is that banks faced with very short-term liquidity problems are unable to fully meet their requirements for funds in view of the cap on call money rates. Prior to April 1985, the banks concentrated on maintaining the cash reserve ratio (CRR) and cumulated their shortfalls onto the statutory liquidity ratio (SLR). With the coming into force of penalties on the daily maintenance of SLR, the banks face penalties at a rate of 13 per cent or 15 per cent per annum on the extent of SLR defaults. As such there is a tremendous pressure to circumvent the 10 per cent cap on call money.

4.4 The Working Group on Participation Certificates and Call Money Market (Chairman: Shri W. S. Tambe) had in its report in May 1979, suggested that the system of prescribing interest rate ceilings on money market instruments should be continued. In its supplementary Report in December 1982, the Working Group had recommended a very select increase in the participants in the call money market and for short-term deposits upto 180 days from financial institutions, the Working Group suggested that interest rates marginally higher than corresponding rates on deposits of comparable maturities from the household sector could be prescribed. The Reserve Bank did not implement these recommendations as institutions had been given a more lucrative outlet in terms of the bills rediscounting market and it was felt administratively difficult to accede to the request of only one institution while rejecting the pleas of other institutions to enter the

call money market. Again, it was felt that a marginal increase in the rates for short-term deposits placed by institutions would not only increase the complexity of the regulatory framework of interest rates but add to the cost of funds without any benefit of increased flow of resources to the banking system. Any significant increase in the flow of resources would necessitate a quantum jump in short-term deposit rates which the Tambe Working Group had not recommended.

4.5 The Chakravarty Committee had considered the problem of the call money market from yet a different stand point. The Committee was of the view that if the Treasury Bill market was activated and the discount rate market-related, dependence on the call money market would be reduced and in such a context the ceiling on the call money rate would not serve any important purpose and therefore, the Committee recommended that the interest rate ceiling on call money should be abolished. The Committee also recommended that the call money market could be made more broad based by increasing the number of institutional participants.

4.6 The Working Group examined several alternatives in this regard. If, as recommended by the Chakravarty Committee, the institutional participants in the call money market are increased and the call money rate is freed it would be necessary to align the Treasury Bill rate. While the Working Group recognises the measures recently taken to introduce the new instrument of a 182 Days Treasury Bill, the overall interest rate structure is far from the kind of alignment of rates envisaged by the Chakravarty Committee. As such, freeing the call money rate with free entry into the call money market would significantly raise the cost of funds to the banking system as institutional funds would switch from short-term deposits to the call money market. The second alternative would be to recognise the realities of the present situation and bring about an increase in the ceiling rate of 10 per cent. There is some justification in the view that when interest rates are administered all along the line, the call money rate should also be administered. In view of the imperatives faced by banks which are short of liquidity, if the 10 per cent ceiling on call money is out of kilter, it could, perhaps, be raised. The other alternative would be to open up the call money market to more participants but keep the ceiling rate at the present level of 10 per cent. Both these alternatives would effectively raise the cost of funds to the banking system as a whole and given the tightly regulated low rates of interest on short-term deposits, it would inevitably raise the cost on the banks' outside liabilities. The Working Group does not favour these alternatives as they do not provide a viable solution to the problems faced by banks and moreover would adversely affect the profitability of the banking system as a whole.

Proposal for Freeing the Inter-Bank Call Money Rates

4.7 The Working Group is of the view that while continuing with the restriction on new entrants in the call money market, the present interest rate ceiling on the call money fixed by the IBA should be abolished and the call money rates should be left to be determined by market forces. The call money rates should be freed only for inter-bank transactions and the ceiling rate of 10 per cent should continue to be maintained for borrowings from non-bank participants in the market, if any. This would ensure that the banking system as a whole would not incur any additional interest cost.

4.8 The Working Group is not oblivious of the risks involved in the removal of the ceiling on the interest rates applicable to call money transactions. Given the skewed distribution of liquidity in the banking system, there is a real danger of a sharp increase in interest rates creating problems for banks which are regular borrowers in the market.

While in the long-run, the solution to this problem lies in the development of an active and competitive market with banks alternating between borrowing and lending, in the short-run, it would be necessary for the Reserve Bank to counsel the surplus banks to ensure that call money operations are not disruptive to the banking system, and the call money rates do not rise to stratospheric levels over prolonged periods. The package of measures recommended by the Working Group later in the report in regard to the bill rediscount market and the development of the Finance House should obviate the kind of problems that warranted the fixing of a ceiling rate on call money transactions in 1973.

Participants in the Call Money Market

4.9 For the reasons mentioned earlier in paragraph 4.5, the Working Group is of the view that the call money market should strictly be an inter-bank market with the participation limited only to the banking system. The policy of denying entry for institutions other than banks would need to be continued. The cases of LIC and UTI, however, are on a slightly different footing. These two institutions are already operating as lenders in the market and it is strongly contended on their behalf that they would continue to need the call money market to park their very short-term funds in view of their commitments to their respective constituents. The Working Group sees merit in this view and would accordingly recommend that these two institutions may be permitted to remain in the market subject to the condition that the call money placed by them would continue to be subjected to the present ceiling rate of 10 per cent. If other money market instruments develop with a wider array of maturities, it is expected that these two institutions, would, on their own, reduce their participation in the call money market and the market would become truly an inter-bank market. The position could be reviewed, if need be, by the Reserve Bank of India in April 1988.

Inter-Bank Money Market – Term Deposit Rates

4.10 The inter-bank term deposit market is strictly limited to banks and as a logical extension of the freeing of the inter-bank call money rate, the Working Group recommends that interest rates on inter-bank term deposits should also be determined by market forces.

Time Frame for Freeing the Call Money Rate

4.11 The Working Group is of the view that the removal of the ceilings on interest rates on call money and inter-bank term deposits should be undertaken at a period of relative ease in the money market and accordingly it is suggested that these measures should be implemented with the inception of the slack season at the end of April 1987.

Brokers

4.12 Brokers have been excluded from the inter-bank call money and term deposit markets since the mid-1970's. This measure was taken against the background of counter-productive destabilising movement of funds among banks and it was felt that such activity would be effectively curbed only by excluding brokers from this market. As the banking system has now adapted itself to operating without brokers and communication facilities have improved, the Working Group recommends that there is no need for brokers to be re-introduced into the call money market. To the extent that broker services are felt necessary after the freeing of the call money rates, the proposed Finance House (discussed in Chapter VIII) could usefully provide this service.

Chapter V: DEVELOPMENT OF THE BILLS REDISCOUNTING MARKET

As already indicated, the Working Group considers the instrument of bills as a key-stone of a well developed and active money market and in this context, the Working Group emphasises the need for taking a number of positive measures to facilitate the emergence of a genuine bill culture in the Indian financial system. The Working Group recognises that earlier efforts to develop the bill market have not been fully effective and there are a number of hurdles in developing the bill market. It is necessary to develop a package of measures covering regulations and procedures, interest rates and legislative amendments so that the obstacles for developing a bill market are largely attenuated if not removed.

Measures to Promote Bill Financing

5.2 The main factors which have come in the way of developing bill finance are: (i) reluctance of industry and trade and Government departments to move towards a bill culture involving as it does observance of strict financial discipline; (ii) non-availability of stamp papers of required denominations and need to affix stamps on each bill; (iii) absence of specialised credit information agencies; (iv) absence of an active secondary market as the rediscounting is permitted only with the apex level financial institutions; and (v) administrative problems like physical scrutiny of invoices accompanying bills to ensure that they are trade-related, physical presentation of bills for repayment, requirement of physical endorsement and re-endorsement of bills at the time of rediscount.

5.3 The Chakravarty Committee emphasised the urgency of removing avoidable impediments to the use of bill finance. The Committee observed that delayed payments by Government and public sector agencies have a dominant impact on the credit flows in the system. The Committee stressed that there is no justification for persisting with a system which transfers the financing cost from the Government and other public sector units to other sectors through non-payment of interest on delayed payment. The Committee recommended that the Government should make it mandatory on the part of all large buyers to include a penal interest clause on delayed payment.

5.4 The Working Group is of the firm view that any attempt to activate the bill market is bound to fail unless a bill culture develops amongst the trade and industry circles and the initiative for this should come from the Government, public sector undertakings and large business houses. In the light of the past experience of failure of persuasive measures, a time has come to push ahead with a set of mandatory instructions in this regard. These measures are aimed at not merely the development of a bill market but the protection of a large number of small and medium industries whose uncollected receivables have reached such dimensions as to threaten their very existence.

5.5 The Government should direct departmental undertakings and public sector organisations that payments for all credit purchases made by them should be made only in the form of bills and the bills accepted in this regard should be strictly honoured on the due dates. Failure to pay the bill on the due date would have to attract a uniform penal rate from the date of acceptance at 2 percentage points above the maximum lending rate of banks. A similar communication would need to be addressed by banks to their clients enjoying working capital limits of more than Rs. 6 crores. It will be the obligation of the collecting banks to bring to the notice of the bankers to the company which have defaulted on payment of the bills and in the event of three such instances of default, it would be necessary for the concerned bankers as a measure of penalty, to reduce the working capital limits suitably.

5.6 At the time of renewal of the working capital facilities for such clients, the banks should call for specific information in regard to the compliance of their instructions in regard to acceptance of bills. Over a three year period there should be a phased increase in the proportion of bill acceptances to total credit purchases to a level of 75 per cent. This phasing should be done in such a manner that a proportion of at least 25 per cent is reached by April 1, 1988 and 50 per cent by April 1, 1989. This stipulation should apply equally to departmental undertakings and public sector organisations financed by the banking system. In respect of clients not adhering to this stipulation, the Reserve Bank should stipulate by way of penalties, a suitable scaling down of the permissible working capital limits and also an increase in the interest rate applicable to such limits. To facilitate easy access to such information, the borrowing clients should be asked to give additional balance sheet information in regard to break-up of sundry creditors for purchases into (a) bills accepted and (b) other creditors.

5.7 As a further measure towards this end, it would be necessary for the banking system to gradually move away from receivable financing to bill financing. If the measures outlined in paragraphs 5.5 and 5.6 above take effect, this should not pose any insurmountable problems. However, here again, certain mandatory measures, particularly for clients having working capital limits of more than Rs. 6 crores, would help in the achievement of the objective more speedily. The Working Group, therefore, recommends that in respect of such clients commencing from April 1988, a gradual phasing out of the receivable financing should be undertaken. To start with, as from April 1, 1988, for calculating drawing power on cash credit/overdraft limits against receivables, only 75 per cent of the eligible receivables should be taken into account. This should be reduced to 50 per cent as from April 1, 1989 and 25 per cent as from April 1, 1990. The rest of receivables should be financed only through demand/usance bill limits.

5.8 The Working Group is of the view that within the overall CAS discipline, it should be possible to introduce a measure of flexibility in regard to sanction of bill limits. Towards this end, the Working Group would recommend that banks be given the discretion to increase the bill limits to a borrower governed by the CAS without the prior approval of the Reserve Bank of India. In addition to the present discretionary powers to sanction additional limits temporarily for periods not exceeding 3 months by 10 per cent of the existing working capital limits subject to an overall ceiling of Rs. 2 crores, it could be provided that bill limits could be raised subject to a separate ceiling of Rs. 1 crore, to meet any increase in the scale of operations.

5.9 It is also necessary for banks to streamline their operations in regard to the conduct

of bill limits so as to achieve a greater financial discipline. At present, it is not unusual for banks to keep the demand bills on their portfolio for any length of time either on the ground that goods had not reached their destination or for accomodating the drawees of bills. These bills are in effect usance bills but are not reckoned as such in the banks' books. Banks must ensure that demand bills which are not settled within ten days of presentation must be promptly returned and the amounts duly collected from the drawers. Where payments are expected over longer periods, the more proper course would be to draw usance bills. All usance bills need not necessarily be on D/A terms; the extent of D/A facilities would be related to the credit standing of the clientele. Banks should also undertake a stricter review of credit facilities extended to the clientele whose bills are not honoured on the due dates.

5.10 Some of the measures recommended by the Working Group in regard to the development of the bill culture may *prima facie* appear harsh. But these have to be seen in the context of considerable laxity that has developed in the system with utter disregard and disrespect to honouring financial obligations. If an active money market has to develop on proper lines, the participants in the market have to develop a culture of honouring their financial obligations as and when they fall due; instances of default have to be exceptional and not a rule. The measures suggested are aimed at not only developing a bill market, but inculcating and strengthening financial discipline which is a *sine qua non* for growth of a healthy financial system.

5.11 The Working Group's attention was drawn to the fact that at present there is a stipulation with regard to the maximum proportion of unsecured advances to total advances and if the bill portfolio of banks grows as envisaged there could, conceivably, be an infringement of this directive. While bills with a usance not exceeding 90 days are excluded from this stipulation, the Working Group recommends that the stipulation on unsecured advances should not be made applicable to all bill financing. So long as the banks ensure that the bills represent genuine trade transaction and are utilised for movement of goods, the spirit of the directive will not stand violated.

Need for Prescribing a Lower Discount Rate

5.12 The Chakravarty Committee observed that there is some reluctance on the part of Government to undertake the additional paper work involved in handling documents of title to goods. This reluctance could perhaps be overcome by providing the necessary financial incentive by way of lower financing charges as compared to those related to loans or cash credits. Development of a bill market requires an adequate supply of first class bills which are freely negotiable and marketable. In the Chakravarty Committee's view, the discount rate applicable to bills has not been sufficiently attractive to borrowers. An active bill market will relieve pressure on banks for extending credit facilities to sellers or buyers while providing the banks with a financial instrument of acceptable liquidity, safety and return.

5.13 Prior to March 1981, the discount rate was lower than the cash credit rate but after the rationalisation of lending rates in March 1981, the two rates were put on par. There is now virtually no interest rate incentive for borrowers to switch over from cash credit to bill finance. At present the scheduled commercial banks can charge an interest rate on commercial transactions in the range of 16.5 – 17.5 per cent irrespective of whether the borrower has a cash credit or a bill limit. On a strict interpretation of the interest rate directives of the Reserve Bank, the discount rate should not exceed 16.75 per cent

(equivalent to an interest rate of 17.5 per cent on a 90 days bill); it is, however, observed that in some cases there is an infringement of the directive and banks are charging a discount rate of 17.5 per cent. With a view to making bill finance more attractive, it is necessary that the maximum discount rate should be sufficiently lower than the interest rate on cash credit. Accordingly, the Working Group recommends that the maximum discount rate on bills should be such that it does not exceed an equivalent effective interest rate of 16.0 per cent, i.e., the effective interest rate on bills would be 1.5 percentage points below the present maximum lending rate of 17.5 per cent. On a 90 days bill, this would imply a maximum discount rate of a little less than 15.5 per cent. This recommendation could be implemented at the end of April 1987 and after a year, an assessment could be made as to whether the maximum discount rate could be freely determined by the banks.

Raising of the Rediscount Rate

5.14 At present the Reserve Bank has fixed a ceiling of 11.5 per cent on the rediscount rate. The Working Group is of the view that the rediscount rate should really be market determined and the freeing of this rate should not create any repercussions on the administered interest rate structure. However, till such time as the supply of resources in the market increases through the induction of more participants and a proper balance develops between demand and supply, it may be necessary to continue with the ceiling provision.

5.15 The Working Group would recommend that as at the end of April 1987, the ceiling on the rediscount rate be increased from 11.5 per cent to 12.5 per cent principally with a view to attracting more participants in the market. It may, perhaps, appear on the face of it that the measures of reducing the bill discount rate and increasing the rediscount rate would affect the interests of banks. A closer examination would reveal that the objective of these measures is to provide banks with easy access to larger resources at relatively cheaper rates, and overall the banks would find the measures beneficial to them.

5.16 The cap on the rate of rediscount would also provide, in the initial period, a moderating influence on the call money market. Once the money market develops on the desired lines, the ceiling on rediscount rate should be removed and the rate be permitted to be determined on market considerations. A review in this regard needs to be undertaken in April 1988.

5.17 The Working Group would recommend that the proposed changes in the bill discount and rediscount rates should be brought into effect at the same time as the changes in the call money and inter-bank term deposits markets are undertaken, i.e., at the end of April 1987.

Participants in the Rediscount Market

5.18 At the present time the Reserve Bank, while determining entry in the rediscount market, takes into account the institutions' area of activity, the size of operations and liquidity. The Working Group recognises that at least in the initial phase, while opening up the rediscount market, it should be ensured that the participants are able to bring into this market a sizeable amount of resources. Too low a limit for the size of a participant's involvement in the rediscount market could have destablising effect given the administered structure of deposit rates. Accordingly, the Working Group recommends

that institutions and other units such as companies, trusts, etc. which can satisfactorily demonstrate to the Reserve Bank that they have a resources surplus of a monthly average of at least Rs. 5 crores per annum should be allowed to participate in the bill rediscounting market. In due course this limit could be reviewed, based on actual experience.

Facilities for Further Rediscount

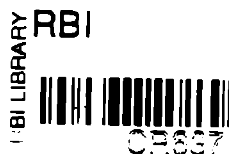
5.19 At present institutions can only supply funds to this market and with a view tc imparting greater liquidity to the market, the Working Group would recommend that further rediscount by the institutions should be freely permitted amongst the participants in the market. The establishment of the Finance House recommended later in the Report and the suggested measures for simplification in the procedures for redisount should ensure the emergence of an active secondary market over time. The Working Group has noted that banks supply resources to the bill rediscounting market to only a very limited extent and there is a case for encouraging banks to even out short-term liquidity imbalances within the banking system through the bill rediscounting market.

Simplification of Procedures for Bills Rediscounting

5.20 The Working Group recommends that the procedures for rediscounting of bills be simplified as indicated below by the end of April 1987. At present the Reserve Bank's guidelines provide for endorsement in favour of the lender at the time of rediscount and re-endorsement at the time of maturity. This procedure has been found to be cumbersome. The Group would recommend that a certificate could be issued by the banks to the rediscounting institutions to the effect that the bank has necessary title to genuine trade bills presented for rediscount. This would greatly help the banks in regard to collecting bills from the various centres to add up to the requisite rediscounts amount and the physical endorsement and lodgement of each bill is obviated. Multiple rediscounting could then be undertaken on the basis of these certificates thereby providing a highly convenient and liquid instrument in the market.

5.21 At present the bills rediscounting market is mainly concentrated in Bombay due to the fact that major financial institutions' headquarters are situated in Bombay. It would be practically impossible for banks to rediscount bills drawn and payable at other centres as the collating of bills would be difficult. The Group, therefore, recommends that the financial institutions and other participants in the market should provide rediscounting facilities at major centres which would, to some extent, help reduce the difficulties for banks in collating bills.

5.22 The Working Group has made a recommendation in Chapter X that the stamp duty on bills be abolished.



Chapter VI: DEVELOPMENT OF A SHORT-TERM COMMERCIAL PAPER MARKET

Commercial paper consists of unsecured promissory notes sold directly by the issuers to investors, or else placed by the borrowers through agents like merchant banks and security houses. It is a short-term debt issued by corporate borrowers directly to investors in the money market, and by the process of securitisation, the intermediation function of the banking system is obviated. The notes could carry an interest coupon but are generally sold at discount below face value to provide a return to the investors. Unlike commercial bills, they need not be related to any underlying self-liquidating trade transaction and there are no standard maturities. The flexibility of the maturities at which they can be issued is one of the main attractions for borrowers and investors since issues can be adapted to the needs of both. The commercial paper market has the advantage of giving highly rated corporate borrowers cheaper funds than they could obtain from the banks while still providing institutional investors with higher interest earnings than they could obtain from the banking system. The system of underwriting commercial paper at a reasonable cost to the borrower (where need be on a revolving basis) ensures that the funds would be available to the borrower on a fairly continuous basis.

6.2 When companies issue commercial paper rather than draw on their lines of bank credit, the banks lose first class clients. The banks, however, earn fees as issuers and dealers in commercial paper. More importantly, since the commercial paper is freely transferable, the banks, financial institutions and other holders of short-term funds are able to easily invest their short-term surplus funds in a highly liquid instrument at attractive rates of return and there would be an effective securitisation of the asset portfolio of banks and institutions. It is for this reason that the commercial paper market has grown in several countries even though in the initial stages, banks viewed this instrument with concern on the ground that it would affect the quality of their business.

6.3 The issue of commercial paper imparts a degree of financial stability to the system as the issuing company has an incentive to remain financially strong. The possibility of raising short-term finance at relatively cheaper cost would provide an adequate incentive for the corporate clients to improve their financial position and in the process the financial health of the corporate sector should show visible improvement.

6.4 If the commercial paper market develops, a part of the funds in the inter-corporate market would flow into the commercial paper market and some of the unhealthy practices in the inter-corporate market would be discouraged by the availability of a viable and attractive alternative instrument.

6.5 Upto date and relevant financial information on the companies raising commercial

paper would be a basic pre-requisite for the development of commercial paper. In the Indian context, the commercial paper market needs to be developed with utmost caution and exacting and unswerving standards need to be evolved. The ICICI has recently set up a Credit Rating Company and this independent institution is expected to be operational by June 1987. One of the prime requisites for the introduction of the commercial paper in the Indian money market can, therefore, be said to have been met and the time is ripe for starting with a limited introduction of this instrument.

6.6 To start with, the access to the commercial paper market should be given only to 'A' rated companies who have a net worth of Rs. 5 crores and above, listed in the stock exchange and who have a good dividend payment record. The companies need to have a debt-equity ratio of not more than 1.5, a current ratio of more than 1.33 and a debt servicing ratio closer to 2. These and other financial parameters entitling a company to an 'A' rating would, however, have to be worked out in greater detail by the Credit Rating Company. What, however, needs to be stressed at this point is, to ensure against failures which could dampen the nascent market, only well-rated companies should be allowed to enter the commercial paper market.

Interest Rate on Commercial Paper

6.7 The Working Group is of the view that the coupon rate on the commercial paper (or the equivalent discount rate) should be freely determined by market considerations and not be administered. In a sense, the range of the interest rates on the commercial paper would be automatically determined within the overall framework of the administered rate structure. So long as the bill rediscounting rate is 12.5 per cent and the maximum lending rate of banks is 17.5 per cent, the effective rate of interest on the commercial paper would have to fall between these two rates. The issue expenses would consist of management fees which are to be negotiated with bankers/merchant bankers, but having regard to the size of the issue and competition in the market, this is unlikely to exceed 0.5 per cent per annum. As the issue is likely to be generally privately placed, there may not be any need for underwriting. The companies may, however, desire to have stand-by facilities with the banks to ensure against difficulties in roll over of funds for which they may have to pay commitment charges of perhaps 0.25 per cent per annum. In addition, there will be the expenses to be incurred on obtaining a credit rating. While the obtention of credit rating in the first instance might entail costs (perhaps 0.1 per cent), the updating of the rating can be done at nominal cost. With an outside limit of 1.0 per cent per annum on issue expenses, the companies entering the commercial paper market could still enjoy rates finer than can be obtained from banks.

6.8 The commercial paper market would have to function within the overall discipline of the CAS system and the amount of commercial paper issued by a company would have to be reduced from the permissible working capital limits. The Reserve Bank would also have to administer (a) the entry of companies in the market (b) the amount of each issue and (c) the total quantum that can be raised in a year.

Participants in the Commercial Paper Market

6.9 The Working Group is of the view that no restriction need be placed on the participants in the commercial paper market; restrictions, if any, would be only by way of the size of the minimum note. The Working Group would recommend that the size of any single issue should not be less than Rs. 1 crore and the size of each note should not be less than Rs. 5 lakhs. The overall size of the commercial paper market, the choice of borrowers, the amount of each issue and the credit rating would provide the necessary regulatory

safeguards and as such further regulation would be redundant. The less regulated that the commercial paper market is the more integrated it will be with the inter-corporate market which, at present, is totally unfettered and sometimes subject to unhealthy practices.

Exemption from Stipulation on Unsecured Advances

6.10 The Working Group recommends that as in the case of bills, commercial paper should be excluded from the stipulation on unsecured advances. This would facilitate banks to hold commercial paper as necessary.

Outline of a Scheme on Short-term Commercial Paper

6.11 The experience in many countries indicates that the development of a commercial paper market must necessarily be gradual and can be developed only by working out a detailed implementation programme. The Working Group has examined some issues which would need specific attention in the Indian context. Accordingly, the Working Group has set out the following framework for developing a commercial paper market in India:

(i) Commercial paper would consist of unsecured promissory notes sold directly by issuers to investors (excluding non-residents) or placed with investors through the agency of banks or other financial agencies.

(ii) Unlike in the case of commercial bills which are tied to a self-liquidating transaction, the commercial paper would not be tied to a specific transaction. The maturity could be 15 days and over but not exceeding 6 months with, if necessary, a Revolving Underwriting Facility of less than three years.

(iii) The issuing company would need to have a net worth of not less than Rs. 5 crores and be listed on the stock exchange and be a party subject to the CAS. The minimum denomination of notes could be Rs. 5 lakhs and the minimum amount of issue by a company could be for Rs. 1 crore.

(iv) The issuing company would need to obtain every six months, a credit rating from a recognised Credit Rating agency. Companies with only a minimum of 'A' rating would be permitted to enter the market.

(v) The interest rate on commercial paper would be market determined and the paper could be issued at a discount to face value or it could be interest bearing; a discount to face value would be a convenient form especially if the paper is fully transferable.

(vi) The issuers would be required to meet dealers fees, rating agency fees and other charges including charges such as for stand-by facilities with banks and these should together not exceed a total of 1.0 per cent of the amount raised.

(vii) The Reserve Bank would authorise the programme size of a company and the timing of issues to ensure an orderly queue. The authorisation would be issued both to the bankers of the company and the company and when the issue is actually placed on the market, it will be the responsibility of the concerned banks to reduce the permissible working capital limits to the extent of the issue under advice to the Reserve Bank. Being a short-term instrument, commercial paper would need to be viewed as an integral part of the money market.

(viii) The Finance House (discussed in Chapter VIII) would impart liquidity to the commercial paper by quoting two-way prices in the secondary market.

(ix) The instrument should not be subject to stamp duty at the time of issue and there should not be any tax deduction at source.

(x) The paper should be freely transferable by endorsement and delivery and there should be no stamp fees on such transfers.

(xi) Legislative amendments or necessary exemptions would be required to ensure that various legal provisions do not inhibit the active development of the commercial paper market.

6.12 While a number of pre-requisites have to be fulfilled before commercial paper becomes operative, the Working Group recommends that necessary legislative/ administrative changes should be completed during the next 12 months and by April 1, 1988, commercial paper should be operative. The Working Group recognises that the growth of commercial paper would be slow, at least in the initial stages, and to avoid uncertainty in the mind of banks, investors and borrowers, the authorities should take an early decision to commit themselves to a time-bound introduction of commercial paper.

Chapter VII: SHORT-TERM MONEY MARKET OPERATIONS IN GOVERNMENT PAPER

Government paper should be an integral part of an active money market. In the Indian context, the scope for active open market operations is limited as the Government securities market is largely a captive market with administered interest rates which are not integrally linked to interest rates in the rest of the financial sector. Recent policy measures have, however, opened up new vistas for developing Government paper as an active short-term money market instrument. The availability of Government short-term paper in an active money market provides a liquid instrument for investment of short-term funds and also enables the authorities to give vital signals to the market and thereby strengthen monetary control. The Working Group recognises that Government paper as a money market instrument would develop only very gradually; nonetheless, it is vital to provide appropriate ancillary facilities to foster the development of such money market instruments.

182 Days Treasury Bills

7.2 The Chakravarty Committee had recommended that Treasury Bills should be developed as a monetary instrument with flexible rates and that this would help better management of short-term liquidity. In this context, a 182 Days Treasury Bill has been introduced in November 1986 on an auction basis. No rediscounting facilities have been provided at the Reserve Bank and it is expected that a secondary market could develop in course of time. It has been recognised that judicious operations by investors would be vital to the success of these Treasury Bill auctions and, over time, as a wide array of maturities emerge, the secondary market could become active.

7.3 The recent measure to introduce auctions for Treasury Bills would be of relevance to money market operations if the volume of such bills increases and a secondary market develops. In this context, the proposed setting up of a Finance House of India (set out in Chapter VIII) would be vital to the development of a secondary market. For an active secondary market it would be necessary for a large number of participants to bid regularly in the auctions and to build up a portfolio of varying maturities. Again, suitable measures would need to be taken to ensure that the Treasury Bill rate remains flexible and reflects variations in short-term liquidity.

Periodicity of Treasury Bill Auctions

7.4 The Working Group recommends that the frequency of the auctions should be increased from monthly intervals to fortnightly intervals. As the instrument develops, consideration could be given to introducing a weekly auction. Increasing the frequency of auctions would generate varying maturities in the market and make the 182 Days Treasury Bill a genuinely liquid money market instrument. If the payments for the accepted Treasury Bill bids are required to be made by the investor on the first day of the

statutory liquidity ratio fortnight of banks i.e., on a Saturday, banks which would be the major investors in this market,would be better able to plan their investment of short-term liquid funds.

Reserve Bank Refinance Facilities

7.5 At present the Reserve Bank provides a stand-by refinance facility against the collateral of Government securities at a rate of 12.5 per cent. The facility is, however, provided only if a bank shows a sustained excess of liquid assets over the stipulated statutory liquidity ratio. Moreover, the facility is essentially on a discretionary basis and prior approval is required for determining the sanctioned limit. In the context of a rapidly changing short-term liquidity position and the introduction of Treasury Bills auctions, there is a need to revamp this refinance facility.

7.6 The Working Group recommends that a new refinance facility labelled Treasury Bill Refinance Facility should be introduced by the end of April 1987 under which banks could be provided refinance against the collateral of their holdings of 182 Days Treasury Bills (the encumbered Treasury Bills would no longer be available as an eligible asset for purposes of the SLR). The refinance limit of a bank could be equivalent to 50 per cent of the holdings of 182 Days Treasury Bills and it would only be appropriate to keep the refinance rate flexible as the Treasury Bill rate is not fixed. The refinance rate should, however, be at least 1.5 percentage points above the prevailing Treasury Bill rate so as to enable a secondary market to thrive. At the same time, the proposed refinance ficility would provide adequate liquidity to the instrument. By providing refinance at a cost 1.5 percentage points above the Treasury Bill rate, the proposed Finance House (discussed in Chapter VIII) would have sufficient scope for undertaking two-way operations in the secondary market and the Reserve Bank refinance facility would be only a last resort for holders of Treasury Bills endeavouring to liquify their holdings for short periods. The proposed refinance facility would be a vast improvement over the present stand-by facility and in the event of the proposed new facility being introduced, the stand-by refinance facility should be terminated.

Inter-Bank Buy-Back Arrangements in Dates Securities

7.7 At the present time, inter-bank buy-back arrangements in dated securities have developed as a mechanism to circumvent the ceiling on the call money market rate. The Working Group has recommended that the ceiling on the inter-bank call money rate should be abolished and accordingly it would be desirable to encourage the development of an inter-bank market in dated securities on a buy-back basis. The Working Group is of the view that the interest rates on such buy-back arrangements should not be subject to any interest rate control. It would, however, be necessary to monitor this market closely to ensure that such operations do not militate against the objectives of the overall regulatory framework. As in the case of the Treasury Bills, the proposed Finance House would also participate in the market for buy-back arrangements in dated securities.

Chapter VIII : SETTING UP OF A FINANCE HOUSE

One of the terms of reference of the Working Group was to examine the need for developing institutions such as Discount Houses. The Banking Commission (Chairman: Shri R. G. Saraiya) recommended that at the time the Commission had submitted its report (in 1972), there was no need for specialised acceptance and discount houses. The Commission, however, recognised that in due course of time, after the bill market is sufficiently developed, there may be need for specialised discount houses (to be formed as joint stock companies) which would offer the services of acceptance credit and discounting function as well as functioning as a money market intermediary to even out the demand for and supply of short-term finance in the money market. The Working Group to Review the System of Cash Credit (Chairman: Shri K. B. Chore) recommended, in 1979, the establishment of a Discount House which can function as an independent body, subject to Reserve Bank supervision, *inter alia,* to even out the liquidity imbalances in the banking system.

8.2 An autonomous public limited company providing discounting and other facilities is necessary for the development of the money market. Such an institution could facilitate the smoothening of short-term liquidity imbalances and also lead to the integration of the short-term money market. By its operations, such an institution could activate the short-term money market and also impart greater flexibility to this market. By functioning as a major money market intermediary, it could also promote a secondary market in short-term money market instruments.

8.3 The Working Group has envisaged a freely operating call money market and has also recommended specific measures to widen and deepen the bill rediscounting market. The Group has also made a concrete recommendation on a time-bound introduction of short-term commercial paper. Furthermore, the Group recognises the important step taken recently to develop the Treasury Bill market. In the kind of milieu emerging in the immediate future, the Working Group is of the view that the time is now ripe for setting up a financial intermediary which would specialise in smoothening liquidity imbalances at the short end and would operate across the whole range of short-term financial instruments.

8.4 The Working Group recommends that an autonomous public limited company called the Finance House of India (FHI) should be set up to deal in short-term money market instruments with the primary objective of imparting improved liquidity to these instruments, and at the same time operating on a commerically viable basis. The authorised capital of the FHI should be Rs 100 crores of which Rs. 50 crores should be initially paid-up and the broad shares could be as follows: Reserve Bank (40 per cent), public sector banks (40 per cent), financial institutions (20 per cent).

8.5 The proposed FHI could be entrusted with the following functions:

(a) To rediscount commercial bills.

(b) Buy and sell short-term commercial paper.

(c) Rediscount 182 Days Treasury Bills as also participate in the auctions for these bills and actively participate in the development of a secondary market in Treasury Bills.

(d) Undertake short-term buy-back arrangements in Government and other approved dated securities to impart short-term liquidity to these securities.

(e) Provide brokerage services for the inter-bank call money market.

(f) Provide services in any other short-term money market instruments which may be evolved.

8.6 The finance house should have a presence in various short-term instruments and it should offer two-way prices. Given that the provision of such services could, at times, put a pressure on the finance house, it should be provided a back-up line of credit from the public sector banks of Rs. 100 crores at a fixed rate of 12 per cent. To enable the finance house to perform its functions efficiently, it should have sufficient liquidity and the Group recommends that the Reserve Bank of India should provide lender of the last resort facilities to the proposed finance house; the amount and the rate of interest on such refinance should be flexible. Thus, through varying the quantum of refinance and the rate of interest on such refinance, the Reserve Bank could provide necessary signals to the short-term money market.

8.7 The finance house should essentially lean against the wind and the day-to-day operations of the finance house should be guided by commercial viability. The aim of the FHI should be to actively trade in these money market instruments rather than become a repository for holding these money market assets; as such the thrust of the FHI's activities would be on turnover of business rather than the holdings of money market assets at any point of time. In this context, the Working Group urges that the FHI should be staffed by a very small number of highly skilled professionals. While the finance house could initially be set up in Bombay, it would ultimately need small outfits in the major financial centres in the country.

8.8 The Group recommends that necessary preparatory work for setting up the finance house be completed within 6 months. The Group suggests that in view of the schedule of other policy responses recommended by the Group which are to be implemented in the slack season of 1987, the FHI should be operative not later than July 1, 1987.

8.9 The Working Group recognises that over a period of time, there would be need for more than one finance house. As the market grows in size, this development would need to be brought about largely through the initiative of banks, financial institutions and merchant bankers in the private sector. The finance houses will need to be regulated by the Reserve Bank of India which would, in course of time, have to lay down the minimum capital requirements and other eligibility guidelines.

Chapter IX: DEVELOPMENT OF OTHER MONEY MARKET INSTRUMENTS

The Working Group recognises that in a dynamic market environment, there should be a continuing development and refinement of money market instruments and the strength of the market would depend on innovations in this regard. However, till the market develops the required degree of sophistication, it would be necessary to closely regulate the creation of new instruments. The Working Group recommends that within the broad framework developed in the Report, each new instrument coming into the market must be specifically approved by the Reserve Bank, which will *inter alia* lay down the terms and conditions on which the instrument can be placed on the market.

9.2 In this context, the Working Group has examined the need for a few additional instruments and the recommendations in this regard are set out below.

Inter-Bank Participation Certificates

9.3 In the late 1970's there was a rapid growth of Participation Certificates (PCs) and it was felt that the manner in which PC's had developed, they were merely deposits from institutions; hence PCs were subject to reserve requirements and eventually phased out. It would be recalled that in the earlier version of the PC, the borrowing bank did not include the PCs as part of its liabilities and the amount of PCs were excluded by the borrowing bank from its total advances. As such the banking system's liabilities and assets were both under-reported to the extent of PCs from institutions. The Working Group is of the view that while there were good reasons for taking measures which put a virtual end to PCs from institutions, there is still a case for developing an inter-bank PC market with a view to evening out short-term liquidity within the banking system. The salient features of the proposed inter-bank PC are sèt out below:

(i) The PCs would be strictly an inter-bank instrument among scheduled commercial banks.

(ii) The inter-bank PC would not be subject to reserve requirements.

(iii) The inter-bank PC would be 'without recourse' to the bank (i.e. this instrument would be a risk-bearing instrument).

(iv) Following the recommendation of the Working Group that inter-bank call money, inter-bank money market term deposits and inter-bank buy-back arrangements of dated securities should not be subject to interest rate ceilings, the interest rate on the proposed inter-bank PC should also be freely determined by the market.

(v) The duration of the inter-bank PC should not exceed 90 days.

(vi) There should be an execution of an 'Agreement of Transfer' by which the specific amount of the advance of the party would be taken off from the issuing (borrowing) bank's advances and be added to the purchasing (lending) bank's advances portfolio. The agreement should also provide for an *inter se* sharing of security.

9.4 The Working Group recommends that from the end of April 1987, inter-bank PCs should be reintroduced in the modified form within the framework indicated above.

Certificates of Deposit

9.5 A Certificate of Deposit (CD) is a document of title to a time deposit. The CDs being bearer documents are readily negotiated and are attractive both to the banker and the investor in that the banker is not required to encash the deposit prematurely while the investor can sell the CD in the secondary market and thereby the instrument has ready liquidity.

9.6 In the Indian context, the Tambe Working Group in its Supplementary Report had made the following observations on CDs:

> "there were divergent views among bankers in regard to the negotiable certificates of deposit (CDs) as an alternative short-term instrument. One view was that the CDs could be introduced with the terms and conditions to be worked out in consultation with the RBI and the IBA. However, a majority of bankers doubted the wisdom of introduction of CDs on the grounds of its inherent weakness in the Indian context. The drawbacks specifically discussed were: (i) absence of secondary market, (ii) administered interest rate structure on bank deposits, and (iii) the danger of CDs giving rise to a large number of fictitious transactions. On the basis of detailed discussion, the Group came to the conclusion that . . . . . introduction of CDs with the shortcomings narrated above would not be advisable at this stage."

9.7 In view of the bulk nature of deposits (say not less than Rs. 10 crores), the Tambe Group was inclined to recommend placing short-term deposits (upto 180 days) with the scheduled commercial banks at an interest rate marginally higher (by one per cent) than the corresponding rates on deposits of comparable maturities for the household sector.

9.8 The short-term deposit rates of banks continue to be very low and raising funds from institutions at rates only marginally higher than the banks present short-term deposit rates would not be a feasible proposition. The Working Group is of the considered view that developing CDs as a money market instruments would not be meaningful unless the short-term deposit rates are aligned with other rates in the system. Accordingly, the Working Group does not recommend the introduction of CDs at this stage. The Working Group, however, recommends that in the context of the various changes proposed by the Working Group and the introduction of the 182 Days Treasury Bill, the structure of short-term deposit rates upto one year as well as the number of maturities could be reviewed by the end of April 1987, and in the light of this review, the feasibility of introducing CDs could be reconsidered.

Development of Factoring Services

9.9 Despite various measures taken over the years to enable the small-scale sector to recover its dues from medium and large industry, (and in particular the public sector)

small-scale units face a liquidity bind because of their inability to efficiently collect their dues. In this context it would be useful to examine the possibility of developing a system of factoring of sales particularly for small-scale units. Factoring is an arrangement by which the 'factor' purchases, on a continuing basis, all the debts of the suppliers of goods and services to trade customers. The function of factoring is to relieve the suppliers of administrative and sales collection tasks so that the unit can concentrate on product/ selling of the produce. Depending on the requirement, the factor can provide services for (i) debt collection and (ii) immediate payment against sales invoices. The factor could assume complete responsibility for realisation of bills without recourse to the clients, i.e.,the client sells the 'receivables' to the factor for a commission and it is the responsibility of the 'factor' to realise the bills/debts. Alternatively, the client could use the services of the factor to act as an agent and prepayment is made with a contractual obligation requiring the sharing of losses arising out of realisation of the debts. In the Indian context, it would be desirable to develop factoring arrangements under which the client sells the debts without recourse to the clients, the commission for such an arrangement will be higher than in the case where the client authorises the 'factor' to be only the agent for collection.

9.10 The Working Group recommends that the banks should be encouraged to set up Factoring Divisions and private non-bank financial institutions attempting to provide factoring services should also be encouraged to do so. The endeavour should be to ensure that at least a few Factoring Divisions are set up by July 1, 1987. After experimenting with individual factoring division by banks and other institutions, the question of further development of this useful instrument could be examined.

9.11 The implications of factoring from a legal angle, particularly the incidence of stamp duty on any instrument created for this purpose, would need to be examined.

Chapter X: LEGISLATIVE CHANGES TO FACILITATE THE DEVELOPMENT OF THE MONEY MARKET

The Working Group has identified a number of areas where certain changes should be made to facilitate the development of the money market. Some of these measures are such as can be readily implemented while others are in the area of institution building. Some of the recommendations of the Group are in the nature of legislative changes and such changes are brought together in this chapter.

10.2 One of the key recommendations of the Group relates to the development of the bill discounting/rediscounting machanism. The imposition of a stamp duty on bills tends to discourage the development of an active bill market. The stamp duty on bills is an onerous burden on a financial instrument which is universally recognised as a preferred financial mechanism and continuing this stamp duty merely encourages the growth of less desirable instruments of financing. The Working Group, therefore, recommends that in the interest of developing a strong financial and banking system, the Government of India should take necessary measures to abolish the stamp duty on bills.

10.3 The Working Group has recommended the introduction of commercial paper as a new money market instrument. This short-term money market instrument would need to be supervised by the Reserve Bank of India. The Working Group recommends that suitable legislative changes relating to various enactments such as the Companies Act, the Capital Issues (Control) Act and the Reserve Bank of India Act should be undertaken so that the Reserve Bank of India can act as the nodal agency for approving the issue of short-term commercial paper by companies and also to enable the Reserve Bank to set out the specific guidelines to be observed in the case of such issues. Furthermore, the Working Group recommends that commercial paper is a new instrument which is being introduced and its viability as an instrument would be better ensured if commercial paper is exempt from stamp duty.

10.4 The Working Group has also recommended the setting up of a Finance House of India and has envisaged the provision of Reserve Bank refinance to the Finance House of India. In this connection, suitable enabling amendments may need to be effected in the Reserve Bank of India Act.

10.5 The Working Group has envisaged a specific phased programme of implementation of various recommendations and it is sugggested that the various legislative changes should be undertaken as to enable the implementation of the recommendations to be undertaken within this time frame.

Chapter XI: RECOMMENDATIONS OF THE WORKING GROUP

The recommendations of the Working Group are summarised below:

Call Money

1. The present interest rate ceiling on the call money fixed by the IBA should be abolished and the call money rates should be left to be determined by market forces. The call money rates should be freed only for inter-bank transactions and the ceiling rate of 10 per cent should continue to be maintained for borrowings from non-bank participants in the market, if any (Paragraph 4.7).

2. It would be necessary for the Reserve Bank to counsel the surplus banks to ensure that call money operations are not disruptive to the banking system and the call money rates do not rise to stratospheric levels over prolonged periods (Paragraph 4.8).

3. The call money market should strictly be an inter-bank market. The LIC and the UTI may be permitted to remain in the market. The position could be reviewed, if need be, by the Reserve Bank of India in April 1988 (Paragraph 4.9).

4. The interest rate on inter-bank term deposits should also be determined by market forces (Paragraph 4.10).

5. The measures relating to the call money and inter-bank term deposit rates should be implemented with the inception of the slack season at the end of April 1987 (Paragraph 4.11).

6. There is no need for brokers to be re-introduced into the call money market. To the extent that broker services are felt necessary after the freeing of the call and inter-bank term deposit rates, the proposed Finance House could usefully provide this service (Paragraph 4.12).

Bills Rediscounting

7. There is a need to take a number of positive measures to facilitate the emergence of a genuine bill culture (Paragraph 5.1).

8. The Government should direct departmental undertakings and public sector organisations that payments for all credit purchases should be in the form of bills which should be strictly honoured on the due dates. Failure to pay a bill on the due date should attract a uniform penal rate of 2 percentage points above the maximum lending rate of banks. A similar procedure should be followed in the case of CAS

parties. In the event of three instances of defaults on payment of bills, the working capital limits should be reduced suitably (Paragraph 5.5).

9. The working capital limits of the large parties should be scaled down and the interest rates increased if bill acceptances are less than a stipulated percentage of credit purchases (Paragraph 5.6).

10. It would be necessary to move away from receivable financing to bill financing and accordingly a programme commencing from April 1988 should be stipulated for phasing out receivable financing. Of the total receivables, the proportion of receivables eligible for financing under the cash credit/overdraft facilities should be 75 per cent from April 1, 1988, 50 per cent from April 1, 1989 and 25 per cent from April 1, 1990. The rest of the receivables should be financed only through demand/usance bill limits (Paragraph 5.7).

11. Within the CAS discipline, banks should be given the discretion to increase bill limits for temporary periods (Paragraph 5.8).

12. The stipulation on unsecured advances should not be made applicable to bill financing (Paragraph 5.11).

13. The maximum discount rate on bills should be such that it does not exceed an equivalent effective interest rate of 16.0 per cent. This should be implemented at the end of April 1987 and after a year, an assessment could be made as to whether the maximum discount rate could be freely determined by the banks (Paragraph 5.13).

14. As at the end of April 1987, the ceiling on the rediscount rate should be increased from 11.5 per cent to 12.5 per cent (Paragraph 5.15).

15. A review as to whether the ceiling on the rediscount rate should be removed could be undertaken in April 1988 (Paragraph 5.16).

16. Institutions and other units such as companies, trusts etc., which can satisfactorily, demonstrate to Reserve Bank that they have a resource surplus of a monthly average of at least Rs. 5 crores per annum should be allowed to participate in the bill rediscounting market (Paragraph 5.18).

17. Further rediscounting by the institutions should be freely permitted (Paragraph 5.19).

18. The procedures for rediscounting bills should be simplified by the end of April 1987 (Paragraph 5.20).

Short-Term Commercial Paper

19. The time is appropriate for starting with a limited introduction of commercial paper (Paragraph 6.5). Initially, access to the commercial paper market should be given only to 'A' rated companies (Paragraph 6.6).

20. The interest rate on commercial paper should be freely determined by market considerations (Paragraph 6.7).

21. The commercial paper market should function within the overall discipline of the CAS. The Reserve Bank should administer the entry in the market, the amount of each issue and the total quantum that can be raised in a year (Paragraph 6.8).

22. There should be no restrictions on the participants in the commercial paper market. The size of any single issue should not be less than Rs. 1 crore and the size of each note should not be less than Rs. 5 lakhs (Paragraph 6.9).

23. Commercial paper should be excluded from the stipulations on unsecured advances in the case of banks (Paragraph 6.10).

24. The framework set out for developing a commercial paper market in India could be adopted (Paragraph 6.11) and necessary legislative/administrative changes should be completed so as to enable commercial paper to be operative by April 1, 1988. The authorities should take an early decision to commit themselves to a time-bound introduction of commercial paper (Paragraph 6.12).

Government Paper

25. For an active secondary market in 182 Days Treasury Bills, it would be necessary for a large number of participants to bid regularly in the auctions and to build up a portfolio of varying maturities. Suitable measures need to be taken to ensure that the Treasury Bill rate remains flexible (Paragraph 7.3). The periodicity of the auctions should be increased (Paragraph 7.4).

26. A Treasury Bill Refinance Facility should be introduced by the end of April 1987 and the refinance rate should be at least 1.5 percentage points above the prevailing Treasury Bill rate. In the event of the proposed facility being introduced, the stand-by refinance facility should be terminated (Paragraph 7.6).

27. Inter-bank transactions in dated securities on a buy-back basis should be encouraged and interest rates on such transactions should not be subject to interest rate control (Paragraph 7.7).

Setting up of a Finance House

28. An autonomous public limited company called the Finance House of India should be set up jointly by the Reserve Bank, the public sector banks and the financial institutions to deal in short-term money market instruments (Paragraph 8.4). The finance house should have back-up facilities with banks and the Reserve Bank (Paragraph 8.6). In view of the schedule of other policy responses which are to be implemented in the slack season of 1987, the Finance House of India should be operative not later than July 1, 1987 (Paragraph 8.8). Over a period of time, there would be need for more than one finance house (Paragraph 8.9).

Development of New Instruments

29. There should be a continuing development and refinement of money market instruments. Each new instrument coming into the market must be specifically approved by the Reserve Bank (Paragraph 9.1).

Inter-Bank Participation Certificates

30. From the end of April 1987, inter-bank participation certificates should be re-introduced in a modified form (Paragraph 9.4).

Certificates of Deposit

31. The introduction of Certificates of Deposit is not recommended at this stage. In the context of the various changes proposed by the Working Group and the introduction of the 182 Days Treasury Bill, the structure of short-term deposit rates upto one year as well as the number of maturities could be reviewed by the end of April 1987 and in the light of this review, the feasibility of introducing Certificates of Deposit could be reconsidered (Paragraph 9.8).

Factoring Services

32. The banks and private non-bank financial institutions should be encouraged to provide factoring services. A few Factoring Divisions should be set up by July 1, 1987 (Paragraph 9.10).

Legislative Changes

33. In the interest of developing a strong financial and banking system, the Government of India should take necessary measures to abolish the stamp duty on bills (Paragraph 10.3).

34. The viability of the new instrument of commercial paper would be better ensured if commercial paper is exempt from stamp duty (Paragraph 10.3).

35. Suitable amendments may need to be effected in the Reserve Bank of India Act to enable the Bank to provide refinance to the Finance House of India (Paragraph 10.4).

Time Frame of Implementation

36. While the measures recommended form an integrated package, there is a need for a well chalked out phased programme and accordingly, a time schedule for implementing the Working Group's recommendations has been set out below.

Time Schedule for the Implementation of the Working Group's Recommendations

	Recommendations	Suggested Date of Implementation
1.	Freeing of the inter-bank call money rate (ceiling of 10 per cent for institutions to be retained)	April 30, 1987
2.	Freeing of the inter-bank term deposit rates	April 30, 1987
3.	Lowering of the effective interest rate on Bills Discounting to 16.0 per cent	April 30, 1987
4.	Increasing the Bill Rediscounting Rate from not exceeding 11.5 per cent to not exceeding 12.5 per cent per annum	April 30, 1987
5.	Feasibility of freeing the Bill Discounting/ Rediscounting Rates to be considered	April 30, 1988
6.	Procedures for Rediscounting bills to be simplified	April 30, 1987
7.	Reduction in three annual phases in the proportion of receivables of borrowers within the purview of the CAS eligible for financing under the cash credit/overdraft facilities as also related measures to encourage bill finance	March 31, 1988 March 31, 1989 March 31, 1990
8.	Short-term Commercial Paper to be operative	April 1, 1988
9.	Treasury Bill Refinance Facility to be introduced	April 30, 1987
10.	Finance House of India to be operative	July 1, 1987
11.	Introduction of Inter-Scheduled Commercial Banks Participation Certificates	April 30, 1987
12.	Review of the structure of short-term deposit rates upto one year	April 30, 1987
13.	Commercial Bills and Commercial Paper to be exempted from the stipulation on unsecured advances	April 30, 1988
14.	Setting up of a few Factoring Divisions by banks and other institutions	July 1, 1987
15.	Legislative measures to facilitate the development of the money market	July 1, 1987 April 1, 1988

ANNEXURE – I

RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

September 5, 1986
Bhadra 14, 1908 (Saka)

MEMORANDUM

The Reserve Bank of India appoints a Working Group to examine the possibilities of enlarging the scope of the money market and to recommend specific measures for evolving money market instruments.

2. The Working Group will consist of the following:

1.	Shri N. Vaghul, Chairman, Industrial Credit and Investment Corporation of India, Bombay.	Chairman
2.	Shri M. J. Pherwani, Chairman, Unit Trust of India, Bombay.	Member
3.	Shri S. Padmanabhan, Chairman, Indian Overseas Bank, Madras.	Member
4.	Shri R. Narasimhan, General Manager (Operations), State Bank of India, Lucknow.	Member
5.	Shri K. Sajeeve Thomas, Vice-President, Citibank, Bombay.	Member
6.	Shri V. B. Desai, Stock/Share Broker, Bombay.	Member

7. Shri S. S . Tarapore, — Member-Secretary
Adviser-in-Charge,
Credit Planning Cell,
Reserve Bank of India,
Bombay.

3. The terms of reference of the Working Group will be as follows:

i) To examine money market instruments and recommend specific measures for their development.

ii) To recommend the pattern of money market interest rates and to indicate whether these should be administered or determined by the market.

iii) To study the feasibility of increasing the participants in the money market.

iv) To assess the impact of changes in the cash credit system on the money market and to examine the need for developing specialised institutions such as discount houses. In this context, the inter-action between the inter-corporate market and the expanded money market could also be examined.

v) Any other issue having a bearing on the development of the money market.

4. The Working Group is expected to submit its Report by the end of December 1986.

5. The Secretariat for the Working Group will be provided by Credit Planning Cell, Reserve Bank of India, Central Office, Bombay.

R. N. Malhotra
Governor

ANNEXURE-2

List of persons with whom the Working Group had discussions

1. Dr. C. Rangarajan,
   Deputy Governor,
   Reserve Bank of India,
   Bombay.

2. Shri A, Hasib,
   Executive Director,
   Reserve Bank of India,
   Bombay.

3. Dr. S. R. K. Rao,
   Principal Adviser,
   Department of Economic
   Analysis and Policy,
   Reserve Bank of India,
   Bombay.

4. Dr. K. K. Mukherjee,
   Chief Officer,
   Department of Banking
   Operations and Development,
   Reserve Bank of India,
   Bombay.

5. Shri D. N. Ghosh,
   Chairman,
   State Bank of India,
   Bombay.

6. Shri. M. N. Goiporia,
   Chairman,
   Central Bank of India
   and
   Chairman,
   Indian Banks' Association,
   Bombay.

7. Shri J. M. Yardi,
   General Manager,
   Grindlays Bank p. l. c.,
   Bombay.

8. Shri N. Venkateswaran,
   Vice-President and
   Country Manager,
   Bank of America N. T. & S. A.,
   Bombay.

9. Mr. S. Konoumi,
   General Manager,
   Bank of Tokyo Ltd.,
   Bombay.

10. Shri. G. Chidambar,
    Chief (Investments),
    Life Insurance Corporation of India,
    Bombay.

11. Shri B. D. Shah,
    General Manager,
    General Insurance Corporation of India,
    Bombay.

12. Shri D. Basu,
    Managing Director,
    SBI Capital Markets Ltd.,
    Bombay.

13. Shri J. R. Joshi,
    Director,
    Champaklal Investments and
    Financial Consultancy Ltd.,
    Bombay.

14. Shri Hemendra Kothari,
    D. S. P. Financial Consultants Ltd.,
    Bombay.

15. Shri M. N. Kampani,
    J. M. Financial and Investments
    Consultnacy Pvt. Ltd.
    Bombay.

16. Professor J. S. G. Wilson,
    Professor Emeritus,
    University of Hull,
    Department of Economics and
    Commerce, HULL - HU 6 RX (U. K.).

17. Mr. Antony K. Leung,
    Area Head – South West Asia,
    Citicorp Investment Bank,
    Manila (Philippines).

STATEMENT - 1

A: Instruments of Money Market Operations, Ceiling Rate of Interest and Participants

	Instruments	Ceiling rate of Interest (Percent)	Institutions eligible to participate
1.	Money at Call (i. e. overnight call money) and short notice (i. e. for periods upto and including 14 days notice)	10.0	Scheduled commercial banks, co-operative banks, LIC and UTI
2.	Inter-bank Term Deposits/ Loans for periods		Scheduled commercial banks and co-operative banks
	i) 15 days to 30 days	10.5	
	ii) 31 days to 60 days	11.0	
	iii) Over 60 days	11.5	
3.	Participation Certificates	10.0	Scheduled commercial banks, LIC, GIC and its subsidiaries, UTI, ICICI, IRBI and ECGC.
4.	Bills rediscounting	11.5	Scheduled commercial banks, LIC, GIC and its subsidiaries, UTI, ICICI, IRBI and ECGC.

Note: The ceiling rates of interest on Sr. Nos. 1 and 2 are fixed by IBA while those for 3 and 4 are fixed by RBI.

B : Scheduled Commercial Banks — Interest Rates on Deposits (Excluding FCNR/NRE)

Type of Deposit	Rate of Interest (Per cent)
Saving Bank Despoits	5.0
15 to 45 days	3.0
46 to 90 days	4.0
91 days to less than 6 months	6.5
6 months to less than one year	8.0
1 year to less than 2 years	8.5
2 years to less than 3 years	9.0
3 years to 5 years	10.0
Above 5 years	11.0

STATEMENT – 2

MONTHLY CALL MONEY RATE : BOMBAY

(Per cent)

Months	1981-82			1982-83			1983-84			1984-85			1985-86			1986-87		
	Minimum	Maximum	Average	Minimum	Maximum	Average	Minimum	Maximum	Average	Minimum	Maximum	Average	Minimum	Maximum	Average	Minimum	Maximum	Average
April	5.68	10.00	7.30	9.91	10.00	9.97	9.20	10.00	9.78	10.00	10.00	10.00	9.93	10.00	9.98	10.00	10.00	10.00
May	6.87	8.46	7.66	8.15	10.00	9.44	6.00	9.39	7.77	8.64	10.00	9.63	10.00	10.00	10.00	10.00	10.00	10.00
June	4.74	8.83	7.07	6.59	7.94	7.16	7.94	9.44	8.92	9.62	10.00	9.92	9.99	10.00	10.00	10.00	10.00	10.00
July	5.66	9.47	7.38	5.00	8.57	6.09	6.60	9.32	7.90	9.55	10.00	9.87	10.00	10.00	10.00	10.00	10.00	10.00
August	7.92	9.52	8.89	4.50	9.77	5.97	6.22	7.17	6.78	9.67	9.98	9.85	9.93	10.00	9.98	9.70	10.00	9.96
·September	8.76	9.97	9.54	4.16	4.33	4.25	6.31	7.61	7.04	9.96	10.00	9.98	10.00	10.00	10.00	9.96	10.00	9.99
October	8.65	10.00	9.73	4.41	4.48	4.44	6.70	8.63	7.84	10.00	10.00	10.00	9.95	10.00	9.99			
November	10.00	10.00	10.00	4.45	5.49	4.73	6.45	9.85	8.31	10.00	10.00	10.00	10.00	10.00	10.00			
December	10.00	10.00	10.00	4.23	9.97	5.84	5.30	10.00	8.22	10.00	10.00	10.00	10.00	10.00	10.00			
January	10.00	10.00	10.00	4.96	9.96	8.07	9.91	10.00	9.98	10.00	10.00	10.00	10.00	10.00	10.00			
February	10.00	10.00	10.00	5.61	9.98	8.67	9.82	10.00	9.96	10.00	10.00	10.00	10.00	10.00	10.00			
March	10.00	10.00	10.00	9.91	10.00	9.96	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00			

Note: Rates are the weighted averages of quotations, the weight being proportional to the amounts accepted during the period.

Source: Reserve Bank of India Bulletin.

STATEMENT – 3

Scheduled Commercial Banks' Borrowings in Inter-Bank Call Money Market

As on the last Friday of*	Amount outstanding (Rs. crores) From Banks	From LIC/UTI	Total
1982-83			
April	342	140	482
May	237	173	410
June	312	229	541
July	235	281	516
August	289	293	582
September	375	296	671
October	365	257	622
November	349	218	567
December	288	142	430
January	275	236	511
February	314	233	547
March	780	212	992
Annual Average	347	226	573
	(60.6)	(39.4)	(100.0)
1983-84			
April	408	212	620
May	244	344	588
June	245	265	510
July	247	264	511
August	353	373	726
September	237	284	521
October	314	252	566
November	283	292	575
December	607	195	802
January	310	308	618
February	558	330	888
March	792	275	1067
Annual Average	383	283	666
	(57.5)	(42.5)	(100.0)
1984-85			
April	568	276	844
May	315	455	770
June	375	335	710
July	392	364	756
August	383	427	810
September	564	351	915

STATEMENT – 3 (Contd.)

Scheduled Commercial Banks' Borrowings in Inter-Bank Call Money Market

As on the last Friday of*	Amount outstandings (Rs. crores)		
	From Banks	From LIC/UTI	Total
October	626	343	969
November	415	318	733
December	784	215	999
January	716	312	1028
February	652	193	845
March	793	197	990
Annual Average	549	315	864
	(63.5)	(36.5)	(100.0)
1985-86			
April	409	277	686
May	416	217	633
June	458	213	671
July	471	304	775
August	538	323	861
September	1103	235	1338
October	652	152	804
November	723	140	863
December (P)	520	223	743
January (P)	1114	131	1245
February (P)	1029	98	1127
March (P)	1899	166	2065
Annual Average	843	224	1067
	(79.0)	(21.0)	(100.0)
1986-87			
April (P)	478	145	623
May (P)	800	98	898
June (P)	447	105	552
July (P)	851	150	1001
August (P)	412	206	618
September (P)	421	128	549
October (P)	435	133	568
November (P)	326	116	442
Average	521	135	656
	(79.4)	(20.6)	(100.0)

*From 1985-86 data are as on the last Reporting Fridays.

(P) Provisional.

Note Figures in brackets indicate percentage to total.

Source: Returns furnished by scheduled commercial banks under Section 42 (2) of the Reserve Bank of India Act, 1934.

STATEMENT – 4

Scheduled Commercial Banks' Reliance on Term Deposits/Loans

(Rs. crores)

As on the last reporting Friday	Term Deposits/Loans (Over 14 days)	
	Borrowed	Lent
1985		
March	420	54
April	645	72
May	800	124
June	867	94
July	882	165
August	907	101
September	1003	79
October	905	87
November	885	80
December	877	95
1986		
January	866	132
February	870	61
March	787	70
April	952	86
May	933	79
June	1098	121
July	1032	95
August	1306	62
September	1454	266
October	1411	216

Source: Special Fortnightly Returns furnished by major banks.

Note: The amount of term deposits/loans lent by scheduled commercial banks to other scheduled commercial banks should normally be close to the amount borrowed by scheduled commercial banks from other scheduled commercial banks and cooperative banks. It would appear that there could be a misclassification of data reported by banks as between call money and term deposits. Please see note in Statement – 8.

STATEMENT – 5

All Scheduled Commercial Banks – Inland Bills Purchased and Discounted and Rediscounted

(Outstanding in Rs. Crores)

As on the last Friday of	Net Bank Credit	Of which Inland bills purchased and discounted	Col. (2) as percentage of Col. (1)	Bills Rediscounted with Reserve Bank	Bills Rediscounted with scheduled commercial banks and approved financial institutions
	(1)	(2)	(3)	(4)	(5)
March 1977	13,173	1,155	8.76	184	41
March 1978	14,939	1,575	10.54	117	19
March 1979	17,795	1,666	9.36	106	28
March 1980	23,110	1,859	8.04	109	65
March 1981	25,371	2,281	8.99	3	103
March 1982	29,681	2,276	7.67	–	212
March 1983	35,493	3,000	8.45	–	187
March 1984	41,294	3,136	7.59	–	236
June 1984	43,613	3,149	7.22	–	366
September 1984	43,505	3,140	7.22	–	347
December 1984	47,951	3,556	7.41	–	283
March 1985	48,953	3,595	7.34	–	533
June 1985	50,921	3,419	6.71	–	788
September 1985	50,559	2,998	5.93	–	1091
December 1985 (P)	52,423	3,183	6.81	–	1042
March 1986 (P)	55,506	3,779	6.81	–	752
June 1986 (P)	56,212	3,530	6.28	–	999
September 1986 (P)	56,665	3,324	5.87	–	892

(P) : Provisional and last reporting Friday.

Source : Section 42(2) Return for Net Bank Credit, Inland Bills purchased and discounted and special Fortnightly Returns from major scheduled commercial banks for Bills Rediscounted with banks and approved institutions.

STATEMENT – 6

Scheduled Commercial Banks' Reliance on Bills Rediscounting Market

(Rs. crores)

As on the last reporting Friday	Bills Rediscount	
	Borrowed	Lent
March 1981	103	1
March 1982	212	15
March 1983	172	13
March 1984	236	21
1985		
March	533	22
April	673	45
May	859	10
June	788	48
July	737	39
August	1022	48
September	1091	3
October	945	64
November	1001	77
December	1042	90
1986		
January	1068	44
February	958	225
March	752	160
April	975	206
May	900	259
June	999	152
July	927	173
August	1019	168
September	892	259
October	801	167

Source: Special Fortnightly Returns furnished by major banks.

STATEMENT – 7

Weekly Variations in Scheduled Commercial Banks' Balances with Reserve Bank of India and Holdings of Government of India Treasury Bills by Banks

(Rs. crores)

Week ended		Scheduled Commercial Banks' Balances with RBI		Holdings of Government of India Treasury Bills by Banks	
		Amount Outstanding	Weekly Variation	Amount Outstanding	Weekly Variation
1986-87					
April	4	11770	+ 717	33	– 71
	11	10472	–1298	1892	+1859
	18	12486	+2014	315	–1577
	25	8520	–3966	4242	+3927
May	2	12596	+4076	699	–3543
	9	10001	–2595	2872	+2173
	16	12128	+2127	42	–2830
	23	11880	– 248	1261	+1219
	30	12558	+ 678	143	–1118
June	6	10197	–2361	3052	+2909
	13	12351	+2154	1018	–2034
	20	10091	–2260	3319	+2301
	27	12940	+2849	789	–2530
July	4	10540	–2400	2269	+1480
	11	13131	+2591	181	–2088
	18	11148	–1983	1612	+1431
	25	13198	+2050	158	–1454
August	1	10336	–2862	2655	+2497
	8	12774	+2438	261	–2394
	15	11589	–1185	1603	+1342
	22	13239	+1650	424	–1179
	29	10993	–2296	3063	+2639
September	5	13451	+2508	301	–2762
	12	10943	–2502	2698	+2397
	19	13128	+2179	216	–2482
	26	11218	–1910	2126	+1910
October	3	13671	+2453	265	–1861
	10	11458	–2213	1928	+1663
	17	13300	+1842	209	–1719
	24	10866	–2434	2810	+2601
	31	13476	+2610	54	–2756
November	7	11161	–2315	2353	+2299
	14	13880	+2719	74	–2279
	21	12655	–1225	1380	+1306
	28	13294	+ 639	1115	– 265
December	5	13407	+ 113	1267	+ 152
	12	14052	+ 645	788	– 479
	19	12634	–1418	1464	+ 676
	26	14959	+2325	105	–1359

STATEMENT – 8

Money Market Borrowings/Lendings by Banks

(Rs. crores)

Instruments	As on the last Friday of													
	March 1981		March 1982		March 1983		March 1984		March 1985		March 1986		October 1986	
	Accepted (1)	Placed (2)	Accepted (3)	Placed (4)	Accepted (5)	Placed (6)	Accepted (7)	Placed (8)	Accepted (9)	Placed (10)	Accepted (11)	Placed (12)	Accepted (13)	Placed (14)
1. Money at Call	452	540	552	363	471	324	698	701	569	171	1905	2216	357	691
2. Notice Money (1-14 days)	134	–	37	2	5	–	137	–	123	–	78	3	75	–
3. Term Deposits	406	67	309	16	153	55	370	36	420	54	787	70	1411	216
4. Participation Certificates	154	–	35	–	12	–	10	–	2	–	–	–	–	–
5. Bills Rediscounted with banks and financial institutions (other than RBI, IDBI and Exim Bank)	103	1	212	15	172	13	236	21	533	22	752	160	801	167
TOTAL	1249	608	1145	396	813	392	1451	758	1647	247	3522	2449	2644	1074
Aggregate Deposits All Scheduled Commercial Banks	37988		43733		51358		60596		72244		85288		93591	
Total of Money Accepted as a percentage to Aggregated Deposits	3.29		2.62		1.58		2.39		2.28		4.13		2.83	

Note: Under the column 'Accepted', funds accepted by scheduled commercial banks from other banks and the financial institutions are given while under the column 'Placed', funds lent by scheduled commercial banks to other scheduled commercial banks are given.

Source: Special Weekly/Fortnightly Return-III from major banks. Data on money at Call and short notice presented in this statement are strictly not comparable with those shown in statement 3 due to different sources. The amount of call money accepted by scheduled commercial banks should normally be more than the amount of call money placed with the scheduled commercial banks. It would appear that there is misclassification of data reported by banks as between call money and term deposits.

STATEMENT – 9

Average Yield on Resources Deployed by Banks

Deployment of Resources (Assuming Rs. 100/- employed)			Interest Earned (Amount in Rs.)	
			Assuming earning on Securities @ 11.5 per cent and on advances @ 17.5 per cent	Assuming earning on Securities @ 7.0 per cent and on advances @ 15.0 per cent
1.	Rs. 3/-	with RBI as CRR earning no interest	Nil	Nil
2.	Rs. 6/-	with RBI as CRR earning interest @ 10.5 per cent	0.63	0.63
3.	Rs. 10/-	with RBI as incremental CRR earning interest @ 10.5 per cent	1.05	1.05
4.	Rs. 3/-	as cash on hand and balances with other banks in current accounts earning no interest.	Nil	Nil
5.	Rs. 34/-	in Securities	3.91	2.38
6.	Rs. 44/-	in Advances	7.70	6.60
Average yield on Rs. 100/- deployed (1 to 6)			13.29	10.66