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**MS-402 (PART-I)**

School of Management Studies and Commerce
**Indian Financial System**

**MS-402 (PART-I)**

School of Management Studies and Commerce

# Indian Financial System

**DEPARTMENT OF MANAGEMENT STUDIES**

**Block I Structure of Indian Financial System**

**Block II Regulators of Financial System**

MS 402

# Indian Financial System

## Block – I

**Block Title-** Structure of Indian Financial System

## Block – II

**Block Title-** Regulators of Financial System


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## Course Code-MS 402

**Course Objective:** This course aims at providing the students the intricacies of Indian financial system for better financial decision making.


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**Unit XXIII Current Developments in the Indian Financial System**

**Suggested Readings:**


1. Machiraju, 'Indian Financial System' – Vikas Publishing House, 2nd Edition, 2002.
2. Varshney P.N., & Mittal D.K., 'Indian Financial System', Sultan Chand & Sons, New Delhi. 2002.
3. Verma J.C., 'Venture Capital Financing in India', Sage, New Delhi, 1997.
4. Sadhale H., 'Mutual Funds in India', Sage, New Delhi, 1997.

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# Block I

# Structure of Indian Financial System

# UNIT 1 FINANCIAL SYSTEM: AN INTRODUCTION

**1.1 Introduction**

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## 1.1 INTRODUCTION

In this unit, you will study about the financial system. Financial system is the backbone of an economy. This unit begins with the introduction to financial system, its interrelationship, functions, role and importance. The last section gives an overview of the Indian financial system.

## 1.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the meaning and concept of financial system.
- Explain the functions, role and importance of financial system in economic development.
- Understand the components of financial system.

## 1.3 INTRODUCTION TO FINANCIAL SYSTEM

The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate sector, government and household sector. There are areas or people with surplus funds and there are those with a deficit. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

Financial system comprises of set of subsystems of financial institutions, financial markets, financial instruments and services which helps in the formation of capital. It provides a mechanism by which savings are transformed to investment.

The word "system", in the term "financial system", implies a set of complex and closely connected or interlinked institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance -the three terms are intimately related yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation.

## 1.4 THE MEANING OF FINANCIAL SYSTEM

A financial system functions as an intermediary between savers and investors. It facilitates the flow of funds from the areas of surplus to the areas of deficit. It is concerned about the money, credit and finance. These three parts are very closely interrelated with each other and depend on each other.

A financial system may be defined as a set of institutions, instruments and markets which promotes savings and channels them to their most efficient use. It consists of individuals (savers), intermediaries, markets and users of savings (investors).

In the worlds of Van Horne, ***"financial system allocates savings efficiently in an economy to ultimate users either for investment in real assets or for consumption".***

Christy has opined that the objective of the financial system is to "***supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with individual desires.***"

According to Robinson, the primary function of the system is "***to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth.***"

According to Prasanna Chandra, ***"financial system consists of a variety of institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments".***

From the above definitions, it may be said that the primary function of the financial system is the mobilization of savings, their distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth.

Thus, financial system is a set of complex and closely interlinked financial institutions, financial markets, financial instruments and services which facilitate the transfer of funds. Financial institutions mobilize funds from suppliers and provide these funds to those who demand them. Similarly, the financial markets are also required for movement of funds from savers to

intermediaries and from intermediaries to investors. In short, financial system is a mechanism by which savings are transformed into investments.

## 1.5 THE CONCEPT OF THE FINANCIAL SYSTEM

The process of savings, finance and investment involves financial institutions, markets, instruments and services. Flow of Funds through Financial System can be understood with the help of the following diagram:

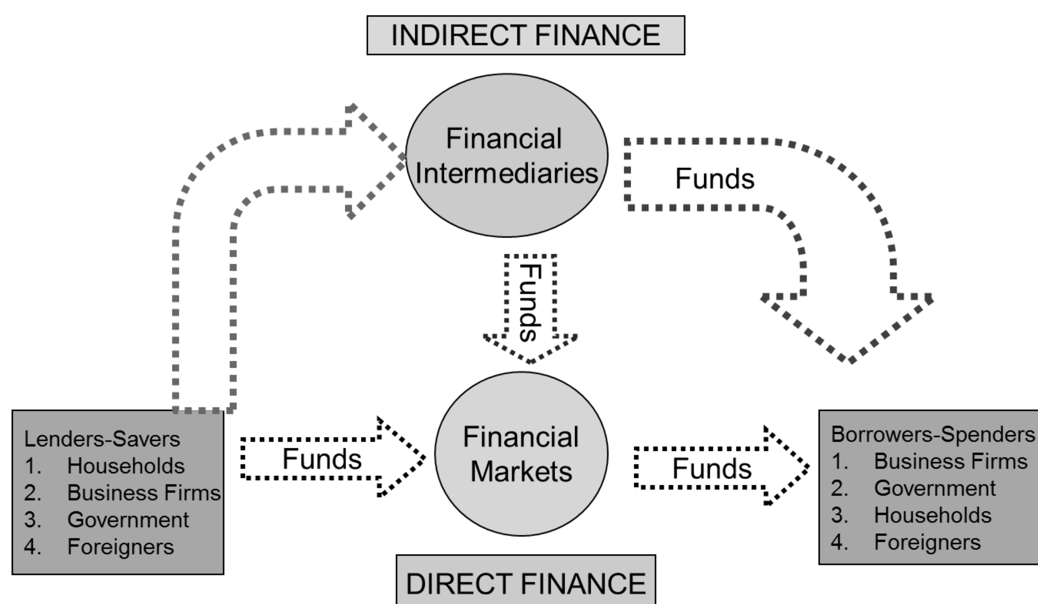


**Fig 1.1 Flow of Funds through Financial System**

Above all, supervision control and regulation are equally significant. Thus, financial management is an integral part of the financial system. On the basis of the empirical evidence, Goldsmith said that "... *a case for the hypothesis that the separation of the functions of savings and investment which is made possible by the introduction of financial instruments as well as enlargement of the range of financial assets which follows from the creation of financial institutions increase the efficiency of investments and raise the ratio of capital formation to national production and financial activities and through these two channels increase the rate of growth……*"

## 1.6 INTER-RELATIONSHIPS IN THE FINANCIAL SYSTEM

A financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. In fact, the country could make this feasible with the active support of the financial system. The financial system has been identified as the most catalyzing agent for growth of the economy, making it one of the key inputs of development.

## 1.7 FUNCTIONS OF FINANCIAL SYSTEM

The financial system of a country performs certain valuable functions for the economic growth of that country. The main functions of a financial system may be briefly discussed as below:

1. **Saving function:** An important function of a financial system is to mobilize savings and channelize them into productive activities. It is through financial system the savings are transformed into investments.

2. **Liquidity function**: The most important function of a financial system is to provide money and monetary assets for the production of goods and services. Monetary assets are those assets which can be converted into cash or money easily without loss of value. All activities in a financial system are related to liquidity-either provision of liquidity or trading in liquidity.

3. **Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced.

4. **Risk function**: The financial markets provide protection against life, health and income risks. These guarantees are accomplished through the sale of life, health insurance and property insurance policies.

5. **Information function:** A financial system makes available price-related information. This is a valuable help to those who need to take economic and financial decisions. Financial markets disseminate information for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment or holding a particular asset.

6. **Transfer function:** A financial system provides a mechanism for the transfer of the resources across geographic boundaries.

7. **Reformatory functions:** A financial system undertaking the functions of developing, introducing innovative financial assets/instruments services and practices and restructuring the existing assets, services etc, to cater the emerging needs of borrowers and investors (financial engineering and re-engineering).

**8. Other functions:** It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

## 1.8 ROLE AND IMPORTANCE OF FINANCIAL SYSTEM IN ECONOMIC DEVELOPMENT

Based on the functions of the financial system, it is seen that it is very important for the development of the economy. Following points indicate the role and importance of financial system:

1. It links the savers and investors. It helps in mobilizing and allocating the savings efficiently and effectively. It plays a crucial role in economic development through saving-investment process. This savings – investment process is called capital formation.

2. It helps to monitor corporate performance.

3. It provides a mechanism for managing uncertainty and controlling risk.

4. It provides a mechanism for the transfer of resources across geographical

boundaries.

5. It offers portfolio adjustment facilities (provided by financial markets and

financial intermediaries).

6. It helps in lowering the transaction costs and increase returns. This will motivate people to save more.

7. It promotes the process of capital formation.

8. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.

In short, a financial system contributes to the acceleration of economic development. It contributes to growth through technical progress.

*Check Your Progress- A*

**Q1. State the meaning of a financial system?**

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-----------------------------------------------------------------------------------------------------------

**Q2. Explain the functions of the financial system?**

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**Q3. MCQs**

i. **Which of the following statements do not explain the role and importance of financial system?**

a. It links the savers and investors.
b. It helps to monitor corporate performance.
c. It leads to uncertainty and controlling risk.
d. It provides a mechanism for the transfer of resources across geographical boundaries.

## 1.9 COMPONENTS OF FINANCIAL SYSTEM

Financial structure refers to shape, components and their order in the financial system. The financial system can be broadly classified into formal (organized) financial system and the informal (unorganized) financial system. The formal financial system comprises of Ministry of Finance, Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and

other regulatory bodies. The informal financial system consists of individual money lenders, groups of persons operating as funds or associations, partnership firms consisting of local brokers, pawn brokers, and non-banking financial intermediaries such as finance, investment and chit fund companies.

The formal financial system comprises financial institutions, financial markets, financial instruments and financial services. These constituents or components of Indian financial system may be briefly discussed as below:

## 1.9.1 FINANCIAL MARKETS

Financial markets are another part or component of financial system. Efficient financial markets are essential for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment. Financial markets bridge one set of financial intermediaries with another set of players. Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. The growth of the financial markets is the barometer of the growth of a country's economy.

Financial market deals in financial securities (or financial instruments) and financial services. Financial markets are the centers or arrangements that provide facilities for buying and selling of financial claims and services. These are the markets in which money as well as monetary claims is traded in. Financial markets exist wherever financial transactions take place. Financial

transactions include issue of equity stock by a company, purchase of bonds in the secondary market, deposit of money in a bank account, transfer of funds from a current account to a savings account etc. The participants in the financial markets are corporations, financial institutions,

individuals and the government. These participants trade in financial products in these markets. They trade either directly or through brokers and dealers. In short, financial markets are markets that deal in financial assets and credit instruments.

**Functions of Financial Markets**:

The main functions of financial markets are outlined as below:

1. To facilitate creation and allocation of credit and liquidity.

2. To serve as intermediaries for mobilization of savings.

3. To help in the process of balanced economic growth.

4. To provide financial convenience.

5. To provide information and facilitate transactions at low cost.

6. To cater to the various credits needs of the business organizations.

**Classification of Financial Markets:**

There are different ways of classifying financial markets. There are mainly five ways of classifying financial markets.

1. Classification on the basis of the type of financial claim: On this basis, financial markets may be classified into debt market and equity market.

*Debt market*: This is the financial market for fixed claims like debt instruments.

*Equity market*: This is the financial market for residual claims, i.e., equity instruments.

2. Classification on the basis of maturity of claims: On this basis, financial markets may be classified into money market and capital market.

*Money market*: A market where short term funds are borrowed and lend is called money market. It deals in short term monetary assets with a maturity period of one year or less. Liquid funds as well as highly liquid securities are traded in the money market. Examples of money market are Treasury bill market, call money market, commercial bill market etc. The main participants' in

this market are banks, financial institutions and government. In short, money market is a place where the demand for and supply of short term funds are met.

*Capital market*: Capital market is the market for long term funds. This market deals in the long-term claims, securities and stocks with a maturity period of more than one year. It is the market from where productive capital is raised and made available for industrial purposes. The stock market, the government bond market and derivatives market are examples of capital market. In short, the capital market deals with long term debt and stock.

3. Classification on the basis of seasoning of claim: On this basis, financial markets are classified into primary market and secondary market.

*Primary market*: Primary markets are those markets which deal in the new securities. Therefore, they are also known as *new issue markets*. These are markets where securities are issued for the first time. In other words, these are the markets for the securities issued directly by the companies. The primary markets mobilize savings and supply fresh or additional capital to business units. In short, primary market is a market for raising fresh capital in the form

of shares and debentures.

*Secondary market*: Secondary markets are those markets which deal in existing securities. Existing securities are those securities that have already been issued and are already outstanding. Secondary market consists of stock exchanges. Stock exchanges are self-regulatory bodies under the overall regulatory purview of the Govt. /SEBI.

4. Classification on the basis of structure or arrangements: On this basis, financial markets can be classified into organized markets and unorganized markets.

*Organized markets*: These are financial markets in which financial transactions take place within the well-established exchanges or in the systematic and orderly structure.

*Unorganized markets*: These are financial markets in which financial transactions take place outside the well-established exchange or without systematic and orderly structure or arrangements.

5. Classification on the basis of timing of delivery: On this basis, financial markets may be classified into cash/spot market and forward / future market.

*Cash / Spot market*: This is the market where the buying and selling of commodities happens or stocks are sold for cash and delivered immediately after the purchase or sale of commodities or securities.

*Forward/Future market*: This is the market where participants buy and sell stocks/commodities, contracts and the delivery of commodities or securities occurs at a pre-determined time in future.

6. Other types of financial market: Apart from the above, there are some other types of financial markets. They are foreign exchange market and derivatives market.

*Foreign exchange market:* Foreign exchange market is simply defined as a market in which one country's currency is traded for another country's currency. It is a market for the purchase and sale of foreign currencies.

*Derivatives market:* The derivatives are most modern financial instruments in hedging risk. The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price. A common place where such transactions take place is called the derivative market. It is a market in which derivatives are traded. In short, it is a market for derivatives. The important types of derivatives are forwards, futures, options, swaps, etc.

## 1.9.2 FINANCIAL INSTITUTIONS

Financial institutions are the participants in a financial market. They are business organizations dealing in financial resources. They collect resources by accepting deposits from individuals and institutions and lend them to trade, industry and others. They buy and sell financial instruments. They generate financial instruments as well. They deal in financial assets. They accept deposits, grant loans and invest in securities.

Financial institutions are the business organizations that act as mobilizes of savings and as purveyors of credit or finance. This means financial institutions mobilize the savings of savers and give credit or finance to the investors. They also provide various financial services to the community. They deal in financial assets such as deposits, loans, securities and so on.

On the basis of the nature of activities, financial institutions may be classified as: (a) Regulatory and promotional institutions, (b) Banking institutions, and (c) Non-banking institutions.

**(a). Regulatory and Promotional Institutions:**

Financial institutions, financial markets, financial instruments and financial services are all regulated by regulators like Ministry of Finance, the Company Law Board, RBI, SEBI, IRDA, Dept. of Economic Affairs, Department of Company Affairs etc. The two major Regulatory and Promotional Institutions in India are Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI). Both RBI and SEBI administer, legislate, supervise, monitor, control and

discipline the entire financial system. RBI is the apex of all financial institutions in India. All financial institutions are under the control of RBI. The financial markets are under the control of SEBI. Both RBI and SEBI have laid down several policies, procedures and guidelines. These policies, procedures and guidelines are changed from time to time so as to set the financial system in the right direction.

**(b). Banking Institutions:**

Banking institutions mobilize the savings of the people. They provide a mechanism for the smooth exchange of goods and services. They extend credit while lending money. They not only supply credit but also create credit. There are three basic categories of banking institutions. They

**(c ). Non-banking Institutions:**

The non-banking financial institutions also mobilize financial resources directly or indirectly from the people. They lend the financial resources mobilized. They lend funds but do not create credit. Companies like LIC, GIC, UTI, Development Financial Institutions, Organization of Pension and Provident Funds etc. fall in this category. Non-banking financial institutions can be

categorized as investment companies, housing companies, leasing companies, hire purchase companies, specialized financial institutions (EXIM Bank etc.) investment institutions, state level institutions etc. Financial institutions are financial intermediaries. They intermediate

between savers and investors. They lend money. They also mobilize savings.

## 1.9.3 FINANCIAL INSTRUMENTS (SECURITIES)

Financial instruments are the financial assets, securities and claims. They may be viewed as financial assets and financial liabilities. *Financial assets represent claims for the payment of a sum of money sometime in the future (repayment of principal) and/or a periodic payment in the form of interest or dividend.* Financial liabilities are the counterparts of financial assets. They

represent promise to pay some portion of prospective income and wealth to others. Financial assets and liabilities arise from the basic process of financing. Some of the financial instruments are tradable/ transferable. Others are non-tradable/non-transferable. Financial assets like deposits with banks, companies and post offices, insurance policies, NSCs, provident funds and pension funds are not tradable. Securities (included in financial assets) like equity shares and debentures, or government securities and bonds are tradable. Hence they are transferable. In short, financial instruments are instruments through which a company raises finance.

The financial instruments may be capital market instruments or money market instruments or hybrid instruments. The financial instruments that are used for raising capital through the capital market are known as capital market instruments. These include equity shares, preference shares, warrants, debentures and bonds. These securities have a maturity period of more than one year.

The financial instruments that are used for raising and supplying money in a short period not exceeding one year through money market are called money market instruments. Examples are treasury bills, commercial paper, call money, short notice money, certificates of deposits, commercial bills, money market mutual funds.

Hybrid instruments are those instruments which have both the features of equity and debenture. Examples are convertible debentures, warrants etc.

Financial instruments may also be classified as cash instruments and derivative instruments. Cash instruments are financial instruments whose value is determined directly by markets. Derivative instruments are financial instruments which derive their value from some other financial instrument or variable.

Financial instruments can also be classified into primary instruments and secondary instruments. Primary instruments are instruments that are directly issued by the ultimate investors to the ultimate savers. For example, shares and debentures directly issued to the public. Secondary instruments are issued by the financial intermediaries to the ultimate savers. For example, UTI and mutual funds issue securities in the form of units to the public.

**Characteristics of Financial Instruments**

The important characteristics of financial instruments may be outlined as below:

1. Liquidity: Financial instruments provide liquidity. These can be easily and quickly converted into cash.

2. Marketing: Financial instruments facilitate easy trading on the market. They have a ready market.

3. Collateral value: Financial instruments can be pledged for getting loans.

4. Transferability: Financial instruments can be easily transferred from person to person.

5. Maturity period: The maturity period of financial instruments may be short term, medium term or long term.

6. Transaction cost: Financial instruments involve buying and selling cost. The buying and selling costs are called transaction costs. These are lower.

7. Risk: Financial instruments carry risk. This is because there is uncertainty with regard to payment of principal or interest or dividend as the case may be.

8. Future trading: Financial instruments facilitate future trading so as to cover risks due to price fluctuations, interest rate fluctuations etc.

**1.9.4 Financial Services**

The development of a sophisticated and matured financial system in the country, especially after the early nineties, led to the emergence of a new sector. This new sector is known as financial services sector. Its objective is to intermediate and facilitate financial transactions of individuals and institutional investors. The financial institutions and financial markets help the financial

system through financial instruments. The financial services include all activities connected with the transformation of savings into investment. Important financial services include lease financing, hire purchase, instalment payment systems, merchant banking, factoring, forfaiting etc.

**The Banking System**

The structure of the banking system is determined by two basic factors – economic and legal. The Development of the economy and the spread of banking habit calls for increasing banking services. The demand for these banking services affects the banks' structure and organization. National objectives and aspirations result in government regulations, which have a profound influence on‟ the banking structure. These regulations are basically of two types. First, regulations which result in the formation of new banks to meet the specific needs of a group of economic activities. Secondly, legislation that affects the structure by means of nationalization, mergers or liquidation.

**Reserve Bank of India**

The Reserve Bank of India as the central bank of the country, is at the head of this group. Commercial banks themselves may be divided into two groups, the scheduled and the non-scheduled banks. The commercial banking system may be distinguished into:

**A. Public Sector Banks**

i) State Bank of India

ii) Associate Bank

iii) 14 Nationalized Banks (1969) Nationalized Banks

iv) 6 Nationalized Banks (1980)

v) Regional Rural Banks Mainly sponsored by Public Sector Banks

**B. Private Sector Banks**

i) Other Private Banks;

ii) New sophisticated Private Banks;

iii) Cooperative Banks included in the second schedule;

iv) Foreign banks in India, representative offices, and

v) One non-scheduled banks

**Cooperative Sector**

The cooperative banking sector has been developed in the country to supplant the village moneylender, the predominant source of rural finance, as the terms on which he made finance available have generally been usurious and detrimental to the development of Indian agriculture. Although the sector receives concessional finance from the Reserve Bank, it is governed by the state legislation. From the point of view of the money market, it may be said to lie between the organized and the unorganized markets.

**Primary cooperative Credit Societies**

The primary cooperative credit society is an association of borrowers and non-borrowers residing in a particular locality. The funds of the society are derived from the share capital and deposits of members and loans from Central Co-operative banks. The borrowing power of the members as well as of the society is fixed. The loans are given to members for the purchase of cattle, fodder, fertilizers, pesticides, implements etc.

**Central Co-operative Banks**

These are the federations of primary credit societies in a district. These banks finance member societies within the limits of the borrowing capacity of societies. They also conduct all the business of a joint-stock bank.

**State Co-operative Banks**

The State Cooperative Bank is a federation of Central cooperative banks and acts as a watchdog of the cooperative banking structure in the State. Its funds are obtained from share capital, deposits, loans and overdrafts from the Reserve Bank of India. The State Co-operative Banks lend money to central cooperative banks and primary societies and not directly to farmers.

**Land Development Banks**

The Land Development Banks, which are organized in three tiers, namely, State, Central and Primary level, meet the long-term credit requirements of farmers for developmental purposes, viz, purchase of equipment like pump sets, tractors and other machineries, reclamation of land, fencing, digging up new wells and repairs of old wells etc. Land Development Banks

are cooperative institutions and they grant loans on the security of mortgage of immovable property of the farmers.

## 1.10 SUMMARY

A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities. Financial system comprises of set of subsystems of financial institutions, financial markets, financial instruments and services which helps in the formation of capital. It provides a mechanism by which savings are transformed to investment.

## 1.11 GLOSSARY

**Financial System**: A financial system may be defined as a set of institutions, instruments and markets which promotes savings and channels them to their most efficient use. It consists of individuals (savers), intermediaries, markets and users of savings (investors).

**Financial Markets**: Financial markets are the centers or arrangements that provide facilities for buying and selling of financial claims and services.

**Financial Institutions**: Financial institutions are the business organizations that act as mobilizes of savings and as purveyors of credit or finance.

**Financial Instruments**: Financial instruments are the financial assets, securities and claims.

**Primary market**: Primary markets are those markets which deal in the new securities.

**Secondary market**: Secondary markets are those markets which deal in existing securities.

**Debt market**: This is the financial market for fixed claims like debt instruments.

**Equity market**: This is the financial market for residual claims, i.e., equity instruments.

**Money market**: A market where short term funds are borrowed and lend is called money market.

**Capital market**: Capital market is the market for long term funds.

## 1.12 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress –A**

Q1. Ans. In section 1.4

Q2. Ans. In section 1.7

MCQ – Ans 3.

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## 1.14 SUGGESTED READINGS

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## 1.15 TERMINAL QUESTIONS

Q1. What are the different components of financial system? Explain them in the context of Indian financial system?

Q2. Why do we need a financial system?

Q3. What do you mean by banking system? What is the role of RBI?

Q4. Discuss the different kinds of financial institutions in a financial system.

# UNIT 2 EVOLUTION OF FINANCIAL SYSTEM IN INDIA

**2.1 Introduction**

**2.2 Objectives**

**2.3. Evolution of the Indian financial system**

**2.4 Phase I: PRE-1951 Organization**

**2.5 Phase II: 1951 to Mid-Eighties**

**2.6 Financial sector reforms in India**

**2.7 Overview of financial services in 21st century**

**2.8 Summary**

**2.9 Glossary**

**2.10 Reference/ Bibliography**

**2.11 Suggested Readings**

**2.12 Terminal & Model Questions**

## 2.1 INTRODUCTION

In the previous unit, you understood the basic concepts of financial system and its components. In this unit, you will study about the evolution of Indian financial system.

## 2.2 OBJECTIVES

After reading this unit you will be able to:

- Understand how the Indian financial system evolved over a period of time
- Explain the reforms which took place in the financial system for India.

## 2.3 EVOLUTION OF THE INDIAN FINANCIAL SYSTEM

The evolution of the Indian financial system has been interlinked with the growth of the macro economics. The financial system has faced several fluctuations from the barter system in pre-industrial economies to universal banking. Indian financial system development is broadly categorized into three phases. The first phase concentrates on pre-1951 organization period. Phase II is denoted from 1951 to 1990 period and Phase-III concentrates on Post-1990

Period.

## 2.4 PHASE I: PRE-1951 ORGANISATION

The organization of the Indian financial system before 1951 had a close resemblance with the theoretical model of a financial organization in a traditional economy, as formulated by R.L. Bennett. A traditional economy, according to him, 'is one which the per capital output is low and constant. The principal features of the pre-1951 financial system were aptly described by L.C.

Gupta as: The principal features of the pre-independence industrial financing organizations are the closed-circle character of industrial entrepreneurship a semi-organized and narrow industrial securities market, devoid of issuing institutions and the virtual absence of participation by intermediary financial institutions in the long-term financing of the industry. A s a result, the industry had very restricted access to outside savings. The act that industry had no easy access to

the outside savings is another way of saying that the financial system was not responsive to opportunities for industrial investment. Such a financial system was clearly incapable of sustaining a high rate of industrial growth, particularly the growth of new and innovating enterprises.

## 2.5 PHASE II: 1951 TO MID-EIGHTIES

In sharp contrast to the position around 1951, when the organization of the financial system left much to be desired, the ability of the system to supply finance and credit to varied enterprises in diverse forms was greatly strengthened during the second phase. The organization of the Indian financial system during the post-1951 period evolved in response to the imperatives of planned economic development. The pursuance of the broad economic and social aims of the state to

secure economic growth with social justice as enshrined in the Indian constitution, under the Directive principles of State policy, the scheme of planned economic development was initiated in 1951.

The introduction of planning had important implications for the financial system. With the adoption of mixed economy as the pattern of industrial development, in which a complementary role was conceived for the public and private sectors, there was a need for an alignment of the financial mechanism with the priorities laid down by the Government's economic policy. In other words, planning signified the distribution of resources by the financial system to be in

conformity with the priorities of the five-year plans. The requirement to allocate funds in keeping with the corresponding pattern implied Governmental control over distribution of

credit and finance. The main elements of the financial organization in planned economic development could be categorized into four broad groups;

i. Public ownership of financial institutions

ii. Fortification of the institutional structure

ii. Protection to investors and

iv. Participation of financial institutions in corporate management.

## 2.5.1 PUBIC OWNERSHIP OF FINANCIAL INSTUTIONS

One aspect of the evolution of the financial system in India during this phase was the progressive transfer of its important constituents from private ownership to public control. Important segments of the financial mechanism were assigned to the direct control of public authorities through nationalization measures, as well as through the creation of entirely new institutions in the public sector.

## 2.5.2 NATIONALISATION

The nationalization of the Reserve bank of India (RBI) in 1948 marked the beginning of the transfer of the important financial intermediaries to Governmental control. This was followed in 1956 by the setting up of the State bank of India by taking over the imperial Bank of India. In the

same year, 245 life insurance companies were nationalized and merged in to the sate-owned monolithic life Insurance Corporation of India (LIC). The year 1969 was a land mark in the history of public control of the private financial intuitions, when fourteen major commercial banks were brought under the direct ownership of the Government of India. Yet another measure, which deserves mention in this connection, was the setting up of the General Insurance Corporation (GIC) in 1972, as a result of the nationalization of general insurance companies. Finally, six more commercial banks were brought under the public ownership in 1980. In addition to nationalization, the control of public authorities on the sources of credit and fiancé led to the creation of battery of new intuitions in the public sector. In the first place, a number of powerful special – purpose financial institutions designated as development banks/ development finance intuitions/term-lending intuitions were set up. A wide range of such intuitions came into being, some of which were national/all India, while others were regional state-level institutions and between them they covered the whole range of industry and provided fiancé in diverse forms another step of considerable significance was the creation of an investment trust organization the Unit Trust of India –in the public sector. The only other important pool of savings, namely, pension and provident funds, were for all purposes under the control of the Government, in terms of the regulations governing their investments. Thus, the public sector occupied a commanding position in the industrial financing system in India, that is, virtually the entire intuitional structure was owned and controlled by the Government.

## 2.5.3 FORTIFICATION OF INSTITUTIONAL STRUCTURE

The relevance of the financial organization in the stimulation of capital formation rests on a broad-based and diversified pattern to the extent that capital formation is institution-elastic. The most significant element in the emergence of a fairly well-developed financial system in India during the second phase was the strengthening of its intuitional structure. The fortification of the institutional structure of the Indian financial system was partly there suit of modification in the

structure and policies of the existing financial intuitions, but mainly due to the addition of newer institutions in the discussions that follow.

## 2.5.4 DEVELOPMENT BANKS

The setting up of a variegated structure of development banking/finance/ term-lending institutions was the most outstanding development in this sphere. This was because in quantitative terms, they grow into a massive source of industrial finance, and as the most important supplier of capital during the period under reference, they could be appropriately designated as the backbone of the system of industrial financing in India. Their role, however, was not merely quantitative. Their relevance had an overwhelming qualitative dimension also in terms of the accent on promotional functions in their operations. This refers to their role as instruments of state policy, of directing capital in chosen areas of industry in conformity with planning priorities, and of generally securing the development of private industry along the desired path, to facilitate effective pubic control of private enterprise. The structure of the development banking consisted of both all India as well as state level institutions. The setting up of the Industrial Finance Corporation of India (IFCI) in 1948 has given the beginning of the era of development banking in India. The full potentialities of these institutions were realized only after some experience in planning, which began in 1951 The IFCI was established to give medium- and long-term credit to industrial enterprises in circumstances where normal banking accommodation was inappropriate, or recourse to the capital issue method impracticable, thus envisaging the role of gap-filler. Under the State Financial Corporations Act, 1951, as counter part of the IFCI at the state level, regional institutions. State Financial Corporations (SFCs), were organized to assist the small-medium enterprise. These institutions, however, functioned purely as industrial mortgage banks, being organized on most orthodox lines. Their policies were characterized by excessive caution; their procedures were dilatory; they concentrated on traditional industries and laid more emphasis on security rather than on prospects. Therefore, they failed to make an impact on the availability of long-term finance to industry and, consequently, could not fulfill the expectation of solving the problem of chronic short age of

industrial capital. There was, therefore, the need for a more dynamic approach on the part of the development banks, if the requirements of the private corporate sector were to be met effectively. This found expression the fact that emphasis shifted from finance to development, so that the new institutions in this sphere could National Industrial Development Corporation (NIDC) was the first attempt towards this reorientation, being established in 1954, to provide both finance and entrepreneurship. Although ambitious in

conception, it ultimately degenerated into a financing agency for the modernization of cotton and jute textiles. Subsequently, it was converted into a consultancy organization and had no concern with the financing of the private industry.

The establishment of the Industrial Credit and Investment Corporation of India (ICICI) Ltd, in 1955 represented a landmark in the diversification of development banking in India, as it was a pioneer in many respects like underwriting of issues of capital, channelization of foreign currency loans from the World Bank to private industry and so.

Consequently, upon the initiation of the Second Five Year plan, there was need for further sophistication of the financing system to cater to the needs of different types of enterprises. The Government of India, as a follow0up, set up the Refinance Corporation of Industry(RCI) Ltd in 1958 to provide finance to the banks against term loans granted by them to medium/small enterprises. This facility was later extended to the State Financial Corporations. The RCI sub

sequent merged with the Industrial Development Bank of India's (IDBI in 1964). The most important in the sphere of development banking in India took place in 1964, when the IDBI was established as a subsidiary of the Reserve Bank of India. It represented a step towards evolving an integrated structure of financing institutions in India. As an apex institution, it had an important role in the task of planned economic development. Accordingly, it not only provided

finance but also coordinated the activities of all the financing institutions. It was delinked from the Reserve Bank of India in 1976 and was converted into a holding company. It was elevated, in a sense, to the same position among the long-term institutional suppliers of industrial capital in India as is occupied by the Reserve Bank of India in the monetary and credit sphere.

At the state level, the machinery of the State Industrial Development Corporations (SIDCs)/State Industrial Investment Corporations (SIICs) were greeted up to meet the financial needs, in terms of the requirements of the Third Five Year Plan.

In 1971, with the functional reorientation of the development banks, the Industrial Reconstruction Corporation of India (IRCI) Ltd was jointly set up by the IDBI, banks and LIC to look after the rehabilitation of sick mills. It was renamed as the industrial Reconstruction Bank of India (IRBI) in 1984. It was converted into a full-fledged public financial institution (PFI) and was renamed as the Industrial Investment Bank of India (IIBI) in 1997. The Technical Consultancy Organizations (TCOs) added a new dimension to the diversification of development banking in India, as a result of joint sponsorship/participation by the IDBI, IFCI and ICICI. Their setting up in the different states of the country was a vital element in the scheme of fortifying the institutional structure of the Indian financial system at the regional level. Finally, another intuitional innovation was the setting up of the Small Industrial Development Bank of India (SIDBI) as a subsidiary of the IDBI, for fostering the development of small and medium enterprises. At the state level, the machinery of the State

Industrial Development Corporation (SIDCs/State industrial investment corporations(SIICs) were geared up to meet the financial needs, in terms of the requirements of the Third Five Year plan. In 1971, with the functional reorientation of the development banks, the industrial Reconstruction Corporation of India (IRCI) Ltd was jointly set up by the IDBI banks, the Industrial Reconstruction Corporation of India (IRCI) Ltd was jointly set up by the IDBI banks and LIC to look after the rehabilitation of sick mills.

Until the early 1990s, the role of the financial system in India was primarily restricted to the function of channeling resources from the surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. After the nationalization of large banks in 1969 and 1980, the Government-owned banks dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management systems and the prudential standards were weak.

All these resulted in poor asset quality and low profitability. Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at concessional terms. In the insurance sector, there was little competition. The mutual fund industry also suffered from lack of competition and was dominated for long by one institution, viz., the Unit Trust of India. Nonbanking financial companies (NBFCs) grew rapidly, but there was no regulation of their asset side. Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction costs and restrictions on movement of funds/participants between the market segments. This apart from inhibiting the development of the markets also affected their efficiency.

*Check Your Progress- A*

**Q1. State the main features of the Indian financial system in phase I?**

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**Q2. State the main elements of the financial organization in planned economic development**.

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## 2.6 FINANCIAL SECTOR REFORMS IN INDIA

It was in this backdrop that wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s with a view to improving the macroeconomic performance of the economy. The reforms in the financial sector focused on creating efficient and stable financial institutions and markets. The approach to financial sector reforms in India was one of gradual and non-disruptive progress through a consultative process. The Reserve Bank has been consistently working towards setting an enabling regulatory framework with prompt and effective supervision, development of technological and institutional infrastructure, as well as changing the interface with the market participants through a consultative process. Persistent efforts have been made towards adoption of international benchmarks as appropriate to Indian conditions. While certain changes in the legal infrastructure are yet to be effected, the developments so far have brought the Indian financial system closer to global standards. The reform of the interest regime constitutes an integral part of the financial sector reform. With the onset of financial sector reforms, the interest rate regime has been largely deregulated with a view towards better price discovery and efficient resource allocation. Initially, steps were taken to develop the domestic money market and freeing of the money market rates.

The interest rates offered on Government securities were progressively raised so that the Government borrowing could be carried out at market-related rates. In respect of banks, a major effort was undertaken to simplify the administered structure of interest rates. Banks now have sufficient flexibility to decide their deposit and lending rate structures and manage their assets and liabilities accordingly.

At present, apart from savings account and NRE deposit on the deposit side and export credit and small loans on the lending side, all other interest rates are deregulated. Indian banking system operated for a long time with high reserve requirements both in the form of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). This was a consequence of the high fiscal deficit and a high degree of monetization of fiscal deficit. The efforts in the recent period have been to lower both the CRR and SLR. The statutory minimum of 25 per cent for SLR has already been reached, and while the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, the CRR of SCBs is currently placed at 5.0 per cent of NDTL. As part of the reforms program, due attention has been given to diversification of ownership leading to greater market accountability and improved efficiency.

Initially, there was infusion of capital by the Government in public sector banks, which was followed by expanding the capital base with equity participation by the private investors. This was followed by a reduction in the Government shareholding in public sector banks to 51 per cent. Consequently, the share of the public-sector banks in the aggregate assets of the banking sector has come down from 90 per cent in 1991 to around 75 per cent in 2004. With a view to enhancing efficiency and productivity through competition, guidelines were laid down for

establishment of new banks in the private sector and the foreign banks have been allowed more liberal entry. Since 1993, twelve new private sector banks have been set up. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time.

## 2.7 OVERVIEW OF FINANCIAL SERVICES IN 21ST CENTURY

Indian financial services industry has been through the toughest of the times and yet stands strong and robust among the world economies. Having a deep impact of the far-reaching changes in the Indian economy since liberalization, the new face of this industry is evolving in a strong, transparent and resilient system. Over the last few years, financial markets have witnessed a significant broadening and deepening of service baskets with the introduction of several new

instruments and products in banking, insurance and capital markets space. The sector was opened up to new private players including foreign companies who embraced international best practices and modern technology to offer a more sophisticated range of financial services to corporate, retail and institutional customers. Financial sector regulators too have been

visionaries to ensure that new regulations and guidelines are in tandem with global norms. These developments have given a robust boost to the development and modernization of the financial

services sector in India.

## 2.7.1 INSURANCE SECTOR

A high-powered committee, set up in 1993 by the Government of India and headed by former RBI Governor, R. N. Malhotra, initiated the reforms process in the Indian insurance sector. Apart from opening up the insurance sector to private players—both to domestic and foreign players (preferably through joint ventures with Indian partners), the Committee recommended establishment of the Insurance Regulatory and Development Authority (IRDA) as an autonomous body to regulate, develop and promote competition in the insurance sector.

The IRDA was finally constituted as an autonomous body in 1999 and incorporated as a statutory body in April 2000. The mission of IRDA is "to protect the interests of the policyholders, to regulate, promote and ensure orderly growth of the insurance industry and

for matters connected therewith or incidental thereto."

With the enactment of the IRDA Act, 1999, the monopoly conferred to the Life Insurance Corporation in 1956 and to the General Insurance Corporation in 1972 was repealed, allowing private sector players to enter the insurance sector. A recent development in the insurance sector, has been enhancement of the limit of foreign investment in insurance sector from 26 to 49 percent under the automatic route.

As of March 2015, this sector comprised 24 life insurance companies and 28 general insurance companies, and one national reinsurer. Among the life insurers, the Life Insurance Corporation (LIC) as the sole public sector company accounts for the lion's share in insurance business. Among the non-life insurers there are six public sector insurers. In addition to these, there is the sole national re-insurer, namely, General Insurance Corporation of India (GIC). Out of 28 non-life insurance companies, there are five private sector players dealing exclusively in health, personal accident and travel insurance segments. With about 360 million policies, India's life insurance sector is perhaps the biggest in the world in terms of number—reflecting India's population size.

The current issues facing Indian insurance are diverse. The key issue is the need for much greater expansion of insurance services, particularly that of life insurance and health insurance. Apart from the need for better spread of social protection, the expansion of insurance funds is also essential for the development of capital markets, particularly the corporate debt market which is typically dependent in institutional investors. Other issues include the efficiency and spread of distributional channels, the level of government control, regulatory constraints, and consumer education and protection. Continuance of an archaic agent-based distribution channels has led to allegations of mis-selling of insurance products

as well as low persistency of insurance policies in India. Besides, there is a huge untapped potential in sectors like health insurance.

## 2.7.2 BANKING SERVICES

The initial foundation of the banking sector reforms in India came from two official reports, viz., the Report of the Committee on Financial System (Reserve Bank of India, 1991) and the Report of the Committee on Banking Sector Reforms (Government of India, 1998), both chaired by former Governor of the RBI, M Narasimham. The Narasimham Committee 1991 was primarily devoted to enhancing operational freedom in the commercial banking sector and recommended measures like reduction of pre-emption of banks' investible resources (via a reduction of cash reserve ratio (CRR) and statutory liquidity ratio (SLR)) and gradual elimination of the administered interest rate structure. Narasimham Committee 1998 recommended further measures for modernizing the banking sector through better regulation and supervision, and introduction of prudential norms. Other elements of financial sector reforms in India include significant reduction of financial repression (including removal of automatic monetization); dismantling of the complex administered interest rate structure to enable the process of price discovery; providing operational and functional autonomy to public sector institutions; preparing the financial system for increasing international competition; opening the external sector in a

calibrated manner; and promoting financial stability in the wake of domestic and external

shocks. All these measures were designed to create an efficient, productive and profitable financial sector. With the initiation of reforms and the transition to indirect, market-based instruments of monetary policy in the 1990s, the RBI made conscious efforts to develop an efficient, stable and liquid money market by creating a favorable policy environment through

appropriate institutional changes, instruments, technologies and market practices.

Accordingly, the call money market was developed into primarily an inter-bank market.

Presently the Indian monetary policy framework, "aims at setting the policy (repo) rate...

(where) repo rate changes transmit through the money market to alter the interest rates in the

financial system".

More recently a number of measures have been initiated towards inculcating a credit culture through enforcement of creditors' rights, and hastening the process of credit recovery. The Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act was passed in 2002, enabling the setting up of debt-recovery tribunals and asset-reconstruction companies. Credit Information Bureaus have been given legal status through passing of the Credit Information Bureau Act in 2005, but these agencies are still in their infancy. Introduction of unique identification for every natural person in the country should potentially be very helpful for the expansion in coverage of these bureaus, thereby leading to reduction in transactions costs for small order lending. Most recently, the

Bankruptcy Act was passed by the Indian parliament in May 2016. Information technology has played a key role in this transformative journey of Indian banking. Technology has enabled more effective, lower cost and real-time delivery of financial services, through the establishment of a modern payments system. Setting up of the Indian Financial Network (INFINET) as the communication backbone for the financial sector, introduction of a Real Time Gross Settlement System (RTGS) and core banking solutions across banks encompassing most of their branches across India, are some of the major technological initiatives implemented. Establishment of the Institute for Development and Research in Banking Technology (IDRBT) by the Reserve Bank in 1996 has helped greatly in promoting connectivity among all the banks through development of and propagation of

common IT standards throughout the system. The new private sector banks, with no legacy

issues to constrain them, enthusiastically adopted the new information technology from their inception, thereby also acting as a competitive spur to induce similar adoption by public sector

banks.

## 2.7.3 MUTUAL FUNDS INDUSTRY IN INDIA

The issuance of the SEBI (Mutual Fund) Regulations in 1996 paved the way for further operational freedom for the players in the MF industry. By January 2003, there were 33 mutual fund companies with total assets of Rs. 1.2 trillion- of which the UTI's share was little more than one-third.

The US-64 scheme of the UTI ran into difficulty in 2001, which resulted in the next rounds of reforms. The UTI was bifurcated into two separate entities—one broadly representing the assets of the then US-64 scheme, assured return and certain other schemes, and the other called the UTI Mutual Fund (sponsored by select public sector banks and the LIC) which operates like any other MF. As of March, 2016 there were 44 asset management companies in the country with assets under management (AUM) of around Rs. 13.5 trillion (or 10 percent of GDP), which though high, is far below the deposits of the commercial banks (at about Rs. 99 trillion or 73 percent of GDP). In terms of net inflows, the share of private sector MFs far exceeded that of public sector MFs. While the growth in the MF industry has been shared both by debt oriented schemes as well as equity oriented schemes, MFs in recent past have shown a preference for debt oriented schemes. Interestingly, the share of the retail investors (includes the retail and high net-worth individuals) of AUM of the MFs was 48.5 percent with the rest (51.5 percent) coming from the institutional investors (includes corporates, Banks/FI's and the FII's).21In a country where direct investments by households in equity and debt market are meager, MFs have a huge potential to grow.

## 2.7.4 PENSION FUNDS:

India, like most of the developing economics, does not have a universal social security system and the pension system has largely catered to the organized segment of the labor force. While, till recently, public sector / government employees typically had a three-fold structure comprising provident fund, gratuity and pension schemes, the bulk of the private sector (with the sole exception of the major corporates) had access only to provident funds, a defined-contribution, fully funded benefit program providing lump sum benefits at the time of retirement. The Employees' Provident Fund (EPF) is the largest benefit program operating in India. Reflecting this state of affairs, the significance of pension funds in the Indian financial sector has been rather limited. The pension funds sector has undergone significant reforms. In recognition of the possibility of an unsustainable fiscal burden in the future, the Government of India moved from a defined-benefit pension system to a defined-contribution pension system, called the "New Pension System" (NPS) in January 2004. While the Government constituted an interim regulator, the Interim Pension Fund Regulatory and Development Authority (PFRDA) to regulate the pension sector in 2003, it finally started functioning as a statutory regulator for the NPS in 2014. As of March 2016, there were 8.7 million subscribers with assets under management (AUM) amounting to Rs. 1.18 trillion. Under the present scheme, a subscriber has the option to select any one of the 8 pension funds, which are primarily floated by public sector banks and/or insurance companies. Considering the fact that India's population is around 1.25 billion in which the share of the old (i.e., 60 years and above) is around 10 percent, pension funds in India have, in principle, a large potential - both as a social security measure as well as means to providing a depth to the financial markets, in both debt and equity market segments. Going forward, pension funds will emerge as sources of funds in infrastructure and other projects with long gestation period, as well as for providing depth to the equity market (perhaps looking for absorbing stocks arising out of disinvestment program of the government).

## 2.7.5 NON-BANKING FINANCE COMPANIES (NBFCS)

Apart from the banks, India has a number of non-banking financial companies (NBFCs). The fundamental difference between banks and NBFCs in India are three: (a) NBFCs cannot accept demand deposits; (b) NBFCs do not form part of the payment and settlement system and cannot issue checks drawn on itself; and (c) deposit insurance facility is not available to depositors of NBFCs, unlike in case of banks. The NBFCs is far from being a homogenous entity and include many diverse types of financial institutions from a housing finance company to an equipment leasing company. The diversity among the entities of the NBFC sector is also reflected in attributes like sizes and the extent of regulatory oversight. As of March 2016, there were 11,682 NBFCs registered with the RBI, of which 202 were deposit-accepting and 11,480 were non-deposit accepting NBFCs, of which 220 were declared as systemically important (i.e., those with an asset size of Rs one billion or more).26 In the popular discourse the role of NBFCs are seen from two distinct angles: (a) they have been very useful for sectors / activities that are generally excluded from formal banking activities;

and (b) at some regularity some of the deposit raking NBFCs have been source of financial irregularity in some localized pockets and raised the issue of consumer protection.

Although NBFCs have existed for a long time in India, these entities experienced sudden spurt in their activities between the late 1980s and the mid-1990s. While, on an average basis, deposits of NBFCs as a proportion of bank deposits were 0.8 percent during 1985–86 to 1989–90, they shot up to as much as 9.5 percent by 1996–97. This sharp jump in NBFC deposits was mostly, "on account of the high rates of interest offered on such deposits". There been sporadic incidence of financial irregularities as well. While traditionally, the regulation of NBFCs was confined to deposit-taking activities of NBFCs, in 1997 the RBI was given comprehensive powers to regulate NBFCs. The amended RBI Act made it mandatory for every NBFC to have minimum net owned funds (NOF) and obtain a certificate of registration from the RBI for commencing or carrying on business. At the current juncture, while a large chunk of deposit and non-deposit taking financial companies are regulated by the RBI, housing finance companies are regulated by National Housing Bank, Chit Funds are regulated by the State Governments, and Mutual Benefit companies are regulated by Ministry of Corporate Affairs, Government of India. This multiplicity of regulators has always become an issue in their functioning. Thus, there has been a cleaning process of the NBFC sector since 1998 so that the shadow banking sector could not overshadow the traditional banking business in India.

Illustratively, presently all deposit taking NBFCs and systemically important non-deposit taking NBFCs are subject to prudential regulations such as capital adequacy requirements and provisioning norms along with reporting requirements. While a number of types of NBFCs exist, which do not come under the ambit of RBI's regulatory oversight, the incidence of financial irregularity involving some NBFCs had come down and had predominantly been confined to the state / district-level. In fact, in recent past after a financial scandal involving an NBFC named Saradha (predominantly active in the state of West Bengal) surfaced in 2013, there has been further tightening of norms on deposit taking NBFCs. Interestingly, in line with the increasing regulatory control, over the years, while acceptance of deposits by the NBFCs had come down, there were fewer lulls in their other activities. Illustratively, the ratio of NBFCs' assets in GDP increased steadily from just 8.4 percent as on March 31, 2006 to 12.9 percent as on March 31, 2015; while the ratio of bank assets increased from 75.4 percent to 96.4 percent during the same period.

## 2.8 SUMMARY

As a consequence of successive reforms over the past 25 years, there has been significant progress in making interest and exchange rates largely market determined, though the exchange rate regime remains one of managed float, and some interest rates remain administered. Considerable competition has been introduced in the banking sector through new private sector banks, but public sector banks continue have a dominant share in the market. Contractual savings systems have been improved, but provident and pension funds in India are still in their infancy. Similarly, despite the introduction of new private sector

insurance company's coverage of insurance can expand much further, which would also provide greater depth to the financial markets.

The extent of development along all the segments of the financial market has not been uniform. While the equity market is quite developed, activities in the private debt market are predominantly confined to private placement form and continued to be limited to the blue-chip companies. Going forward, the future areas for development in the Indian financial sector would include further reduction of public ownership in banks and insurance companies, expansion of the contractual savings system through more rapid expansion of the insurance and pension systems, greater spread of mutual funds, and development of institutional investors. It is only then that the both the equity and debt markets will display greater breadth as well as depth, along with greater domestic liquidity.

India continues its journey towards a financially inclusive regime through innovative policies involving a multi-pronged approach. India has come a long way from a financially repressive regime to a modern financial sector where public sector financial institutions tend to compete with the private sector financial institutions. The Indian authorities while reforming the financial sector had to constantly keep the issues of equity and efficiency in mind.

## 2.9 GLOSSARY

**Financial Institutions**: Financial institutions are the business organizations that act as mobilizes of savings and as purveyors of credit or finance.

**Financial Instruments**: Financial instruments are the financial assets, securities and claims.

**Primary market**: Primary markets are those markets which deal in the new securities.

**Secondary market**: Secondary markets are those markets which deal in existing securities.

**Debt market**: This is the financial market for fixed claims like debt instruments.

**Equity market**: This is the financial market for residual claims, i.e., equity instruments.

**Money market**: A market where short term funds are borrowed and lend is called money market.

**Capital market**: Capital market is the market for long term funds.

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## 2.12 TERMINAL QUESTIONS

Q1. Discuss the differences in phase I and phase II of financial system organization.

Q2. Explain the main financial sector reforms in 1990s?

Q3. Discuss the financial services development in the 21st century.

# UNIT 3 STRUCTURE OF INDIAN FINANCIAL SYSTEM

**3.1 Introduction**

**3.2 Objectives**

**3.3 Indian Financial System**

**3.4 Functions of Financial System**

**3.5 Structure of Indian Financial System**

**3.6 Summary**

**3.7 Glossary**

**3.8 Answers to Check Your Progress**

**3.9 References/Bibliography**

**3.10 Suggested Readings**

**3.11 Terminal and Model Questions**

## 3.1 INTRODUCTION

In the previous units we have studied about what financial system is and its various components. We also studied evolution of financial system in India. In this unit we will study the Indian financial system and its structure. This unit will also cover the topics about the functions of Indian Financial system and the role various components of Indian financial system.

Financial System is a set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy. Financial system is very important for the development of any country. It is the backbone of the economy of every country. A strong and robust financial system will lead the country towards rapid development by properly mobilizing and channelizing funds in that economy.

L. M. Bhole has defined financial system "as a set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy". The components of financial system are banking and non-banking financial institutions, financial instruments, financial markets and financial services. These components help in efficient, effective and smooth allocation and transfer of funds.

According to Prasanna Chandra, a financial system consists of various institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments.

H R Machiraju defines financial system as a set of institutions and markets which fosters savings and channels them to their most efficient use.

Financial system is broadly categorised as: formal financial system and informal financial system. The formal financial system is institutional, organised and regulated system while the informal financial system is non-institutional, unorganised and unregulated system. Indian financial system is of two types: formal financial system and informal financial system. Financial dualism i.e. coexistence of formal and informal financial system and cooperation between them is observed in most of the developing nations.

## 3.2 OBJECTIVES

After reading this unit you will be able to understand the;

- Structure of Indian financial system.
- The functions Indian financial system.
- The role of the components in Indian financial system.

## 3.3 INDIAN FINANCIAL SYSTEM

Financial system plays a very important role in the economic development of any country through capital formation. It is a set of closely-connected and complex institutional arrangements through which the surplus funds from individuals, organisations or firms are channelized to the individual or institutional borrowers. The institutional arrangement takes care of all the mechanisms involved such as production, distribution, exchange and holding of all types of financial instruments, the operation of all financial markets and institutions.

Indian financial system can be divided into two categories: formal financial system and informal financial system. The structure of Indian financial system is depicted in fig. 3.1. Informal financial system is unorganised and unregulated. Lack of access to financial services to certain sections of society, lack of financial awareness and rigid system and rules are some of the reasons responsible for the emergence and flourishing of informal financial system. People who are in need of funds get financial help from moneylenders, pawn brokers, landlords, traders, relatives, etc. who sometimes charge exorbitant amount of interest. Though the interest rate is generally very high in informal financial system, the poor and needy find it helpful due to the flexibility of operation and easy access to funds.

The formal Indian financial system is regulated by various regulatory bodies such as the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), the Ministry of Finance (MoF), the Insurance Regulatory and Development Authority (IRDA), etc. In India,

majority of population still live in rural area. Lack of availability of banking services and financial awareness were the main reasons of thriving of informal financial system in rural region. But, now things have changed. Financial inclusion is helping those who do not have access to affordable financial services to get access to and join the mainstream economy. Banks are aggressively marketing their financial products and services and are opening branches in rural regions or using innovative ideas to connect to the people from rural regions. This has benefitted large population.

## 3.4 FUNCTIONS OF FINANCIAL SYSTEM

Financial system is the backbone of any economy. The strong financial system of an economy leads to the growth of that economy. The most important function of the financial system in to mobilize savings and help them channelizing into productive investment. The other functions of a financial system are explained as below:

1. **Supply of money/liquidity** – For the uninterrupted working of the industrial sector and production, continuous supply of funds is very essential in any economy. An efficient and strong financial system can ensure this liquidity in to an economy of that country.
2. **Mobilization of savings** – By encouraging people for savings, a large pool of savings can be created. These savings can provide the capital required for the production of goods and services in the country. Banks accept deposits from the savers and provide these as loans to the borrowers. Savers get returns in terms of interest on their savings and borrowers get capital to run their businesses by paying interest, thus, financial system plays an important role of mobilizing these savings from surplus fund units to the fund deficit units.
3. **Channelizing savings into productive investment -** Mere savings cannot help in the development of an economy. These savings need to be put to the most productive uses. An individual investor may not have the knowledge about financial markets or which financial instrument to choose for maximum gain. Financial intermediaries have infrastructure, expertise and information about the correct investment option for the individual. They can help these individuals in choosing the right investment option.
4. **Efficient functioning of payment mechanisms** – For the exchange of goods and services an efficient payment mechanism is essential. The financial system provides that mechanism across the globe. Financial system plays significant role in the efficient functioning of payment mechanisms buy ensuring safe, smooth and swift transactions. To achieve financial system operating and allocation efficiencies, a smooth and efficient payment and settlement system is required and banks provide this payment mechanism though cheques, credit and debit cards, promissory notes, electronic payments, etc.
5. **Transformation services** – Various transformation services provided by financial institutions are:
    - **Maturity transformation function** – Financial intermediaries can design different investment products as per the needs and preferences of the investors.

Similarly, they provide different products as per the needs, preferences and maturity requirements of the borrowers. This is maturity transformation function.

- **Size transformation function –** Banks accept small deposits from large number of savers. This pooling of large number of saving can help banks to give large amount of loans to fund deficit units. This is size-transformation.
- **Liability- asset transformation function –** Individuals and organizations deposit their money in the banks. These deposits are assets for these individuals and organizations but liabilities for the banks as they have to pay interests on these deposits. Banks lend this money to the borrowers and get interest on these loans. These liabilities become assets for the banks. This asset-liability transformation.
- **Risk transformation function –** A well-developed financial system has diverse financial instruments which will give better and diverse investment options to the investors to choose from. This diversification helps in reducing risk. This is called risk transformation.

6. **Portfolio adjustment facilities –** Financial institutions provide portfolio adjustment facilities such as provision of cheap, reliable and quick way of purchasing and selling of wide variety of financial instruments such as equity, bonds, debentures through financial markets
7. **Creation of financial structure –** A financial system also helps in building a stable financial structure which will reduce the cost of transactions. It will lower the cost of borrowing and will have a positive effect on the rate of return on the investments thus enticing more people to save more and invest more.

## 3.5 STRUCTURE OF INDIAN FINANCIAL SYSTEM

Fig 3.1 shows the structure of Indian financial system. The formal Indian financial system is set of four main components. For the smooth functioning of the economy and for the growth in the development of the country, these four components need to be properly coordinated. A strong financial system of an economy increases productivity and thus helps in the development of that economy. The four main components of formal Indian financial system as are:

1) Financial institutions
2) Financial markets
3) Financial Services and
4) Financial instruments.

The most important function of the financial system in to mobilize savings and help them channelizing into productive investment. In Indian financial system, financial institutions play this role through various financial instruments.

### 3.5.1 FINANCIAL INSTITUTIONS

Financial institutions are business organisations which act as link between lenders and borrowers. They facilitate the mobilization of funds in the economy, i.e. collecting the surplus funds from the investors and lending them to the borrowers. They are the major source of long-term funds and help in capital formation in an economy. Financial institutions are banking institutions such as commercial banks, development banks, private banks, etc. and non-banking institutions such as life insurance companies, mutual fund companies, stock exchanges, financial brokers, etc. They are also called financial intermediaries.

Financial institutions are very crucial for the efficient and smooth functioning of any economy. Countries with developed financial institutions grow faster and countries with weak ones are more likely to undergo financial crisis (Pathak, 2018). Financial institutions act as a bridge between the surplus spending units and the fund deficit units. Their main economic activity is buying and selling of financial assets or securities. They have varied customer base which ranges from individuals, small firms to very large industries and vast geographical range from small towns to inter-continents.

Financial Institutions are divided into four main categories. They are:

1. Banking institutions
2. Non-banking institutions
3. Mutual funds
4. Insurance and housing finance companies.

In this section a brief introduction of financial institutions is given. They are explained in detail in subsequent units.

**1. Banking Institutions**

Banking Institutions are one of the most important pillars of financial system and the success /failure of any economy depends on them. They help in mobilizing the savings, channelizing them into productive investment and supplying and maintaining liquidity in economy.

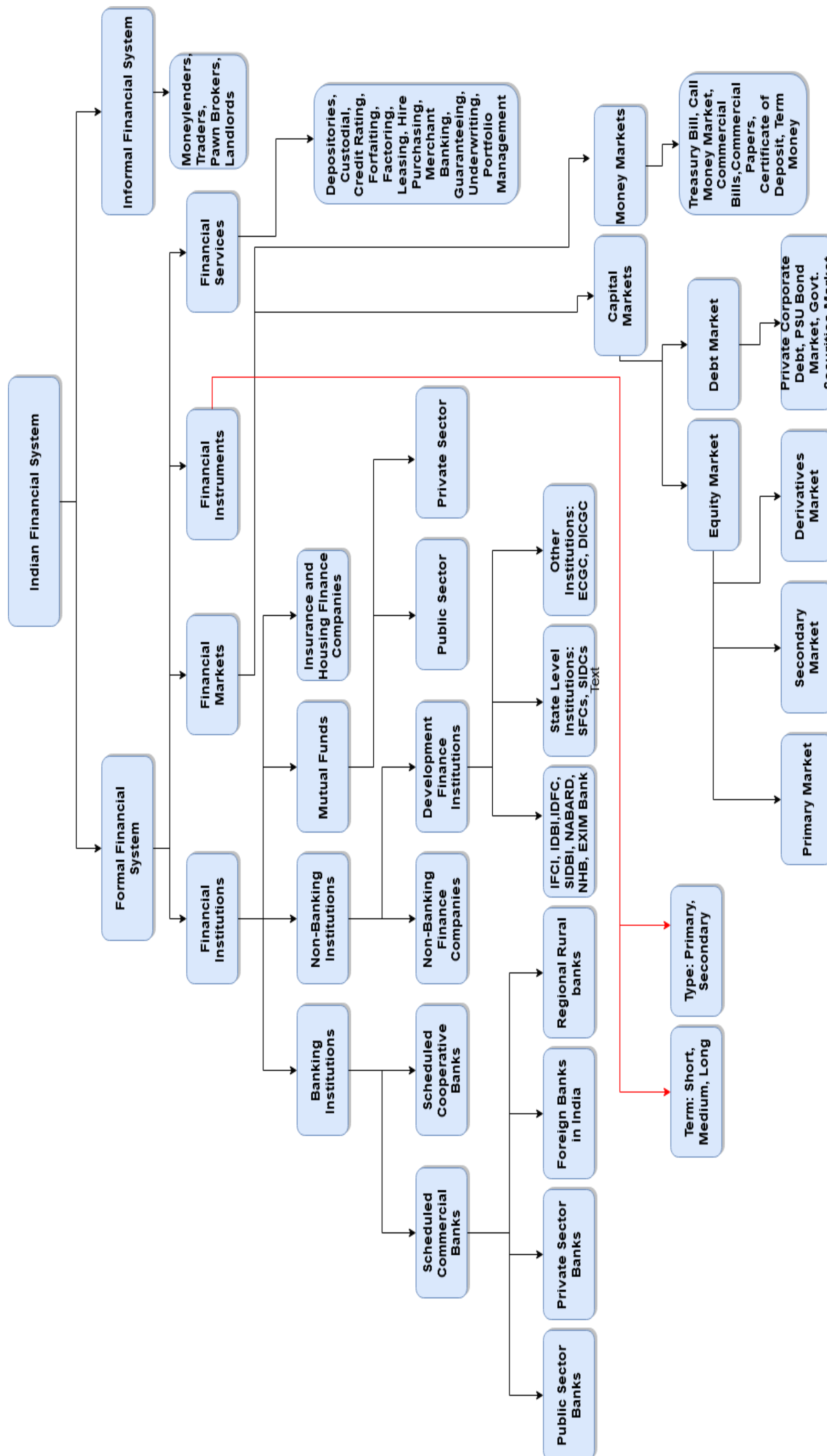


Fig 3.1 Indian Financial System

**Fig 3.1 Source: Indian Financial System by Bharati V.Pathak**

Banks are the financial institutions which are scheduled as per the Section 5(1) (b) of the Banking Regulation Act and are defined as the institutions/companies which can accept deposits from public which are repayable or withdrawable on demand through draft, cheque, or order and can lend this money to individuals or corporations. Banks accept deposits from public which are their main source of fund. They deploy these funds in the financial market through lending. Banks earn interest on these lending to finance their operation expenses. Banks provide deposit, withdrawl, credit, etc facilities to the public. People earn interest on their savings by depositing it in banks.

Banking institutions are classified as: scheduled commercial banks and scheduled cooperative banks.

**Scheduled Commercial Banks:** Scheduled commercial banks are those banks which are included in the second schedule of Reserve Bank of India Act, 1934. On the basis of their ownership and area of operation, they further classified as public sector banks, private banks, foreign banks in India and Regional Rural Banks (RRBs). In public sector banks the Government has major share holding. They are divided in two groups: State Bank of India (SBI) and Nationalised banks such as Central bank of India, Bank of Baroda, Indian Bank, Indian Overseas Bank, Punjab and Sindh Bank, etc. Public sector banks in India have bigger geographical reach, bigger size and more branch networks and access to low cost deposits than the private banks.

In 1990, on Narsimham Committee's recommendation new private sector banks were allowed to operate. "Private Sector Banks means banks licensed to operate in India under Banking Regulation Act, 1949, other than Urban Co-operative Banks, Foreign Banks and banks established under specific Statutes (RBI, 2016)". Reserve Bank of India has limited the shareholding for individuals and non-financial entities to 10 % of the total paid up capital. Some of the examples of private banks are HDFC Bank, Axis Bank, Kotak Mahindra Bank, ICICI Bank.

Foreign banks are international banks which are allowed to operate either as a wholly owned subsidiary (WOS) or as bank branches in India. Wholly owned subsidiaries are locally incorporated separate legal entities and they have their local board of directors with own capital base. Branches are not separate legal entities; the parent bank is responsible for their liabilities. Standard Chartered Bank, City Bank, United Overseas Bank, Deutsche Bank, HSBC, Royal Bank of Scotland are some of the examples of foreign banks operating in India.

Regional Rural banks (RRBs) are scheduled commercial banks which are operating at regional level in different states of India, established for providing banking facilities in rural and semi-urban regions, loans to small and marginal farmers, artisans, small entrepreneurs, disbursing funds under government schemes such as MGNREGA, pensions schemes, etc. Some of the examples are Uttarakhand Grameen Bank, Prathama UP Grameen bank, Maharashtra Grameen Bank, Himachal Pradesh Grameen Bank, etc.

**Scheduled Co-operative Banks:** Scheduled cooperative banks are financial entities which are formed by its members and are registered under the State or Central Registrar of Co-operative

Societies. It is regulated by the Registrar of Co-operative Societies and Reserve Bank of India. They are owned by their customers i.e. customers are the members and has one member one vote policy. They are classifies as: urban co-operative banks and rural co-operative banks. The rural co-operative banks provide regular banking services as well as financial assistance to agriculture and rural activities, promote savings and investment among the small income groups and have wider reach in the rural regions.

**2. Non-Banking Institutions**

Non-banking institutions in India are broadly classified as:

Non-Banking Financial Companies (NBFCs) and Development Financial Institutions (DFIs) – (Bharati Pathak pg 396)

**Non-Banking Financial Company (NBFC):** Reserve Bank of India defines a Non-Banking Financial Company (NBFC) as a "company registered under the Companies Act, 1956, engaged in the business of loans and advances, acquisition of shares/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property". The main business of NBFC is to receive deposits under any scheme / arrangement or in any manner and to lend in any manner. Hire-purchase Finance Companies, Equipment Leasing Companies, Loan Companies, Investment Companies are some of the companies whose activities are listed under NBFC.

**Development Financial Institutions:** After independence there was immediate need of development financial institutions to increase the growth and pace of industrialisation, to provide long-term funds for the modernisation, reconstruction, expansion and diversification of existing industries and investment funds for setting up new projects and industries. In 1948 the first development financial institution Industrial Finance Corporation of India Limited (IFCI) was set up for providing medium and long-term credit to industries. Subsequently State Financial Corporations (SFCs) were established in different states of India and National Small Industries Corporation was established. In 1955 the Industrial Credit and Investment Corporation of India Limited (ICICI) was established which was wholly privately-owned institution. It provides credit as well underwriting services also. In 1958 RBI set up Refinance Corporation for Industry (RCI) and in 1964 Industrial Development Bank of India (IDBI) was set up. To promote medium and large-scale industries in respective states, State Industrial Development Corporations (SIDCs) were established. Other such development financial institutions in India are National Bank for Agriculture and Rural Development (NABARD), Export Import Bank of India (EXIM), Small Industries Development Bank of India (SIDBI), Export Credit Guarantee Corporation of India ltd. (ECGC), Deposit Insurance and Credit Guarantee Corporation (DICGC), etc.

**3. Mutual Funds:** Securities and Exchange Board of India (SEBI) Regulations, 1996 defines mutual fund as "a fund established in the form of a trust to raise money through the

sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments or gold or gold related instruments or real estate assets". A mutual fund is a company/financial institution that pools money from small/big investors and collectively invests it in securities such as equity, bonds, debentures, etc. This diversified combined holding of securities is called portfolio. Mutual fund companies provides following services:

- Portfolio Management
- Pension fund management
- Venture capital funds management
- Money market funds management
- Real estate funds management
- Offshore funds management

On the basis of exit, mutual funds are classified as open-ended and close-ended funds. On the basis of type of securities, they are classified as equity funds, balanced funds or debt funds.

**4. Insurance and Housing Finance Companies:**

**Insurance Company:** Insurance Company is another form of non-banking financial institution whose principal business is to provide insurance such as life, health, crop, motor, etc. i.e. by covering risk in return of certain amount called premium. Insurance can be defined as a legal contract between two parties whereby one party called the insurer undertakes to pay a fixed amount of money on the happening of a particular event, which may be certain or uncertain (Pathak, 2018). Insurance company, also called insurer issues insurance policy which is a debt instrument to the insured against a fixed premium for the policy term. Insurer invests this collected premium in financial market in corporate securities, government bonds, etc. thus provide capital for new ventures as well as old ones, for long-term infrastructure projects. Insurance companies are regulated by Insurance Regulatory and Development Authority (IRDA). Life Insurance Corporation (LIC), General Insurance Company (GIC), HDFC Ergo, Star Health Insurance Company are some of the examples of insurance companies.

**Housing Finance Company (HFC):** It is non-banking financial company whose main business is providing finance for acquisition or construction of houses which can include development of plots of lands for the construction of new houses. It also offers finances for the repair or renovation of old/existing houses. Housing finance companies are regulated by National Housing Bank. LIC Housing Finance, HDFC, Indiabulls, Tata Capital, LT Housing Finance are some of the renowned housing finance companies in India.

***Check Your Progress A***

**Q1. What are the components of Indian financial system?**

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**Q2. Explain the various functions of financial system.**

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**Q3. Describe financial institutions and their role in Indian financial system.**

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## 3.5.2 FINANCIAL MARKETS

Second important component of a financial system is financial market. A financial market is the channel between individual/institutional investors and individual/institutional borrowers. Financial market is a place where or a mechanism through which the participants deal in financial instruments such as equity, bonds, currency, etc. Financial markets in India are divided in to two categories: Money market and capital market.

**Money Market:** In the money market, short term securities which have a maturity period of less than one year are traded. To meet the temporary or short term requirement of cash and obligations, money market enables raising short term funds and also in deployment of surplus funds to earn short term returns on the investment. It helps in maintaining the equilibrium in short term surplus and deficiency of funds. It is the source of working capital for the institutions. Examples of short term securities are Promissory Notes, Treasury Bills, Call Notes, Commercial Papers, Certificate of Deposit, Bills of Exchange, etc.

**Capital Market:**

In the capital market, the securities which have long term maturity. i.e. more than one year are traded. The focus of this market is on fixed investment. The major participants in this market are insurance companies, corporate and retail investors, mutual fund companies, institutional investors, etc. Capital markets are further classified as: equity market and debt market.

Equity market is divided in to three sections: primary market, secondary market and derivatives market. In primary market, also called New Issue Market (NIM), new financial securities are offered to the investors. These securities are offered for the first time, hence the name New Issue Market. Raising of additional capital through Initial Public Offering (IPO) or debentures takes place in a primary market.

In secondary market, existing securities are sold or transferred from one investor to another. Over The Counter (OTC) market and the exchange traded market are two components of secondary market. In derivatives market, derivatives are traded. Derivatives are financial instruments whose value is derived from other forms of assets such as stocks, bonds, currencies and commodities. Derivatives are either exchange-traded derivatives or over-the-counter (OTC) derivatives.

Debt market is a market where the debt instruments such as debentures, Government bonds, Certificate of Deposits, Treasury Bills, Commercial Papers, etc. are bought or sold. In debt instruments the holder gets fixed payment usually in terms of interest. These instruments are less risky.

## 3.5.3 FINANCIAL SERVICES

Financial services are the services provided by various financial institutions in channelizing or mobilising the savings from individual/institutional investors to the individual/institutional borrowers. Financial services are classified as: fund-based financial services and non-fun based or fee-based financial services. Various banking services such as accepting deposits, providing loans are performed by the commercial banks. Development banks get funds from the government and lend them for the development projects. Non-banking services are performed by various non-banking institutions such as mutual fund companies, insurance companies. They collect savings from the investors and provide loans to institutional investors, invest in the capital market. The examples of financial services are provision of funds such as asset financing, venture capital, trade financing, etc., managing investible funds such as mutual funds, portfolio management, etc., risk financing, consultancy, market operations, etc.

Other than the above mentioned banking, investment and insurance services, there are some other important financial services such as depositories, custodial, credit rating, forfeiting, factoring, leasing, hire-purchasing, underwriting, etc.

### 3.5.4 FINANCIAL INSTRUMENTS

A financial instrument is a claim against a person or an institution for payment of a sum of money at a future date or a payment in the form of interest or dividend. It is a monetary contract between two parties.

The *Association of Chartered Certified Accountants (ACCA)* defines financial instrument as "a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity." These instruments include cash, deposits, trade receivables, loans to other entities, debt instruments, shares, debentures, etc.

Financial instruments, also called securities are tradable in the market and are negotiable. They are classified as primary/direct securities and secondary/indirect securities. Primary/direct securities are securities created and offered to the general public for investment by the ultimate borrowers. Examples of primary securities include equity shares, debentures, etc. Secondary/indirect securities are those financial securities which are issued by financial intermediaries to the savers. Examples of secondary securities are policies by insurance companies, mutual funds, bank deposits, etc.

Financial instruments are also classified on the basis of term period as: short-term and long-term financial instruments. Short-term financial instruments are those financial instruments having maturity period less than one year. The financial instruments which have maturity more than one year are called long-term financial instruments.

***Check Your Progress B***

**Multiple Choice Questions (MCQs)**

1. Financial system helps in the economic growth of an economy by
   (a) Mobilising savings

   (b) Allocating savings to proper uses
   (c) Encouraging savings or raising inducement to save
   (d) All of these
2. Financial system consists of

   (a) Financial institutions

   (b) Financial markets

   (c) Financial instruments

   (d) All of these
3. Primary securities are also known as

   (a) Hand-to-hand securities

(b) Direct securities

(c) Active securities

(d) None of these

4. The market where financial assets are introduced for the first time is called

   (a) New issue market

   (b) Primary market

   (c) Initial Public Offer (IPO)

   (d) All of these

5. DFIs stands for

   (a) District financial institutions

   (b) Development financial institutions

   (c) Discount financial institutions

   (d) Direct financial institutions

**Q6. Explain the types of financial markets.**

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**Q7. Describe financial instruments.**

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## 3.6 SUMMARY

- Financial System is a set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy.
- Indian Financial system is broadly categorized as formal and informal financial system.

- Informal financial system is still prevalent in rural regions and moneylenders, pawn stores, landlords, relatives, etc. are sources of finance.
- Formal Indian financial system has four main components. They are financial institutions, financial markets, financial instruments and financial services.
- Financial institutions comprises of banking institutions, non-banking institutions, mutual funds and insurance and housing finance companies.
- Financial markets are classified as money markets and capital markets. Capital markets are further classified as equity markets and debt markets.
- Financial instruments are securities that are tradable in the market and are negotiable. They are classified as primary/direct securities and secondary/indirect securities.

## 3.7 GLOSSARY

**Financial System –** It is a set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy.

**Financial institutions –** Financial Institutions are those entities or organisations which act as a link between the lender and the borrower. They act as an intermediary between those who have excess fund and those who are need of funds.

**Financial markets –** Financial market is a place where or a mechanism through which the participants deal in financial instruments such as equity, bonds, currency, etc.

**Private Sector Banks -** Private Sector Banks means banks licensed to operate in India under Banking Regulation Act, 1949, other than Urban Co-operative Banks, Foreign Banks and banks established under specific Statutes.

**Non-Banking Financial Company (NBFC)** – It is a company registered under the Companies Act, 1956, engaged in the business of loans and advances, acquisition of shares/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

**Capital Markets –** In capital markets financial securities of medium and long term maturity i.e. more than one year are traded. They are of two types: primary market and secondary market.

**Capital market financial intermediaries -** The capital market financial intermediaries are individuals, financial or non-financial institutions or firms who act as a mediator to facilitate a negotiation, investment deal, business deal, etc.

**Money Markets –** In money markets financial securities of short term maturity i.e. less than one year are traded.

**Financial Instruments –** A financial instrument is a claim against a person or an institution for payment of a sum of money at a future date or a payment in the form of interest or dividend. It is a monetary contract between two parties.

## 3.8 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress –B**

1. (d)
2. (d)
3. (b)
4. (d)
5. (b)

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## 3.11 TERMINAL QUESTIONS

Q1. Discuss in brief the structure of Indian Financial System.

Q2. Write a short note on role of banking institutions in Indian financial system.

Q3. Write a short note on money market.

Q4. Explain how a financial system helps in linking the fund surplus units to funds deficit units.

Q5. Explain the functions of financial system.

Q6. Explain how financial intermediation is done by financial institutions in Indian financial system.

# UNIT 4 MONEY MARKETS

**4.1 Introduction**

**4.2 Objectives**

**4.3 Money Market and Capital Market**

**4.4 Meaning, Characteristics and Functions of Money Market**

**4.5 Importance of Money Market**

**4.6 Money Market Instruments**

**4.7 Summary**

**4.8 Glossary**

**4.9 Answer to Check Your Progress**

**4.10 Reference/ Bibliography**

**4.11 Suggested Readings**

**4.12 Terminal & Model Questions**

## 4.1 INTRODUCTION

In this unit, you will study about the money markets, their meaning and structure.

## 4.2 OBJECTIVES

After reading this unit you will be able to:

- Differentiate between money market and capital market.
- Understand what are money markets and how are they structured.
- Explain the various instruments used in money markets

## 4.3 MONEY MARKET AND CAPITAL MARKET

On the basis of maturity of claims, financial markets may be classified into money market and capital market.

*Money market*: This market is characterized by borrowing and lending of short term funds. It specializes in short term monetary assets with a maturity period of one year or less. The examples of money market are treasury bill market, call money market, commercial bill market etc. Government, banks and financial institutions participate in the market. To

summarize, money market is a place where the demand for and supply of short term funds are met.

*Capital market*: On the other hand, a capital market is characterized by long term funds. The instruments (long-term claims, securities and stocks) usually have maturity of more than a year. It is the market from where productive capital is raised and made available for industrial purposes. The stock market, the government bond market and derivatives market are examples of capital market. In short, the capital market deals with long term debt and stock.

## 4.3.1 DISTINCTION BETWEEN CAPITAL AND MONEY MARKET

There are many differences between the money market and capital market. The first, being operations in the money market are for a duration up to one year and deals in short term financial assets whereas in capital market operations are for a longer period beyond one year and therefore, deals in medium and long term financial assets. Secondly, the money market is not a well-defined place like the capital market where business is done at a defined place viz. stock exchanges. The transactions in the money market are done through electronic media and other written documents. The major points of distinction are enumerated as follows.

(1) In the Capital Market, there is classification between Primary Market and Secondary Market. While there is no such sub-division in money market, as such. However, slowly a secondary market in greater form is coming up in Money Market also.

(2) Capital Market deals for fund of long term requirement. In contrast, the Money Market generally, supply fund for short term requirement.

(3) If the volume of business of Capital Market is considered (both Primary and Secondary Markets), it will lag behind the total value of transaction in Money Market.

(4) While the number of instruments dealt with in the Money Market are many like

- (a) Interbank Call Money,
- (b) Notice Money upto 14 days
- (c) Short-term deposits upto 3 months
- (d) 91-days treasury bill
- (e) 182-days treasury bill
- (f) Commercial Paper etc.

The number of instruments in Capital Market are shares and debentures.

(5) The players in Capital Market are general investors, brokers, Merchant Bankers, Registrar to the issue, underwriters, Corporate Investors, Foreign Financial Institutions (Fll) and Bankers. While in money market, the participants are Bankers, RBI and Government.

(6) Rate of interest in money market is controlled by RBI or central bank of any country. But capital market's interest and dividend rate depends on demand and supply of securities and stock market's conditions. Stock market regulator is in the hand of SEBI.

(7) The degree of risk is small in the money market. The risk is much greater in capital market.

The maturity of one year or less gives little time for a default to occur, so the risk is minimized.

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

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

# 4.4 MEANING, CHARACTERISITICS AND FUNCTIONS OF MONEY MARKET

## 4.4.1 MEANING OF MONEY MARKET

Money market is a segment of financial market. It is a market for short term funds. It deals with all transactions in short term securities. These transactions have a maturity period of one year or less. Examples are bills of exchange, treasury bills etc. These short-term instruments can be converted into money at low transaction cost and without much loss. Thus, money market is a

market for short term financial securities that are equal to money. According to Crowther, **"***Money market is a collective name given to various firms and institutions that deal in the various grades of near money*". Money market is not just a place; it is an activity. It includes all organizations and institutions that deal in short term financial instruments.

## 4.4.2 CHARACTERISTICS OF MONEY MARKET

The following are the characteristics of money market:

- Deals with Short term financial instruments like short term funds and debt instruments.
- Wholesale market where deals are done through phone calls and without the help of intermediaries/brokers.
- It is a conglomerate of several different markets
- The money market is instrumental in smooth implementation of the country's monetary policy.
- Its an essential link between banks and RBI

### 4.4.3 FUNCTIONS OF MONEY MARKET

Money market performs the following functions:

- Liquidity management of commercial banks, business undertakings and other non-banking financial institutions.
- Providing the central bank with the tools to manage liquidity in the economy through necessary interventions.
- Enabling access to short term funds at low transaction costs.
- Meeting short term needs of institutions owned by the government.
- Providing short term investment opportunities to businessmen
- Facilitating flow of funds smoothly by being a bridge between borrowers and lenders of short term funds.
- Enhancing liquidity and safety in financial markets

## 4.5 IMPORTANCE OF MONEY MARKET

**Importance of Money Market**

A well-developed money market is essential for the development of a country. It supplies short term funds adequately and quickly to trade and industry. A developed money market helps the smooth functioning of the financial system in any economy in the following ways:

1. **Development of trade and industry**: Money market is an important source of finance to trade and industry. Money market finances the working capital requirements of trade and industry through bills, commercial papers etc. It influences the availability of finance both in the national and international trade.

2. **Development of capital market**: Availability funds in the money market and interest rates in the money market will influence the resource mobilization and interest rate in the capital market. Hence, the development of capital market depends upon the existence of a developed money market. Money market is also necessary for the development of foreign exchange market and derivatives market.

3. **Helpful to commercial banks**: Money market helps commercial banks for investing their surplus funds in easily realizable assets. The banks get back the funds quickly in times of need. This facility is provided by money market. Further, the money market enables commercial banks to meet the statutory requirements of CRR and SLR. In short, money market provides a stable source of funds in addition to deposits.

4. **Helpful to central bank**: Money market helps the central bank of a country to effectively implement its monetary policy. Money market helps the central bank in making the monetary control effective through indirect methods (repos and open market operations). In short, a well-developed money market helps in the effective functioning of a central bank.

5. **Formulation of suitable monetary policy**: Conditions prevailing in a money market serve as a true indicator of the monetary state of an economy. Hence it serves as a guide to the Government in formulating and revising the monetary policy. In short, the Government can formulate the monetary policy after taking into consideration the conditions in the money market.

6. **Helpful to Government**: A developed money market helps the Government to raise short term funds through the Treasury bill floated in the market. In the absence of a developed money market, the Government would be forced to issue more currency notes or borrow from the central bank. This will raise the money supply over and above the needs of the economy. Hence the general price level will go up (inflationary trend in the economy). In short, money market is a device to the Government to balance its cash inflows and outflows. Thus, a well-developed money market is essential for economic growth and stability.

## 4.6 MONEY MARKET INSTRUMENTS

Money market is involved in buying and selling of short term instruments. It is through these instruments; the players or participants borrow and lend money in the money market. There are various instruments available in the money market. The important money market instruments are:-

**1.** Call and short notice money

2. Commercial bills

3. Treasury bills

4. Certificate of deposits

5. Commercial papers

6. Repurchase agreements

7. Money market mutual funds.

8. ADR/GDR

These instruments are issued for short period. These are interest bearing securities. These instruments are discussed below in detail.

### 4.6.1. CALL AND SHORT NOTICE MONEY

These are short term loans. Their maturity varies from one day to fourteen days. If money is borrowed or lent for a day it is called call money or overnight money. When money is borrowed, or lent for more than a day and up to fourteen days, it is called short notice money. Surplus funds of the commercial banks and other institutions are usually given as call money.

Banks are the borrowers as well as the lenders for the call money. Banks borrow call funds for a short period to meet the cash reserve ratio (CRR) requirements. Banks repay the call fund back once the requirements have been met. The interest rate paid on call loans is known as the call rate. It is a

highly volatile rate. It varies from day to day, hour to hour, and sometimes even minute to minute. **Features of Call and Short Notice Money**:

1. These are highly liquid.

2. The interest (call rate) is highly volatile.

3. These are repayable on demand.

4. Money is borrowed or lent for a very short period.

5. There is no collateral security demanded against these loans. This means they are unsecured.

6. The risk involved is high.

## 4.6.2. COMMERCIAL BILLS

When goods are sold on credit, the seller draws a bill of exchange on the buyer for the amount due. The buyer accepts it immediately. This means he agrees to pay the amount mentioned therein after a certain specified date. After accepting the bill, the buyer returns it to the seller. This bill is called trade bill. The seller may either retain the bill till maturity or due date or get it discounted from some banker and get immediate cash. When trade bills are accepted by

commercial banks, they are called commercial bills. The bank discounts this bill by deducting a certain amount (discount) and balance is paid.

A bill of exchange contains a written order from the creditor (seller) to the debtor (buyer) to pay a certain sum, to a certain person after a certain period. According to Negotiable Instruments Act, 1881, a bill of exchange is ‘an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument’.

**Features of Commercial Bills**

**1.** These are negotiable instruments.

2. These are generally issued for 30 days to 120 days. Thus, these are short term credit instruments.

3. These are self-liquidating instruments with low risk.

4. These can be discounted with a bank. When a bill is discounted with a bank, the holder gets immediate cash. This means bank provides credit to the customers. The credit is

repayable on maturity of the bill. In case of need for funds, the bank can rediscount the bill in the money market and get ready money.

5. These are used for settling payments in the domestic as well as foreign trade.

6. The creditor who draws the bill is called drawer and the debtor who accepts the bill is called drawee.

**Types of Bills**

Many types of bills are in circulation in a bill market. They may be broadly classified as follows:

1. Demand Bills and Time Bills: - Demand bill is payable on demand. It is payable immediately on presentation or at sight to the drawing. Demand bill is also known as *sight bill*. Time bill is payable at a specified future date. Time bill is also known as *usance bill*.

2. Clean Bills and Documentary Bills: When bills have to be accompanied by documents of title to goods such as railway receipts, bill of lading etc. the bills are called documentary bills. When bills are drawn without accompanying any document, they are called clean bills. In such a case, documents will be directly sent to the drawee.

3. Inland and Foreign Bills: - Inland bills are bills drawn upon a person resident in India and are payable in India. Foreign bills are bills drawn outside India and they may be payable either in India or outside India.

4. Accommodation Bills and Supply Bills: - In case of accommodation bills, two parties draw bills on each other purely for the purpose of mutual financial accommodation. These bills are then discounted with the bankers and the proceeds are shared among themselves. On the due dates, the parties make payment to the bank. Accommodation bills are also known as **'wind bills' or 'kite bills'**. Supply bills are those drawn by suppliers or contactors on the Government departments for the goods supplied to them. These bills are not considered as negotiable instruments.

## 4.6.3. TREASURY BILLS

Treasury bills are short term instruments issued by RBI on behalf of Government These are short term credit instruments for a period ranging from 91 to 364. These are negotiable instruments. Hence, these are freely transferable. These are issued at a discount. These are repaid at par on maturity. These are considered as safe investment. Thus, treasury bills are credit instruments used by the Government to raise short term funds to meet the budgetary deficit. Treasury bills are popularly called T-bills. The difference between the amount paid by the tenderer at the time of purchase (which is less than the face value), and the amount received on maturity represents the interest amount on T-bills and is known as the discount.

**Features of T-Bills**

**1.** They are negotiable securities.

2. They are highly liquid.

3. There is no default risk (risk free). This is because they are issued by the Government

4. They have an assured yield.

5. The cost of issue is very low. It does not involve stamp fee.

6. These are available for a minimum amount of Rs. 25000 and in multiples thereof**.**

**Types of T-Bills**

There are two categories of T-Bills. They are:

**1. Ordinary or Regular T-Bills**: These are issued to the public, banks and other institutions to raise money for meeting the short term financial needs of the Government. These are freely marketable. These can be bought and sold at any time.

2. **Ad hoc T-Bills**: These are issued in favour of the RBI only. They are not sold through tender or auction. They are purchased by the RBI on tap. The RBI is authorized to issue currency notes against there. On the basis of periodicity T-bills may be classified into four. They are as follows:

1. 91-Day T-Bills

2. 14-Day T-Bills

3. 182-Day T-Bills: - These were introduced in November 1986 to provide short term investment opportunities to financial institutions and others.

4**.** 364-Day T-Bills

## 4.6.4. CERTIFICATE OF DEPOSITS (CDS)

With a view to give investor's greater flexibility in the development of their short term surplus funds, RBI permitted banks to issue Certificate of Deposit. CDs were introduced in June 1989. CD is a certificate in the form of promissory note issued by banks against the short-term deposits of companies and institutions, received by the bank. Simply stated, it is a time deposit of specific

maturity and is easily transferable. It is a document of title to a time deposit. It is issued as a bearer instrument and is negotiable in the market. It is payable on a fixed date. It has a maturity period ranging from three to twelve months. It is issued at a discount rate varying between 13% to 18%. The discount rate is determined by the issuing bank and the market. All scheduled banks except Regional Rural Banks and scheduled co-operative banks are eligible to issue CDs

to the extent of 7% of deposits. It can be issued to individuals, corporations, companies, trusts, funds and associations. CDs are issued by banks during period of tight liquidity, at relatively high interest rate. Banks rely on this source when the deposit growth is low but

credit demand is high. They can be issued to individuals, companies, trusts, funds, associates, and others.

The main difference between fixed deposit and CD is that CDs are easily transferable from one party to another, whereas FDs are non-transferable.

**Features of CDs**

**1.** These are unsecured promissory notes issued by banks or financial institutions.

2. These are short term deposits of specific maturity similar to fixed deposits.

3. These are negotiable (freely transferable by endorsement and delivery)

4. These are generally risk free.

5. The rate of interest is higher than that on T-bill or time deposits

6. These are issued at discount

7. These are repayable on fixed date.

8. These require stamp duty.

## 4.6.5. COMMERCIAL PAPERS (CPS)

Commercial paper was introduced into the market in 1989-90. It is a finance paper like Treasury bill. It is an unsecured, negotiable promissory note. It has a fixed maturity period ranging from three to six months. It is generally issued by leading, nationally reputed credit worthy and highly rated corporations. It is quite safe and highly liquid. It is issued in bearer form and on discount. It is also known as *industrial paper* or *corporate paper.* CPs can be issued in multiples of Rs. 5 lakhs subject to the minimum issue size of Rs. 50 lakhs. Thus, a CP is an unsecured short term promissory note issued by leading, creditworthy and highly rated corporates to meet their working capital requirements. In short, a CP is a short term unsecured promissory note issued

by financially strong companies.

**Advantages of Commercial Paper**

**1.** These are simple to issue.

2. The issuers can issue CPs with maturities according to their cash flow.

3. The image of the issuing company in the capital market will improve. This makes easy to raise long term capital

4. The investors get higher returns

5. These facilitate securitization of loans. This will create a secondary market for CP.

**Disadvantages of Commercial Papers**

1. It cannot be repaid before maturity.

2. It can be issued only by large, financially strong firms.

## 4.6.6. REPURCHASE AGREEMENTS (REPO)

REPO is basically a contract entered into by two parties (parties include RBI, a bank or NBFC). In this contract, a holder of Government securities sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price. At the end of the period the borrower repurchases the securities at the predetermined price. The difference between the purchase price and the original price is the cost for the borrower. This cost of borrowing is called repo

rate. A transaction is called a Repo when viewed from the perspective of the seller of the securities and reverse when described from the point of view of the suppliers of funds. Thus, whether a given agreement is termed Repo or Reverse Repo depends largely on which party initiated the transaction. Repo is a transaction in which a participant (borrower) acquires

immediate funds by selling securities and simultaneously agrees to repurchase the same or similar securities after a specified period at a specified price. It is also called *ready forward contract*.

## 4.6.7. MONEY MARKET MUTUAL FUNDS (MMMFS)

Money Market Mutual Funds mobilize money from the general public. The money collected will be invested in money market instruments. The investors get a higher return. They are more liquid as compared to other investment alternatives. The MMMFs were originated in the US in 1972. In India the first MMMF was set up by Kothari Pioneer in 1997. But this did not succeed.

**Advantages of MMMFs**

**1.** These enable small investors to participate in the money market.

2. The investors get higher return.

3. These are highly liquid.

4. These facilitate the development of money market.

**Disadvantage of MMMFs**

**1.** Heavy stamp duty.

2. Higher flotation cost.

3. Lack of investors education.

## 4.6.8. AMERICAN DEPOSITORY RECEIPT AND GLOBAL DEPOSITORY RECEIPT

ADRs are instruments in the nature of depository receipt and certificate. These instruments are negotiable and represent publicly traded, local currency equity shares issued by non - American company. For example, an NRI can invest in Indian Company's shares without bothering dollar conversion and other exchange formalities. If the facilities extended globally, these instruments are called GDR. ADR are listed in American Stock exchanges and GDR are listed in other than American Stock exchanges, say Landon, Luxembourg, Tokyo etc.,

***Check Your Progress- A***

**Multiple Choice Questions:**

Q1. Their maturity varies from one day to fourteen days

a. Commercial Paper
b. Call Money
c. Commercial Deposit
d. ADR

Q2. _______ is a short term unsecured promissory note issued by financially strong companies.

a. Commercial Paper
b. Call Money
c. Commercial Deposit
d. ADR

Q3. In this contract, a holder of Government securities sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price.

a. Commercial Paper
b. REPO
c. MMMF
d. ADR

Q4. ______is a certificate in the form of promissory note issued by banks against the short-term deposits of companies and institutions, received by the bank.

a. Commercial Paper
b. Call Money
c. Commercial Deposit

d. ADR

Q5. ________are short term instruments issued by RBI on behalf of Government.

a. Treasury Bills
b. Call Money
c. GDRs
d. ADR

## 4.7 SUMMARY

Money market is a segment of financial market. It is a market for short term funds. It deals with all transactions in short term securities. These transactions have a maturity period of one year or less. Examples are bills of exchange, treasury bills etc. These short-term instruments can be converted into money at low transaction cost and without much loss. A well-developed money market is essential for the development of a country. It supplies short term funds adequately and quickly to trade and industry. A developed money market helps the smooth functioning of the financial system in any economy through development of trade and industry, development of capital market, being helpful to commercial banks, being helpful to central bank, formulation of suitable monetary policy. The important money market instruments are Call and short notice money, Commercial bills, Treasury bills, Certificate of deposits, Commercial papers, Repurchase agreements, Money market mutual funds and ADR/GDRs.

## 4.8 GLOSSARY

**Call and short notice money**- These are short term loans. Their maturity varies from one day to fourteen days. If money is borrowed or lent for a day it is called call money or overnight money. When money is borrowed, or lent for more than a day and up to fourteen days, it is called short notice money.

**Commercial bills**- When trade bills are accepted by commercial banks, they are called commercial bills. The bank discounts this bill by deducting a certain amount (discount) and balance is paid.

**Treasury bills**- Treasury bills are short term instruments issued by RBI on behalf of Government for a period ranging from 91 to 364.

**Certificate of deposits**- CD is a certificate in the form of promissory note issued by banks against the short-term deposits of companies and institutions, received by the bank.

**Commercial papers**- CP is an unsecured short term promissory note issued by leading, creditworthy and highly rated corporates to meet their working capital requirements.

**Repurchase agreements**- In this contract, a holder of Government securities sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price. At the end of the period the borrower repurchases the securities at the predetermined price.

## 4.9 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress –A**

**Q1. b**

**Q2. a**

**Q3. b**

**Q4. c**

**Q5. a**

## 4.10 REFERENCES


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## 4.11 SUGGESTED READINGS


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## 4.12 TERMINAL QUESTIONS

Q1. Differentiate between capital markets and money markets.

Q2. Explain the meaning of money market, its functions and importance.

Q3. Discuss the different instruments in the money market.

# UNIT 5 MONEY MARKET ORGANIZATION

**5.1 Introduction**

**5.2 Objectives**

**5.3 Distinct features of Money Market**

**5.4 Structure of Money Market**

**5.5 Structure of the Indian Money Market**

**5.6 Money Market Participants in India**

**5.7 Role of Institutions in Indian Money Market**

**5.8 Features of Money Market Instruments in India**

**5.9 Determination of interest rates**

**5.10 Summary**

**5.11 Glossary**

**5.12 Reference/ Bibliography**

**5.13 Suggested Readings**

**5.14 Terminal & Model Questions**

## 5.1 INTRODUCTION

In the previous unit you understood the meaning, functions and instruments of money market. In this unit you will study about the Indian money markets, their organization and structure.

## 5.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the structure of money market.
- Understand the organization of money market in India.
- Explain the various instruments used in money markets in India.

## 5.3 DISTINCT FEATURES OF MONEY MARKET

According to, former governor of the RBI, the money market, like the foreign exchange market, is more a concise description of transactions than a location, unlike a stock market. It is what happens between banks, financial institutions, corporates, and others who have money to *place* or *park* for a very short period, viz., a day, a week, or a fortnight.

The distinct features of Money Market are given below:

(i) It is one market but collection of markets, such as, call money, notice money, repose, term money, treasury bills, commercial bills, certificate of deposits, commercial papers, inter-bank participation certificates, inter-corporate deposits, swaps futures, options, etc. and is concerned to deal in particular type of assets, the chief characteristic is its relative liquidity. All the sub-markets have close inter-relationship and free movement of funds from one sub-market to another. There has to be network of large number of participants which will add greater depth to the market.

(ii) The activities in the money market tend to concentrate in some centre which serves a region or an area; the width of such area may vary considerably in some markets like London and New York which have become world financial centres. Where more than one market exists in a country, with screen-based trading and revolutions in information technology, such markets have rapidly becoming integrated into a national market. In India, Mumbai has emerged as a national market for money market instruments.

(iii) The relationship that characterizes a money market should be impersonal in character so that competition will be relatively pure.

(iv) In a true money market, price differentials for assets of similar type (counterparty, maturity and liquidity) will tend to be eliminated by the interplay of demand and supply. Even for similar types of assets, some differential will no doubt continue to exist at any given point of time which gives scope for arbitrage.

(v) Due to greater flexibility in the regulatory framework, there are constant endeavors for introducing new instruments/innovative dealing techniques;

(vi) It is a wholesale market and the volume of funds or financial assets traded in the market are very large.

## 5.4 STRUCTURE OF MONEY MARKET

Money market consists of a number of sub markets. All submarkets collectively constitute the money market. Each sub market deals in a particular financial instrument. The main components or constituents or sub markets of money markets are as follows:

1. Call money market

2. Commercial bill market

3. Treasury bill markets
4. Certificates of deposits market
5. Commercial paper market
6. Acceptance market
7. Collateral loan market

## 5.4.1. CALL MONEY MARKET

Call money is required mostly by banks. Commercial banks borrow money without collateral from other banks to maintain a minimum cash balance known as cash reserve ratio (CRR). This interbank borrowing has led to the development of the call money market. Call money market is the market for very short period loans. In the call money market, surplus funds of financial institutions, and banks are traded. There is no demand for collateral security against call money. In India call money markets are mainly located in big industrial and commercial centres like Mumbai, Kolkata, Chennai, Delhi and Ahmedabad. Participants or Players in the Call Money Market include scheduled commercial banks and RBI, non-scheduled commercial banks, co-operative banks, foreign banks, discount and finance houses of India and primary dealers.

The above players are permitted to operate both as lenders and borrowers.

## 5.4.2. COMMERCIAL BILL MARKET

Commercial bill market is another segment of money market. It is a market in which commercial bills (short term) are bought and sold. Commercial bills are important instruments. They are widely used in both domestic and foreign trade to discharge the business obligations (or to settle business obligations). Discounting is the main process in this market. Hence commercial bill market is also known as *discount market*. There are specialized institutions known as discount houses for discounting commercial bills accepted by reputed acceptance houses. RBI has permitted the financial institutions, mutual funds, commercial banks and cooperative banks to enter in the commercial bill market.

## 5.4.3. TREASURY BILLS MARKET

Treasury bill market is a market which deals in treasury bills. In this market, treasury bills are bought and sold. Treasury bill is used by the Government to raise short term funds for meeting temporary Government deficits. Thus, it represents short term borrowings of the Government.

The Government can absorb excess liquidity in the economy through the issue of T-bills in the market. It does not lead to inflationary pressure. For purchasers/investors, it is a ready market and is a safety instrument to invest. Treasury bills are eligible securities for SLR requirement. The market provides hedging facility.

## 5.4.4. CERTIFICATES OF DEPOSITS (CDS) MARKET

CD market is a market which deals in CDs. CDs are short term deposit instruments to raise large sums of money. These are short term deposits which are transferable from one party to another. Banks and financial institutions are major issuers of CD. These are short term negotiable instruments. It enables the depositors to earn higher return on their short-term surplus. This market provides maximum liquidity and the banks can raise money in times of need. This improves their lending capacity.The market provides an opportunity for banks to invest surplus funds and the transaction cost of CDs is lower.

## 5.4.5. COMMERCIAL PAPER MARKET

Commercial Paper Market is another segment of money market. It is a market which deals in commercial papers. Commercial papers are unsecured short term promissory notes issued by reputed, well established and big companies having high credit rating. These are issued at a discount. Commercial papers can now be issued by primary dealers and all India financial institutions. They can be issued to (or purchased by) individuals, banks, companies and other registered Indian corporate bodies (Investors in CP).

## 5.4.6. ACCEPTANCE MARKET

Acceptance market is another component of money market. It is a market for banker's acceptance. The acceptance arises on account of both home and foreign trade. Bankers' acceptance is a draft drawn by a business firm upon a bank and accepted by that bank. It is required to pay to the order of a particular party or to the bearer, a certain specific amount at a specific date in future. It is commonly used to settle payments in international trade. Thus, acceptance market is a market where the bankers' acceptances are easily sold and discounted.

## 5.4.7. COLLATERAL LOAN MARKET

Collateral loan market is another important sector of the money market. The collateral loan market is a market which deals with collateral loans. Collateral means anything pledged as security for repayment of a loan. Thus, collateral loans are loans backed by collateral securities such as stock, bonds etc. The collateral loans are given for a few months. The collateral security is returned to the borrower when the loan is repaid. When the borrower is not able to repay the loan, the collateral becomes the property of the lender. The borrowers are generally the dealers in stocks and shares.

*Check Your Progress- A*

**Q1. State the different kinds of markets operating as part of the money market.**

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**Q2. State the difference between commercial bills market and treasury bills market**.

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## 5.5 STRUCTURE OF THE INDIAN MONEY MARKET

In the Indian money market RBI occupies a key role. It is the nerve Centre of the monetary system of our country. It is the leader of the Indian money market. The Indian money market is highly disintegrated and unorganized. The Indian money market can be divided into two sectors - unorganized and organized. In between these two, there exists the co-operative sector. It can be included in the organized sector. The organized sector comprises of RBI, SBI group of banks, public sector banks, private sector banks, development banks and other financial institutions.

The unorganized sector comprises of indigenous bankers, money lenders, chit funds etc. These are outside the control of RBI. This is the reason why Indian money market remains underdeveloped.

### 5.5.1 FEATURES OF THE INDIAN MONEY MARKET

The features of the Indian money market are as follows:

- **Existence of unorganized segment**: The most important defect of the Indian money market is the existence of unorganized segment. The unorganized segment comprises of indigenous bankers, moneylenders etc. This unorganized sector does not follow the rules and regulations of the RBI. Besides, a higher rate of interest prevails in the unorganized market.
- **Lack of integration:** Another important drawback of the Indian money market is that the money market is divided into different sections. These sections are loosely

connected to each other. There is no co-ordination between the organized and unorganized sectors. With the setting, up of the RBI and the passing of the Banking Regulations Act, the conditions have improved.

- **Disparities in interest rates**: Interest rates in different money markets and in different segments of money market still differ. Too many interest rates are prevailing in the market. For example, borrowing rates of Government lending rate of commercial banks, the rates of co-operative banks and rates of financial institutions. This disparity in interest rates is due to lack of mobility of funds from one segment to another.
- **Seasonal diversity of money market**: The demand for money in Indian money market is of seasonal in nature. During the busy season from November to June, money is needed for financing the marketing of agricultural products, seasonal industries such as sugar, jaguar, etc. From July to October the demand for money is low. As a result, the money rates fluctuate from one period to another.
- **Absence of bill market:** The bill market in India is not well developed. There is a great paucity of sound commercial bills of exchange in our country. As a matter of habit, Indian traders resort to hundies rather than properly drawn bill of exchange.
- **Limited instruments:** The supply of short term instruments like commercial bills, treasury bills etc. are very limited and inadequate.
- **Limited number of participants**: The participants in the Indian money market are limited. Entry in the money market is tightly regulated.
- **Restricted secondary market:** Secondary market for money market instruments is mainly restricted to rediscounting of commercial bills and treasury bills.
- **No contact with foreign money markets**: Indian money market has little contract with money markets in other countries.

## 5.5.2 RECENT DEVELOPMENTS IN THE INDIAN MONEY MARKET

The recent developments in the Indian money market may be briefly explained as below:

- Integration of unorganized sector with the organized sector: RBI has taken many steps to bring the institutions in the unorganized sector within its control and regulation. These institutions are now slowly coming under the organized sector. They started availing of the rediscounting facilities from the RBI.
- Widening of call money market: In recent years, many steps have been taken to widen the call money market. The number of participants in the call money market is increasing. LIC, GIC, IDBI, UTI and specialized mutual funds have been permitted to enter into this market as lenders only. The DFHI and STCI have been permitted to operate both as lenders and borrowers.
- Introduction of innovative instruments: New financial instruments have been introduced in the money market. On the recommendation of the Chakkraborty Committee, the RBI introduced 192 days T-bills since 1986. A new instrument in the

form of 364 days T-bills was introduced at the end of April 1992. Again, new instruments such as CDs, CPs, and interbank participation certificates have been introduced. Necessary guidelines also have been issued for the operation of these instruments.

- Introduction of negotiable dealing system: As negotiable dealing system, has been introduced with a view to facilitating electronic bidding in auctions and secondary market transactions in Government securities and dissemination of information.
- Offering of market rates of interest: In order to popularize money market instruments, the ceiling on interest rate has been abolished. Call money rate, bill discounting rate, interbank rate etc. have been freed from May 1, 1989. Thus, today Indian money market offers full scope for the play of market forces in determining the rates of interest.
- Satellite system dealership: The satellite system dealership was launched in 1996 to serve as a second tier to primary dealers in retailing of Government securities. RBI has decided to allow players such as provident funds, trusts to participate in government bond auctions, on a non-competitive basis.
- Promotion of bill culture: All attempts are being taken to discourage cash credit and overdraft system of financing and to popularize bill financing. Exemption from stamp duty is given on rediscounting of derivative usance promissory notes arising out of genuine trade bill transactions. This is done to promote bill culture in the country.

## 5.6 MONEY MARKET PARTICIPANTS IN INDIA

The money market in India is characterized by ***two*** segments -

- Organized Segment
- Unorganized Segment

### 5.6.1 ORGANIZED SEGMENTS

The principal intermediaries in the organized segment are:

a. The commercial and other banks,

b. Non-banking finance companies and

c. Co-operative societies.

The primary activity of these intermediaries is to accept deposits from the public and lend them on a short-term basis to industrial and trading organizations. In recent years, they have extended their activities to rural areas to support agricultural operations. There is also an active inter-bank loan market as part of the organized money market.

The salient features of the organized money market in India are

(i) A significant part if its operations which is dominated by commercial banks, is subject to tight control by the Reserve Bank of India which

(a) regulates the interest rate structure (on deposits as well as loans), reserve requirements and sectoral allocation of credit and

(b) provides support to the banks by lending them on a short-term basis and insuring the deposits made by the public.

(ii) It is characterized by fairly rigid and complex rules which may prevent it from meeting the needs of some borrowers even though funds may be available

(iii) overall, there is a paucity of loanable funds, mainly because of the low rate of interest paid on deposits.

## 5.6.2 UNORGANIZED SEGMENT:

The principal participants in the unorganized money market are

a. Money Lenders,

b. Indigenous Bankers,

c. Nidhis (mutual loan associations) and

d. Chit Funds.

They lend, primarily to borrowers who are not able to get credit from the organized money market. The characteristics of the unorganized money market are:

(i) informal procedures,

(ii) flexible terms,

(iii) attractive rates of interest to depositors and

(iv) high rates of interest to borrowers.

The size of the unorganized money market is difficult to estimate, though it appears to be fairly large. However, its importance relative to that of the organized money market is declining. This is a welcome development from the point of view of the Reserve Bank of India because of the existence of a large unorganized market frustrates its efforts to control credit. Access to call money market was restricted to scheduled commercial banks until 1971 when the RBI permitted the Unit Trust of India (UTI) and the Life Insurance Corporation of India (LIC) to deploy their short-term funds. The list was later expanded to include cooperative banks, term-lending financial institutions (such as IDBI, IFCI, ICICI and SCICI), MFs launched by the public sector banks and investment institutions, and the MFs set up in private sector.

The RBI allowed the MMMFs set up in the public and private sectors to participate in the money market. Former finance minister agreed in principle to allow the Department of Posts to invest its short-term funds in the call money market. While banks and the UTI can lend as well as borrow, financial institutions, General Insurance Corporation (GIC), LIC, MFs, and MMMs can only lend in the call money market. The private sector banks and MFs have been

demanding a level playing field vis-a-vis the UTI regarding the facility to borrow from the money market so as to meet their redemption requirements. This facility comes in handy for them, particularly in a declining market, as they can obtain the required short-term funds at a lower cost. This is because of the large difference between the cost of the short-term funds in the organized money market and that in the unorganized, or informal, money market. MMMFs provide an ideal vehicle for an average investor to reap the benefits of high call money rates and high yields on money market instruments which, hitherto, have been enjoyed only by banks and financial institutions while paying a lower rate of interest on deposits. This is because retail investors can't invest in money market instruments due to the restrictions in terms of eligibility and the minimum amount of investment despite higher return offered by these securities.

## 5.7 ROLE OF INSTITUTIONS IN INDIAN MONEY MARKET

The important institutions operating in money market are:

**Reserve Bank of India (RBI)** is the most important participant of money market which takes requisite measures to implement monetary policy of the country. As the Central bank, RBI regulates the money market in India and injects liquidity in the banking system, when it is deficient or contracts the same in opposite situation.

**Schedule Commercial Banks (SCBs)** form the nucleus of money market. They are the most important borrower/supplier of short-term funds. They mobilize the savings of the people through acceptance of deposits and lend it to business houses for their short-term working capital requirements. While a portion of these deposits is invested in medium and long-term Government securities and corporate shares and bonds, they provide short-term funds to the Government by investing in the Treasury Bills.

**Co-operative Banks:** Function similarly as the commercial banks.

**Financial and Investment Institutions:** These institutions (e.g. LIC,UTI,GIC, Development Banks etc.) have been allowed to participate in the call money market as lenders only.

**Corporates:** Companies create demand for funds from the banking system. They raise short-term funds directly from the money market by issuing commercial paper. Moreover, they accept public deposits and also indulge in inter-corporate deposits and investments.

**Mutual Funds:** Mutual funds also invest their surplus funds in various money market instruments for short periods. They are also permitted to participate in the Call Money Market. Money Market Mutual Funds have been set up specifically for the purpose of mobilization of short-term funds for investment in money market instruments.

**Discount and Finance House of India:** The Discount and Finance House of India Limited (DFHI) has been set up by the Reserve Bank of India jointly with public sector banks and all–India financial institutions to deal in short-term money market instruments. It started

operations in April, 1988. At present DFHI participates in the inter-bank call/notice money market and term deposit market, both as lender and borrower. It also rediscounts 182 Days Treasury Bills, commercial bills, CDs and CPs. The DFHI's turnover in the various segments of the money market has shown improvements during the last few years. DFHI has been involved in:

(a) Participation in the call money market

(b) Dealing in Treasury Bills

(c) Repo facility to banks

(d) Re-discounting short term commercial bills

(e) Participating in the Inter-bank call money, notice money and term deposit market:

(f) Dealing in Commercial papers, Certificate of Deposits and Government securities

It may not be out of place to mention that after the setting up of DFHI, there has been an upsurge of activities in the money market.

## 5.8 FEATURES OF MONEY MARKET INSTRUMENTS IN INDIA

The instruments of money market are characterized by short duration, large volume, de–regulated interest rates, and high liquidity. These are safe investments owing to issuer's inherent financial strength. The traditional short-term money market instruments consist of mainly call money and notice money with limited players, treasury bills and commercial bills. The new money market instruments were introduced giving a wider choice to short term holders of money to reap yield on funds even for a day or to earn a little more by parking funds by instruments for a few days more or until such time till they need it for lending at a higher rate.

### 5.8.1 CALL/NOTICE MONEY IN INDIA

The core of the Indian money market structure is the inter-bank call money market which is centralized primarily in Mumbai, but with sub-markets in Delhi, Kolkata, Chennai and Ahmedabad. The activities in the call money are confined generally to inter-bank business, predominantly on an overnight basis, although a small amount of business, known as notice money was also transacted side by side with call money with a maximum period of 14 days.

Those who can both borrow as well as lend in the market - RBI, Commercial Banks, Co-operative banks and Primary Dealers. Those who can only lend Financial institutions-LIC, UTI, GIC, IDBI, NABARD, ICICI and mutual funds etc. Corporate entities having bulk lendable resources of minimum of Rs.5 crores per transactions have been permitted to lend in call money through all Primary Dealers provided they do not have any short-term borrowings from banks. Brokers are not permitted in the market. Current and expected

interest rates on call money are the basic rates to which other money markets and to some extent the Government securities market are anchored. Interest rate in the market is market driven and is highly sensitive to the forces of demand and supply. Within one fortnight, rates are known to have moved as high as and/or touch levels as low as 0.50% to 1% Intra-day variations as also quite large. Hence, the participants in the markets are exposed to a high degree of interest rate risk. The call money rates have been fluctuating widely going up to 70 per cent and dropping to around 3 per cent in the recent past. One of the most important factors contributing to volatility in the market is mismatches in assets and liabilities created by the banks.

## 5.8.2 INTER-BANK TERM MONEY IN INDIA

This market which was exclusively for commercial banks and co-operative banks has been opened up for select All India Development Financial Institutions in October, 1993. The DFIs are permitted to borrow from the market for a maturity period of 3 to 6 months within the limits stipulated by Reserve Bank of India for each institution. The market is predominantly 90-days market. The market has shown a lot of transactions following withdrawal of CRR/SLR on liabilities of the banking system.

## 5.8.3 INTER-BANK PARTICIPATION CERTIFICATE (IBPC) IN INDIA

The IBPCs are short-term instruments to even-out the short-term liquidity within the banking system. The primary objective is to provide some degree of flexibility in the credit portfolio of banks and to smoothen the consortium arrangements. The IBPC can be issued by scheduled commercial bank and can be subscribed to by any commercial bank. The IBPC is issued against an underlying advance, classified standard and the aggregate amount of participation in any account time issue. The participation can be issued in two types, viz. with and without risk to the lender. While the participation without it can be issued for a period not exceeding 90 days. Participation is now with risk for a period between 91 days and 180 days. The interest rate on IBPC is freely determined in the market. The certificates are neither transferable nor prematurely redeemable by the issuing bank.

In the case of the bank issuing IBPC with risk, the aggregate amount of participation would be reduced from the aggregate advance outstanding. The participating bank would show the aggregate amount of such participation as part of its advances. In cases where risks have materialized, the issuing bank and participating bank should share the recoveries proportionately.

However, in without risk sharing management, the issuing bank will show the amount of participation as borrowing while the participating bank will show the same under advances to banks. In case of any loss, the issuing bank should compensate fully the participating bank. The scheme is beneficial both to the issuing and participating banks. The issuing bank can secure funds against advances without actually diluting its asset-mix. A bank having the highest loans to total asset ratio and liquidity bind can square the situation by issuing IBPCs.

To the lender, it provides an opportunity to deploy the short-term surplus funds in a secured

and profitable manner. The IBPC with risk can also be used for capital adequacy management. A bank with capital shortfall can temporarily park its advances with other banks which have surplus capital. It can also be used for meeting shortfall in priority sector lending by swapping such advances with those banks who exceed the priority sector lending obligations.

## 5.8.4 INTER CORPORATE DEPOSIT IN INDIA

The inter corporate market operates outside the purview of regulatory framework. It provides an opportunity for the corporates to park their short-term surplus funds at market determined rates. The market is predominantly a 90 days market and may extend to a maximum period of 180 days. The market which witnessed flurry of activities has received a serious jolt in the wake of series of defaults. The market of inter-corporate deposits maintains secrecy. The brokers in this market never reveal their lists of lenders and borrowers, because they believe that if proper secrecy is not maintained the rate of interest can fall abruptly. The market of inter-corporate deposits depends crucially on personal contacts. The decisions of lending in this market are largely governed by personal contacts.

Inter-corporate loans have been a traditional feature of corporate financing in India. This scheme of market operates freely and outside the regulatory framework and the risk of lending in this market is such that periodic failures characterize this market.

## 5.8.5 TREASURY BILLS (TBS) IN INDIA

Among money market instruments TBs provide a temporary outlet for short-term surplus as also provide financial instruments of varying short-term maturities to facilitate a dynamic asset-liabilities management. The interest received on them is the discount which is the difference between the price at which they are issued and their redemption value. They have assured yield and negligible risk of default. In order to provide investors with instruments of varying short-term maturities, government of India provided TBs of 14 days, 91 days, 182 days and 364 days maturity.

The auction of 91 days TBs was first introduced in January, 1993. While the uniform price auction method is followed in respect of 91 days TBs, the cut off yield of other TBs are determined on the basis of discriminatory price auctions. The non-competitive bids in respect of 14 and 364 days TBs are accepted outside the notified amount. The discretion to accept non-competitive bids fully or partially rest with RBI. The amount to be accepted at the auctions and the cut-off price are decided by the Reserve Bank of India on the basis of its public debt management policy, the conditions in money market and the monetary policy stance.

Although State Government also issued treasury bills until 1950, since then it is only the Central Government that has been selling them. In terms of liquidity, for short term financing, the descending order is cash, call loans, treasury bills and commercial bills. 14 days Intermediate TBs was introduced with effect from 1st April, 1997. State Governments,

foreign, Central Banks and other specialized bodies with whom RBI has an agreement are only allowed to invest in this TB.

The treasury bills are issued in the form of promissory note in physical form or by credit to Subsidiary General Ledger (SGL) account or Gilt account in dematerialized form. TBs can be purchased by any person, firm, company corporate body and institutions. State Government, Non-Government Provident Funds governed by the PF Act, 1925 and Employees Provident Fund and Miscellaneous Provisions Act, 1952 are eligible to participate in the auctions of 14 days and 91 days TBs on a non-competitive basis. Noncompetitive bids are accepted at the weighted average price arrived at on the basis of competitiveness bids accepted at the auctions. TBs are approved securities for the purpose of SLR. While Reserve Bank of India does not participate in the auctions of 14 days and 364 days TBs, it will be at its liberty to participate in the auctions and to buy part or the whole of the amount notified in respect of 91 days TBs. The Primary Dealers also underwrite a minimum of 25% of the notified amount of the 91 days TBs. They also underwrite the amount offered by RBI in respect of 14 and 364 days TBs.

TBs are issued in lots of Rs. 25,000 (14 days and 91 days)/Rs. 1,00,000 (364 days). The treasury bills are repaid at par on the expiry of their tenor at the office of the Reserve Bank of India, Mumbai. All the treasury Bills are highly liquid instruments available both in the primary and secondary market. 182 day treasury bills are also available in the market. The Reserve Bank of India introduced 182 days Treasury Bills in November, 1986. 182 Days Treasury Bills are issued in minimum denomination of Rs. one lakh and in multiples thereof. However, in the secondary market, the deals are presently transacted for a minimum amount of Rs. 25 lakhs and thereafter in multiples of Rs. 10 lakhs. The 182 days treasury bills are, however, yet to become popular to combat the volatility of the call money market, as the yield is still not attractive though it is market determined. Moreover, RBI refinance against treasury bills is only 50% of the value.

## 5.8.6 COMMERCIAL BILLS IN INDIA

The commercial bill is an instrument drawn by a seller of goods on a buyer of goods. RBI has pioneered its efforts in developing bill culture in India, keeping in mind the distinct advantages of commercial bills. The RBI introduced Bills Market Scheme (BMS) in 1952 and the Scheme was later modified into New Bills Market Scheme (NBMS) in 1970 on the recommendation of Narasimham Committee. Under the Scheme, commercial banks can discount with approved institutions (i.e. Commercial Banks, Insurance Companies, Development Financial Institutions, Mutual Funds, Primary Dealers, etc.) the bills which were originally discounted by them provided that the bills should have arisen out of genuine commercial trade transactions. The interest rate on re-discounting of bills was deregulated in May, 1989. Notwithstanding various benefits accruing to this mode of financing, bill financing is yet to develop on a scale commensurate with the credit provided by the banks to the commercial sector.

## 5.8.7 CERTIFICATE OF DEPOSITS (CDS) IN INDIA

The CDs are negotiable term-deposits accepted by commercial bank from bulk depositors at market related rates. CDs are usually issued in dematerialized form or as a Usance Promisory Note. All scheduled banks (except RRBs and Co-operative banks) are eligible to issue CDs. They can be issued to individuals, corporates, trusts, funds and associations. NRIs can also subscribe to CDs but on non-repatriable basis only. In secondary markets such CDs cannot be endorsed to another NRI. The CDs can be issued by scheduled commercial banks (excluding RRBs) at a discount to face value for a period from 3 months to one year. For CDs issued by Financial institutions maturity is minimum 1 year and maximum 3 years. The CDs can be issued for minimum amount of Rs. 5 lakhs to a single investor. CDs above Rs. 5 lakhs should be in multiples of Rs. 1 lakh. There is, however, no limit on the total quantum of funds raised through CDs. CDs issued in physical form are freely transferable by endorsement and delivery. Procedure of transfer of dematted CDs is similar to any other demat securities. The

CDs can be negotiated on or after 30 days from the date of issue to the primary investor. The CDs were introduced in June, 1989 with the primary objective of providing a wholesale resource base to banks at market related interest rates. The instrument was effectively used to cover certain asset sources and has since emerged as instrument for effective asset-liability management. Free transferability of instrument (after 30 days from issue) assures liquidity to the instrument. Banks can invest in CDs for better funds management; such investments beside yielding high return can be netted with liability to the banking system for CRR/SLR purpose. This type of asset also attracts only lower rate of weight under Capital Adequacy Standards. The CDs market witnessed a spurt in activities during 1995 against the backdrop of liquidity crisis. In terms of the provisions of CD Scheme, banks were allowed to issue CDs to their customers upto an aggregate amount equivalent to 5 per cent of their aggregate deposit.

Since a CD is eligible for rediscounting in the money market only after 30 days of holding, the maturity period of CDs available in the market can be anywhere between 1 month to one year.

Despite the large size of the primary market for CDs, there has been virtually no activity in the secondary market and the holders keep the CDs till maturity.

The Banks are facing some of the problems in issuing certificate of deposits (CDs). For the banks CDs are subject to reserve requirements, while for FIs, there is no such need. Recently, FIs have been allowed to issue CDs. It is contended that whereas the cost of borrowing for FIs does not change, for banks the break even for lending is put at 30 per cent per annum against the competition pricing of 16 to 17 per cent. The banks feel a review is necessary to remove the anomaly.

## 5.8.8 COMMERCIAL PAPER IN INDIA

Commercial paper (CP) has its origin in the financial markets of America and Europe. When the process of financial dis-intermediation started in India in 1990, RBI allowed issue of two

instruments, viz., the Commercial Paper (CP) and the Certificate of Deposit (CD) as a part of reform in the financial sector as suggested by Vaghul Committee. A notable feature of RBI Credit Policy announced on 16.10.1993 was the liberalization of terms of issue of CP. At present, it provides the cheapest source of funds for corporate sector and has caught the fancy of corporate sector and banks. Its market has picked up considerably in India due to interest rate differentials in the inter-bank and commercial lending rates. Commercial Paper (CP) is an unsecured debt instrument in the form of a promissory note issued by highly rated borrowers for tenors ranging between 15 days and one year.

Corporates raise funds through CPs on an ongoing basis throughout the year. Some go in for CPs issuance to redeem old issues. It is generally issued at a discount freely determined by the market to major institutional investors and corporations either directly by issuing corporation or through a dealer bank.

It partly replaces the working capital limits enjoyed by companies with the commercial banks and there will be no net increase in their borrowing by issue of CP. As a regulatory body, RBI lays down the policies and guidelines with regard to commercial paper to maintain a control on the operational aspects of the scheme.

The CPs can be issued by all non-banking (financial as well as non-financial) companies and All-India Financial Institutions. Effective from September 6, 1996, Primary dealers (PDs) have also been permitted to raise funds by issuing CPs. The instrument is instantly advantageous to the issuer and the investor. The issue of CPs does not involve bulky documentation and its flexibility with the opportunities can be tailored to meet the cash flow of the issuer. A highly rated company can raise cheaper funds than from the financing bank while the investor can deploy its short-term surplus at relatively high return. The secondary market for CPs ensure liquidity and the compulsory credit rating imparts inherent strength to the issuer's ability to meet the obligations on maturity. The bank as managers or dealers of the instrument get fees to supplement their income. Bank can also invest their surplus short-term funds in CP.

The credit rating of CPs play an important role. A rating is assigned for a particular amount and depends on the company’s debt obligation vis-a-vis the level of cash accruals. The Credit Rating Information Services of India Limited (CRISIL) promoted by ICICI is one of the credit rating agencies in India, the others being ICRA (originally Investment Information and Credit Rating Agency of India Limited) and Credit Analysis & Research (CARE).

Virtually no secondary market exists for CPs today, it has become imperative that steps to develop a healthy secondary market.

## 5.8.9 MONEY MARKET MUTUAL FUNDS (MMMFS):

One of the recent development in the sphere of money market is the establishment of Money Market Mutual Funds, the guidelines of which have been made public by the Reserve Bank of India. Money Market Mutual Funds (MMMFs) can be set up by the banks and public financial institutions. There can also be Money Market Deposit Accounts (MMDAs). The limit for raising resources under the MMMF scheme could not exceed 2% of the sponsoring

bank's fortnightly average aggregate deposits. MMMFs are primarily intended for individual investors including NRIs who may invest on a non–repatriable basis. MMMFs would be free to determine the minimum size of the investment by a single investor. The minimum lock in period would be 46 days.

## 5.8.10 REPURCHASE OPTIONS (REPO.) AND READY FORWARD (RF) CONTRACTS

Repo transactions are of recent origin which has gained tremendous importance due to their short tenure and flexibility to suit both lender and borrower. Under these transactions the borrower places with lender certain acceptable securities against funds received and agrees to

reverse this transaction on a pre–determined future date at agreed interest cost. No fixed period has been prescribed for this transaction. However, generally repo transactions are for minimum period of 14 days and maximum period of 1 year. The interest on such transactions is market determined and built in the structure of the Repo. The transactions can be undertaken by commercial banks, financial institutions, brokers. At present Repo transactions, have been prohibited in all securities except treasury bills.

Ready forward (RF) transactions are structured to suit the requirements of both borrower and lender and have therefore, become extremely popular mode of raising/investing short term funds. The borrower has advantage of raising funds against its securities without altering its assets mix while lender finds a safe avenue giving attractive returns. Moreover, the funds management for both borrower and lender is improved as the date of reversal of transaction is known in advance.

The RBI intervenes in the market as and when required by conducting repos (ready forward purchases) through its two subsidiaries, namely, Securities Trading Corporation of India (STCI) and Discount and Finance House of India (DFHI). In India, the repo market in Government securities and PSU bonds became very active in 1980s, and the deals were generally interbank. While certain regulatory restrictions were put in place in 1987, in the aftermath of securities scam, RBI imposed a ban on inter-bank repos in 1992 in all instruments except TBs. Since then RBI has made several relaxations in regard to Repo Transactions.

Of late, RBI has been conducting Repo auctions for 3/4 days to mop-up the excess liquidity released to the system through reduction of CRR/Intervention in the forex market. Further, a SLR surplus and CRR deficit bank can use the repo deals as a convenient way of adjusting SLR/CRR positions simultaneously. The Repo is a convenient instrument for Asset- Liability Management.

## 5.9 DETERMINATION OF INTEREST RATES

Call money rates were regulated in the past by the RBI or by a voluntary agreement between the participants through the intermediation of the Indian Banks Association (IBA). The interest rates have been deregulated and left to the market forces of demand for; and supply of, short term money as part of the financial sector reforms.

## 5.10 SUMMARY

Money market consists of a number of sub markets. All submarkets collectively constitute the money market. Each sub market deals in a particular financial instrument. The main components or constituents or sub markets of money markets are : Call money market, Commercial bill market, Treasury bill markets, Certificates of deposits market, Commercial paper market, Acceptance market and Collateral loan market. The Indian money market can be divided into two sectors - unorganized and organized. In between these two, there exists the co-operative sector. It can be included in the organized sector. The organized sector comprises of RBI, SBI group of banks, public sector banks, private sector banks, development banks and other financial institutions.The unorganized sector comprises of indigenous bankers, money lenders, chit funds etc. The important institutions operating in money market are: Reserve Bank of India (RBI), Schedule Commercial Banks (SCBs), Co-operative Banks, Financial and Investment Institutions, Corporates, Mutual Funds and Discount and Finance House of India. The instruments of money market are characterized by short duration, large volume, de–regulated interest rates, and high liquidity. These are safe investments owing to issuer’s inherent financial strength. The traditional short-term money market instruments consist of mainly call money and notice money with limited players, treasury bills and commercial bills. The new money market instruments were introduced giving a wider choice to short term holders of money to reap yield on funds even for a day or to earn a little more by parking funds by instruments for a few days more or until such time till they need it for lending at a higher rate.

## 5.11 GLOSSARY

**Call and short notice money**- These are short term loans. Their maturity varies from one day to fourteen days. If money is borrowed or lent for a day it is called call money or overnight money. When money is borrowed, or lent for more than a day and up to fourteen days, it is called short notice money.

**Commercial bills**- When trade bills are accepted by commercial banks, they are called commercial bills. The bank discounts this bill by deducting a certain amount (discount) and balance is paid.

**Treasury bills**- Treasury bills are short term instruments issued by RBI on behalf of Government for a period ranging from 91 to 364.

**Certificate of deposits**- CD is a certificate in the form of promissory note issued by banks against the short-term deposits of companies and institutions, received by the bank.

**Commercial papers**- CP is an unsecured short term promissory note issued by leading, creditworthy and highly rated corporates to meet their working capital requirements.

**Repurchase agreements**- In this contract, a holder of Government securities sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price. At the end of the period the borrower repurchases the securities at the predetermined price.

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## 5.14 TERMINAL QUESTIONS

Q1. Discuss the different sub markets of the money markets.

Q2. With special reference to India, explain the structure of money markets and the recent developments.

Q3. Explain the role of different institutions involved in the money market in India.

Q4. Discuss the different instruments in the money market in India.

# Block II
# Regulators of Financial System

# UNIT 6 REGULATIONS IN FINANCIAL SYSTEM

**6.1 Introduction**

**6.2 Objectives**

**6.3 Reserve Bank of India**

**6.4 Securities and Exchange Board of India (SEBI)**

**6.5 Insurance Regulatory and Development Authority of India (IRDA)**

**6.6 Summary**

**6.7 Glossary**

**6.8 Answer to check your progress/Possible Answers to SAQ**

**6.9 References/Bibliography**

**6.10 Suggested Readings**

**6.11 Terminal and Model Questions**

## 6.1 INTRODUCTION

In the previous unit you have understood how does the money market works and which are the money market institutions. For the smooth functioning of the money market, it should be well aligned with the capital market, at this juncture the need of a regulatory institution to promote transparency in the interest of the corporate as well as retail investors will always be there. And at this direction RBI, SEBI and IRDA play a prominent role. Capital plays an important part for the production of product and services in a country. Its importance is more felt in the case of developing countries, where the funds are regularly needed for the economic growth and development. For this the economy needs a robust Capital market which can helps in the capital formation. By capital formation we mean channelizing savings from the savers to the users of capital i.e. Industry and Corporate entities. Importantly we had three major sub-processes in capital formation Savings, Financing and Investments. Savings mean the ownership of funds is channelized towards the other purposes while ensuring a return for the savings period. Financing is pooling of savings and made it available for investments. Investments are the usage of savings for production of goods and services to ensure returns as a share of profit from such business activity to be shared with the financing institution and the savers. In other words a higher rate of capital

information will ensure growth of the Gross Domestic Product (GDP ); which in turn raise the level of income and capital for the economic development of the country. The capital market constitutes primary capital market and the secondary capital market. By primary market we mean the market for new issues and secondary market is the place of trading for the existing securities by the investors. In primary market the securities are issued through public issue by prospectus through Initial Public Offers (IPO), private placements, right issues and preferential issues. The secondary capital market can be divided into two; on the basis of secondary market for the corporate and financial intermediaries and other for the government securities and public sector undertaking bonds. For corporate and financial intermediaries, the trading in issues takes place by registered brokers-both individual as well as institutions through (1) the registered stock exchanges, (2) the National Stock Exchange of India Ltd. (NSE), (3) the Over-the-Counter Exchange of India (OTCEI) and (4) the Interconnected Stock Exchange of India (ISE) . But for the Government and the public sector undertaking

Financial institutions in an economy play a vital role to mobilize the savings and allocate them to those in needs of the funds. For providing cost effective financial services the synchronization between financial institutions, financial markets and financial instrument. Financial institutions and financial markets

provide a infrastructural support and platform to bring the savers and investors of the funds into the financial system. They provide several financial products and services, and are delivered by special financial institutions and agencies. These institutions and agencies encourage a higher level of savings and investments, so that they can channelize it better and provide better returns to the savings and investments. For doing these financial institutions issue different kinds of financial products or instruments known as securities. These securities are traded at securities market known as Stock Exchanges at national and regional level to cater different needs of security providers and investors. These financial products and services are promoted while meeting all the regulations and governing norms set by the respective regulatory authority for the securities, the institutions or agency.

## 6.2 OBJECTIVES

After reading this you would be able to understand:

- Role and purpose of Reserve Bank of India (RBI)
- Role and purpose of Securities and Exchange Board of India (SEBI)
- Role and functions of Insurance Regulatory and Development Authority of India (IRDA)

## 6.3 RESERVE BANK OF INDIA

Reserve Bank of India (RBI) is the Central bank of India. It was set up on the recommendations of the Royal Commission of Indian Currency (Hilton Young Commission) in 1926, while in 1934 on the statutory basis of the Reserve Bank of India Act, 1934 had established the apex financial institution of India in 1934.

Historically RBI had begun its operations by taking over the Controller of Currency functions of Government and management of Government accounts and public debt from the Imperial Bank of India.

Since its inception RBI had played a major role in the growth of the economy and development of the financial infrastructure of the country. For this it had financed and developed various sectors and institutions like Unit Trust of India (UTI), Industrial and Development Bank of India (IDBI), Deposit Insurance and Credit Guarantee Corporation of India (DICGC) , the National Bank for Agriculture and Rural Development (NABARD) etc.

On April 1, 1935 RBI started its operations in Calcutta (now known as Kolkatta in West Bengal) as a privately owned institution. Initially the Central Office of the Reserve Bank was established in Calcutta but was changed to Mumbai in 1937. Today the Governor of RBI sits at Central office and policy formulation take place. In 1949, after fourteen years from its inception, it was nationalized and today it is a fully owned institution by the Government of India.

It has 19 Regional Offices mostly operating from the state capitals of India and had 9 Sub-offices.

RBI is entrusted with the management of foreign exchange reserve of the country which includes the gold and other holdings like foreign currencies. It also functions as a note issue and currency managing institution as per the preamble and specific provisions of RBI Act, 1934.

### 6.3.1 OBJECTIVE

With the opening of the Indian economy the focus of Bank had shifted back from industry specific support to establishing and giving new shape to the economy with its core functions like monetary policy, bank supervision and regulation, overseeing the payment system and developing of financial markets to align effectively with the international financial markets.

The Preamble of RBI defines the objectives and functions of the Reserve Bank as "…to regulate the issue of Bank Notes and keeping of reserves with a view of securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

"……it is expedient to make temporary provision on the basis of the existing monetary system, and to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures;"

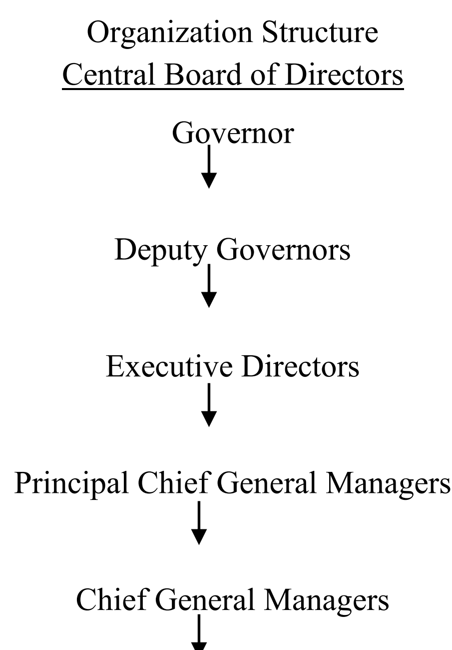
## 6.3.2 ORGANIZATION STRUCTURE

Government of India under the Reserve Bank of India Act, 1934, appoints/nominates the Central Board. This board functions as general superintendence and directs for the Reserve Bank's affairs.

Board is nominated for a period of four years with the following constituents:

- **Official Directors:** Full time having one Governor and not more than four Deputy Governors.
- **Non-Official Directors:** Ten of the Directors are considered from different fields of expertise and Central Government nominates two government officials, while other four Directors-one each from four local boards, represents four different regions of the country i.e, Mumbai, Calcutta, Chennai and New Delhi, and become part of this constitution.

With this the advice and representation on the economic matters and interest of the local cooperative and indigenous banks is taken care. Hence RBI can design and regulate accordingly.



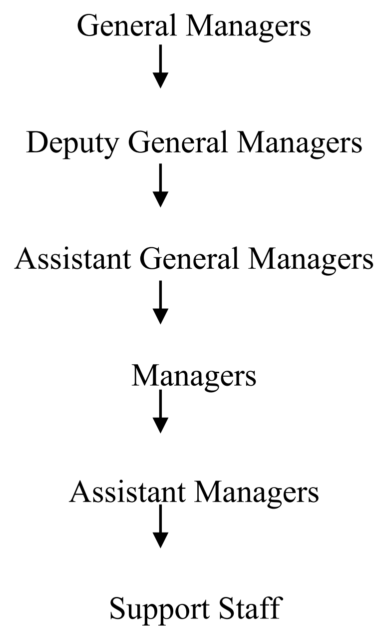



Fig 6.1

Fig 6.1 Source: RBI website

## 6.3.3 LEGAL FRAMEWORK

RBI recommend broad parameters for operations at banking level within this the country's whole banking and financial system functions.
To achieve this goal the apex bank acts under a legal framework. The framework is provided by various Acts and their amendments under which the Bank functions. Older acts are even abolished and new Acts replace them as per the changing needs of the society and the financial system.

The Acts can categorically be defined as:

- Acts administered by Reserve Bank of India
- Other relevant Acts

Acts administered by Reserve Bank of India ( year wise)

- Reserve Bank of India Act, 1934
- Banking Regulation Act, 1949
- Foreign Exchange Management Act, 1999

- Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002
- Credit Information Companies (Regulation) Act, 2005
- Public Debt Act, 1944 was replaced by Government Securities Act, 2006
- Government Securities Regulations, 2007
- Payment and Settlement Systems Act, 2007
- Factoring Regulation Act, 2011
- Payment and Settlement Systems Regulations, 2008 and Amended up to 2011 and BPSS Regulations, 2008
- The Payment and Settlement Systems (Amendment) Act, 2015 - No. 18 of 2015

Other relevant Acts ( year wise)

- Negotiable Instruments Act, 1881
- Bankers' Books Evidence Act, 1891
- State Bank of India Act, 1955
- Companies Act, 1956/ Companies Act, 2013
- Securities Contract (Regulation) Act, 1956
- State Bank of India Subsidiary Banks) Act, 1959
- Deposit Insurance and Credit Guarantee Corporation Act, 1961
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- Banking Secrecy Act, 1970
- Regional Rural Banks Act, 1976
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- National Bank for Agriculture and Rural Development Act, 1981
- National Housing Bank Act, 1987
- Recovery of Debts Due to Banks and Financial Institutions Act, 1993
- The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993
- Competition Act, 2002
- The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003
- Indian Coinage Act, 2011

## 6.3.4 MAIN FUNCTIONS OF THE RESERVE BANK OF INDIA

Broadly the main functions of the RBI are as following:

- Formulating, implementing and monitoring the monetary policy.
- Prescribing broader factors of the banking operations for the proper functioning of the country’s banking and financial system functions.
- Promote and sustain foreign exchange market in India.
- Issue, Exchange and Destroy currency notes and coins.
- Ensures and promotes developmental activities to support national objectives.

- Acts as Banker to Central & State Governments and all scheduled banks.
- Carry out merchant banking function for the Central and State Governments.

**ROLE OF THE APEX FINANCIAL INSTITUTION**

**Monetary Authority of India** Formulating, implementing and monitoring the monetary policy. Through monetary policy RBI maintains the price stability and make certain adequate flow of credit to the productive sectors of the nation. To increase the volume and terms of credit it directs the banks and banks provide credit to specific sectors like agriculture, small and medium enterprises, infrastructure, housing, micro credit and non-banking financial institutions, etc as per the changing priorities of the nation. Its regulatory policies are in line with the monetary policy and the intermediate target.

**Regulatory authority** Prescribing broader structure of the banking operations for the country's banking and financial system functioning. This also ensures public confidence in the system, protect various depositors' interest and provide cost-effective banking services to the public.

**Foreign exchange control** RBI promotes and maintain foreign exchange market in India, to safeguard the interest of traders (exporters and importers), tourists (from and in India), students (national and international) and any other users of the currency.

**Issuer of Currency** Issue, Exchange and Destroy currency notes and coins as per its usage and life span in the currency market. To ensure adequate and good quality currency be part of the financial system.

**Development Role** Ensures and promotes developmental activities to support national objectives. With monetary and financial stability it ensures development of the financial system by setting up of development financial institutions like Industrial Development Bank of India (IDBI), National Bank for Agriculture and Rural Development (NABARD), the National Housing Bank (NHB), Infrastructure Development Finance Company Limited (IDFC), the Unit Trust of India (UTI), etc.

**Banker to the Governments** Banker to Central & State Governments and all scheduled banks. The Central Government trust the RBI with all its money, remittances, exchange and banking transactions in India and deposit all of its cash with RBI free of interest. Carry out merchant banking function for the Central and State Governments

**Bankers to the Bank** the scheduled banks maintain minimum balances as per the existing Cash Reserve Ratio (CRR) in current accounts and as working funds for clearing adjustments with the RBI. Through refinancing schemes RBI takes care of temporary liquidity gaps and as funds are needed it lends as the lender of last resort to promote financial stability.

*Check Your Progress- A*

**Q1. State the objectives of Reserve Bank of India.**

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**Q2. Explain the four main function of RBI**.

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**Q3. MCQs**

a) RBI is;

i) Monetary Authority of India
ii) Regulatory Authority
iii) Issuer of Currency
iv) All of above

b) Which of the institution was not setup by RBI as its developmental role

i) IDBI
ii) NABARD
iii) NHB
iv) CBI

c) CRR stands for

i) Cash Resources Ratio
ii) Cash Reverse Ratio
iii) Cash Reserve Ratio
iv) Cash Retirement Ratio

Q4. Fill in the Blanks with appropriate word or words.

a) _____________ is the Central bank of India.
b) In 1934 on the statutory basis of the _______________________________had established the apex financial institution of India
c) ____________mostly operates from the state capitals of India and had 9 Sub-offices.
d) _______________under the Reserve Bank of India Act, 1934, appoints/nominates the Central Board.

## 6.4 SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

Globalization of financial services had brought the providers of financial services and the users of them on the same platform. Everything was becoming International leaving far behind the national boundaries and at this juncture the need of the stable and effective financial markets and financial institutions was felt. In 1991 with the announcement in favor of Liberalization, Privatization and Globalization the completion had become intense between the national and international providers of financial services. Due to this trade in the primary and secondary markets of the capital market had grown significantly.

In an efficiently functioning financial system the Banking sector, Capital markets and Insurance sector play a prominent role. The attraction of the Indian Financial System is that all of them are regulated independently by different regulators, specifically Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and Insurance Regulation and Development Authority of India (IRDA).

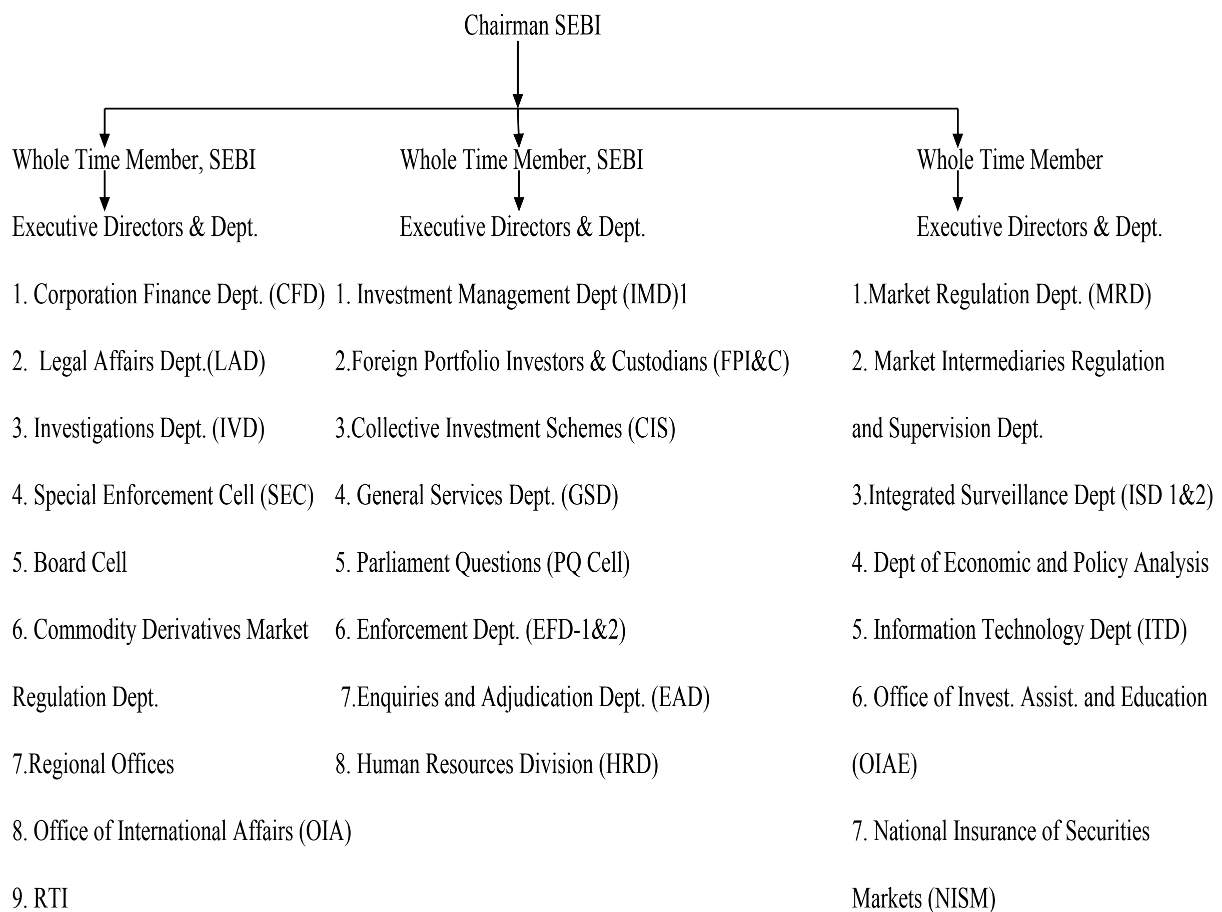
In India trading of securities and the operations of the stock exchanges are governed by the provisions of the Securities Contracts (Regulation) Act, 1956. While the capital market including the market for equity and debt securities is regulated by SEBI. It was established under the Securities and Exchange Board of India Act, 1992 as a regulatory authority for the capital markets in India. SEBI has good full autonomy and authority to regulate and develop the capital market.

### 6.4.1 OBJECTIVES

The four important objectives which this acts make SEBI serve are , Protection, Development, Regulation and Supervision:

a) Protection of the interest of the investors in securities.
b) Development of the securities market
c) Regulation of the securities market
d) Supervision of securities market

# 6.4.2 ORGANIZATION



### 6.4.3 LEGAL FRAMEWORK

Broadly the SEBI works under the legal framework created by the following acts;

- The Securities Contracts (Regulation) Act 1956
- Securities and Exchange Board of India Act 1992
- The Depositories Act 1996
- The Securities Laws (Amendment) Act 2014
- The Finance Act

These Acts regularly consider the amendments by the Finance Act for the respective year and any other amendment to the respective Act.

### 6.4.4 MAIN FUNCTIONS OF SEBI

With the various departments and divisions SEBI primarily functions in the following directions;

- Issuance and listing of securities on the stock exchanges, while security should need to follow the existing or changing listing requirements.
- Supervises the execution and operations of Commodity Derivatives Exchanges in India.
- Arrangement involving merger, demerger, amalgamation or reduction in capital of a company and corporate restructuring through Takeovers and buy back of securities
- Corporate governance
- Ensure following of accounting and auditing standards
- Delisting of securities
- Handling quasi-judicial matters against violators for those under the SEBI's disciplinary jurisdiction
- Ensuring surveillance system for monitoring the market segments
- Market surveillance and recognizing potentially illegal activities and referring them to investigations, enforcement and other departments
- Registering and regulating mutual funds, venture capital funds, foreign venture capital investors, collective investment schemes including plantation schemes, Foreign Institutional Investors (FIIs), Portfolio Managers and Custodians.
- Handling investor complaints
- Regulating, supervising and inspecting market intermediaries while ensuring compliance monitoring , fees collection and handling investor grievances. These market intermediaries deal in different market segments, i.e., equity, equity derivatives, currency derivatives, debt and debt related derivatives and commodity derivatives. Actions are taken against regulation violating intermediaries.
- Overall risk assessment of the intermediary
- Formulates policies and supervises functioning and operations of Stock exchanges, Depositories and Clearing Corporations

- Regulation of securities markets by setting norms in line with the international setting bodies and law enforcement agencies to promote international regulatory and enforcement cooperation.
- Investor education and ensuring forwarding complaints to respective department, their follow up and provide investors with the proper response in this direction.
- Handle complaint issues related to issue of shares, transfer of shares, dividends and compliance with listing conditions

## 6.4.5 FOREIGN PORTFOLIO INVESTORS AND MUTUAL FUNDS

**Foreign Portfolio Investors**

Advantage in favor of Indian Financial Markets is the ability to off er relatively higher growth than the developed and other such developing economies . Due to this India was able to attract net investments in Indian equities and debt from Foreign Institutional Investor (FII) or Foreign Portfolio Investors (FPI) (With the commencement of FPI Rules from June 1, 2014, the previous FIIs, Sub Accounts and QFI (Qualified Foreign Investor), are merged into a new investor category termed as Foreign Portfolio Investor (FPIs) in further discussion we will refer this kind of foreign investment as FPI). Some reports also suggest that India has emerged as one of the strongest economy in terms of deals taking place in the area of Mergers and Acquisitions (M&A) and also the private equity (PE) investments in recent past. Reports by SEBI states that there were 8214 registered FPIs in India and had a Cumulative Net Investment of USD 223,951 million by December 2015.

Securities and Exchange Board of India (SEBI) as per the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 defines and provide a framework for registration of Foreign Investors as Foreign Portfolio Investor as per the sub-section (1) of Section 30 with sub-section (1) of Section 11, clause (ba) of sub-section (2) of Section 11 and sub-sections (1) and (1A) of Section 12 of the Securities and Exchange Board of India Act, 1992 and under Section 25 of the Depositories Act, 1996.

(g) "foreign institutional investor" denote an institution registered under the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 and

(h) “foreign portfolio investor” signifies a person satisfying eligibility criteria prescribed under Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 and registered under Chapter II of these regulations, which shall be deemed to be an intermediary in terms of the provisions of the Act

Eligibility criteria of FPI as per the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014:

The foreign applicant can get itself registered with the designated depository participant to trade in the Indian securities markets, but the depository participants should check the satisfaction of following conditions by the applicant;

a) Applicant should be a person not resident in India.
b) Residence of the applicant should be in a country whose security market regulator had signed Multilateral Memorandum of Understanding of International Organization of Securities Commission or should be a signatory to bilateral Memorandum of Understanding with the Securities and Exchange Board of India.
c) In case of Applicant being a bank, then it should be a resident of a country whose central bank is a member of Bank of International Settlements.
d) The applicant shall not be a resident of a country identified in the public statement of Financial Action Task Force as: (i) a jurisdiction having a strategic Anti-Money Laundering or combating the Financing of Terrorism deficiencies to which counter measures apply or (ii) a jurisdiction without sufficient progress in addressing deficiencies or action plan developed with the Financial Action Task Force addressing the deficiencies.
e) The applicant is not a Non-Resident Indian (NRI). Legal permission to invest in securities outside the country of its incorporation or establishment or place of business should be with the applicant.
f) Authorization should be with applicant as per the Memorandum of Association and Articles of Association or equivalent document(s) or the agreement to invest by its own or behalf of its client.
g) Sufficient experience, good track records, professional competence, financial soundness, reputation of fairness and integrity should be with the applicant.
h) Grant of certificate of operation should be in the interest of the development of the securities market.
i) The applicant should be fit and proper person as per the criteria specified in Schedule II of the Securities and Exchange Board of India (Regulation), 2008.
j) Any other criteria as being specified by the SEBI from time to time.

**Categories of Foreign Portfolio Investor**

SEBI had categorized the foreign portfolio investors in following categories and an applicant shall ask for registration in one of the categories;

a) I-shall include Government and Government related investors such as Central Banks, Government Agencies, Sovereign wealth funds and International or multinational organizations or agencies.
b) Category II- i) appropriately regulated broad based funds such as mutual funds, investment trusts, insurance/reinsurance companies ii) appropriately regulated persons such as banks, asset management companies, investment managers/advisors, portfolio managers iii) not appropriately regulated broad based funds but whose investment manager is appropriately registered, responsible and regulated as registered as

Category II foreign portfolio investor. iv) university funds and pension funds and v) university related endowments already registered with SEBI as Foreign Institutional Investors or sub-accounts.

c) Category-III includes all others not eligible under Category I and II as foreign portfolio investors such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

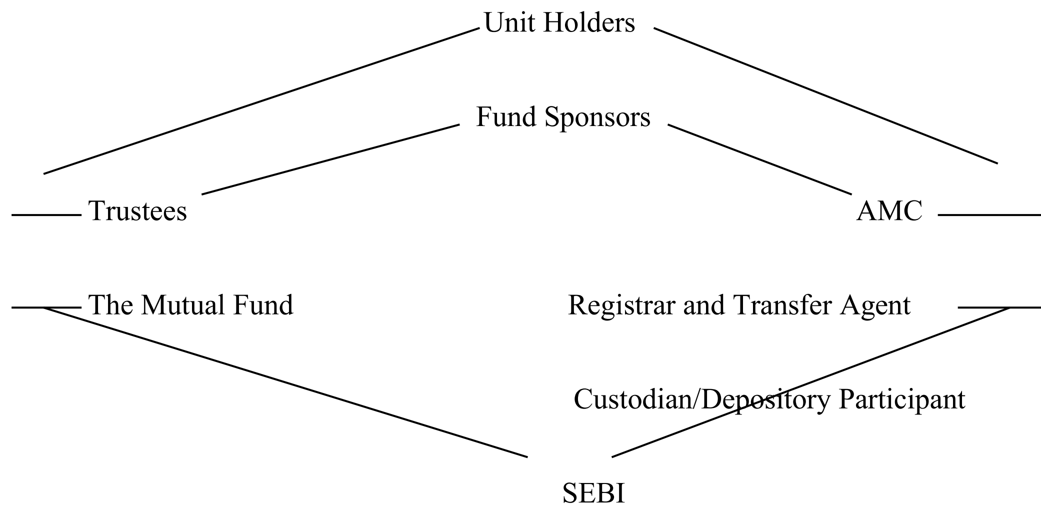
**Mutual Funds**

Mutual fund can be defined as the collective investment of the savings by the investors in a portfolio of diverse securities by a professional financial agent, later all returns and expenses are equally shared by the unit holders of the fund.

Mutual fund as a financial intermediary mobilizes the money from the small investors by selling their own units of capital for purchasing financial assets or securities issued by others. By this way the investor's risk of losing its invested money get diversified due to the expertise of the portfolio manager ; broadly known as Asset Management Company (AMC). AMC professionally manages the funds with higher degree of expertise and better understanding of complexities of the financial markets and its movement upward or downward. With risk diversification and professional management mutual funds helps in getting better liquidity of funds as per need and convenience of investor with flexibility to invest with small money in different growing sectors. With all these the investors are protected by SEBI as funds have to abide and adhere to the strict regulations issued by it time to time.

Historically mutual funds were introduced in India in 1963 through the setup of Unit Trust of India (UTI) under the UTI Act, 1963 as a special act of parliament. Mutual Fund Regulations in January 1993 gave edge to mutual funds and all the mutual funds except UTI now were under a common regulatory framework. This became a gateway for the private and foreign institutions to venture into the mutual fund industry, as a result Kothari Group of companies came out with the first private mutual fund with Pioneer ( a US fund company) in the same year.

**Structure of Mutual Funds as per Association of Mutual Funds in India(AMFI)**




Based on the structure the major part of mutual fund are:

1) **Trustees** or a board of trustees is a body of individuals who manages the mutual fund; it can also be managed by a corporate entity known as a trust company.
2) **Fund sponsor** can be a person or entity that establishes a mutual fund
3) **Unit Holder** buys the units of the mutual fund when floated in the market
4) **AMC or Asset Management Company** is constituted company by the sponsors of the mutual fund or the trustees to act as the investment manager of the fund.
5) **Registrar and Transfer Agent** contributes by maintaining the records of the unit holder or investors
6) **Custodian or depository participant** acts as a safe keeper of cash and securities of the mutual fund.

**Types of Mutual Funds**

Based on function, investment pattern, portfolio objective, geographical location and other mutual funds can be of following types:

- Functionality-Open ended schemes, Closed ended schemes and interval schemes
- Investment Pattern-equity funds and debt funds
- Portfolio Objective-Income, Growth and Balanced Funds
- Geographical Locations-Domestic and Off shore
- Other mutual funds- Exchange Traded Funds (Gold ETFs, etc.), Real Estate Mutual Funds, P/E ratio mutual funds

## 6.5 INSURANCE REGULATORY AND DEVELOMENT AUTHORITY OF INDIA (IRDA)

Insurance companies' acts as a financial intermediary who collects funds in the form of premium for insurance policies and invests them in financial assets i.e, government bonds, corporate securities and other approved options of investments and markets to make it available for other institutions. In India insurance companies dealing in life and non-life, public sector and private sector are regulated by Insurance Regulatory and Development Authority of India (IRDA).

IRDA was set up in 1996, initially it was known as Insurance Regulatory Authority but as a autonomous body IRDA came into existence through the IRDA I Act, 1999 on April 19, 2000 to regulate and develop the insurance business and reinsurances in India. This act had revised the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalization) Act, 1972.

Government of India as per Section 4 of IRDAI Act, 1999 constitutes authority and it functions with the help of a Chairman with five whole time members and four part-time members.

The authority constitutes an Insurance Advisory Committee to bring out regulations for the promotion of insurance and protects interests of the insurance policy holders. This committee had representation from consumer's side by a leading consumer activist, industry, insurance agents, women's organizations and other interest groups. These regulations relate to registration of insurers, their conduct of business, solvency margins and carry out reinsurance business, licensing, and code of conduct intermediaries.

IRDA had also formed a Surveyor and Loss Assessors Committee; a panel of charted accountants to carry out investigations and inspections as per need of the Authority.

**Duties, powers and functions of IRDA**

Authority gets duties, powers and functions as per the Section 14 of IRDAI Act, 1999. This section empowers IRDA to perform its duty to legalize, promote and ensure growth of Insurance and re-insurance business in India while ensuring the interest of all the stakeholders. And they primarily include the following:

- Authority issues the applicant (insurance agency or company) registration certificate and any such issue related to registration;
- Safeguard interests of the policy holders;
- Train intermediary or insurance intermediaries and agents, ensures code of conduct and qualification for the agents;
- Surveyors and loss assessors are to follow the code of conduct set by it;
- Encourage efficiency in promoting insurance businesses;

- Insurance and re-insurance business are promoted and regulated by the set norms to protect the interest of the investors
- Impose fees and charges;
- It ensures conducting enquiries and investigations for the organizations associated with the insurance business;

As per the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938) it regulates the offers by the general insurers to its customers;

- Set norms to be abided by the insurers and other insurance intermediaries while maintaining their books and financial statements;
- Make conform investment of funds by insurance companies as per the set norms;
- Standardize margin of solvency to be maintained by insurance organizations;
- Disputes between insurers and intermediaries or even insurance intermediaries is arbitrated by it;
- Functioning of the Tariff Advisory Committee is supervised by it;
- Decides about the percentage of premium income of the insurer to finance schemes;
- Identify and communicate about percentage of life insurance business and general insurance business by the insurer at the rural level or social sector; and
- Exercises the other prescribed powers.

***Check Your Progress- B***

**Q1. State the objectives of SEBI.**

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**Q2. Discuss as per Section 14 of IRDAI act, 1999 what are the different duties, powers and functions of IRDA.**

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**Q3. MCQs**

**a) Select amongst the following the major player(s) in the mutual fund**

i. Trustees
ii. Fund sponsor
iii. Asset Management Company
iv. All of the above

**b) Select which of these are the types of mutual funds**

i. Income fund
ii. Growth fund
iii. Balanced Funds
iv. All of the above

**c) Insurance Regulatory and Development Authority (IRDA) issues the applicant the insurance agency or company**

i. Certificate of registration
ii. Renewal of registration
iii. Modification of registration
iv. All of the above

**Q4. Fill in the Blanks with appropriate word or words.**

a) SEBI stands for ____________________________________________.

b) SEBI primarily functions in the ___________and __________of securities on the stock exchanges.

c) Four important objectives which this acts make SEBI serve are_______,________, ________and ________.

d) FIIs stand for __________________________.

e) SEBI supervises the functioning and operations of ___________ _______Exchanges in India.

## 6.6 SUMMARY

In this unit we had learnt that the apex financial institution of the country Reserve Bank of India (RBI) with Securities and Exchanges Board of India (SEBI) and Insurance Regulatory and Development Authority of India (IRDA) are building regulatory foundation to have a smooth relationship between financial system and the economic growth of the country.

Financial crisis of 2007-2008 had shown to the world what worst can happen in the world economic system and for all of its associates if they are not regulated properly. For any economy survival in isolation is nearly impossible. To understand the Indian Financial System better we need to understand the role and functioning of these institutions, i.e, RBI, SEBI and IRDA.

## 6.7 GLOSSARY

**DICGC**-Deposit Insurance and Credit Guarantee Corporation of India
**FII-**Foreign Institutional Investor
**FPI**-Foreign Portfolio Investors
**GDP** Gross Domestic Product
**IDBI** Industrial and Development Bank of India

**IDFC** Infrastructure Development Finance Company Limited
**IPO** Initial Public Offers
**IRDA** Insurance Regulatory and Development Authority of India

**ISE** Interconnected Stock Exchange of India
**NABARD** National Bank for Agriculture and Rural Development
**NHB** National Housing Bank
**NSE** National Stock Exchange of India Limited
**OTCEI** Over the Counter Exchange of India
**RBI** Reserve Bank of India
**SARFAESI** Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
**SCRA** Securities Contract (Regulation) Act
**SEBI** Securities and Exchange Board of India
**UTI** Unit Trust of India

**Development Role** Ensures and promotes developmental activities to support national objectives.

**Mutual Fund-** Mutual fund can be defined as the collective investment of the savings by the investors in a portfolio of diverse securities by a professional financial agent, later all returns and expenses are equally shared by the unit holders of the fund.

## 6.8 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress –A**

Q3. a) iv b) iv c) iii

Q4 a) Reserve Bank of India (RBI)

b) Reserve Bank of India Act, 1934

c) Regional Offices

d) Government of India

**Check Your Progress –B**

Q3. a)iv b) iv c) iv

Q4 a) Securities and Exchange Board of India

b) Issuance and listing

c) Protection, Development, Regulation and Supervision

d) Foreign Institutional Investors

e) Commodity Derivatives

## 6.9 REFERENCES


- The Reserve Bank of India website www.rbi.org.in
- Securities and Exchange Board of India website http://www.sebi.gov.in
- Association of Mutual Funds in India website www.amfiindia.com
- Insurance Regulatory and Development Authority of India
- website www.irdai.gov.in

## 6.10 SUGGESTED READINGS


1. Association of Mutual Funds in India press releases
2. IRDA Annual Reports and press releases
3. RBI Annual Reports
4. Reserve Bank of India, report on Currency and Finance
5. SEBI Annual report
6. Securities and Exchange Board of India publications

## 6.11 TERMINAL QUESTIONS

Q1. Comment on the role of the securities market in the economic development of the country?

Q2. Discuss the role of RBI as monetary authority while performing role of regulator and supervisor of financial markets in India?

Q3. How SEBI ensures fair play of foreign portfolio investors in the Indian stock market?

Q4. What is a mutual fund and what are its major advantages?

Q5. Why should investor prefer a mutual fund to direct investment in the stock market?

# UNIT 7 FINANCIAL MARKET

**7.1 Introduction**

**7.2 Objectives**

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**7.4 Major players in Financial Market**

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## 7.1 INRODUCTION

In the previous unit you learnt about what financial system is and also that financial system comprises of mixture of intermediaries, market and instruments that are related to each other. It provides a system by which savings are transformed in to investments. In this unit you will study about the financial markets which is one of the most important components of financial system and which is performing the crucial function in the saving-investment process as a facilitating organization. Also, in this unit you will study about the different segments of financial market in detail.

Financial markets are not in itself sources of finance but they are a link between the savers and investors. In a broder term, financial market may be described as any marketplace where buyers and sellers participate in the buying and selling of assets such as equities, bonds, currencies and derivatives. The main organized financial markets in India are the money

market and the capital market. The money market is the market for short term securities while the capital market is the market for long-term securities, i.e. securities having a one or more than one year as a maturity period. Financial markets can also be classified as primary and secondary markets. Where the primary market deals with new issues and the secondary market is meant for trading in outstanding or existing securities.

## 7.2 OBJECTIVES

After reading this unit you will be able to;

- Understand the meaning of financial market.
- Know about the important functions financial market.
- Find out the major players in the financial market.
- Develop an understanding about the different segments of financial markets.

## 7.3 FUNCTIONS OF FINANCIAL MARKETS

The primary function of financial market is to assist the transfer of funds from surplus units (lender) to deficit units (borrowers). Normally, the households have excess funds in the form of their savings which they lend to the corporate sectors and public sectors with the expectation of some return. A financial market consists of investors or buyers, sellers, brokers, dealers, and does not refer to any physical place. The participants in the market are linked to each other through the formal trade rules and communication networks for originating and trading financial securities. The primary market in which the public issue of securities is made through the prospectus is called the retail market and there is no physical location for that. The investors are reached by direct mailing or invitation to bid within price band as in book building. On the other hand, the secondary market or stock exchange where securities are traded is an auction market and may have a physical location such as Bombay Stock Exchange or the trading floor of Delhi, Ahmadabad and other exchanges where the exchange members meet to trade securities face to face. But with the introduction of electronic trading terminal the face to face trading has disappeared. In the Over the Counter (OTCEI) Market and National Stock Exchange, the trading in securities is screen based. On line trading has been introduced by Bombay Stock Exchange and other stock exchanges have also introduced the same.

Financial markets trade in money and their cost is the rate of return the buyer expects from the market. The value of financial assets changes with the expectations of the investors' on earning or interest rates. Investors expect the higher return for a given level of risk (by paying the lowest price) and users of funds attempts to borrow at the lowest rate possible. The interaction among the investors and users of funds in a properly functioning of capital market ensures the flow of capital to the best user. Investors receive the highest return and the users obtain the funds at the lowest cost.

To sum up, the important functions of financial markets are:

1) Borrowing & Lending: Financial market transfers fund from one economic agent (saver/lender) to another (borrower) for the purpose of either consumption or investment.
2) Price Determination: Prices of the new assets as well as the existing stocks of financial assets are set in financial markets. Determination of prices is a major function of financial market.
3) Assimilation and Co-ordination of Information: It gathers and co-ordinates information regarding the value of financial assets and flow of funds in the economy.
4) Liquidity: Investors can readily sell their financial assets through the mechanism of financial markets. In the absence of financial markets which provide such liquidity, the motivation of investors to hold financial assets will be considerably diminished.
5) Risk Sharing: It distributes the risk associated in any transaction among several participants in an enterprise.
6) Efficiency: It reduces the cost of transaction and acquiring information. It helps to increase efficiency in financial market.

## 7.4 MAJOR PLAYERS IN FINANCIAL MARKET

The principle participants in the financial market are as follows:

Banks: The banking sector is the lifeline of the modern economy. They are the one of the important financial pillars of the financial system and play a vital role in the success/ failure of the economy. Banks generally accept deposits from the public and distribute the credit to various sectors of economy such as agriculture, industry, infrastructure, services and government. Banks are the major participants in the financial market.

Insurance Companies: Insurance companies issue contracts to individuals or firms with a promise to refund them in future in case of any event and they use funds to invest in debt, equities, mutual funds, real estate etc. to generate cash flows to pay future claims.

Finance Companies: Finance companies engage in short to medium term financing for businesses by collecting funds by issuing debentures and borrowing from general public.

Merchant Banks: Merchant banks are rendering diverse services and functions such as organizing and extending finance for investment in projects, assistance in financial management, raising Eurodollar loans and issue of foreign currency bonds, financing local authorities, financing export of capital goods.

Companies: Companies invest their surplus funds which are generated from business operations in money market instruments, government securities, commercial bills, mutual funds and stocks of other companies.

Mutual funds: Mutual funds are the financial intermediaries which acquire funds mainly from the general public and invest them in a large and well diversified portfolio of securities such as money market instrument, Corporate and Government bonds and shares to generate returns. Mutual fund is also the principal participant in financial market.

Government: Authorized dealers basically look after the demand-supply operations in financial market. It also works to fill in the gap between the demand and supply of funds.

***Check Your Progress- A***

**Q1. What is Financial Market?**

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**Q2. Discuss the functions of financial market.**

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**Q3. Who are the major players of the financial market?**

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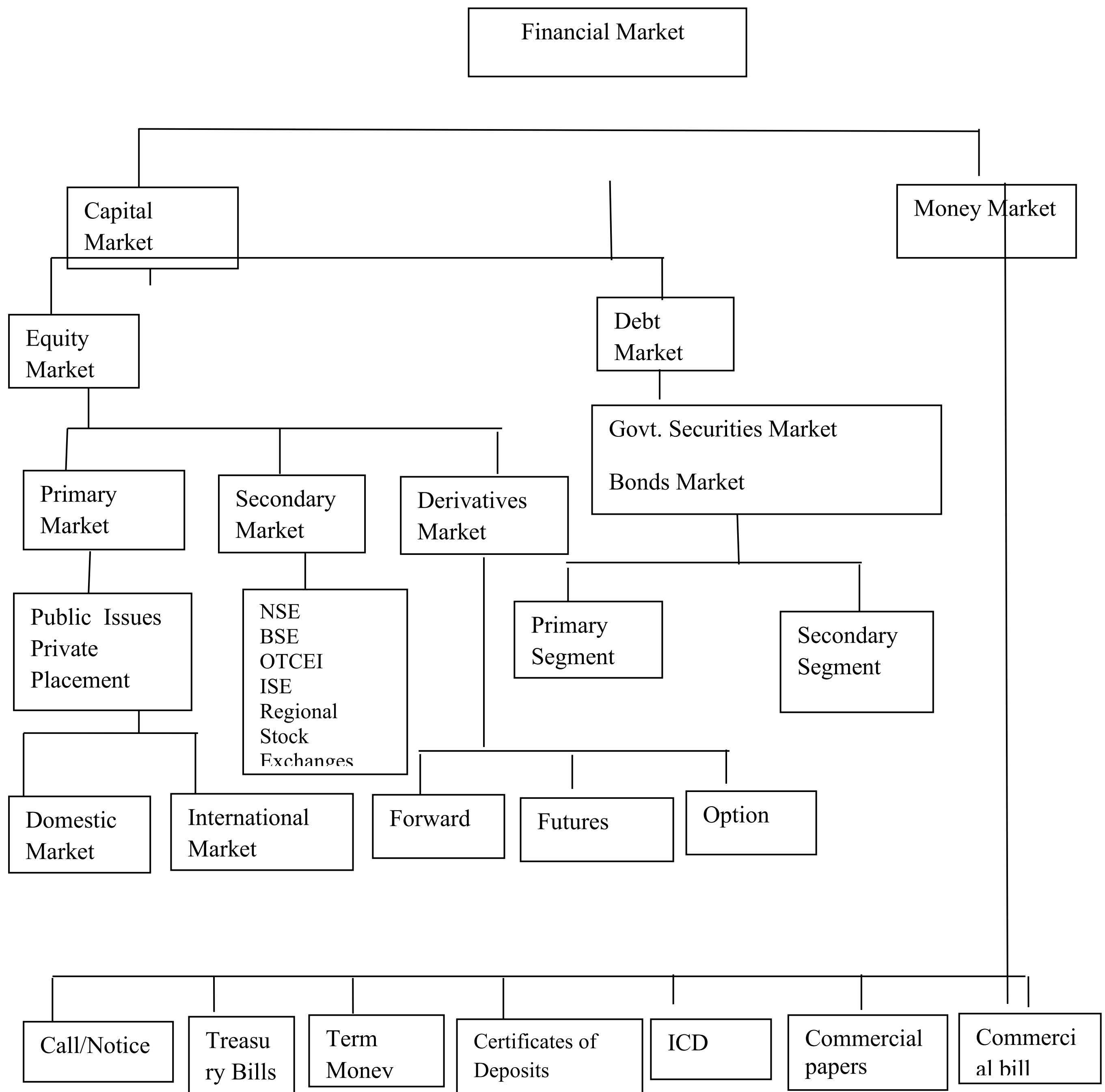


**Fig – 7.1 Segments of the Financial Market**

Fig- 7.1 depicted the various segments of the financial markets. The major segments of financial market are capital market and money market. In this unit all the segments/ components of financial markets will be explained in detail.

# 7.5 CAPITAL MARKET

Capital market is the market where securities and bonds are issued to raise medium to long term finance. The securities that are issued and traded in the market are shares, bonds and other long term instruments. These securities are issued by governments- central and state, companies- private and public and local government to raise money to fulfill their long term needs. The suppliers of money in the market include individual investors, insurance companies, banks, mutual funds, pension funds organization. Capital market is not a compact unit but a highly decentralized system. The purpose of capital market is

- To mobilize long- term savings of people to finance long term investments needs;
- To provide risk capital in the form of equity or quasi equity to entrepreneurs
- To encourage broader ownership of productive assets;
- To provide liquidity with a mechanism enabling the investor to sell financial assets;
- To lower the cost of transactions and information ; and
- To improve the efficiency of capital allocation through a competitive pricing mechanism

Capital market has two segments; 1) Primary/ New issue Market and 2) Secondary Market/ Stock Exchange Market. Primary market deals with the new securities, that is, securities which are not previously available and offered to the investors first time. These securities are first time offered to the investors or funds are mobilized through the public issues of prospectus, private placement, right issues and preferential issues. Whereas secondary market is a market in which, existing securities are resold and bought among investors or traders usually on a stock exchange, over the counter or elsewhere. From the peripheral /marginal role in the early eighties, capital market now occupies the centre stage in the Indian financial system.

Link between the Primary and Secondary Capital Market

Even though the secondary market is many times larger than the primary market, they are interdependent in many ways.

The primary market is a market for new issues, but the volume, pricing and timings of new issues are influenced by returns in the stock market. Returns in the stock market depend on macroeconomic factors. Favorable economic factors help firms to earn higher returns, which in turn create favorable conditions for the secondary market. This in turn, influences the market prices of the stock. Moreover, favorable macroeconomic factors necessitate raising fresh capital to finance new projects, expansion and modernization of existing projects. A buoyant secondary market, in turn, induces investors to buy new issues if they think that is a

good decision. Hence, a buoyant secondary market is indispensable for the presence of a vibrant capital market.

- The secondary market provides a basis for the determination of prices at which new issues can be offered in the primary market.
- The depth of the secondary market depend upon the activities of the primary market because as much as the bigger of the entries of the corporates, the larger the number of instruments available for the trading in the secondary market.
- New issues of a large size and bunching of large issues may divert funds from the secondary market to the primary market, thereby affecting the stock prices.

Capital Market Instruments

Capital market instruments are the long term sources of finance. They come under two broad categories: (i) direct and (ii) derivatives. The first group includes the (a) Equity shares, (b) Preference shares, (c) Debentures and (d) Innovative debt instruments. Equity and preference shares represent the ownership securities on the other hand debentures and innovative debt instruments are the creditorship securities. Derivative instruments are defined by the Securities Contracts (Regulation) Act to include (1) a security derived from a debt instrument, share, secured/unsecured loan , risk instrument or contract for differences , or any form of security and (2) a contract that derive its value from the underlying securities. Derivative contracts are of various types. The most common are forwards, futures and options. Derivatives are discussed in details in the following section of this unit.

The main capital market instruments in India are portrayed as:

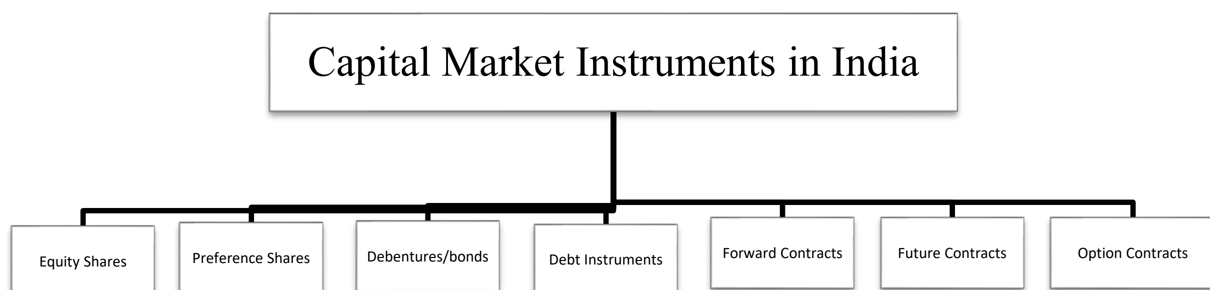


**Fig- 7.2 Capital Market Instruments in India**

In this section we will discuss about the Equity Shares, Preference Shares and Debentures. Debt Instruments and Derivative products are explained in detail in the following sections of the unit.

Equity shares: The total capital of a company is divided into large number of units. Each unit is given an equal value. Such value is called par value (face value) and each such unit is called a 'share'. In short share is a unit of capital. An investor can contribute in the capital of the company by purchasing shares of the company. Equity shares are the main source of long term capital of the company and it represent the real ownership of a company. The holders of the equity shares have voting rights and they participate in the important decision of the company. Features of equity shares are given below:

- Voting right for the shareholders.
- No maturity period
- Residual claim on income as well as on assets
- No fixed dividends
- Chances of getting bonus shares
- Pre-emptive rights

Preference shares: Preference shares are shares on which the dividend is paid by the company, subject to the availability of the sufficient profits. Preference share holders are given preference over and above equity shareholders. Such preference is given at the time of income distribution and at the time of liquidation of company when assets are distributed. These have the following features;

- Fixed dividend percentage on the face value
- Preference over equity shareholders
- A fixed maturity period or provision of conversion in to the equity shares
- No voting rights
- No privilege for right and bonus shares

Generally these shares do not command the high market value because of the fixed dividend and no privilege for right and bonus shares.

Types of Preference Shares

- Redeemable versus non-redeemable preference shares
- Convertible versus non -convertible preference shares
- Participating preference shares

Debentures: Debentures are the loan taken by the company from the general public-they carry a coupon rate called rate of interest. Interest on these is generally paid half yearly and

payments of these are the legal obligation of the company. Company has to pay interest whether it earned profit or not. Debentures have the following features:

- Like preference shareholders debenture holders also don't have the voting rights.
- Payment of interest is at the fixed rate.
- Debentures can be secured or unsecured
- Debenture holders have priority over the preference shares holders and equity shareholders.
- Interest is tax deductible expense for the company.

Type of Debentures

- Redeemable versus non-redeemable
- Convertible versus non -convertible
- Debentures with warrants
- Debentures with options
- Deep discount debenture/ zero coupon bonds
- Floating rate bonds
- Index link debentures

***Check Your Progress- B***

**Q1. Discuss the different instruments of capital market?**

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**Q2. Discuss the privileges available to the preference shareholders over the equity share holders.**

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**Q3. Discuss the features of debentures.**

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**Fill in the blanks:**

Q4. ………………… and ……………… are the two main segments of Capital Market.

Q5. A share is a ………. of a capital.

# 7.6 DERIVATIVE MARKET

The derivative is a financial instrument whose value is derived from the value of one or more underlying assets which can be commodities, interest rates, precious metals, currency, bonds, stocks, indices etc. The word 'derivative' comes from the verb 'to derive'. It indicates that it has no independent value. The emergence of the market for derivatives contracts originates from the desire of risk-averse economic units to guard themselves against uncertainties arising out of the fluctuations in assets price. Most common derivative instruments are Forwards, Futures, Options and Swaps. A derivative is a contract between two or more parties whose value is based on an agreed upon underlying financial asset, index or security. Derivatives are used for speculations and hedging purpose. Speculators seek to profit from changing prices in underlying assets, index or security. Derivatives have numerous uses as well as various risks. The market for financial derivatives has grown tremendously both in terms of variety of instruments and turnover. The value of the underlying assets of these derivatives is more than USD16 trilion (more than Rs.15 lakh crore), which is about three times the value of stock traded on the New York Stock Exchange (NYSE) and twice the size of the United States GDP. The derivatives market is the financial market for the derivatives.

Types of Financial Derivatives

Derivatives have become increasingly important in the field of finance in the recent years. Forwards, futures, options, swaps, warrant are the major types of financial derivatives which are used for hedging. Derivatives are off-balance sheet transactions and they cannot be put on the balance sheet unless the underlying assets are bought and paid for. For instance, if an investor buys an option to purchase shares, the balance sheet is unaffected until and unless the shares are bought and paid for. Following are the different types of financial derivatives.

Forward contracts: A forward contract is a customized contract between two parties, where settlement takes place on a specific date in future at a price agreed today. Forward contracts are bilateral contracts and hence exposed to counter party risk. Each contract is custom designed and hence is unique in terms of contract size, expiration date and the asset type and quality. The contract has to be settled by delivery of the asset on expiration date. A major drawback of the forward contract is the risk of default. To minimize the risk of default, another financial instrument is introduced, the futures.

Futures: Like a forward contract, a futures contract is an agreement between two parties to buy and sell an asset at a certain time in future at a certain price. Unlike forward contracts, future contracts are normally traded on an exchange. This means that the contract is traded just like a normal stock, where the supply and demand of similar futures determine the trading price of the contract.

To make trading possible, the exchange specifies certain standardized features of the contract. As the two parties of the contract do not necessarily know each other, the exchange also provides the mechanism that gives the two parties a guarantee that the contract will be honoured.

Futures prices are settled on a daily basis. For example, if the futures contract price is Rs.30 and the market price is Rs. 27, the difference has to be settled so that by the settlement date neither party will see a benefit in defaulting on the contract.

In both Forwards and Futures Contracts, once entered, the two parties cannot go back on it. In order to introduce some flexibility in this an Option is introduced.

Options: Options are contract where the holder of the instrument has the right to buy or sell the underlying asset at a predetermined price. A person who has an Option Contract need to execute the trade only if he wants to execute it. In other words he has the Option. An option can be a call option or put option. A call option gives the buyer a right to purchase an assets at a specified price on or before some specified expiration date. The specified price is called the Strike Price.

For example, a May 31 call option on Infosys stock with a strike price of Rs. 1550 entitles the owner of the Option to purchase the stock on or before the expiration date at Rs. 1550. The holder of the Option is not required to exercise the Option. Whatever is the price of Infosys stock on that day, the Option Holder can purchase the stock at Rs. 1550 till the expiration date. Normally the option is exercised if the price of the stock is above the Strike Price, If not exercised before the expiration date of the contract, a call option simply expires and has no value. If the market price of Infosys is Rs 1700 on a particular day during the life of the Option, the Option holder can exercise his option and buy the Infosys stock at Rs 1550. He can sell in the market and make a profit.

A put option gives the holder the right to sell the asset at a specified price on or before some specified expiration date. While call option is exercised when the price of the stock is more

than the Strike price, a Put Option is exercised when the price of the stock is less than the strike price. For example, the holder of the put option of the Infosys stock at a strike price of RS.1550 can sell the stock at Rs. 1550 irrespective of the price in the market.

It should be borne in mind that a person has to pay the price to buy a Call or Put Option. Purchasing call option is a bullish strategy because calls provide profits when the price of the stock goes up, while purchasing put is a bearish strategy.

Foreign Currency Options:

A currency option offers the right to buy or sell a quantity of foreign currency for a specified amount of domestic currency. Company that do large amount of business in foreign currency, reduce their risk by holding an Option that reduces their risk of holding foreign exchange.

Warrants: Warrants are long-term options with three to seven years of expiration. In contrast stock options have a maximum life of nine months. Warrants are issued by companies as a means of raising finance with no initial servicing costs, such as dividend or interest. They are like a call option on the stock of the issuing firm. A warrant is a security with a market price of its own that can be converted into a specific share at a predetermined price and date. If warrants are exercised, the issuing firm has to create a new share which results in the dilution of ownership. Warrants are sweeteners attached to bonds to make these bonds more attractive to the investor.

Swaps: Swaps are generally customized arrangements between counterparts to exchange one set of financial obligations for another as per the terms of agreement. The major types of swaps are currency swaps, and interest –rate swaps, bond swaps, coupan swaps, debt-equity swaps.

***Check Your Progress- C***

**Q1. What are derivatives?**

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**Q2. How do futures contracts differ from forward contracts?**

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**Q4. What are options?**

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**Q5. Fill in the Blanks**

a) Forward contracts are bilateral contracts and hence exposed to ……………… risk.

## 7.7 DEBT MARKET

Debt market refers to the financial market where investors buy and sell debt securities, mostly in the form of bonds. These markets are important sources of funds, especially in a developing economy like India's. India's debt market is one of the largest markets in Asia. The total size of the Indian debt market is currently estimated to be in the range of USD 150 billion to 200 billion. India's debt market accounts for approximately 30 percent of its GDP. The Indian debt market in terms of volume is larger than the equity market.

The most distinguishing features of the debt market instruments of Indian debt market are that the return is fixed. This means, returns are almost risk-free. This fixed return on the bond is often termed as the 'coupon rate' or the 'interest rate'. Therefore the buyer (of bond) is giving the seller a loan at a fixed interest rate, which equals the coupon rate.

Classification of Indian Debt Market: Indian debt market can be classified into two categories:

- Government Securities Market (G-Sec Market): The government securities market is at the core of financial markets. Activity in the government securities market can affect the overall investment in the economy. It consists of central and state government securities. It means that loans are being taken by the central and state governments. The government securities market accounts for more than 90 percent of the turnover in the debt market. It constitutes the principal segment of the debt market.
- Bond Market: It consists of financial institutions bonds, corporate bonds and debentures and public sector units bonds. These bonds are issued to meet financial requirements at a fixed cost, and hence, remove uncertainty in financial costs. The Indian bond market, measured by the estimated value of the bonds outstanding, is next only to the Japanese and Korean bond markets in Asia.

Different types of Debt Instruments

The NSE Wholesale Debt Market Segment (WDM) has emerged as an active platform for trading in debt instruments. BSE also started trading in debt instruments. The different types of debt instruments available in the Indian debt market are the following.

Government Securities: It is the Reserve Bank of India that issues Government Securities or G-Secs on behalf of the Government of India. These securities have a maturity period of 1 to 30 years. G-Secs offer a fixed interest rate, where interests are paid semi-annually. As government security is a claim on the Government, it is an absolutely secured financial instrument which guarantees the certainty of both income and capital. It is, therefore, also called a 'gilt-edged' (which means of the best quality) security or stock.

Corporate Bonds: These bonds come from PSUs and Private corporations and are offered for an extensive range of tenure up to 15 years. Compared to government securities corporate bonds carry higher risk, which depend upon the corporation, the industry where the corporation is currently operating, the current market conditions, and the rating of the corporation. However, these bonds also give the higher returns than the G-Secs.

Certificate of Deposits: Certificates of deposits are being issued in India since 1989, by banks, either directly to the investors or through the dealers. CDs are documents of title to time deposits with banks. They are interest bearing, maturity dated obligations of banks and are technically a part of bank deposits. They represent bank deposit accounts which are transferable. CDs are marketable or negotiable money market instruments in bearer form and are known as Negotiable Certificates of Deposit. Banks can issue CDs with maturity period of not less than 7 days and not more than one year, from the date of issue.

Commercial Papers: Commercial papers were introduced in January 1990, to enable highly-rated corporate borrowers to diversify their sources of short term borrowings and also provide an additional instrument to the investor. These are issued with the maturity of 7 to 365days. CPs are issued by corporate entities at a discount on face value.

Zero Coupon Bonds (ZCB): ZCBs are available at a discount on their face value. There is no interest paid on these instruments but on maturity the face value is redeemed from the RBI. A bond of face value 100 will be available at a discount say at Rs.80 and the date of maturity is after two years. This implies an interest rate on the instrument. When the bonds are redeemed, Rs 100 will be paid. The securities do not carry any coupon or interest rate that is unlike dated securities no interest is paid out every year.

Convertible Bond: In a convertible bond the holder of the bonds have the option to convert the bond into equity at a fixed conversion price.

Regulation of the Debt Market

The RBI regulates the government securities market and money market while corporate debt market comes under the purview of the Securities Exchange and Board of India (SEBI).

In order to promote an orderly development of the market, the government issued a notification on March2, 2000, delineating the areas of responsibility between the Reserve Bank of India and the SEBI. The contracts for sale and purchase of government securities, gold related securities, money securities and securities derived from these securities, and ready forward contracts in debt securities shall be regulated by the RBI. Such contracts, if executed on the stock exchanges shall, however, be regulated by SEBI in a manner that is consistent with the guidelines issued by the RBI.

Primary and Secondary Segments of the Debt Market

In the primary segment, new debt issues are floated either through public prospectus, right issue, or private placement. The private placement market is more attractive because the cost of raising a loan is only half of that of raising loans from the market. Under the current guidelines, corporates are required to report details of resources raised through private placements to the stock exchanges- BSE and NSE. This was aimed at giving investors a good idea of how the companies propose to use these funds and also guage the risk return allowed. In mid-2006, the US private placement market was opened up for Indian Companies. Reliance Industries Limited was the first Indian companies which tap the US private placement market and raised $300 million through a 10-12 year loan.

The debt instruments are traded on the OTCEI, the BSE, and the WDM segment of the NSE. The BSE is the first exchange in the country to provide an electronic trading platform for corporate and other non-government debt securities through the order-matching system. The clearing and settlement of the trades is undertaken through the clearing house of the exchange. The National Stock Exchange of India Ltd. set up a separate segment for trading in debt securities known as the Wholesale debt market segment of the exchange in June 1994. Prior to this separate segment of NSE, the only trading mechanism available in the debt market was the telephone. The NSE provided, for the first time in the country, an online, automated, screen-based system known as NEAT (National Exchange for Automated Trading) across a wide range of debt instruments. NEAT supports an anonymous order-driven market and also provides on-line market information system.

Initially, government securities, T-bills, and bonds issued by public sector undertakings were made available for trading. Now this range has been widened to include non-traditional instruments, such as floating rate bonds, zero coupon bonds, index bonds, commercial papers, certificates of deposit, corporate debentures, state government loans, SLR and non-SLR bonds issued by financial institutions and local bodies, units of mutual funds and securitized debt.

*Check Your Progress- D*

**Q1. What is Debt Market?**

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**Q2. Discuss the features of Government Securities.**

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**Q3. What are the Zero Coupon Bonds?**

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**Q4. Fill in the Blanks**

a) **The NSE's …………………………………….. has emerged as an active platform for trading in debt instruments.**

## 7.8 FOREIGN EXCHANGE MARKET

The foreign exchange market in India comprises of (a) the Reserve Bank at the apex, (b) Authorized Dealers (ADs) licensed by Reserve Bank, and (c) customers such as exporters and importers, corporates and other foreign exchange earners. The players in the foreign exchange market are controlled by the Foreign Exchange Management Act (FEMA) 1999. With the transition to a market determined exchange rate system in March 1993 and the

subsequent gradual but significant liberalization of restrictions on various external transactions, the forex market in India has acquired more depth.

The Indian forex market has grown in depth in the 1990s as a result of the implementation of number of recommendations of three important committees, viz. , the High level committee on Balance of payments (Chairman : Dr C.Rangarajan), the Report of the Expert Group on Foreign Exchange Markets in India (Chairman: Shri O.P.Sodhani) and the Committee on Capital Account Convertibility (Chairman: Shri S.S.Tarapore).

Purpose and Organization

The foreign exchange market encompasses all transactions involving the exchange of different monetary unit for each other. Its purpose is to facilitate transfer of purchasing-power denominated in one currency into another, or in other words, to trade one currency for another. It acts as intermediary for individual buyers and sellers. The foreign exchange market links financial activities in different currencies.

The foreign exchange market is not a physical place. It is a network of banks, dealers and brokers who are dispersed throughout the leading financial centres of the World. Currency transactions are channeled through the worldwide interbank or wholesale market in which banks trade with each other. In the spot market, currencies are traded for immediate delivery (two business day) while in the forward market, contracts are made to buy and sell currencies for future delivery. Trading is in currencies of high income countries whose government impose few restrictions on currency trade. The predominant currency is US Dollar. Limit of convertibility inhibits the use of currencies of developing countries.

Functions of Foreign Exchange Market

The important functions of foreign exchange market are:

1) To make necessary arrangement to transfer purchasing power from one country to another.
2) To provide adequate credit facilities for the promotion of foreign trade.
3) To cover foreign exchange risks by providing hedging facilities.
4) To assist corporates to raise funds in foreign countries/ foreign currency.
5) To facilitate flow of foreign funds into the various segments of economy.
6) To foster growth in key segments.

Foreign Exchange Management Act (FEMA) 1999

The main objective of Foreign Exchange Regulation Act, 1973 (FERA), was to consolidate and amend the law, regulate certain payments; dealings in foreign exchange and securities; transactions indirectly affecting foreign exchange ; the import and export of currency , for the conservation of foreign exchange resources of the country; and finally , the proper utilization of this foreign exchange so as to promote the economic development of the country. The

FERA has since been repealed. The Foreign Exchange Regulation Act, 1973 was replaced by the Foreign Exchange Management Act with effect from June 1, 2000. The FEMA consolidated and amended the law relating to the foreign exchange with the objectives of facilitating external trade and payments and of promoting the orderly development and maintenance of foreign exchange market in India. The provisions of FEMA extends to all over India and also applies to all branches, offices and agencies outside India owned or controlled by a person resident in India and also to any such person to whom this Act applies.

Meaning of certain Important terms used in FEMA

'Authorised person' means any bank or other person including authorized money changer or dealer, authorized under the FEMA to deal in foreign exchange and securities.

'Capital account transaction' means a transaction by which there may be a change(either an increase or decrease) in the assets or liabilities outside India of person resident in India or assets or liabilities in India of persons resident outside India.

'Current account transaction' means a transaction other than capital account transaction. For example,

i) Payments due with respect to the foreign trade done, other business, services, and short-term banking and credit facilities in the ordinary course of business.
ii) Payments due as interest on loans and as income from investment;
iii) Remittances for living expenses of parents, spouse and children residing abroad; and
iv) Expenses in connection with foreign travel,education and medical care of parents, spouse and children.

'Currency' is defined under the FEMA not only to include all currency notes but also postal notes, postal orders, money orders, cheques, drafts, travellers' cheques, letters of credit, bills of exchange and promissory notes,credit cards or such other similar instruments as may be notified by the RBI.

'Foreign currency' is defined to mean any currency other than Indian currency.

The term 'foreign exchange' is much wider than the term foreign currency, it includes the following:

i) Amount payable in any foreign currency;
ii) Drafts, travellers'cheques, letters of credit or bills of exchange ,expressed or drawn in Indian currency but payable in any foreign currency;
iii) Drafts, travellers'cheques, letters of credit or bills of exchange drawn by banks,institutions or persons outside India, but payable in Indian currency.

Under the FEMA, 'security' is defined to include shares, stocks, bonds and debentures, Government securities, saving certificates, deposit receipts and units of any mutual fund etc. However it does not include bills of exchange or promissory notes or any other instruments which may be notified by the RBI.

Under the FEMA the term ‘foreign Security means any security as stated above.

Under the FEMA a ‘person’ is defined to include the following entities:

I. An individual;

II. A Hindu Undivided Family;

III. A company;

IV. A firm;

V. An association of persons or a body of individuals, whether incorporated or not;

VI. Every artificial juridical person; and

VII. Any agency, office or branch owned or controlled by such person.

## 7.9 MONEY MARKET

Money market is the market in which short term funds are borrowed and lent. Short term funds up to one year and for financial assets that are close substitutes for money are dealt in the money market. Money market is a very important component of Indian Financial System. As the Reserve Bank observes, “as in most developing countries, the money market in India comprises two sectors which may be classified as organized sector and unorganized sector. The organized sector of money market consists of Commercial Banks in India, which includes private sector and public sector banks and also foreign banks. The unorganized sector consists of indigenous bankers including the Non-banking Finance Companies (NBFCs).

Features of Money Market

The money market has certain distinct operational features as compared to the capital market. First, while in the money market the operations (raising and deployment of funds) are for short duration (normally up to one year), in the capital market they are for long duration. Further money market is the institutional source of working capital to the industry, the focus of the capital market being on financing fixed investments. There are large numbers of participants in the money market: commercial banks, mutual funds, investment institutions, financial institutions and finally the Reserve bank of India. The Central bank occupies a strategic position in the money market. The money market can obtain funds from the central bank either by borrowing or through sale of securities. In addition, the money market is a wholesale market. The volumes are very large and generally transactions are settled on a daily basis. Trading in the money market is conducted over the telephone followed by written confirmation from both the borrowers and lenders.

Money Market Instruments

Money market instruments in India mainly comprise: call/ notice money market, term money, certificates of deposits, commercial paper, RePo, commercial bills, treasury bills and inter-corporate funds. Of these instruments, call/notice money market and treasury bills form the most important segment of the Indian money market. Treasury bills, call money market and certificates of deposit provide liquidity for government and banks while commercial paper and commercial bills provide liquidity for the commercial sector and intermediaries.

Money Market and Capital Market

There is strong link between the money market and the capital market:

- Often financial institutions actively involved in the capital market are also involved in the money market.
- Funds raised in the money market are used to provide liquidity for long-term investments and redemptions of funds raised in the capital market.
- In the development process of financial markets, the development of the money market typically precedes the development of the capital market.

***Check Your Progress- E***

**Q1. Discuss the features of Money Market.**

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**Q2. Discuss the different money market instruments.**

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**Q3. Discuss the link between capital market and money market.**

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## 7.10 SUMMARY

The progressive liberalization of economic policies has led to a rapid growth of the financial markets in India. Financial markets, local as well as international, particularly capital markets have been undergoing metamorphic changes in the recent past. The announcement of reforms package in 1991 increased the volume of business in both the primary and secondary segment of the capital market. Now the Indian capital market is more organized fairly integrated, mature, global and modernized market. The risk-averse nature of human beings has brought the growth in derivatives market. Derivatives help the risk-averse human beings by offering a mechanism of hedging risks. Further the debt market and money market are critical to the development of a developing country like India which requires a huge amount of capital for its industrial and infrastructure growth. Debt market is the market for long-term debt instruments while money market is the market for short- term debt instruments. A developed money market is a prerequisite for the development of a debt market. The foreign exchange market links financial activities in different currencies. The liberalization of foreign exchange policies has given more depth to the foreign exchange market.

## 7.11 GLOSSARY

**Capital Market –** A market comprising institutions which deals in the purchase and sales of securities, e.g. new issue market and the stock exchange.

**Counter Party –** The other party (buyer or seller) to a transaction.

Financial Market- It is market for the exchange of capital and credit in the economy.

**Gilt-edged securities-** They are fixed interest Government Securities traded on the stock exchange. They are called gilt-edged because it is certain that interest will be paid and that they will be redeemed on the due date. A gilt-edged security does not include treasury bills.

**Hedging-** The act of reducing uncertainty about future price movements in a commodity, financial security or foreign currency. This can be done by

undertaking forward sales or purchases of commodity, security or currency in the future market or b taking out an option that limits the option holders.

**Money Market-** It refers to the financial institutions that deal in short term securities and loans, gold and foreign exchange.

**Stock Exchange-** it is a market in which securities are bought and sold.

## 7.12 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress- B**

Ans. 4.) Primary market, secondary market; 5) unit

**Check Your Progress- C**

Ans. 5) Counter party

**Check Your Progress- D**

Ans. 4) Wholesale Debt Market (WDM)

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## 7.15 TERMINAL QUESTIONS

Q1. Discuss in detail the different segments of Indian financial markets. Also discuss how these segments relate to each other.

Q2. Write a note on the Indian Debt Market.

Q3. What are the Financial Derivatives? Discuss the different derivatives instruments available in the Indian capital Market.

Q4. How do primary and secondary markets contribute to the economic growth of country?

# UNIT 8 PRIMARY MARKET

**8.1 Introduction**

**8.2 Objectives**

**8.3 Primary Market**

**8.4 Book Building**

**8.5 Green Shoe Option**

**8.6 New issue market intermediaries**

**8.7 Primary Issues Activities**

**8.8 Resource Mobilization from International markets**

**8.9 Summary**

**8.10 Glossary**

**8.11 Answer to check your progress**

**8.12 Reference/ Bibliography**

**8.13 Suggested Readings**

**8.14 Terminal & Model Questions**

## 8.1 INTRODUCTION

In the previous unit you learnt about the financial market, its functions and the major players participating in the financial market. You also learnt that the main segment of financial market is the money market and capital market. The money market is the market of short term funds (less than one year) whereas capital market is the market for medium to long term funds. Along with these you learnt about Derivative markets, Debt Market and foreign exchange markets which are also the important segments of the financial market. These markets can further be classified as primary market and secondary market. Primary market deals with the new securities so it is also called the new issue market. It is a market for fresh capital whereas secondary market is a market in which, existing securities are sold and bought among investors and it is also called the stock market.

In this unit you will study about the primary market in detail .You will also learn about the different intermediaries and the critical role they are playing in the process of selling new issues, and also the various methods through which the funds can be raised in the primary market via domestic market as well as from international market.

## 8.2 OBJECTIVES

After reading this unit you will be able to:

- Learn about the primary market and its features.
- Understand about the various methods through which the capital can be raised.
- Know about the role of intermediaries in the process of selling new issues.
- Know about the different instruments used to raise capital from the international market.

## 8.3 PRIMARY MARKET

The primary market is a market for new issues. It is also called the new issue market. In the primary market securities (shares, bonds, and debentures) are offered to the public for subscription for the purpose of raising capital or funds. These securities may be issued in domestic and or international market. The issue of securities, shares, bonds in the primary market is subject to the fulfilment of a number of pre-issue guidelines issued by SEBI and also to compliance to various provision of companies act. The funds are mobilized in the primary market through public issue, right issues and private placement. Bonus issue is also one of the ways to raise capital but it does not bring in any fresh capital. Sometimes companies instead of distributing profits by way of dividend issue bonus shares to their existing shareholders. Bonus shares are issued in the ratio of the existing shares held by the shareholders. Shareholders need not to pay for the bonus shares issued to them by companies. By issuing bonus shares retained earnings are converted into capital. Thus, bonus shares enable companies to restructure their capital. Bonus is the capitalization of free reserves. Bonus issues fascinate the shareholders as they don't have to pay for them and in addition, they add to their wealth.

In India, new capital issues are floated through public issue, right issues and private placement by government companies, non-government public limited companies (private sector), public sector undertakings, banks and financial institutions. Public issues can be further classified into Initial Public offerings (IPO) and Further Public Offerings (FPOs). In a public offerings, offer or invitation to subscribe for shares or debentures are made to the general public. The issuer company makes detailed disclosures as per the Disclosure and investor Protection (DIP) guidelines in its offer document (Prospectus) and offer it for subscription. Right issue (RI) is when a listed company proposes to issue fresh securities to its existing shareholders as on a recorded date. When a company issue securities to some selected people or to institutional investors is called private placement. No prospectus is issued in Private placement. Private placement covers equity shares, preference shares, and debentures. This is the fastest and inexpensive way for the company to raise capital. There are three categories of participants in the primary market. They are the issuer of securities,

investors in securities and intermediaries. The last named render services to both the issuer and investors to enable the sale and purchase of securities.

Features of Primary Market

1) In the primary market companies issue securities directly to investors.
2) After receiving the prescribed funds the company allot share/securities to the investors.
3) Primary market facilitates companies to raise capital for setting new business ventures, or for expanding or modernizing existing business.

## 8.4 BOOK BUILDING

Before 1992, New issue Market was regulated by the Controller of Capital issues (CCI) under the Capital Issues (Control) Act, 1947. Companies had to obtain permission from the CCI to raise capital from the primary market. The price of the new issue was fixed by the controller which was based on the prescribed formula set by CCI. The issue price was set far below the market price of the company's share. The fixed price resulted in the underprcing of many issues.

On May 30, 1992 when the Capital Issues (Control) Act, 1947 was repealed, all the controls relating to raising of resources and fixing of issue price was with the company itself. The issue of capital by companies and other body corporates now do not require the consent from authority regarding either for making the issue or for pricing it. Now the promoter and its merchant banker together decide the issue price without taking into account the investor's feedback. The dishonest promoters and greedy merchant bankers brought out issues with rosy but unreal projections and sold shares at a very high premium but most of the issues were quoted below their offer price on the day they were listed at the stock exchange. Out of the 4000 issues that hit the market in 1992-96, more than 3000 quoted below their offer price on the day they were listed. These issues killed the primary market. Investors shied away from the market after burning their hands in those premium issues that are quoted on the stock exchange not only below the issue price but also below their par value.

Following the inefficient functioning of the capital market system, an alternative method, called the book building method, is slowly becoming popular in India. Under book building method the issue price of the Initial Public Offering (IPO) is determined on the Investors' demand.

SEBI guidelines defines Book Building as "a process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built-up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document".

Book building is essentially a process used by companies raising fund through Public offerings- both Initial public offers (IPOs) or Follow-on Public offers (FPOs) to aid price and demand discovery. It is a mechanism where , during the period for which the book being built or you can say the period for which the book for offer is open , the bids are collected from investors at various prices , which are within the price band specified by the issuer. Price band means the floor price and cap price. Investors can bid within these price bands. For example, the PNB issue's price band was Rs. 350 and Rs.390. Rs 350 is the floor price and the Rs. 390 is the cap price. Investors can bid at any price between Rs.350 and Rs.390. The issuer may mention the floor price and price band in the red herring prospectus. A bid is usually open for at least three working days but not more than seven working days. So we can say that Book building is basically an auction of shares. During the process on both the NSE and the BSE, investors can watch the book being built a chart shown indicates the bid price and the quantity of shares being bid for. The issuer, in consultation with the lead book runner, determines the issue price (Final Price) after the bid closure. Once the issue price is determined number of securities to be offered shall also be determined. Those bidders who bid at and above the final price become entitled for the allotment of the specified securities. As the issue price is determined the final prospectus containing all the disclosures in accordance with the provisions of regulation including the price and number of specified securities proposed to be issued shall be registered with the registrar of Companies. Although the concept of Book Building is relatively new in India, but it is a common practice in most developed countries.

Difference between shares offered through Book Building and Fixed Price Issue of the public issues.

| Features | Fixed Price Issue | Book Building Issue |
|---|---|---|
| Offer Price | Price at which the securities are offered and would be allotted is made known in advance to the investors. | A 20% price band is offer within which investors are allowed to bid and final price is determined by the issuer only after closure of bidding. |
| Demand | Demand for securities offered is known at the closure of the issue | In case book building, the demand can be known everyday as the book is built or during the bidding period. |
| Payment | 100% advance payment is required to be made by the investors at the time of application. | 10% advance payment is required to be made by QIBs along with the application, while other categories of investors have to pay 100% advance along with the application. |

Table 8.1 Source: Bharti Pathak

**Reverse Book Building**

Reverse book building is a process wherein the shareholders are asked to bid for the price at which they are willing to offer their shares. It is just similar to the reverse auction. This process helps in discovering the exit price and is used by companies who want to delist their shares or buy-back shares from the shareholders. In the reverse auction process the promoter appoint a merchant banker and also a trading member for placing bids on the online electronic system. The promoter and merchant banker shall make a public announcement in one English, one Hindi and one regional language newspaper of the region where the concerned recognised stock exchange is located. In addition to this they will also dispatch a letter of offer to the public shareholders along with the bidding form. Shareholders may approach the trading member for placing offers on the on-line electronic system with the bidding form. Bidding will be done only in the electronic form and through the stock exchange trading mechanism. The BRLM gave the list of the trading members who are eligible to participate in the reverse book building process to the stock exchange. At the closure of the offer, the BRLM announce the final price and the acceptance (or not) of the price by the promoter. Any remaining public shareholders may tender shares to the promoter at the same final price up to a period of one year from the date of delisting.

Special provisions have been provided in case of voluntary delisting of small companies. Equity shares of such companies may be delisted without following the Reverse Book Building process and by following a separate procedure specified in the Regulations.

## 8.5 GREEN-SHOE OPTION

The SEBI permitted the green-shoe option in book building issues when it amended the guidelines in August 2003.A green shoe option is an over-allotment option in the public issue and provides the post-listing price stabilizing mechanism for a period not exceeding 30 days in accordance with the provisions of Chapter VIIIA of the DIP guidelines. Green Shoe option is an option to the underwriter as per provision contained in an underwriting agreement that gives the underwriter the right to sell investors more shares than originally planned by the issuer if the demand for the security issues proves higher than the expected. This option is to the extent of 15% of the total issue size set by the issuer. It is also referred to as an over-allotment option.

Underwriters use green shoe option in one of the two ways. If the IPO is a success and stock prices surge, the underwriters use this option, buy the extra stock from the company at the predetermined price and sell those extra shares at a profit, on to whoever bought them. On the other hand if the price starts to fall, they buy back the shares from the market instead of the company to cover their short position, supporting the price of the stock. From an investor's

point of view, an issue with green shoe option provides more probability of getting shares and also that post listing price may show relatively more stability as compared to market.

Examples of Green -Shoe Options

A famous example of green shoe option is the Facebook Inc. IPO in 2012. In that case, the underwriters had agreed to sell 421 million shares of the company at $38. The issue was very popular and they exercised their greenshoe option by selling 484 million shares in the market.

In 2014 during the Alibaba Group Holding Ltd., IPO's underwriters exercised their greenshoe option and make $ 25 billion, which proved to be the largest IPO in the history.

## 8.6 NEW ISSUE MARKET INTERMEDIARIES

The most important aspect regarding the whole process of selling new issues has been boosted by the emergence of variety of intermediaries and it is one of the most crucial organisational developments in the Indian primary market. The major new issue market intermediaries are merchant banker/lead managers, underwriters, bankers to an issue, registrars, and share transfer agents, debenture trustees and portfolio managers.

Merchant banker/ Lead manager

Merchant banker requires compulsory registration with the SEBI as per the SEBI (Merchant Banker) Regulations, 1992 to act as book running lead manager (BRLM) to an issue. The lead manager performs the pre -issue as well as post- issue activities. Issue means an offer for sale of securities by body corporate to public or to the existing holders of the securities through the merchant banker. The pre-issue activities include the preparation of prospectus and other information relating to the issue, determining the financial structure, tie-up of financiers, appointment of registrars to deal with share application and transfers, arrangement of underwriting / sub-underwriting, placing of issue, selection of brokers and bankers to the issue, drawing up marketing strategies for the issue, compliance of procedural formalities with the stock exchanges and Registrar of Companies (ROC). Post-issue activities include management of escrow accounts, coordinating, non-institutional allocation, Intimation of allocation, coordination with the registrar for dispatching of refunds, dematerializing of securities, listing and trading of securities and coordinating with the other intermediaries involved in the issue process.

Underwriters

Another important intermediary in the new issue market is the underwriters to issues of capital who agree to take up securities which are not fully subscribed. They assure that the issue will be subscribed either by others or by themselves. To act as an underwriter, a certificate of registration must be obtained from the SEBI. Underwriting is not mandatory after April 1995, but its organisation is an important element of the primary market.

Underwriters of the issues are appointed by the companies in the consultation with lead manages / merchant bankers of the issues. Merchant bankers' statement regarding that the underwriters' assets are adequate to meet their obligation should be incorporated in the prospectus.

Bankers to an Issue

Bankers to an Issue are appointed in all the collection centres and by the merchant bankers to perform the activities such as collection of application money from the investors, transfer of this amount to escrow account, and refund of application money.

Registrar to an Issue and Share transfer Agents

Registrar to an Issue and Share transfer Agents must obtained a certificate of registration from the SEBI on payment of the requisite fees. Registrar to an issue carry out the activities such as collecting of applications from the investors, keeping a proper record of applications and money received from investors or paid to the seller of securities and assisting companies in determining the basis of allotment of securities in consultation of stock exchanges, finalising the allotment of securities, despatching allotment letters, refund orders, certificates and other related documents in respect of issues. Share transfer agents maintain the records of holders of securities or on behalf of companies and deal with activities related to the transfer/ redemption of its securities.

Debenture Trustees

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company or a body corporate or any private placement of debentures by a listed or proposed to be listed company. A trust deed means the deed executed by the body corporate in favour of the trustees named therein for the benefit of the debenture holders. Only banks, public financial institutions, insurance companies and body corpora1tes fulfilling the capital adequacy requirement of Rs. 2 crore in terms of networth as per the latest audited balance sheet can act as trustee. Like other intermediaries debenture trustees need to get registration with the SEBI on payment of requisite fees.

Portfolio Managers

Portfolio managers are the persons who made a contract or agreement with the clients to advise/direct/ undertake, on behalf of clients to act as discretionary portfolio manager or Non-discretionary portfolio manager for the management of the portfolio of securities of the clients. In discretionary portfolio management the manager use his discretion with regards to the management / investments of the clients on behalf of the investors whereas in non-discretionary portfolio management the manager manages funds in accordance to the directions of the clients.

*Check Your Progress- A*

**Q1. How are funds mobilized in the primary market?**

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**Q2. What is reverse book building?**

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**Q3. What is the Green -Shoe Option?**

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**Q4. Discuss the pre-issue and post issue activities of Merchant Banker.**

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**Q5. Fill in the blanks:**

a) Primary market is also known as ………………………
b) ……………. Issue does not bring in any fresh capital.
c) In a book building , a bid is usually open for at least ………working days but not more than ………… working days.

## 8.7 PRIMARY ISSUES ACTIVITIES

Primary Issues are classified into Public Issues, Right issues and Private Placement (Fig-8.1)

Public Issues

Public issue means an Initial Public offer (IPO) or Further public offer (FPO).

Initial Public Offering (IPO)

An Initial Public Offering (IPO) is an offering when an unlisted company makes either a fresh issue of securities (i.e. equity shares and convertible securities) or an offer for sale of its existing securities or both for the first time to the public. A convertible security means a security which is convertible into/ exchangeable with equity shares of the issuer at a later date with / without the option of the holder and it includes the convertible debt instruments and convertible preference share. In case of an IPO, the information regarding the company's past performance, its track record in the past is unavailable which create problem for the potential investors to take decision in favour of the company's issue or to make investment in that company. To enable investors to take decisions and protect their interest, SEBI has laid down stringent entry norms for the entities raising funds through an IPO and FPO.

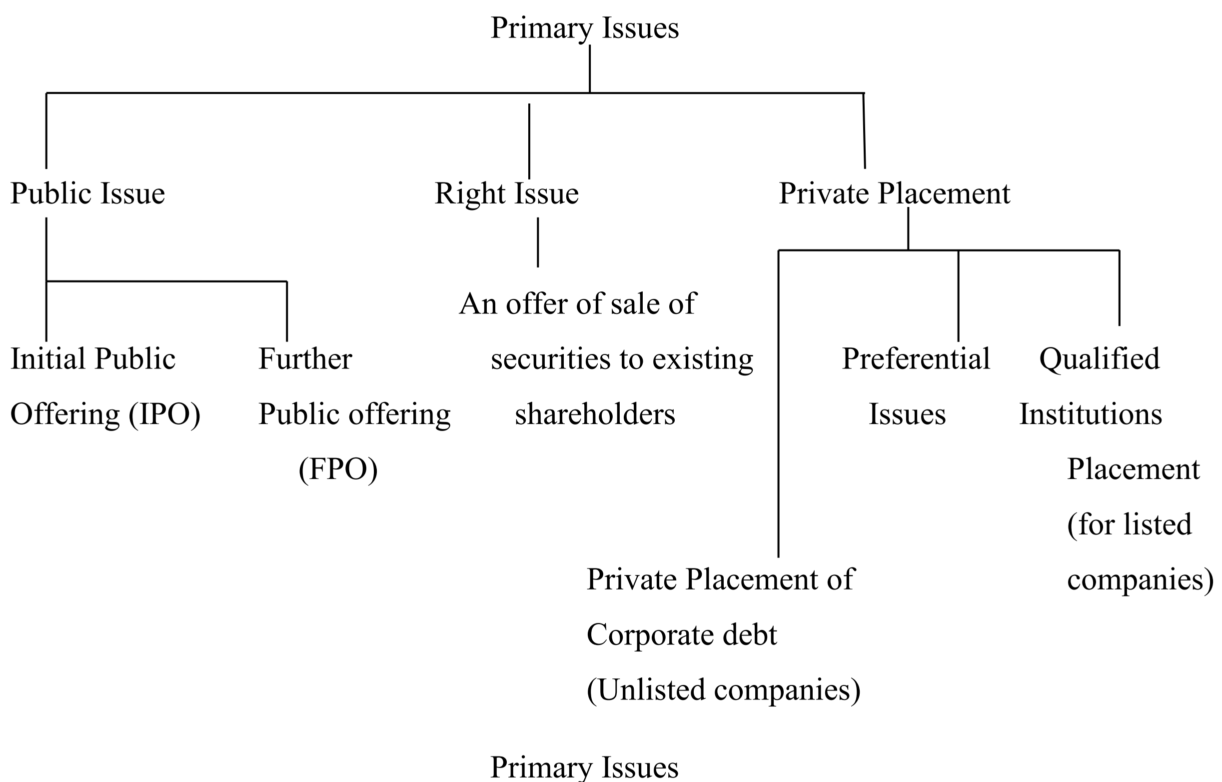


**Fig-8.1 Primary issue as depicted in Bharti Pathak page no.132**

The entry norms for entities raising funds through the IPO of equity shares or any other security which may be converted into or exchanged with equity shares at a later date are as follows:

Entry Norm 1: The Company desirous to raise funds through IPO required meeting following requirements. It is commonly known as 'Profitability Route'.

- Net tangible assets of at least Rs. 3 crores in each of the preceding three full years and not more than 50%is held in monetary assets. If the monetary asset exceeds 50%, the issuer should make firm commitment to utilise the excess in its business.
- Minimum average pre-tax profit of Rs. 15 crore calculated on a restated and consolidated basis during the three most profitable years out of the immediately preceding five years.
- Net worth of at least Rs.1 crore in three years.
- If there is change of name of company, at least 50% revenue for preceding one full year should be from the activity indicated by the new name.
- The aggregate of the proposed issue and all previous issues in the same financial years in terms of issue size (i.e., offer through offer document and promoters' contribution) does not exceed 5 times its pre-issue net worth as per the audited balance sheet of the last financial year.

SEBI has provided two other alternative routes to the company if it does not satisfy any of the above mentioned five requirements.

Entry Norm II : It is commonly known as 'QIB Route'.

- The issue is made through book building process and 75% of the issue to be mandatorily allotted to the qualified institutional buyers (QIBs) and refund full subscription money if it is unable to make allotment to them.
- The minimum post-issue face value capital shall be Rs.10 crore or there shall be compulsory market making for atleast 2 years.

Entry Norm III: It is commonly known as 'Appraisal Route'.

- The 'project' is appraised and participated to the extent of 15% by FIs/ scheduled commercial banks of which at least 10%comes from the appraiser. In addition, at least 10% of the issue size shall be allotted to QIBs, failing which the full subscription money shall be refunded.
- The minimum post-issue face value capital shall be Rs.10 crore or there shall be compulsory market making for at least 2 years.

In addition to satisfying theses above said entry norms, the company shall also need to satisfy the criteria of having at least 1000 prospective allottees in its issue otherwise allotment will be cancelled. Also, every issuer has to get IPO grading from at least one SEBI registered credit rating agency as on the date of registering prospectus/red herring prospectus with the ROCs.

Further public offering (FPO)

An FPO is made when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document. FPO is also known as subsequent or seasoned public offerings. SEBI Guidelines defines listed company as a company which has any of its securities offered through an offer document listed on a recognized stock exchange and also includes the public limited companies whose securities are listed on the recognized stock exchange. Listed companies issues FPO for their growth and diversification plans. A company can issue FPO if it fulfils the following two conditions:

- The aggregate of the proposed issue and all previous issues in the same financial years in terms of issue size (i.e., offer through offer document, firm allotment and promoters' contribution) does not exceed 5 times its pre-issue net worth as per the audited balance sheet of the last financial year.
- If there is change of name of company, at least 50% revenue for preceding one full year should be from the activity indicated by the new name.

If the company does not satisfied the above conditions it can make a public issue by complying with QIB route or appraisal route as specified for IPOs.

Listed companies with good track record find it easy to raise capital through FPO mode but due to cumbersome procedural requirements and high cost and time, it is no longer an attractive route to raise funds. Listed companies increasingly prefer the right issues or Qualified Institutional Placement (QIP) route to raise funds. During March 2017 there were 26 public issues, all of them were IPOs which mobilized Rs. 3223 crore.

Rights Issue

Right issue is the issue of new securities in which the existing shareholders are given the pre-emptive rights to subscribe to the new issue on a pro-rata basis. In the right issues existing shareholders have given the rights to subscribe to a proportionate number of fresh, extra shares at a pre-determined price. Generally, companies offer right shares to expand, diversify or restructure their balance sheet. The SEBI (ICDR) Regulations define right issue as an offer of specified securities by a listed company to the shareholders of the company as on the record date fixed for the purpose. Section 81(1) of the Companies Act, 1956, specifies the mode of issuing right shares. As per Clause(a) of Section 81, the right shares 'shall be offered to the persons who, at the date of the offer, are holders of equity shares of the company, in proportion as nearly as circumstances admit, to the capital paid-up on those shares on that date.' Thus, for deciding the rights entitlement only the capital paid up on each share is relevant.

Right shares are offered to the existing shareholders at a discount to the market price due to a variety of reasons. Firstly, they want their issue fully subscribed. Secondly, to reward their existing shareholders. Thirdly, to hike their stake in their companies, thus, avoiding the preferential allotment route which is subject to lot of restrictions. Funds raised through this route did not affect the stake of both its existing shareholders and promoters.

Right issue is different from public issue;

- In right issues, new shares are offered to the existing shareholders while in public issues shares are issued to public at large.
- In case of right issue, existing shareholders can renounce their 'rights entitlements' (REs) while there is no rights entitlement in case of public issue.
- In case of right issues shares are allotted based on the shareholding as on record date whereas 'proportionate allotment' based on application size in public issues. All details of the shareholders on a record date are available with the company.

According to SEBI guidelines, no listed issuer company can offer right issues where value of securities including premium is more than Rs.50 lakh, unless a draft letter of offer has been filed with SEBI, through a merchant banker, at least 30 days prior to the filing of the letter of offer with the designated stock exchange.

The ICDR regulations put restrictions on the issue of right shares: (a) An issuer can make right issue only after reserving shares of the same class in favour of holders of outstanding convertible debt instruments in proportion to the convertible part. b) Equity shares reserved for the holders of full or partially convertible debt instruments shall be issued to them at the time of conversion on the same terms on which the equity shares are offered in the right issues.

The issuer who wants raise funds through right shares should announce a record date after which the rights issue cannot be withdrawn. If the withdrawal is made by the issuer, he cannot make an application for listing of any of its specified securities on any recognized stock exchange for 12 months from the day on which the record date was announced. Companies can issue right shares by sending a letter of offer to the shareholders whose names are recorded in the books on a particular date. In March 2017 four right issues were offered which mobilized Rs. 1387 crore.

Private Placement of Corporate Debt

In the primary capital market funds can be raised through public issues, right issues and private placement. In public issues, securities are offered to the general public. In the right issues securities are issued to the existing shareholders on pro-rata basis. In case of private placement securities are directly offer to the small numbers of investors through merchant bankers. These investors are the selected clients such as financial institutions, banks, corporates and high net worth individuals. Company law defines a privately placed issue to be the one seeking subscription from 50 members. In private placement no prospectus is issued. Funds raised through the private placement route offers several advantages to the issue company. The time taken and cost of raising funds through this route is very less as compared to the public issues and right issues. Private placement route is more flexible than other routes as such it does not require the detailed compliance of formalities, rating, and disclosure norms. Because of these advantages this route of raising finance is more popular in USA where generally, debt instruments are privately placed. In India this route is gaining momentum during last few years, in view of the prolonged subdued conditions in the new

issue market. In terms of instruments, debt instruments, mainly bonds and debentures are preferred the most and equity portion is raised through the preference shares. The major issuers of these securities are financial institutions, banks, and central and state level undertakings. The subscribers of the securities are banks, mutual funds, provident fund and high net worth individuals.

In India, privately placed securities are admitted for trading, but are not listed. Banks do not trade these securities and hold them till maturity. Hence, there is no secondary market for such securities. During March 2017, 85,633 crore was raised through private placement route in the corporate bond market

Preferential Issue

A preferential issue means an issue of specified securities by listed companies to a selected group of persons on a private placement basis and does not include an offer of securities made through a public issue, right issue, bonus issue, employee stock option scheme, employee stock purchase scheme or qualified institutions placement or an issue of sweat equity shares or depository receipts issued in a country outside India and foreign securities. As of public / right issue is cumbersome and requires compliance with statutory provisions. Hence, many companies opt for preferential allotment of shares for raising funds. Such allotments are made to various strategic groups including promoters, foreign partners, technical collaborators and private equity funds. There were 27 preferential allotments (amounting to 4,170 crore) listed at BSE and NSE together during March 2017, compared to 27 preferential allotments (amounting to 1,099 crore) listed during February 2017.

Conditions for Preferential issues

The conditions for preferential issues by a listed issuer are:

1. A special resolution by the shareholders.
2. All equity shares held by the proposed allottees are in dematerialized form (demat form).
3. The issuing company is in compliance with the conditions for continuous listing specified in the listing agreement.
4. It has obtained PAN from each applicant before making the allotment.

Qualified Institution Placement (QIP)

SEBI introduced Qualified Institutional Placement (QIP) as an alternative mechanism of funds raising for listed companies from Indian Securities market in 2006. In a QIP, a listed issuer issues equity shares or non-convertible debt instruments along with warrants and convertible securities other than warrants to Qualified Institutional Buyers only on private placement basis. In March 2017, 3626.49 crore was mobilized through one QIP issue compared to 172.8 crore mobilized through one QIP issue in the previous month.

Conditions for QIP

A listed issuer may make a QIP of securities if it satisfies the following conditions;

1. A special resolution by its shareholders.
2. Listing of shares of same class which are proposed to be allotted/pursuant to conversion or exchange of eligible securities offered to QIP on a stock exchange having nation -wide trade terminal for a period of at least one year to the issue of notice to the shareholders for convening their meeting to pass the special resolution.
3. The requirement of minimum public shareholding specified in the Securities Contract (Regulation) Rules must be complied.
4. The special resolution should specify that the allotment would be through QIP. The relevant date should also be specified. Relevant date means (i) the date of meeting in which board of directors decides to open the issue in case of allotment of shares,(ii) in case of allotment of eligible convertible securities the date (a) of the meeting specified in (i) or (b) on which their holders became entitled to apply for shares.

A SEBI registered merchant banker should manage QIP and exercise due diligence. While seeking in-principle approval for listing, he should furnish to the stock exchange on which the same class of shares of the issuer are listed a due diligence certificate to the effect that the eligible securities are issued under QIP and all the requirements have been fulfilled.

Qualified Institutional Buyer

Qualified Institutional Buyer (QIBs) is those institutional investors who possess an expertise and financial muscle to evaluate and invest in the capital markets. In terms of Clause 2.2.2B (v) of DIP guidelines, a 'Qualified Institutional buyer' shall mean;

a) Public financial institution as defined in section 4A of the Companies Act,1956.

b) Scheduled commercial banks;

c) Mutual funds;

d) Venture capital funds registered with SEBI;

e) Foreign venture capital investors registered with SEBI;

f) Provident funds with minimum corpus of Rs.25 crore;

g) State industrial development corporations

h) Foreign institutional investors registered with SEBI;

i) Multilateral and bilateral development financial institutions;

j) Insurance companies registered with IRDA

k) Pension funds with minimum corpus of Rs.25 crore.

These entities are not required to register with SEBI as QIBs. Any entity falling under the categories specified above is considered as a QIB for the purpose of primary issuance process.

*Check Your Progress- B*

**Q1. Define listed company**

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**Q2. QIB's**

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**Q3. Difference between right issues and public issues.**

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**Q4. What are the advantages to the issuer who raised funds through private placement?**

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**Q5. Fill in the Blanks;**

1. Prospectus is not issued in ...................
2. Right issue is the issue of new securities to the ……………. Shareholders.

# 8.8 RESOURCE MOBILIZATION FROM INTERNATIONAL MARKETS

As it was mentioned in the beginning of the unit that funds can be raised in the primary market from the domestic market as well as international market. After the reforms of 1991 Indian companies were allowed to raise equity from the international market earlier only debt funds can be raised from the international markets. In the early 1990's there was foreign exchange crisis and the government of India was unable to meet the import requirements of the companies. Hence allowing Indian companies to raise funds from the international market seemed a more sensible option. This permission encouraged Indian companies to become global.

Indian companies can raise funds from international capital markets through Global Depository Receipts (GDRs)/American Depository Receipts (ADRs), Foreign Currency Convertible Bonds (FCCBs), and External Commercial Borrowings (ECBs).

**Global Depository Receipts (GDRs)**

Global Depository Receipts (GDRs) are essentially an equity instruments created by Overseas Depository Banks (ODBs) which are authorised by the issuing companies in India to issue GDRs outside the country to non-resident investors against the shares/bonds of the issuing Indian companies held with the nominated domestic custodian bank (DCBs). The shares underlying the GDRs should be denominated only in Indian currency. The shares corresponding to the GDRs may be one or more. The GDRs could be issued in a negotiable form. A holder of GDR can, at any time, convert it into the number of shares that it represents. For all good purposes, GDRs can be treated as direct investment in the issuing companies. There are, however ceiling on foreign equity participation. They can be traded on international market. Indian companies GDRs are mostly listed on Luxembourg Stock Exchange and the London Stock Exchange. Indian GDRs are primarily sold to institutional investors and the major demand of Indian GDRs is in UK, USA, Hongkong, Singapore, France and Switzerland. The aggregate of foreign investment, made either directly or indirectly through GDRs/ADRs mechanism, should not exceed 51 percent of the issue and the subscribed capital of the issuing company.

**American Depository Receipts (ADRs)**

ADRs are negotiable (transferable) instruments, denominated in dollars, and issued by US Depository Bank. A non-US company that seeks to list in the US, deposits its shares with a bank and receives a receipt which enables the company to issue American Depository Shares (ADSs). These ADSs serve as stock certificates and are used interchangeably with ADRs which represent ownership of deposited shares. There is no legal and technical difference between a ADRs and GDRs. As they are listed on the New York Stock Exchange (NYSE) and the NASDAQ (National Association of Securities Dealers Automated Association), ADR

issues offer access to the US institutional and retail markets while GDRs issues offer access only to the US institutional market. ADRs listing require comprehensive disclosures and greater transparency as compared to a GDR listing.

**Foreign Currency Convertible Bonds (FCCBs)**

FCCBs are bonds issued by Indian companies and subscribed by a non-resident in foreign currency. They carry a fixed interest or coupon rate and are convertible into ordinary shares of issuing company at a preferred price. These bonds are listed and traded abroad. Interest paid on these bonds is in dollars and if the holder did not exercise the conversion option the redemption is also made in dollars. Thus, foreign investors prefer FCCBs whereas Indian companies prefer to issue GDRs. The interest rate is low but exchange risk is more in FCCBs as interest is payable in foreign currency. Only companies with low debt equity ratios and large forex earnings potential choose FCCBs to raise funds from international market. Companies intending to raise funds from abroad through the issue of GDRs and FCCBs will need to obtain prior permission of the department of Economic Affairs, Ministry of Finance, Government of India.

**External Commercial Borrowings (ECBs)**

External Commercial Borrowings are borrowings raised from the international markets by corporates. ECBs include commercial bank loans, buyer's credit, supplier's credit; securities instrument (for example, floating rates notes and fixed interest bonds) availed from non-resident lenders with minimum average maturity of 3 years. Indian corporates prefer ECBs to raise funds as the cost of borrowings is low in the international market. ECBs need sound risk management- both interest rate and forex risk. Any default has wider repercussions in terms of increasing the risk premium for the subsequent borrowers from India. ECBs can be accessed under two routes, the automatic route and the approval route. ECBs under automatic route do not required RBI/Government approval. The ECBs for investment in real sector-industrial sector and especially infrastructure sector in India- are under automatic route. ECBs that do not come under the automatic route are considered by an empowered committee of Reserve Bank for approval. The eligible borrowers under the approval route are a) financial institutions dealing exclusively with infrastructure export finance, such as IDFC, ILFS, Power Finance Corporation, IRCON, and EXIM bank. (b) banks and financial institutions which participated i the textile/steel sector restructuring package approved by the Government to the extent of their investment in the package and assessment by RBI on prudential norms. (c) FCCBs by housing finance companies which satisfy the minimum criteria of networth during the previous 3 years of Rs 500crore, listing on BSE/NSE, minimum size of FCCBS is USD 100 million; the applicant should submit the purpose/plan of utilization of funds. (d) Entities in the service sector namely hotels, hospital and software companies have been permitted to avail ECB. (e) cases falling outside the purview of the automatic route limits.

**Types of Investors**

There are three important types of investors; Stag, Chicken, and Pig.

Stag

A stag is an investor who buys shares through a famous company's issues, i.e., on application when the company comes out with a share issue. He does this with a simple view; buy at the face value (i.e., par value) and sell either before the company gets listed on the stock exchange ( i.e., before trading starts on the stock exchange),or on the first day of the listing or in the first few days of the company gets listed on the stock exchange.

The idea behind this is simple; buy at a low price (on application) and sell at a profit when the price goes up in the first few days of the company's listing. There is a quiet little risk involved in this kind of trading.

Chicken

Ever heard the term-'chicken-hearted'? If you called someone 'chicken hearted', you meant to call that person a coward, i.e., someone lacking courage. Chicken is an investor who does not have the courage to take risk. He is a risk-averse, i.e., he avoids taking risk. He does not wish to lose money. So he does not speculate; he also avoid buying/selling anything for the short term. Typically, he invests money in fixed deposits (mostly with nationalized banks; he would not trust private sector banks) and government bonds, like those issued by RBI. On a rare occasion, he might invest in some blue chip stocks (like SBI) for the long term.

Blue chip stocks relate to those companies that are financially secure, have a long track record of consistent growth ,and sometimes, high dividend payout history.

Pig

As an investor, a pig is the contrast of a chicken; a pig loves to take risk, to make the large profit. Being impulsive and greedy by nature, he buys on the spur of the moment, without doing any background check on how the company is performing or whether the share price will rise.

A pig is darling of a stock broker (bear/bull). Since he is a huge risk-taker, the stock brokers love him. The pig may or may not make money but the stock broker always does (by earning commission).

## 8.9 SUMMARY

Primary market is the market where securities (shares/bonds/ debentures) are offered to the public for subscription, for the purpose of raising funds. The securities issued in the primary market are subject to the fulfillment of the number of pre-issue guidelines by SEBI and compliance to various provisions of the Company Act. In the primary market funds are raised through the public issue of prospectus, right issue and through the private placement. While public and right issues involve the detailed procedure but private placements or preferential issues are relatively simpler. There are number of intermediaries in the primary market such

as merchant banker, bankers to an issue, underwriters, debenture trustees, registrar to an issue and share transfer agent, portfolio managers who are playing a very important role in selling new issues in the primary market. After the reforms of 1991 companies are allowed to raise equity capital from the international market. Before that only debt can be raised from the international market. Indian companies can raise funds from international capital markets through Global Depository Receipts (GDRs)/American Depository Receipts (ADRs), Foreign Currency Convertible Bonds (FCCBs), and External Commercial Borrowings (ECBs). So it can be say that healthy and regulated primary market is very important for maintaining the confidence of issuers, intermediaries and investors and also in order to keep pace with the changing scenario and to address the concerns of various market participants the amendments in the primary market has been required from time to time.

## 8.10 GLOSSARY

**Red herring prospectus-** Red herring prospectus is a prospectus which does not have details of either price or number of shares being offered.

**Coupon-**The interest paid on a bond expressed as a percentage of the face value. If a bond carries a fixed coupon, the interest is paid on an annual or semi-annual basis. The term also describes the detachable certificate entitling the bearer to payment of the interest.

**Coupon Rate-** The interest rate stated on the face of coupon.

## 8.11 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress- A**

Ans. (5)New issue market, (6) Bonus, (7) 3, 7

**Check Your Progress- B**

Ans 1. private placement, 2. existing

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## 8.14 TERMINAL QUESTIONS

Q1. How are funds mobilized in the primary market from the domestic as well as from International market?

Q2. What is book building? Describe the book building process. Discuss the benefits and limitations of book building.

Q3. What are the different intermediaries to an issue? Discuss the role of each intermediary in detail.

Q4. What is an IPO? State the entry norms laid by the SEBI for making an IPO. What are the requirements that need to be fulfilled by an unlisted company wishing to go public?

Q5. Discuss right issues. Why do promoters offer right issues? Also state why companies prefer to raise funds through private placement than public issues and right issues?

# UNIT 9 SECONDARY MARKET

**9.1 Introduction**

**9.2 Objectives**

**9.3 Secondary Market**

**9.4 Listing Requirement**

**9.5 Trading in stock exchanges**

**9.6 Stock Exchanges**

**9.7 Secondary Market intermediaries**

**9.8 Summary**

**9.9 Glossary**

**9.10 Answers to check your progress**

**9.11 Reference/ Bibliography**

**9.12 Suggested Readings**

**9.13 Terminal & Model Questions**

## 9.1 INTRODUCTION

In the previous unit you have learned about the primary market, role and functions of primary market intermediaries such as merchant bankers or book running lead managers, underwriters, registrar to the issue, bankers to the issue, portfolio managers and debenture trustees. They are playing an important role in the sale of new securities. Further funds are mobilized in the primary market through public issue, right issues and private placement. In public issues shares are offered to the public through prospectus. In right issue new shares are offered to the existing shareholders and in private placement, shares are offered to the selected group of people. In the previous unit you have also learned about the book building and reverse book building. Book building is the mechanism through which an offer price of the issue is determined. Whereas in reverse book building shareholders are asked to bid for the price at which they are willing to offer their shares. Along with all these you have also learned about ADRs, GDRs, FCCBs and ECBs the capital market instruments to raise funds by Indian companies from the international market. In this unit you will learn about the

secondary market and its functions, listing requirements of the securities, trading and settlement system in the stock exchanges, brief view about the major stock exchanges of India and role and functions of secondary market intermediaries.

## 9.2 OBJECTIVES

After reading this unit you will be able to:

- Learn about the nature and significance of secondary market.
- Understand about the listing of securities, trading and settlement arrangements.
- Know about the major stock exchanges of India.
- Know about the role and functions of the secondary market intermediaries.

## 9.3 SECONDARY MARKET

The capital market has two interdependent and inseparable segments viz. the new issuers (the primary market) and stock (secondary) market. In the primary market issuers raise the fresh capital from the investors by making initial public offers or right issues or through the private placement, on the other hand secondary market provides liquidity to these instruments, through trading and settlement on the stock exchanges. In the primary market, the issuer has direct contact with the investors, whereas in the secondary market, the dealings are done between two investors and the issuers does not come into the picture. The secondary market operates through two mediums- Over the Counter (OTC) Market and the Exchange Traded Market. OTC Markets are the informal type of market where the trades are negotiated and securities are traded and settled bilaterally over the counter. In Indian market OTC exchange is recognized as OTCEI, but this exchange does not give much volumes. Another option is trading through the stock exchanges where buyers and sellers do not know each other. The settlement of trade done as per the fixed time schedule and trades executed on the stock exchange are settled through the clearing corporation, who acts as a counterparty and guarantees settlement. A stock exchange is defined under Section 2(3) of the Securities Contract (Regulation) Act,1956, ‘ as anybody of individuals whether incorporated or not , constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities’.

Functions of secondary market

- To provide liquidity and marketability of securities i.e. equity and debt instruments.
- To contributes to economic growth by channelizing funds in to the most efficient channel through the process of disinvestment to reinvestment.
- To ensure a measure of safety and fair dealing in trading of securities to protect invetors’ interests.
- To provide an instant valuation of securities due to the changes in the internal environment (company-wide and industry -wide). Such valuation leads to the

measurement of cost of capital and the rate of return of the companies at the micro level.

- To induce companies to improve their performance as the market price of the security reflects the performance of the company and this market price readily available to investors.

**Development of the Stock Market in India**

The stock market in India came into existence at the end of the eighteenth century when long term negotiable instruments were first issued. The enactment of companies Act in 1850 which introduced the feature of limited liability, arouse the interest of investors in corporate securities. The first organised stock exchange formed in India was Bombay (now Mumbai) stock exchange started in 1875 and it stated to be the oldest in Asia. This was followed by the formation of the Ahmadabad stock exchange in the 1894 to facilitate dealings in the shares of textile mills established there. The Calcutta (now Kolkata) stock exchange was started in 1908 to provide the market for shares of Plantations and Jute mills. Then the Madras (now Chennai) was started in 1937. In order to promote the orderly development of the stock market, the government of India introduced a comprehensive legislation called the Securities Contract (Regulation) Act, 1956.

Till 1960, Calcutta stock exchange (CSE) was the largest stock exchange in India. In 1961, there were 1203 listed companies across the various stock exchanges of India. Of these, 576 were listed on the CSE, 297 listed on the BSE and rest on the other stock exchanges. During the later half of 1960 the relative importance of CSE declined while that of the BSE increased sharply.

Till the early 1990, the Indian stock market comprised regional stock exchanges with the BSE heading the list.

**Post-Reforms Market Scenario**

After the initiations of reforms in 1991, the Indian secondary market now has a four-tier form as follows.

- Regional Stock Exchanges
- The National Stock Exchanges (BSE and NSE)
- The Over the Counter Exchange of India (OTCEI)
- The Inter-Connected Stock Exchange of India (ISE)

There were 15 regional stock exchanges in India. The NSE came into existence in 1992 with the best global practices. The OTCEI was set up in 1992 as a stock exchange, providing small and medium sized companies the means to raise capital. ISE is the stock exchange of stock exchanges. The ISE commenced its trading operations in February 26, 1999.

# 9.4 LISTING REQUIREMENTS

A company who wants its securities to be traded on the floor of a stock exchange must list its securities on an exchange. A company can get its securities listed on more than one stock exchange. Earlier it was compulsory for the companies to list on the regional stock exchange that is nearest to its registered office, but now it is not mandatory. A security listed on one exchange is permitted for trading on the other exchange. As per the Securities Contracts (Regulation) Rules ,1957, guidelines issued by Securities and Exchange Rules , Bye laws and Regulations, a company must comply with the following in order to get its shares listed on any recognized stock exchange. Basic listing requirements are as follows:

1. The Memorandum and Articles of Association must not contain any provisions that restrict free transfer of shares.
2. The company must offer for public at least 25 percent of its issued capital.
3. The minimum issued capital of the company should be atleast Rs. 10 crore in case of BSE and Rs.5 crore in case of other exchanges.
4. Application should be invited in denomination of market units of trading.
5. No previous track record is necessary.

In case the company securities are not allowed by exchange to be listed, the company cannot proceed with allotment of shares. In such case company can file an appeal before SEBI under Section 22 of Securities Contract (Regulation) Act, 1956 and also the Securities Appellate Tribunal (SAT).

The listing of securities is essential as it provides:

1. Ready marketability and makes securities more liquid and transferable.
2. Ensure proper supervision and control over the securities dealings.
3. Protect the interest of the investors and general investing public.

Delisting of Securities

To improve the transparency, the SEBI made it compulsory for the listed companies to make available their half yearly results and disclose their balance sheets- audited or un-audited every 6 months to the stock exchanges. In case the companies fail to comply with the requirements an exchange can take disciplinary actions as such of suspension/ delisting of the securities. Delisting means removal of securities of a listed company from the stock exchange where it was registered. An exchange may delist the securities if;

- The networth of the company reduced to less than its paid-up capital.
- The securities of the listed companies are not continuously traded on the exchange.
- The promoters/ directors of the company indulge in insider trading, manipulation of share prices and unfair market practices of securities.

- The promoters/directors/ persons in management indulge in the malpractices including malpractices in dematerialisation of securities in excess of issued securities or delivery of securities which are not listed or for which the trading permission has not granted.
- Trading in the securities of the company remained suspended for more than six months.
- Shareholding of the company held by the public has come below the limit specified in the listing agreement under the SCR Act.

The SEBI may specify any other reasons in which the securities of the company can be delisted.

***Check Your Progress- A***

**Q1. What is the role of Secondary Market?**

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**Q2. What are the listing requirements under SCR Act?**

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**Q3. What is delisting?**

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## 9.5 TRADING IN STOCK EXCHANGES

The open –outcry system, which was prevailed a few years ago has been now replaced by an online, screen based electronic trading system. Now a days trading has been shifted from the floor to the brokers office where trades are executed through the computer terminals. All stock exchanges together have 8000 terminals all across the country. In a screen based trading system members generally enter their requirements regarding number of shares they want and at what price, the transaction is executed as soon as it find a matching order from

the counter-party. The online screen based electronic trading system is far superior than the open-outcry system as it ensures the transparency and also enables the participants to see the full market during real time. This system has enabled a large number of participants, in every part of the country, to trade in full anonymity with one another simultaneously, thereby improving the liquidity and depth of the market. This system provides the single trading platform instead of the different trading centres spread all over the country.

Trading in stock exchanges take place either on the basis of order-driven trading system and Quote –driven trading system. In the order-driver market system, orders from all over the country entered into an electronic system and matched directly and continuously without the intervention of the Jobbers. In the quote-driven system, there are market makers who continuously offer two-way quotes-buy-and-sell quotes and are willing to buy and sell any quantity. The BSE provides both these systems while the NSE provides only the order-driven system.

There are two types of orders: limit orders and market orders. Limit orders are those trades which will be only executed at the prices specified by the investors. Usually, retail investors and fund houses place limit orders. Market orders are those trades which are executed at the latest quoted bid or offer price on the trading screen. There are certain orders (buy or sell) which already exist in the trade book at the time of trade matching which are known as passive orders. While active orders are incoming orders that are matched against the passive orders, stock exchanges are charges different prices for both the active and passive orders.

Steps involved in Online Trading

1. Investors needs to sign the ‘member-client agreement’ if they are dealing directly with the broker or ‘broker-sub broker- client tripartite agreement’ if they are dealing with sub-brokers to execute trades on his behalf from time to time. They are required to give the details of their Permanent account number, which is mandatory for the investors participating in the securities market, their name, date of birth, educational qualification, occupation, residential status, address, bank and depository account details, and if they are already registered with some another broker, then the name of the broker and concerned stock exchange and the client Code Number in the client registration form.
2. An investor has to open a Demat Account with a depository participant in his name for the purpose holding and transferring of the shares. He also has to open a bank account for debiting and crediting money for trading in the securities market.
3. Investors who want to trade in the stock market places order with the broker to buy/sell the required quantity of specified securities.
4. The order is matched at the best price based on the price-time priority.
5. The order which is executed electronically is communicated to the broker’s terminal.
6. The broker issues the trade confirmation slip to the investor.
7. A contract note is issued by the broker to the investor within 24 hours of trade execution. A contract note is a confirmation of trade done by the broker on behalf of the investor. Order code number is mentioned on the contract note. Its unique number

which is printed on the contract note at every transaction. The time when investor has placed the order and the time when the order is executed is also mentioned on the contract note.

8. The payment for the shares purchased or delivery of shares in case of sales of shares is required to be done prior to the pay-in date for the relevant settlement.
9. Pay-in of funds and securities take place before T+2 day as settlement cycle is on T+2 rolling settlement basis, w.e.f. April 1, 2003. Pay-in day is the day when broker shall make payment or delivery of securities to the exchange.
10. Pay-out of funds and securities take place on T+2 day. Pay-out day is the day when the exchange makes payment or delivery of securities to the broker. The brokers make payment to the investor within 24 hours of the payout.
11. The investor can get direct delivery of securities in his beneficial owner account/Demat account.

Depository System and Dematerialization

A depository is an organization which holds securities (shares, bonds, government securities, mutual funds units etc.) of various investors in electronic form at the request of the investors through the registered Depository Participant. It also provides services related to transactions (transfer of ownership) in securities. According to Section 2(e) of the Depositories Act, 1996, ‘ Depository means a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under Section 12(1A) of the Securities and Exchange Board of India Act, 1992. At present two Depositories, viz. National Securities Depository Limited (NSDL) and Central Depository Service (India) Limited (CDSL) are registered with SEBI.

A Depository Participant (DP) is an agent of the depository through which it deals with the investors and provides depository services. Public financial institutions, scheduled commercial banks, foreign banks operating in India with the approval of the Reserve Bank of India, state financial corporations, custodians, stock-brokers, clearing corporations/ clearing houses, NBFCs and Registrar to an issue or share transfer agent complying with the requirements prescribed by the SEBI can be registered as DP.

To avail the services of a depository an investor is required to open a Beneficial Owner (BO) account with a Depository Participant (DP) of any depository.

Dematerialisation is the process through which securities in physical form are converted to electronic form and credited in to BO’s account of investor by DP. In order to dematerialise the securities the investor fills in a Dematerialise Request Form (DRF) and submits the physical securities that are to be dematerialised along with the DRF to DP. Separate DRF has to be filled for each ISIN. ISIN (International Securities Identification Number) is a unique 12-digit alpha-numeric identification number allotted for a security (E.g. IMF483C01068). Equity-fully paid up, equity partly paid up, equity with differential voting rights issued by the same issuer will have different ISINs. Besides equity shares, dematerialisation facility has

also been extended to instruments like commercial paper and bonds. One of the significant event in the Indian capital market has been the dematerialisation of shares as it has boosted the micro-structure of the market in general and of stock exchange in particular. At the end of March, 2016 there were 145 lakhs Demat accounts with NSDL and 107 lakhs Demat account with CDSL.

Carry Forward Deals, or Badla

The carry forward deals or Badla was a unique feature of Indian stock exchanges, especially of the BSE. Generally in normal trading buyer or seller of securities take/ give delivery and pay/receive the consideration at the end of each settlement period. However, in Badla system, buyer or seller enjoyed the facility of carrying forward the transaction from one settlement period to another settlement period. In simple terms it was the postponement of his commitments to the next period. This process could be repeated several times subject to the condition that it will not permitted beyond the 70 days and at the end of this period, the transaction must be completed. But this system was highly misused by the leading market players such as big companies, particularly those who have their own investment and finance subsidiaries .through such subsidiaries; they manipulate the stock prices and prop up stocks of their parent companies. Although Badla or carry forward facility , was quite popular and accounting for nearly 90% of the trade at all stock exchanges but because of heavy speculation and securities scam Badla system has been banned by the SEBI in 1993.Following the ban, there was a steep decline in the turnover on the stock market. Therefore it was revised and resumed again on the recommendation of Patel Committee Report in 1996. In March 1997, the SEBI constituted J.R.Varma Committee to review the revised carry forward system (RCFS). The committee recommended a Modified Carry Forward System (MCFS) which was accepted by the SEBI. In March 2001, after the Ketan Parekh Scam came to light and the payment crisis occurred in Kolkata Stock Exchange, the SEBI completely banned Badla. This old system was replaced by a new system- rolling settlement.

Rolling Settlement

With a view to enhance the liquidity, shorten the carry forward cycle and make the derivatives trading feasible in the stock market, the SEBI introduced the compulsory rolling settlement. Although the OTCEI was the first exchange which introduced the rolling settlement when it started its operations in 1992 but it was not success for the OTCEI as here was no margin trading facility for borrowing funds or shares. Rolling settlement was introduced by the SEBI for the first time in January, 2000 in the form of T+5 days settlement basis. T is the trade day and 5 is the number of business days after the trade date on which delivery of securities and cash payments are due for settlement. In other words, T+5 means that all open position at the end of trading date result in delivery and payments five working days later. Rolling Settlement system replaced the Badla system in a phased manner. Indian stock markets moved to T+3 rolling settlement cycle in April 2002. This cycle was further

shortened to T+2 day w.e.f. April1, 2003. The stock brokers are required to adhere to the following schedule in T+2 rolling settlement.

In a T+2 settlement, confirmation and determination of obligation take place on T+1 basis, while pay-in and pay-out of funds and securities take place on the second trading day. Shorter settlement period leads to the lower trading cost for market participants and also reduced the risk of counter-party failure. The SEBI now aims for T+1 settlement cycle. In a T+1 settlement cycle, as soon as an investor buys shares, the broker's terminal will give the buying order, the system will check the investor's bank account and debit funds and in turn , deposit shares in his demat account within a few seconds.

Securities Lending and Borrowing (SLB)

Securities Lending and Borrowing is a scheme which enables the lending of the idle securities by the investors in the market and earning a return through the same. The lender of the stock charges interest for lending the stock. The security lending and borrowing scheme is essentially a facility for the short sellers. A short seller is a person who sells the securities which he does not own at the time of sales. The securities lending and borrowing scheme enables the short seller to borrow shares from the SEBI- registered 'Approved Intermediary'(AIs) and deliver them to the buyer against outstanding commitments. When the prices decline, he replaces the borrowed shares by buying from the market. The borrower of the securities pay interest to lender on the value of securities borrowed. The borrowers of securities are usually broker, speculators, market makers, custodian banks, clearing corporations and finance companies. The lenders are mutual funds, insurance companies, custodian banks, finance companies, brokers and high net worth individuals. Stock lending increases the liquidity of stocks as more and more players are able to sell or take position. It controls the bull market. Stock lending through the clearing house can help carry forward short sales and check volatility in the share prices at the time of settlement. It facilitates timely settlement and avoids delivery failure.

Circuit Breakers

Lots of scams took place such as Harshad Mehta, Katen Parekh scams in the stock market. The real sufferers of these scams are small investors. To protect the interest of investors from the excessive volatility in prices, the SEBI introduced, in 1995, scrip wise daily circuit breakers or price bands. The price bands serve as boundaries for the stock's trading and the exchange will not accept orders that are set outside the minimum and the maximum of the price range. The purpose behind price bands and circuit breakers are to control mass buying or selling of shares and send a market spiraling into one direction, and perhaps most importantly, to curb panic selling. Circuits are of two types – circuit for an index and circuit for stock price. So if an index or price of the stock moved beyond the threshold it is said to be enter in the circuit. When a stock enters an upper circuit, it puts an investor who has already invested in the stock at an advantage. On the contrary a stock movement into a lower circuit places the investor at a disadvantage because it is now difficult to sell off these shares as they have lost a lot of money. During the circuit breaker trading is halt/ suspended, automatically for a specified period. In India, circuit breakers are used to halt both rising and declining

prices. If on the particular day stock prices move 20% on the either side, the trading on the stock will immediately halted. If the index changes 10% on either side, immediately the trading will be halted in the market for the day unless and until investors regain their confidence.

Margin Trading

Margin trading is a new concept in India as the RBI allowed the banks to finance margin trading in shares from 18 September 2001. Margin trading refers to the process where investors can purchase more quantities of shares than they can afford to. Margin trading permits investors to buy shares by giving 40% of the deal value as 'margin', while borrowing 60% from the banks. Banks provide finance to investors through stockbrokers for trading in securities. The margin customer has to sign a margin agreement, pledging securities as loan collaterals. Before they lend the client margined securities, the brokers also ask customers to sign a stock-loan consent form. Investors generally use margins to own more shares without having the capacity to pay for them.

***Check Your Progress- B***

**Q1. Why are circuit breakers used ?**

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**Q2. What is a rolling settlement?**

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**Q3. What is Depository ?**

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## 9.6 STOCK EXCHANGES

Indian stock markets are one of the oldest in Asia. Its history dated back to nearly 200 years ago. The Bombay Stock Exchange was inaugurated in 1899 when the brokers formally established a stock market in India. Thus, the stock exchange at Bombay was consolidated. After that more and more stock exchanges have emerged in India and this forms a huge capital market in India.

Equity Market in India: The Indian Equity Market is popularly known as the Indian stock market. The Indian equity market is the third biggest market after China and Hong Kong in the Asian region.

Stock Exchange: Stock Exchange is an organized and regulated financial market where securities (bonds, notes, shares) are bought and sold at prices governed by the forces of demand and supply. The stock exchanges are granted permission for their operations in the securities market by SEBI under SCR Act, 1956.

The Role of Stock Exchanges: Stock exchanges have multiple roles in the economy. This may include the following:

1. Raising Capital for Businesses: The Stock Exchanges provide facilities to the companies to raise capital for expansion, diversification or growth through selling shares to the investing public.
2. Facilitating Company growth: A takeover bid or a merger agreement through the stock market is one of the simplest and most common ways for a company to grow by acquisition or fusion.
3. Creating Investment opportunities for small investors: As opposed to other businesses that require huge capital outlay, investing in shares is open to both the large and small stock investors because a person buys the number of shares they can afford. Therefore the stock exchanges provide the opportunity for small investors to own shares of same companies as large investors.
4. Barometer of the Economy: At the stock exchanges, share prices rise and fall depending, largely, on market forces. Share prices tend to rise or remain stable when companies and the economy in general show signs of stability and growth. An economic recession, depression or financial crisis ultimately leads to a stock market crash. Therefore, the movement of share prices and in general of the stock indexes can be an indicator of the general trend in the economy.
5. Speculation: The stock exchanges are also fashionable place for speculation. In a financial context, the terms “speculation” and “investment” are actually quite specific. For instance, although the word “investment” is typically used , in a general sense, to mean any act of placing money in a financial vehicle with the intent of producing returns over a period of time, most ventured money- including funds placed in the world’s stock markets is actually not investment but speculation.

**Demutualisation of Stock Exchanges**

Demutualisation refers to transition process of an exchange from a 'member-owned organization' to a 'shareholder-owned company. In other words, it is the transformation of the legal structure of the exchange from a mutual form to business corporation form and so termed as demutualisation. After demutualisation the ownership, the management, and the trading rights at the exchange are segregated from one another. The NSE, The BSE, The OTCEI and the ISE were set up as demutualised stock exchanges. Through demutualization, a stock exchange becomes a corporate entity, changing from a non-profit making company to a profit-and tax-paying company. Demutualization makes the operations of stock exchange transparent, which facilitates better governance.

The Indian market, at present has 6 recognized stock exchanges. 4 regional stock exchanges, the BSE, the NSE.

Bombay Stock Exchange (BSE): BSE is the oldest stock exchange of Asia. The extensiveness of the indigenous equity broking industry in India led to the formation of the Native Share Brokers Association in 1875, which later became Bombay Stock Exchange Limited (BSE). BSE is widely recognized due to its important and pre-eminent role in the growth of the Indian capital market.

- In 1995, the trading system transformed from open outcry system to an online screen-based order-driven trading system.
- The exchange opened up for foreign ownership (foreign institutional investment).
- Allowed Indian companies to raise capital from abroad through ADRs and GDRs.
- Expanded the product range (equities/derivatives/debt)
- Introduced the book building process and brought in transparency in IPO issuance.
- Depositories for share custody (dematerialization of shares).

The world's biggest stock exchanges based on market capitalization:

1. New Stock Exchange
2. Nasdaq OMX
3. Japan Exchange Group of Tokyo
4. Euronext
5. Hong Kong Exchange

Bombay Stock Exchange secured 10th position globally and another Indian exchange National Stock Exchange has been placed at 11th position. Bombay stock exchange is the largest in the world in terms of number of listed companies.

National Stock Exchange (NSE): With the liberalization of the Indian economy, it was found inevitable to lift the Indian Stock market trading system on part with the international standards. On the basis of the recommendations of high powered Pherwani Committee, the

National Stock Exchange was incorporated in 1992 by Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Finance Corporation of India(IFCI), all insurance Corporation, selected Commercial Banks and others.

Trading at NSE takes place through a fully automated screen-based trading mechanism which adopts the principle of an order-driven market. Trading members can stay at their offices and execute the trading, since they are linked through a communication network. The prices at which the buyer and seller are willing to transact will appear on the screen. When the prices match, the transaction will be completed and a confirmation slip will be printed at the office of the trading member.

NSE has several advantages over the trading exchanges. They are as follows:

- NSE brings an integrated trading network across the nation.
- Investors can trade at the same price from anywhere in the country since inter-market operations are streamlined coupled with the countrywide access to the securities.
- Delays in communication, late payments and the malpractices prevailing in the traditional trading mechanism can be done away with greater operational efficiency and informational transparency in the stock market operations, with the support of total computerized network.

Over the Counter Exchange of India (OTCEI): The traditional trading mechanism prevailed in the Indian stock markets gave way to many functional inefficiencies such as absence of liquidity, lack of transparency, unduly long settlement periods and benami transactions, which affected the small investors to a great extent. To provide improved services to investors, the country's first ring less , script less electronic stock exchange-OTCEI-was created in 1992 by country's premier financial institutions-Unit Trust Of India(UTI), Industrial Credit and Investment Corporation Of India (ICICI). Industrial Development Bank of India (IDBI), SBI Capital Markets, Industrial Finance Corporation of India (IFCI), General Insurance Corporation and its subsidiaries and CanBank Financial Services.

Compared to the traditional exchanges, OTC Exchange Network has the following advantages:

- OTCEI has widely dispersed trading mechanism across the country which provides greater liquidity and lesser risk intermediary charges.
- Greater transparency and accuracy of prices is obtained due to the screen-based scrip less trading.
- Since the exact price of the transaction is shown on the computer screen, the investor gets to know the exact price at which she/he is trading.
- Faster settlement and transfer process compared to other exchanges.

The OTCEI is no longer a functional exchange as the same has been de-recognized by SEBI vide its order dated 31 Mar 2015.

Regional Stock Exchanges

One important segment of Indian capital market was its 19 regional stock exchanges, which were highest in the world. The emergence of these stock exchanges was the result of India's geographical and telecommunications limitations. The area of operation and jurisdiction of these stock exchanges were specified. These stock exchanges served as a link between local companies and local investors. Reputed local companies got them listed on these stock exchanges and these regional stock exchanges promoted trading in these local scrips. This increased the competition among the local companies and they listed their securities on as many exchanges as possible to attract the investors all over the country. All these stock exchanges followed their own practice and procedure in respect of listing and trading of securities, clearing and settlement of transactions, and risk containment measures. Regional stock exchanges did well till 1990s but in 1990s, new stock exchanges – OTCEI, NSE and ISE were set up and they were permitted for nationwide trading. Subsequently, all stock exchanges were permitted to expand across the nation but this did not increase the trading volume of regional stock exchanges because investors from remote area's now directly deal with the NSE and BSE through the facility of online trading. Many large companies decided to delist on all stock exchanges except the BSE and NSE. With turnovers sinking, most RSEs acquired membership of the BSE or the NSE and became their stockbrokers.

In 2001-02, the NSE commanded around 80% of the turnover, while the BSE accounted for 16 % only. The rest 4% turnover were from the regional stock exchanges together. The share of the RSEs came down to 1% in 2004-05, 0.19 % in 2005-06 and 0.01% in 2008-09. The RSEs were needed when there was no electronic trading. But as of now the BSE and NSE is providing nationwide, screen based on line trading, so the question arises whether the RSEs needed at all and whether RSEs will survive in front of these national stock exchanges in the long run. The RSEs will be forced to shut down as low turnover volume will result in huge revenue deficit. Unfortunately, most of the stock exchanges do not have the money to upgrade their IT infrastructure, a prerequisite to survive and compete in the future. With a view to revive these exchanges, the SEBI allowed to outside investors to invest in them. It allowed single-entity holding up to 15% in the stock exchanges. The government has allowed foreign direct investment and portfolio investors to buy equity of these stock exchanges with a limit of 49%. However, despite the outsider investor's investment, these stock exchanges have not yet managed to restart their operations.

"SEBI, vide Circular No. MRD/DoP/SE/Cir -36/2008 dated December 29, 2008, issued Guidelines and laid down the framework for exit by stock exchanges whose recognition is withdrawn and/or renewal of recognition is refused by SEBI and who may want to surrender their recognition. The said Guidelines were reviewed and modified vide Circular No. CIR/MRD/DSA/14/2012 dated May 30, 2012 (hereinafter referred to as "Exit Circular, 2012"). In terms of clause 2.2 of Exit Circular, 2012, a stock exchange, where the annual trading turnover on its platform is less than ₹1000 crore, can apply to SEBI for voluntary surrender of recognition and exit, at any time before the expiry of two years from the date of issuance of the said Circular. In terms of clause 2.3 of the said Circular, if any stock exchange

Faile to achieve a turnover of ₹1000 crore, it would be subject to compulsory exit process". Source (http://www.iseindia.com/TechPDF/Exit_Order_ISE.pdf)

After SEBI's this notice most of the stock exchanges whose annual trading turnover was less than Rs. 1000 crore had follow the exit route. So as of now (Aug 2017) there are only 6 recognized stock exchanges in India. The list is given below.

List of Recognized Stock Exchanges

| Sr. No. | Name | Valid Upto |
|---|---|---|
| 1 | **Ahmedabad Stock Exchange Ltd.** | PERMANENT |
| 2 | **BSE Ltd.** | PERMANENT |
| 3 | **Calcutta Stock Exchange Ltd.** | PERMANENT |
| 4 | **Magadh Stock Exchange Ltd.** | PERMANENT |
| 5 | **Metropolitan Stock Exchange of India Ltd.** | Sep 15, 2017 |
| 6 | **National Stock Exchange of India Ltd.** | PERMANENT |

(Note: The Hyderabad Securities and Enterprises Ltd (erstwhile Hyderabad Stock Exchange), Coimbatore Stock Exchange Ltd, Saurashtra Kutch Stock Exchange Ltd ,Mangalore Stock Exchange, Inter-Connected Stock Exchange of India Ltd, Cochin Stock Exchange Ltd, Bangalore Stock Exchange Ltd , Ludhiana Stock exchange Ltd, Gauhati Stock Exchange Ltd, Bhubaneswar Stock Exchange Ltd, Jaipur Stock Exchange Ltd, OTC Exchange of India , Pune Stock Exchange Ltd, Madras Stock Exchange Ltd, U.P.Stock Exchange Ltd, Madhya Pradesh Stock Exchange Ltd, Vadodara Stock Exchange Ltd and Delhi Stock Exchange Ltd have been granted exit by SEBI vide orders dated January 25, 2013, April 3, 2013, April 5, 2013, March 3, 2014, December 08, 2014, December 23, 2014, December 26, 2014, December 30, 2014, January 27, 2015, February 09, 2015, March 23, 2015, March 31, 2015 ,April 13, 2015, May 14, 2015, June 09, 2015, November 09, 2015 and January 23, 2017 respectively.)

Source : ( http://www.sebi.gov.in/stock-exchanges.html)

## 9.7 SECONDARY MARKET INTERMEDIARIES IN INDIA

There are various intermediaries who operate at a stock exchange and are registered at numbers of the exchanges. Regulation of these intermediaries is an essential part of the framework for regulation of securities market. These intermediaries are playing an important part in security market so it is necessary that all the intermediaries maintain high standards of integrity and fairness and also act with due skill, care and diligence to enhance the confidence

of the investors. The various intermediaries' regulations have been framed under the SEBI Act 1992 and Depositories Act 1996 for the registration and regulation of all these market intermediaries. The various functions and duties performed by these intermediaries are given below.

1) Jobber

Jobbers are the independent security merchants who buy and sell securities on their own account. They cannot deal with the public directly and are barred from taking commission. They deals with the brokers who, in turn, make transactions on behalf of public. Jobbers generally quotes two prices, one at which he is prepared to sell a particular security. The difference between the two prices is 'spread' as it was known, would be his profit which is known as Jobber's turn.

2) Broker

A broker is a middleman who brings a buyer and a seller together. He helps strike the deal; he charges brokerage and commission for his services from both the parties. He does not buy or sell for himself; he does this to earn commission. Brokers are the experts who forecast trends in prices and advise their clients in making fruitful transaction. They get orders from the investors and execute that orders from the jobbers. In stock market, there are both individual brokers as well as corporate brokers (like Motilal Oswal). A certificate of registration from the SEBI is mandatorily required to act as a broker. The registration of a broker with the SEBI would be subject to following conditions;

1. Holds the membership of any stock exchange.
2. He pays the requisite fees to the SEBI.
3. Take adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keeps the SEBI informed about the number, nature and other particulars of the complaints.
4. At all times abide by the code of conduct.
5. Maintain the specified minimum networth.

**Type of stock brokers**

There are two important types of brokers: Bear and Bull. Though brokers, they are called by these peculiar names after the kind of speculation they indulge in.

Bear

A bear is a broker and a speculator. He is a pessimist; he expects the price of share to fall. So what he tries to do is to sell at today's price, which he fears will fall in the future. He believes that selling the shares at today's higher price, he can avoid making a loss in the future. If there is large-scale selling by a large number of bears, such a market sentiment is called bearish.

Bull

A bull is a broker and a speculator. He is an optimist; he expects the price of shares to rise. So what he tries to do is to buy at today's price, which he hopes will rise in the future. He believes that by buying shares at today's lower price, he can make a big profit in the future after selling the shares at higher price. If there is large scale buying by a large number of bulls, such a market sentiment is called bullish.

3) Sub brokers

A Sub-broker acts on behalf of a stock broker as an agent for assisting the investors in buying and selling of securities through such broker, but he is not a member of a stock exchange. Although to act as a sub-broker, a certificate of registration from SEBI is required. SEBI grants a registration certificate to a sub-broker subject to the following conditions.

1. He pays the prescribed fees to the SEBI.

2. Take adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keeps the SEBI informed about the number, nature and other particulars of the complaints.

3. He must be authorised by the broker in writing to deal with the securities

Sub-brokers wanted to do business with more than one broker need to be separately registered with SEBI for each broker. The agreement between a sub-broker and broker can be terminated only after giving prior written notice of at least six months by either party. A sub-broker is expected to maintain high standard of integrity and fairness in conduct of his business.

4) Portfolio Manager

A portfolio manager is the body corporate which, pursuant to a contact or agreements with the clients or investors advise, direct or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise), management and administration of the portfolio of the securities or the funds of the clients as the case may be. Portfolio managers are required to acquire the certificate of registration from the SEBI to act as a portfolio manager.

5) Depository Participants

A depository is an organization which holds securities of a shareholder in an electronic form and facilitates the transfer of ownership of securities on the settlement dates. To act as a depository a company formed and registered under the companies act 1956 need to require a certificate of registration from the Securities and Exchange Board of India. Investors deal with the depository through the depository participants. A depository participant (DP) could be a public financial institution, a bank, a custodian, or a stock broker. A depository participant acts as an agent of the depository and functions like a securities bank as an investor has to open an account with the DP. The SHCIL was the first DP registered with the SEBI. The DP can offer the depository services only after it gets registered with the SEBI.

6) Credit Rating Agency

An agency that performs the rating of the debt instruments is known as credit rating agency. Credit rating is an opinion of the relative capacity of a borrowing entity to service its debt obligations within a specified time period. Credit rating enables investors to draw up the credit-risk profile and assess the adequacy or otherwise of the risk premium offered by the market. It saves the investors' time and enables them to take quick decision regarding the investment in the particular instrument and also provides them better choices among the available investment opportunities based on their risk-return preferences. A rating agency is required to obtain the certificate of registration from the SEBI.

Investors Grievances and Redressal

Investors are the real backbone of the securities market. Protection of the interests of investors is highly important for the intermediaries, stock exchanges and the regulators associated with this market. Although at most care is taken through regulations and compliance efforts that the investor's rights are protected and they by no means they are aggrieved by any intentional or unintentional wrong doing or activities of any participants in the market. There are certain occasions when the investors have grievances against the intermediary or broking firm through which it deals in the market or against the company for which it is a shareholder. In the event of such a grievance, the investor is required to first approach the concerned intermediary /trading firm /company for settling of the grievance. If the investor is not satisfied with their response then in such a situation, the matter can be brought to the notice of the stock exchange where the broking firm holds its membership or can also be brought to the notice of the market regulator, the SEBI. The Exchange and SEBI also taken up the grievances against the various intermediaries registered with it independently and advise the registered trading member to redress the grievance.

***Check Your Progress- C***

**Q1. What is Screen based trading?**

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**Q2. Discuss the role of stock exchanges?**

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**Q3. What is demutualization of stock exchanges?**

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**Q4. What are the functions of a broker?**

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**Q5. Who are the main suppliers of capital in the market?**

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**Q5. Choose the options;**

i. Stock markets moved to which of the following settlement system fromApril1, 2003

a) T+1

b) T+3

c) T+2

d) T+5

ii. Which of the following stock exchange is for small cap companies?

a) Inter-connected stock exchange of India

b) OTCEI

c) NSE

d) BSE

Q6. Fill in the blanks:

a) The Indian equity market is the third biggest market after………. and………. in the Asian region.
b) The oldest stock exchange in Asia is …………..
c) At present there are ……. recognized stock exchanges operating in India.

## 9.8 SUMMARY

In this unit you learnt that secondary market is a market in which the existing securities are traded. This market is also known as stock market. Listing of securities are mandatory for companies which wants there securities to be traded on the stock market or stock exchange. They have to comply with the listing requirements prescribed by the SCR Act. To eliminate the problems like theft, fake transfers, transfer delays, paper work associated with the physical certificates Demat system has been introduced by SEBI. The dematerialization of shares and introduction of settlement in Demat form changed the face of Indian stock market. Another major reform which affects the Indian stock market was the introduction of rolling settlement. The rolling settlement system eliminates the Badla system in a phased manner. Over the years, NSE and BSE have emerged as nation- wide stock exchanges contributing more than 99% of the total turnover. Since the establishment of SEBI, the securities market in India has developed significantly. SEBI made it ensure that Indian securities market develops in terms of products, technology, participants, surveillance and enforcement in tandem with international standards.

## 9.9 GLOSSARY

**Broker-** An intermediary between a buyer and a seller in a highly organized market.

**Dividend-** It is the amount of a company's profits that the board of directors decides to distribute to ordinary shareholders.

**Dematerialize-** The process of transforming securities holdings in physical form to the electronic form through the depository participant.

**Depository-** A system of organization which keeps records of securities of depositors in physical or electronic form.

**Foreign Currency Convertible Bond (FCCB)-** It is an unsecured debt instrument denominated in the foreign currency and issued by an Indian company. It is convertible in to share, or in some case into GDRs, at a predetermined rate.

**Stock** – It is the basic ownership unit of a company. Also referred as share or equity.

## 9.10 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress- C**

Ans. 5.i. c ,

ii. b ,

6. A. China, Hong Kong;

b. BSE, c . 6

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## 9.13 TERMINAL QUESTIONS

Q1. Discuss the nature and significance of secondary market.

Q2. Explain the listing of securities, trading and settlement arrangements.

Q3. What are the major stock exchanges of India?

Q4. Discuss the role and functions of the secondary market intermediaries.

# UNIT 10 STOCK EXCHANGES IN INDIA

**10.1 Introduction**

**10.2 Objectives**

**10.3 History of Stock Exchange in India**

**10.4 Stock Exchanges in India**

**10.5 Objectives of Stock Exchanges**

**10.6 Functions of Stock Exchanges**

**10.7 Working of Stock Exchanges in India**

**10.8 Advantages of Stock Exchanges in India**

**10.9 Brief Description of Active Stock Exchanges in India**

**10.10 Summary**

**10.11 Glossary**

**10.12 Answers to check your progress**

**10.13 Reference/ Bibliography**

**10.14 Suggested Readings**

**10.15 Terminal & Model Questions**

## 10.1 INTRODUCTION

As already discussed in previous units, financial markets are divided into two types: money market and capital market. Capital market is further divided into two categories: primary market or new issue market and secondary market. Secondary market is also called stock market, stock exchange or share market. In stock market old or existing securities, also called secondary securities, are traded. Shares and bonds are two important securities that are traded in secondary market. The primary market and secondary market, their functioning and instruments traded in them have been discussed in detail in unit VIII and Unit IX. This unit describes stock exchanges, their functions, significance, how they function in India.

The Securities Contracts (Regulation) Act of 1956 has defined a stock exchange as "any body of individuals, whether incorporated or not, constituted before corporatization and demutualization under sections 4A and 4B, or a body corporate incorporated under the Companies Act, 1956 (1 of 1956) whether under a scheme of corporatization and demutualization or otherwise, for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities".

Demutualization is the process through which any member-owned organisation can be made shareholder-owned company and such company can be listed on a stock exchange.

## 10.2 OBJECTIVES

After reading this unit you will be able to understand

- What is stock exchange?
- Brief history of stock exchange.
- Stock exchanges in India.
- How stock exchanges function in India.
- Various functions and significance of stock exchanges in India.

## 10.3 HISTORY OF STOCK EXCHANGE

The history of stock market dates back to thirteenth century. The moneylenders in Venice used to trade debt between each other. They would exchange one form of loan with other form amongst them. They also purchased government debt issues and sold them to the individual investors. This started the trading in government securities. In the late fourteenth century, Belgium was the first country to have stock market system. In late fourteenth century, Antwerp became the international trade center where the merchants would buy goods at certain price in anticipation of increase in price and then earn profits by selling those goods at high price. Rich merchants used to lend money to the people in need of funds at high interest rates and then sell the bonds which were backed by these loans. They used to pay interest to the people who purchased these bonds.

To travel and trade globally, a substantial amount of capital was required and it was difficult even for the well-established merchants to raise the huge capital alone. Therefore, a group of investors became business partners by pooling their savings and formed joint-stock companies. In the year 1611, the Amsterdam Stock Exchange was established and the trading of shares of Dutch East India Company was done. The Dutch East India was the world's first publicly traded company and was the only company whose shares were traded on the Amsterdam Stock Exchange for many years. The company had raised capital by selling stock and paid dividends to the investors on those shares. The shares of the various East India Companies were handwritten on the sheets of papers.

This idea of trading these paper shares spread to Portugal, France, Spain and England. The other industries also started raising start-up capital through selling of their shares. These papers were sold by one investor to the other. In England there was no stock exchange. The brokers and investors would meet in the coffee shops to perform trading. Debt issues and shares for sale used to written up and either posted on the shops' doors or mailed as a newsletter. As the trade volume increased, an organised marketplace where the trading of the shares would take place became necessary. In 1773, the traders took over the coffeehouse which they were using

as marketplace and renamed it as the stock exchange, and thus, the London Stock Exchange was formed.

In 1790, the America's first stock exchange, Philadelphia Stock Exchange was established. In 1817, the Buttonwood traders created New York Stock and Exchange Board. On the basis of Philadelphia Stock Exchange model, they found New York Stock Exchange (NYSE). The New York Stock Exchange is the largest stock exchange in the world. In 1971, another stock exchange, the National Association of Securities Dealers Automated Quotations (NASDAQ) came into operation in America. NASDAQ allowed the investors to do trading in-personal as well as electronically. They were able to buy and sell shares electronically through computer networks across all the American regional exchanges. Today, almost every country has its own stock exchange.

# 10.4 STOCK EXCHANGES IN INDIA

In India, the history of stock market dates back to eighteenth century. East India Company started trading in loan securities. Around 1930, corporate share trading was started in Mumbai (then Bombay) in which bank and cotton press stocks were traded. Under a banyan tree, opposite the Town Hall of Mumbai, a dozen brokers started informal trading. In 1875, an informal association called the Native Shares and Stock Brokers Association, Bombay was organised by 22 brokers and thus the Bombay Stock Exchange (BSE) was formed at Dalal Street. In May 1927, the Bombay Stock Exchange got recognition under the Bombay Securities Contracts Control Act, 1925. Bombay Stock Exchange is considered as the Asia's oldest stock exchange and first one to get permanent recognition under Securities Contract Regulation Act, 1956.

Subsequently, Ahmedabad Stock Exchange was established in 1894 for trading in shares of textile mills. Calcutta (now Kolkata) Stock Exchange started its operation in 1908 with trading of plantation and jute mills. In 1920, Madras (now Chennai) Stock Exchange was set up and began operation.

The volume of trading at Bombay Stock Exchange was the highest. It dominated the stock market, but had few drawbacks such as less transparency, undependable and unreliable clearing and settlement system, etc. which needed to be regulated. As a result, Securities and Exchange Board of India was formed in 1988 as a financial market regulator. It was formed as a non-statutory body but in 1992 it became a statutory body. Stock markets in India are regulated by the central government under the Securities Contract (Regulation) Act, 1956.

In 1992, another stock exchange called National Stock Exchange (NSE) was formed with an objective to bring transparency in the stock market. It got recognition in 1993 and began operation in 1994. National Stock Exchange was the first stock exchange in India to start trading electronically. NSE had the modern and fully automated screen based trading system which helped people from anywhere in the country to get stock price information and trade. To

compete with NSE, Bombay Stock Exchange (BSE) also started electronic trading system in 1995 called BSE On-Line Trading (BOLT).

Till 2018, there were more than 20 stock exchanges operating in India, but, at present there are only 9 active stock exchanges. The list of active exchanges in India is as follows:

- Bombay Stock Exchange (BSE)
- National Stock Exchange (NSE)
- Calcutta Stock Exchange (CSE)
- India International Exchange (India INX)
- Metropolitan Stock Exchange of India
- Indian Commodity Exchange Limited (ICEX)
- Multi Commodity Exchange of India (MCX)
- NSE International Exchange (NSE IFSC)
- National Commodity and Derivatives Exchange (NCDEX)

The following 19 stock exchanges have been granted exit by Securities and Exchange Board of India (SEBI).

- The Hyderabad Securities and Enterprises Ltd (erstwhile Hyderabad Stock Exchange)
- Coimbatore Stock Exchange Ltd
- Saurashtra Kutch Stock Exchange Ltd
- Mangalore Stock Exchange
- Inter-Connected Stock Exchange of India Ltd
- Cochin Stock Exchange Ltd
- Bangalore Stock Exchange Ltd
- Ludhiana Stock exchange Ltd
- Gauhati Stock Exchange Ltd
- Bhubaneswar Stock Exchange Ltd
- Jaipur Stock Exchange Ltd
- OTC Exchange of India
- Pune Stock Exchange Ltd
- Madras Stock Exchange Ltd
- U.P.Stock Exchange Ltd
- Madhya Pradesh Stock Exchange Ltd
- Vadodara Stock Exchange Ltd
- Delhi Stock Exchange Ltd and
- Ahmedabad Stock Exchange Ltd

# 10.5 OBJECTIVES OF STOCK EXCHANGES

Old or existing securities are resold or purchased on stock exchanges. Stock exchanges facilitate the trading of securities of central and state government, public sector and private sector companies. As per the Securities Contracts (Regulation) Act, 1956, "a stock exchange is defined as any body of individuals, whether incorporated or not, or a body corporate incorporated under the Companies Act, 1956, for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities".

Stock exchange is considered as the heart of capital market. It also represents the health of the economy of the country. It plays a very important role in developing trade, commerce and industries in a country. The objectives of establishing stock exchange in a country as given as below:

1 **Capital Formation:** The primary objective of the stock exchange is facilitating the raising of capital by the companies for their expansion, diversification, etc. thus helping in the growth of economy and development of nation. Companies sell their stock to the public through equity, preference and right shares or borrow from general public through debt instruments and use the funds received for the capital requirements of the company.

2 **Facilitate Trading:** Stock market is a place where existing securities are traded. It facilitates trading of financial securities such as equities, debt instruments, commodities, etc. nationwide as well as internationally.

3 **Security and Transparency:** Another important objective of stock exchange is to provide an efficient, fair and transparent market for trading of financial securities to investors. Stock exchanges create a more protected environment for investors which help the investors to evaluate the risk and return on their investment as companies have to provide correct and dependable information about them and their financials.

4 **To inculcate habit of saving:** People can earn good returns on their investments by investing wisely in financial securities. This inspires them to save regularly.

5 **Convenience:** Another important objective of stock exchange to provide access to stock market from the convenience of home. An investor does not need to run from place to place to invest his money or to buy securities. It provides convenience of trading from anywhere in the world.

6 **To raise financial awareness:** For the economy to improve and grow, people need to be aware of all the financial investment options they have. The fund surplus entities invest money to earn returns on their investment. This invested money help the fund deficit units to improve their financial condition. This gives boost to the company as well as economy.

7 **To present information:** Another objective of stock exchange to provide all the correct information about the management, transactions and financial condition of a company to the investors. The fluctuations in the prices reflect the company's as well as country's economic condition. Also price trends in stock market indicate trade cycles.

8 **To protect investors from frauds:** Stock exchange is governed by rules and regulations by SEBI. These rules and regulations help in keeping check on price manipulations, insider trading, overtrading, etc.

9 **To form a link between an investor and borrower:** Stock exchange helps in facilitating and mobilising of funds from the surplus fund entities to the fund deficit entities, thus forming a link between a borrower and an investor.

10 **To provide access:** Stock exchange ensures and provides equal access to investors all over the country. A domestic as well international investor can access the information and can invest in the financial securities from anywhere in the world through an appropriate communication network.

11 **To develop economy:** The most important objective of stock exchange is helping the fund deficit companies to raise capital. Companies can raise funds required for their day-to-day operations, expansion or diversification. This will increase the growth of industries and thus help in development of the country.

## 10.6 FUNCTIONS OF STOCK EXCHANGE IN INDIA

The important functions of the stock exchange are as follows:

1 **Act as Economic Barometer:** The stock exchange is the mirror which reflects the economic condition of a country. Major changes in the economy of a country due to social, political, economic or climate reasons reflect in the share prices. The rise or fall in stock prices indicates the boom, recession or depression cycles of the economy. The stock exchange act as an economic barometer which reflects the economic and business condition in a country.

2 **Mobilization of savings and capital formation:** Stock exchange forms a link between the investors and borrowers. The fund surplus entities invest their money in the stock market. The fund deficit units or borrowers raise capital through securities. So the stock exchange performs the function of linking the investors and fund deficit entities and facilitates the mobilization of savings and capital formation.

3 **Contribution to economic growth:** In stock exchange, financial securities are traded. The securities are bought and sold. This process of disinvestment and reinvestment helps in capital formation. The funds generated by the companies can be used in productive activities which can increase the industrial production and thus help in economic growth.

4 **Pricing of securities**: The stock market helps in the valuation of securities on the basis of their demand and supply. There is more demand for the securities of profitable and growth oriented companies and they are valued higher. This valuation of securities is not only useful for investors but also for government and creditors. The investors can know the value of their investment, the creditors can value the creditworthiness and government can impose taxes on value of securities.

5 **Safety of transactions:** Companies get listed on stock exchange only after the verification of the all their credentials and after getting listed, they have to abide by all the rules and regulations. This procedure ensures safety of transactions when trading on stock exchange.

6 **Spreading of equity cult:** Spreading equity cult means making people aware about investment and encouraging them to invest in ownership securities by regulating new

issues and better trading practices. Stock exchange educates people on investment and encourages them to invest in wider ownership securities.

7 **Providing scope for speculation:** Speculation is purchasing of financial securities solely with a purpose of gaining profit through price movement to a target price. Stock exchange provides a restricted and controlled scope for speculation.

8 **Better allocation of capital:** The stock market transactions result in funds flow from the less profitable to more profitable enterprises. The share prices of the profit making companies are generally high and these shares are actively traded on the exchange which helps these companies to raise new capital easily and grow their business. It also helps investors in getting better returns by allocating their funds to profitable channels.

9 **Promoting the habit of savings and investment:** With proper market studies and financial awareness, investors can earn good profits on their investment in securities. This can promote habit of savings and investment in them which will infuse more funds in to the stock market.

10 **Providing liquidity and marketability to existing securities:** Stock exchange is a ready and continuous market for trading i.e. buying and selling of securities. It provides a platform where buyers and sellers can buy and sell the securities. The investors can invest in long-term as well as short term securities. They can easily convert their investments into cash if needed by selling those securities.

***Check Your Progress A***

**1. Fill in the blanks:**

- **i.** __________________________ is a place where existing securities are traded.
- **ii.** Stock exchange is governed by rules and regulations by ______________________.
- **iii.** At present, there are ________ active stock exchanges in India.
- **iv.** _________________was the first stock exchange in India to provide automated screen-based trading system.

**Q2. Write brief history of stock exchange.**

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**Q3. What are the functions of stock exchange in India?**

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**Q4. Write short note on how first stock exchange was set up in India.**

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## 10.7 WORKING OF STOCK EXCHANGES IN INDIA

Stock exchange is the platform where securities are traded. Shares, bonds, commodities are bought or sold, all the information such as their real-time prices, volume traded, etc. is made available through stock exchanges. In stock exchange secondary securities are traded. But how does this happen? How the order is placed? How is it executed? How the transfer of securities takes place? To get answer of all these questions, we need to understand how stock exchanges in India work.

Trading on stock exchange is like auction where there is buyer, who bids for securities through his registered broker at certain price and seller who puts his securities on sale through his registered broker at certain price. Buyer will try to get the securities at lowest possible price and seller will try to sell at highest possible price. When both the prices match, the trade is executed. Let's understand the whole process in detail. But before that one needs to learn about various functionaries and their roles in stock exchange.

The various functionaries are:

- Stock Broker/Broker
- Sub-broker
- Jobbers
- Portfolio Consultants
- Institutional Investor
- Speculators

**Stock Broker/Broker:** Broker is the registered member of the stock exchange who transacts securities on behalf of his client and gets commission for his services. A broker can be an individual, a corporate or an institution. A broker has to register through SEBI to the stock exchange of which he wants to be the member. He has to pay prescribed registration fee and maintain security deposit with the stock exchange. He must abide by all the rules and regulations and the code of conduct. He should not indulge in any fraudulent and manipulative

transactions and also should not disclose the financial information of his client to anyone. In case of breach of any above condition his registration will be cancelled.

Broker is a very important functionary of stock exchange. A non-member of stock exchange cannot trade in securities directly. Broker arranges sell or purchase of securities on behalf of his client and charges brokerage /brokerage fee which is fixed by the stock exchange. When a non-member hires the services of broker, he makes an agreement with the broker on non-judicial stamp paper. Broker takes margin money from his client to make payment or settlement of trade for that client. The client authorizes the broker to buy or sell securities on his behalf as and when instructed. Broker needs to be prompt, fair and careful in all the transactions.

**Sub-Broker:** A stock-broker is an agent of stockbroker who helps investor/client in trading of securities through a stockbroker. He is not the member of a recognized stock exchange. He gets letter of recommendation from a stock broker who is the member of a recognized stock exchange. Broker is an agent who helps his client in buying or selling of securities. Sub-broker is an agent of broker. As there are limited numbers of brokers in a stock exchange, they are not able to deal with each and every investor. To facilitate this they appoint their sub-brokers who work in a similar fashion. The sub-brokers buy or sell securities in a stock exchange on behalf of their clients. They also get brokerage which is relatively lower than that of the broker. Like broker, the activities of the sub-broker have to be fair, prompt, efficient and careful.

**Jobbers:** Jobbers are the members of stock exchange who buy or sell shares in which they are specialized. They are generally specialized in few shares and are professional speculators. Unlike brokers or sub-brokers they are independent dealers in securities and they buy and sell securities on their own account. They do not work on commission basis but work for profit making. As a dealer in securities, a jobber gives two quotations, lower one for buying which is called 'bid price' and higher one for selling called 'ask price'. The difference between the ask price and bid price is called jobber's spread. It can be negative, zero or positive.

**Portfolio Consultant:** Portfolio is the combination of different kinds of financial securities. There is a risk in holding financial securities and this risk can be reduced by diversifying the portfolio i.e. by including variety of assets or securities in portfolio. Every investor wants an optimum portfolio where return is maximised and risk is minimised. Portfolio consultants are such financial advisors who determine and make an optimum portfolio which maximizes the return on investment and minimizes the risk involved. There are many portfolio consultants in India such as Asset Management Companies, Merchant Banks, etc. They charge some fee for providing their services.

**Institutional Investors:** Institutional investors are the organisations, banks, Non-Banking Financial Institutions (NBFCs), Mutual Fund companies, Life Insurance Corporation of India (LIC) which invest in the securities in stock market. Foreign Institutional Investors (FIIs) are the foreign firms and institutions who invest in country's security market. Security market is highly influenced by institutional investors as their volume of trading is very high as compared to retail/individual investors. They act as trend setters in the securities market as based on their activity in the market i.e. buying or selling affects the market value of the securities. If any

institutional investor is buying any security, the market price of that security will go up and if the institutional investor is selling the security, its market value goes down.

**Speculators:** Speculation means buying and selling of financial security with an expectation to earn profit from anticipated change in the value of that security. Speculators perform import function in valuation of securities. There are four types of speculators in securities market. They are bull, bear, lame duck and stag. Bull is that speculator who expects that the price of securities will rise in future and therefore buys those securities to sell them at higher prices in future and earn profits. Bear is the speculator who expects that there will be fall in securities prices in future. If the prices fall as per his speculation before the delivery date, he will buy those securities at low prices and sells them at higher prices and makes profit.

Lame duck is that speculator who is not able to meet his commitment i.e. unable to buy or sell a certain security at a pre-determined price on a fixed date as that security is not available in the market at his expected price. Stag is an investor in share market who buys and sells share for making fast profits. He generally applies for those shares of the companies in initial public offering (IPO) which are in demand. After allotment as the price rises he sells them and earns profit.

**How stock market works in India**

New companies offer their shares to general public and institutional investors though Initial Public Offering (IPO). The companies file a draft offer document which contains information about company, number of shares on offer, price band and financials with the SEBI. After getting approval from SEBI, they can offer their shares to investors in primary market or New Issue Market. The company then allots shares to investors who bid for them in IPO. The shares are then listed on stock exchange and are now ready for trading in secondary market. Earlier the shares were in paper form. Now they are in electronic form, also called dematerialized form. An investor requires a demat account for buying and selling of securities. Depository Participant (DP), which is an agent of depository, provides demat account facility to investors. Depository is an organization which holds securities of investors in digital form.

When an investor places a buy order online for a particular security, the stock broker/broker places that order in the market and matches it with a sell order from seller. On matching the order is successfully executed. After getting conformation from the stock exchange, confirmation to buyer and seller is also sent. In India, the executed trades are settled on T+2 basis i.e. settlement within two working days from the date of transaction. The shares are transferred to the buyer’s demat account and funds to the seller’s account. All this is done electronically through computer networks and that has reduced the transaction and processing time to a great extent.

## 10.8 ADVANTAGES OF STOCK EXCHANGES IN INDIA

The advantage of stock exchanges in India listed below are categorised from the point of view of investors and companies. Let's discuss them one by one.

**Advantages of stock exchanges to the investors:**

1. Stock exchange provides ready and convenient facility of trading i.e. buying and selling securities at will and at opportune time.
2. Investors do not have to worry about the delivery or payment issues as stock exchanges ensure safety and transparency in transaction dealings.
3. Stock exchange help in pricing of securities and availability of the pricing information about the securities help investors in deciding which securities to buy and when to buy.
4. Investors can get loans against these securities from banks as banks prefer them as collateral because of their liquidity and convenient valuation.

**Advantage of stock exchange to the companies:**

1. Companies whose securities are listed on stock exchange are considered as financially sounds and therefore have better goodwill and credit-rating in the market which helps them in raising capital easily.
2. The market reach to their securities increases due to stock exchanges as investor from all over the world can invest in them.
3. Increased goodwill and better credit rating increases the demand and value of these securities thus enhancing the bargaining power in mergers, acquisitions, etc.
4. The companies can decide the timing, price and size of issue.

## 10.9 BRIEF DESCRIPTION OF ACTIVE STOCK EXCHANGES IN INDIA

At present there are total 9 stock exchanges active in India. They are described as below:

**Bombay Stock Exchange (BSE)** - Bombay Stock Exchange was established in 1875. Started with few brokers under the Banyan tree, opposite of Town Hall in Mumbai (then Bombay), today it is one of the largest stock exchange in India, oldest in India as well as in Asia. As the number of broker increased, their place of working kept changing. Finally, in 1874 they shifted to Dalal Street, brokers' street in English. In 1875, they formed an official organization called 'The Native Share and Stock Brokers Association'. Later on it was renamed as Bombay Stock Exchange. In May 1927, the Bombay Stock Exchange got recognition under the Bombay Securities Contracts Control Act, 1925. Bombay Stock Exchange is considered as the Asia's oldest stock exchange and first one to get permanent recognition under Securities Contract Regulation Act, 1956.

In 1986, BSE launched SENSEX (Sensitive Index), an index to measure the overall performance of the exchange. Earlier there was an open outcry system of trading in BSE, but,

in 1995, BSE switched to automated screen-based electronic trading system called BSE Online trading (BOLT).

**National Stock Exchange (NSE):** National Stock Exchange was set up in 1992 in Mumbai by India's leading financial institutions such as IDFC, IFCI, ICICI, GICI, LICI, SBI Capital Markets ltd, etc. It was the first stock exchange in India to provide modern and fully automated screen-based electronic trading system which gave access to everyone from anywhere to it. It provided easy access and transparency in trading. It became the biggest stock exchange in India in terms of trading volume.

This largest stock exchange of India operates with vision "To continue to be a leader, establish a global presence, and facilitate well-being of people". Nifty 50 is the benchmark index of NSE and it was first launched in 1996. NSE played a very crucial role in establishing the National Securities Depository Limited (NSDL) in the year 1995 to provide depository services to the investors. The securities are held in electronic form in NSDL.

**Calcutta Stock Exchange (CSE):** The second oldest stock exchange in India, the Calcutta Stock Exchange was established in 1908 in Kolkata (then Calcutta). In 1980 it got its permanent recognition by the Government of India under the relevant provisions of the Securities Contracts (Regulation) Act, 1956. It offers trading facilitates in capital markets, options and futures markets of the National Stock Exchange (NSE) and The Bombay Stock Exchange (BSE). Initially, it was set up as Calcutta Stock Exchange Association which later in 1923 became a joint stock company. Now it is public limited company.

**India International Exchange (India INX):** India INX is the first international stock exchange of India. It was established in 2017 in Gift City, Gujarat and is wholly-owned subsidiary of the Bombay Stock Exchange. Unlike other regular stock exchanges where individual stocks are traded, India INX deals in derivatives and debt securities.

India INX has launched an international primary market platform, Global Securities Market to connect global investors with Indian and foreign issuers. This exchange operates 22 hours a day and six days a week to facilitate trading for Non-Resident Indians and global investors. The operating sessions are 4:30 am to 5 pm and 5:01 pm t 2:30 am. It is considered as the world's fasted stock exchange and operates on the world's most advanced technology platform, Eurex T7.

**NSE International Exchange (NSE IFSC):** A wholly-owned subsidiary of National Stock Exchange, NSE International Exchange was established in 2016 in International Financial Service Centre (IFSC), Gift City, Gujarat. Trading of Securities in any international currency except rupees is allowed on this exchange. This exchange operates 16 hours on daily basis in two sessions, 8 am to 5 pm and 5:30 pm to 11:30 pm.

**Multi Commodity Exchange of India (MCX):** Situated in Mumbai, this exchange was established in 2003. It is India's first independent and largest commodity derivatives exchange. It is also the first listed exchange in India. It provides trading platform for commodities such as metals such as Gold, Silver, Copper, Aluminum, Nickel, Lead, etc., crude oil, bullion, agricultural commodities such as cotton, crude palm oil, pepper, rubber, cardamom, etc.,

natural gas and energy. It offers commodity options contracts, base metals futures contracts and bullion index futures contracts. It is the leading derivative exchange in India.

**Metropolitan Stock Exchange of India:** It was founded in 2008 in Mumbai and got recognition under the section 2(39) of the Companies Act, 1956 by the Ministry of Corporate Affairs, Government of India in 2012. Indian public sector banks, private sector banks, domestic financial institutions are some of the shareholders of Metropolitan Stock Exchange of India. It provides high-tech trading platform for capital market, futures and Options, currency derivatives and debt instruments. In 2013, it launched its index SX40 which is a free-float based index of 40 large cap, diversified liquid stocks.

**Indian Commodity Exchange Limited (ICEX):** Indian Commodity exchange is not a regular exchange where shares are traded. It is commodity exchange which trades in commodity derivatives. It got its approval for operation in 2017. It is located in Mumbai.

**National Commodity and Derivatives Exchange (NCDEX):** National Commodity and Derivatives Exchange is an online commodity exchange founded in 2003 in Mumbai. It is a public limited company and provides platform for trading in commodity derivatives. It is leading agriculture commodity exchange in India and includes 23 commodities such as spices, pulses, guar, etc. It offers options contracts for five agriculture commodities and future contracts for 21 agriculture commodities on the exchange platform.

***Check Your Progress B***

**Q1. Write any three differences between broker and jobber.**

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**Q2. Write short note on institutional investors.**

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**Q3. Define spread.**

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## 10.10 SUMMARY

- A stock exchange is defined as “any body of individuals, whether incorporated or not, or a body corporate incorporated under the Companies Act, 1956, for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities”.
- The objectives of stock exchange are capital formation, facilitate trading, to ensure security and transparency, to inculcate habit of saving, to raise financial awareness, to present correct information, to provide convenience of trading, to protect investors from frauds, to form a link between borrower and investor and help in development of the country.
- Institutional investors are the organisations, banks, Non-Banking Financial Institutions (NBFCs), Mutual Fund companies, Life Insurance Corporation of India (LIC) who invest in the securities in stock market. Foreign Institutional Investors (FIIs) are the foreign firms and institutions who invest in country’s security market. They are the trendsetters in the securities market.
- In India there are 9 active stock exchanges. Bombay Stock Exchange is the first stock exchange in India and was established in 1875. There were more than two dozen stock exchanges operating in India, but 19 have been granted exit by SEBI.
- The various functionaries in stock exchange are stock broker, sub-broker, jobber, portfolio consultant, institutional investors and speculators.

## 10.11 GLOSSARY

**Financial markets –** Financial market is a place where or a mechanism through which the participants deal in financial instruments such as equity, bonds, currency, etc.

**Capital Markets –** In capital markets financial securities of medium and long term maturity i.e. more than one year are traded. They are of two types: primary market and secondary market.

**Money Markets –** In money markets financial securities of short term maturity i.e. less than one year are traded.

**Stock Exchange -** Stock exchange is defined as any body of individuals, whether incorporated or not, or a corporate body, incorporated under the Companies Act, 1956, for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.

**Demutualization** - It is the process through which any member-owned organisation can be made shareholder-owned company and such company can be listed on a stock exchange.

**Institutional Investors -** Institutional investors are the organisations, banks, Non-Banking Financial Institutions (NBFCs), Mutual Fund companies, Life Insurance Corporation of India (LIC) which invest in the securities in stock market.

**Foreign Institutional Investors (FIIs)** - Foreign Institutional Investors (FIIs) are the foreign firms and institutions who invest in country's security market.

**Portfolio –** It is the combination of different types of financial securities held by an investor.

**Portfolio Consultant -** Portfolio consultants are such financial advisors who determine and make an optimum portfolio which maximizes the return on investment and minimizes the risk involved.

**SEBI –** Securities and Exchange Board of India.

## 10.12 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress A**

**Ans 1**

i. Stock Exchange
ii. SEBI
iii. 9
iv. 19

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## 10.14 TERMINAL QUESTIONS

Q1. List the advantages of stock exchanges in India.
Q2. Explain the role of broker in stock exchange.
Q3. Explain how sub-broker is different from broker.
Q4. What happen when an investors places a bid to buy shares?
Q5. Write short note on NSE.
Q6. What is bid price and ask price?
Q7. What is the function of portfolio consultant?

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# Indian Financial System

**DEPARTMENT OF MANAGEMENT STUDIES**

**Block III Financial Intermediaries**

**Block IV Financial Instruments**

**MS 402**

# Indian Financial System

## Block – III
**Block Title- Financial Intermediaries**

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**Block Title- Financial Instruments**

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## Course Name: Indian Financial System

## Course Code-MS 402

**Course Objective:** This course aims at providing the students the intricacies of Indian financial system for better financial decision making.


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**Unit XXIII Current Developments in the Indian Financial System**

**Suggested Readings:**


1. Machiraju, 'Indian Financial System' – Vikas Publishing House, 2nd Edition, 2002.
2. Varshney P.N., & Mittal D.K., 'Indian Financial System', Sultan Chand & Sons, New Delhi. 2002.
3. Verma J.C., 'Venture Capital Financing in India', Sage, New Delhi, 1997.
4. Sadhale H., 'Mutual Funds in India', Sage, New Delhi, 1997.

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# Block III

## Financial Intermediaries

# UNIT 11 ROLE OF FINANCIAL INTERMEDIARIES

**11.1 Introduction**

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**11.3 Financial System**

**11.4 What is Financial Intermediary?**

**11.5 Capital Markets**

**11.6 Role of Financial Intermediaries**

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## 11.1 INTRODUCTION

A financial system is a backbone of the economy of any country. A robust and well-developed financial system is very essential for proper channelizing and mobilizing funds in a country. L. M. Bhole has defined financial system "as a set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy". A Financial system includes various entities or sub-systems such as banking and non-banking financial institutions, financial instruments, financial markets and financial services which help in efficient, effective and smooth allocation and transfer of funds.

Financial system can be broadly classified into two types: formal and informal financial system. The formal financial system is institutional, organised and regulated system while the informal financial system is non-institutional, unorganised and unregulated system. Limited or no access to financial services, lack of financial literacy, higher transaction cost, a lot of paperwork and mortgage requirements, etc. helps in thriving the informal financial system in a country.

The Indian financial system consists of formal financial system and informal financial system. The formal financial system is regulated by various regulatory bodies such as the Reserve Bank of India, which is the apex bank in India, the Ministry of Finance, the Securities and Exchange Board of India (SEBI), etc. It consists of commercial banks, co-operative banks, mutual funds, capital markets, etc. A formal financial system has to follow

the rules and regulations set by the regulatory bodies. An informal financial system is unregulated and mainly consists of moneylenders, chit-fund companies, etc. These moneylenders exploit the borrowers by charging the exorbitant amount of interest on the money they have given on loan. Due to the lack of financial services in rural areas, people still have to depend on these informal financial service providers.

Financial Intermediaries are those entities or organisations which act as a link between the lender and the borrower. They act as an intermediary between those who have excess fund and those who are need of funds. They help in facilitating the financial transaction between the investors and the borrowers. These financial intermediaries are helping in reducing the gap between the needy and the one who has surplus funds.

## 11.2 OBJECTIVES

After studying this unit, you should be able to;

- Describe the financial system
- Explain various components of a financial system
- Describe the capital market
- Explain financial intermediaries
- Explain the various types of financial intermediaries
- Describe the roles of financial intermediaries
- Explain the importance of financial intermediaries

## 11.3 FINANCIAL SYSTEM

Financial system plays a very important role in the development of an economy. It is a set of closely-connected and complex institutional arrangements through which the surplus funds from individuals, organisations or firms are channelized to the individual or institutional borrowers. The institutional arrangement takes care of all the mechanisms involved such as production, distribution, exchange and holding of all types of financial instruments, the operation of all financial markets and institutions.

"A financial system consists of various institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments." – Prasanna Chandra.

"Financial System is a set of institutions, instruments and markets which fosters saving and channels them to their most efficient use." – H.R. Machiraju.

The important functions of a financial system are to encourage people to save more, proper channelize these savings and use these savings to increase the productivity in an economy. The pooling of these small savings from a large number of savers can create a big amount of money which can help the big industrial borrowers in getting their need of large capital

fulfilled. This will put these savings to efficient, effective productive use. The savers will get return on their investments and the borrowers will get the capital to sun their businesses.

## 11.3.1 COMPONENTS OF A FINANCIAL SYSTEM

A financial system is set of various components. Their proper coordination is very essential for the smooth functioning of an economy. A strong financial system of an economy increases productivity and thus helps in the development of that economy. A financial system of an economy has following main components.

1) Financial instruments,
2) Financial markets
3) Financial Services and
4) Financial institutions

### 11.3.1.1 Financial Instruments

A financial instrument is a claim against a person or an institution for payment of a sum of money at a future date or a payment in the form of interest or dividend. It is a monetary contract between two parties.

The *Association of Chartered Certified Accountants (ACCA)* defines financial instrument as "a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity." These instruments include cash, deposits, trade receivables, loans to other entities, debt instruments, shares, debentures, etc.

Financial instruments, also called securities are tradable in the market and are negotiable. They are classified as primary/direct securities and secondary/indirect securities. Primary/direct securities are securities created and offered to the general public for investment by the ultimate borrowers. Examples of primary securities include equity shares, debentures, etc. Secondary/indirect securities are those financial securities which are issued by financial intermediaries to the savers. Examples of secondary securities are policies by insurance companies, mutual funds, bank deposits, etc.

### 11.3.1.2 Financial Markets

Second important component of a financial system is financial market. A financial market is the channel between individual/institutional investors and individual/institutional borrowers. Financial market is a place where or a mechanism through which the participants deal in financial instruments such as equity, bonds, currency, etc. Financial markets in India are divided in to two categories: Money market and capital market.

**Money Market:** In the money market, short term securities which have a maturity period of less than one year are traded. To meet the temporary or short term requirement of cash and obligations, money market enables raising short term funds and also in deployment of surplus funds to earn short term returns on the investment. It helps in maintaining the equilibrium in short term surplus and deficiency of funds. It is the source of working capital for the institutions. Examples of short term securities are Promissory Notes, Treasury Bills, Call Notes, Bills of Exchange, etc.

**Capital Market:** In the capital market, the securities which have long term maturity. i.e. more than one year are traded. The focus of this market is on fixed investment. The major participants in this market are insurance companies, corporate and retail investors, mutual fund companies, institutional investors, etc. Capital markets are further classified as: primary markets and secondary markets. In primary markets, also called New Issue Markets (NIM), new financial securities are offered to the investors. These securities are offered for the first time, hence the name New Issue Market. Raising of additional capital through Initial Public Offering (IPO) or debentures takes place in a primary market.

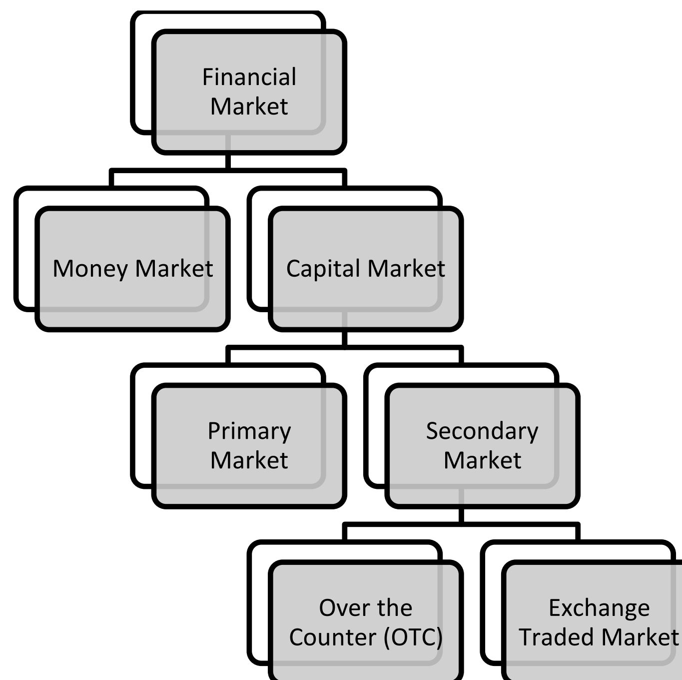


**Fig. 11.1 Financial Markets**

In secondary market, existing securities are sold or transferred from one investor to another. Over The Counter (OTC) market and the exchange traded market are two components of secondary market.

### 11.3.1.3 Financial Services

These are the services provided by various financial institutions in channelizing or mobilising the savings from individual / institutional investors to the individual/institutional borrowers. Financial services are classified as: fund-based financial services and non-fun based or fee-based financial services. Various banking services such as accepting deposits, providing loans are performed by the commercial banks. Development banks get funds from the government and lend them for the development projects. Non-banking services are performed by various non-banking institutions such as mutual fund companies, insurance companies. They collect savings from the investors and provide loans to institutional investors, invest in

the capital market. The examples of financial services are provision of funds such as asset financing, venture capital, trade financing, etc., managing investible funds such as mutual funds, portfolio management, etc., risk financing, consultancy, market operations, etc.

#### 11.3.1.4 Financial Intermediaries

Financial intermediaries are the financial institutions which facilitative the mobilizing of funds in the economy, i.e. collecting the surplus funds from the investors and lending them to the borrowers. Financial intermediaries are banking institutions such as commercial banks, development banks, private banks, etc. and non-financial institutions such as life insurance companies, mutual fund companies, stock exchanges, financial brokers, etc. We will study in detail about financial intermediaries in next section.

## 11.3.2 FUNCTIONS OF FINANCIAL SYSTEM

Financial system is the backbone of any economy. The strong financial system of an economy leads to the growth of that economy. The most important function of the financial system in to mobilize savings and help them channelizing into productive investment. The other functions of a financial system are explained as below:

1. **Supply of money/liquidity** – For the uninterrupted working of the industrial sector and production, continuous supply is very essential in any economy. An efficient and strong financial system can ensure this liquidity in to an economy of that country.
2. **Mobilization of savings** – By encouraging people for savings, a large pool of savings can be created. These savings can provide the capital required for the production of goods and services in the country. Banks accept deposits from the savers and provide these as loans to the borrowers. Savers get returns in terms of interest on their savings and borrowers get capital to run their businesses by paying interest, thus, financial system plays an important role of mobilizing these savings from surplus fund units to the fund deficit units.
3. **Channelizing savings into productive investment -** Mere savings cannot help in the development of an economy. These savings need to be put to the most productive uses. An individual investor may not have the knowledge about financial markets or which financial instrument to choose for maximum gain. Financial intermediaries have infrastructure, expertise and information about the correct investment option for the individual. They can help these individuals in choosing the right investment option.
4. **Efficient functioning of payment mechanisms –** Financial system plays significant role in the efficient functioning of payment mechanisms buy ensuring safe, smooth and swift transactions.
5. **Transformation services –** Various transformation services provided by financial institutions are:
    - **Maturity transformation function –** Financial intermediaries can design different investment products as per the needs and preferences of the investors.

Similarly, they provide different products as per the needs, preferences and maturity requirements of the borrowers. This is maturity transformation function.

- **Size transformation function –** Banks accept small deposits from large number of savers. This pooling of large number of saving can help banks to give large amount of loans to fund deficit units. This is size-transformation.
- **Liability- asset transformation function –** Individuals and organizations deposit their money in the banks. These deposits are assets for these individuals and organizations but liabilities for the banks as they have to pay interests on these deposits. Banks lend this money to the borrowers and get interest on these loans. These liabilities become assets for the banks. This asset-liability transformation.
- **Risk transformation function –** The developed financial system has diverse financial instruments which will give better and diverse investment options to the investors to choose from. This diversification helps in reducing risk. This is called risk transformation.

## 11 .4 WHAT IS FINANCIAL INTERMEDIARY?

Financial Intermediary is an institution or a firm which acts as a link between the saver and the borrower. The saver and the borrower can be individual or institutional. Financial intermediary facilitates the mobilisation of public funds for the productive utilisation so that the public earns some return on their invested funds. This surplus fund collected from the public is given as loan to the individual or institutional borrowers who are in need of funds for their day-to-day or business operations.

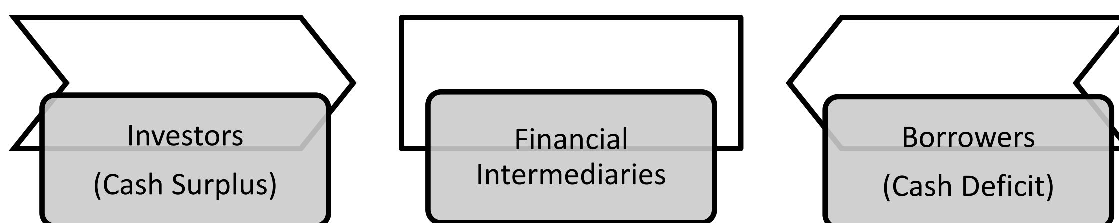


**Fig.11.2 Financial Intermediary**

The financial intermediaries are financial service providers. The financial service provider can be a bank, a non-banking finance company or a mutual fund company. The consumer is a borrower who needs funds for carrying out certain economic activities. There are many people who have surplus funds after meeting out all their expenses. They would like to invest those funds and earn better returns. At the same time there are borrowers who are need of

funds for their economic activities. Financial intermediaries constitute that link between the people who want to invest their surplus fund and the people who are in need of fund. They channelize surplus cash from individuals or organisations savers to the individual or institutional borrowers.

## 11.4.1 ADVANTAGES OF FINANCIAL INTERMEDIARIES:

Advantages of financial intermediaries to borrowers:

- Large fund requirement is met with the help of the financial intermediaries.
- Possibility of getting funds at low rate of interest.
- Involvement of financial intermediaries increases the chances of availability of funds.

Not only the borrowers, but also the lenders are benefitted from financial intermediaries. The benefits of financial intermediaries to lenders are as follows:

- The first and foremost advantage is low risk. The funds collected from the savers are lent to several people. This minimizes the risk. Also, financial intermediaries scrutinize the borrowers before lending which helps in lowering the risk.
- Offer greater liquidity.
- Customized financial services as per the requirement of the customers.
- There is a convenience of transaction when financial intermediaries are involved in the trade.
- Saving in time and costs.

## 11.4.2 FUNCTIONS OF FINANCIAL INTERMEDIARIES

The various functions of financial intermediaries are as given below:

- The first and foremost important function of financial intermediaries is to collect funds from surplus fund units and channelizing them to the fund deficit units i.e. to convert the savings into the investments.
- To provide short term and long term loans.
- To help the clients in investing their money to maximize their returns.
- To reduce risk by diversifying the savings of clients into diverse financial instruments.

## 11.4.3 TYPES OF FINANCIAL INTERMEDIARIES

Financial intermediaries are the important component of a financial system. Financial institutions are the most important source of finance to the manufacturing industry of a country. They are important for the growth and development of an economy. They help in channelizing the funds from fund surplus units to the fund deficit units thus providing capital to the industries and businesses. They not only play important role in money market but also

in the capital market. The various financial institutions acting as intermediaries in the financial market are as follows:

1. Commercial banks
2. Non-Banking Financial Companies (NBFC)
3. Development Financial Institutions (DFI)
4. Mutual Funds
5. Insurance companies
6. Stock Exchanges Stock Exchanges: These include the NSE (National Stock Exchange), BSE (Bombay Stock Exchange), MCX (Multi Commodity Exchange), etc
7. Financial/Stock Brokers
8. Underwriters
9. Depository and Depository participants
10. Registrars

# 11.5 CAPITAL MARKETS

We have already studied about money market and capital market in the previous section. In capital market, all those securities which have maturity period more than one year are traded. Capital markets are of two types: primary capital market and secondary capital market. In primary market, for capital formation fund raising is done through public issue, private placement, rights issue and preferential issue. In primary capital market, new securities are traded. In secondary capital market, the existing securities are traded. The secondary market provides liquidity and marketability to the old and existing equity as well debt instruments.

The secondary market is further classified as: Over The Counter (OTC) market and the exchange traded market**.**

## 11.5.1 CHARACTERISTICS OF CAPITAL MARKETS:

- Large volume of trade and transaction.
- High volatility and therefore, susceptible to panic and distress selling.
- Affected by negative externalities such as failure one segment affects other segments.
- Timing is very crucial in capital markets.
- Due to integration of domestic markets with international markets, domestic markets can get adversely affected by the vulnerability or failure of any international market.

Therefore, these markets need close supervision and monitoring to safeguard the interest of investors and to reduce and diversify the risk. For this, Securities and Exchange Board of India (SEBI) was established in 1992. The functions of SEBI are listed as below:

- A regulator of all the activities of the capital market.
- To curb malpractices such as false issue, insider trading, delay in delivery, violations of rules and regulations of stock exchanges.

- To protect the rights of investors.
- To protect the investments of the investors.
- To develop a code of conduct for the intermediaries such as banks, non-banking institutions, mutual fund companies, insurance companies, etc.

The capital market financial intermediaries are individuals, financial or non-financial institutions or firms who act as a mediator to facilitate a negotiation, investment deal, business deal, etc.

## 11.5.2 THE CAPITAL MARKET FINANCIAL INTERMEDIARIES

The capital market financial intermediaries are broadly classified into two categories:

A. Banking institutions and
B. Non-banking institutions.

**A. Banking Institutions:** Banking institutions are the backbone of financial system of a country. They play a very important role in the money market as well as the capital market. In capital market, they provide medium term and long term funds to the fund deficit units. They form a link between the savers and borrowers by collecting funds from the surplus funds units and make them available to the fund deficit units. They are the creator as well as supplier of credit. They are divided into two categories: Public sector banks, also called nationalised banks and private sector banks. There are many Indian private banks can as well as foreign banks who are offering financial services in India. There are many Regional Rural Banks (RRBs) and co-operative banks which also look after the financial services in rural region along with the urban India. In capital market, all these banks play a very significant role.

**B. Non-banking institutions:** The various non-banking financial intermediaries are: National and state level Development Financial Institutions (DFIs), Non-banking Finance Companies (NBFCs), investment institutions, insurance companies, mutual funds companies, stock exchanges, depository participants, etc.
They are explained separately along with their role in capital market in the following section.

***Check Your Progress- A***

**Q1. What are the components of a Financial System?**

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**Q2. What is Financial Intermediary?**

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**Q3. What are the characterises of financial intermediary?**

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## 11.6 ROLE OF FINANCIAL INTERMEDIARIES IN CAPITAL MARKETS

There are various financial intermediaries involved in capital market which provide different financial services in primary and secondary capital market.

### 11.6.1 INTERMEDIARIES INVOLVED IN PRIMARY MARKET

In primary market new capital is raised through fresh or new issue of securities. Through bonus issue, prospectus, private placement and rights issues, capital or funds are mobilised in the primary market. Sometimes to increase the liquidity of their stock, to reduce the stock price or to restructure their capital, companies issue bonus shares. Bonus shares do not bring fresh capital but help in converting the retained earnings into capital.

In India, private companies, government and non-government companies, banks and financial institutions raise new capital through prospectus, public subscribes, private placement and rights issues. Through prospectus and public subscribes, issues are offered to general public. Merchant bankers are appointed by the companies for organising these public issues. Public issue of new securities has to follow a procedure led by SEBI and it takes time and money to raise capital through this method. By private placing of securities, companies can raise capital in less time than public issue. In private placement, no prospectus is required to be issued and company sells securities to some selected individual investors or institutional investors.

There are three important components of primary market. They are: the issuers of securities, the intermediaries and the investors who are interest in buying these securities. The intermediaries are the entities who provide services to both the other entities in selling and buying of new issue of securities.

The various intermediaries involved in new issue of securities are Book Running Lead Managers (BRLM), registrars to the issues, Syndicate members, bankers to the issue, escrow companies, underwriters, depository participants, solicitors, auditors, etc.

## 11.6.2 ROLE OF FINANCIAL INTERMEDIARIES INVOLVED IN PRIMARY MARKET

In the previous section we have already studied about the primary market, how funds are raised and the various intermediaries involved in the market. The role of these intermediaries will be described in the following section:

A. **Book Running Lead Managers (BRLM):** Book Running Lead Managers (BRLM) are the merchant bankers who are registered with SEBI as per the SEBI Merchant Bank Regulations, 1992. The lead merchant banker undertakes all the pre-issue activities such as due diligence of management, operations, legal, business plans, strategies, etc., offer document drafting and designing, prospectus finalising, deciding strategies to be adopted for the marketing of issue, ensuring fulfilment of all the stipulated requirements and formalities with the Registrars of Companies (ROC) and Stock Exchanges.
   After the public offer is made, the lead merchant banker assumes the post-issue responsibility. The post-issue activities includes managing the escrow accounts in which the funds are deposited from public who have applied to the new issue, co-ordinating with the other intermediaries who are involved in the issue process, intimation of allocation of securities to the applicants, non-institutional allocation, listing and trading of securities, dematerialising of securities and coordinating with registrars for sending the refunds to the applicants who couldn't get the securities allotted.

B. **Registrar to the Issue:** After the issue offer is made, individual and institutional investors apply to the issue though various banking and non-banking institutions who provide trading services. Through book-building offer price of the securities is decided. The money is collected from the investors who have applied to the issue. The registrar to the issue undertakes following activities:
   - Finalising the list of allottees
   - Ensuring crediting of shares to the demat accounts of eligible allottees. It is compulsory to issue all the new Initial Public Offering (IPOs) in dematerialised form.
   - Coordinating with merchant banker for dispatching refund order to the people who didn't get the securities allotted.

C. **Bankers to the Issue:** Lead merchant banker appoints bankers in all the mandatory collection centres for carrying out following functions:
   - Collecting application amounts,
   - Transferring this application amount to the escrow accounts and

- Dispatching the refund amounts to the applicants who did not get the issue allotment.

### 11.6.3 INTERMEDIARIES IN SECONDARY MARKET

The secondary market is commonly called stock market. It is the market where the existing securities are bought and sold again.

- Commercial Banks
- Investment Banks
- Non-Banking Finance Companies
- Credit Unions
- Stock Exchanges Stock Exchanges: These include the NSE (National Stock Exchange), BSE (Bombay Stock Exchange), MCX (Multi Commodity Exchange), etc
- Mutual fund companies
- Insurance companies
- Financial/Stock Brokers
- Underwriters
- Depository and Depository participants
- Registrars
- Clearing Corporations

### 11.6.4 ROLE OF FINANCIAL INTERMEDIARIES IN SECONDARY MARKET

#### 11.6.4.1 Commercial Banks

The commercial banks form the major component of the structured financial system. The main function of the commercial banks is to accept deposits from the savers, individual as well as institutional and mobilize these savings to the borrowers, again individual as well as institutional. They are creator as well as supplier of credit to the individual and organizations. Commercial banks provide financial services to both money and capital markets.

Since last few decades, commercial banks have started diversifying their forms of financing. They are not only deposit or lending banks anymore or their scope is not limited to money market only. They have successfully ventured into capital market by subscribing directly to the shares and debentures of corporate enterprises and also by lending against them. They play an important role of financial intermediary in handling the payment mechanism in stock trading. When a person sells shares, the amount after deducting all the brokerage and other fees gets credited to his bank account. Similarly, when a person buys shares, his bank account will get debited for that amount. Banks, on behalf of their merchant banking subsidiaries, also acts as custodian of securities.

Banks directly or indirectly play various roles in capital market. They are summarized as follows:

- Investor in financial securities such as shares, debentures, equity-oriented mutual funds.
- Lending to individuals for investing capital markets.
- Lender for paying advances against financial securities to individuals.
- Lender to sub-brokers and market makers by providing them advances.
- Financer to stock-brokers for margin trading.
- Lender to provide advances for any purpose where financial securities such as shares, debentures, etc. are taken as primary security.
- Providing venture capital funds.
- Providing bank loans for financing promoter's contribution.
- Provide loans to corporates against the shares, debentures, etc taken as security.
- Offering bridge loans to organizations against expected equity flow/issues.

**11.6.4.2 Non-Banking Financial Companies (NBFC)**

Non-Banking Financial Companies are very much similar to commercial bank except that their deposits are not part of the money supply. They accept public deposits and offer this money as loan for a period of one year more. They provide various services which are listed as below:

- Providing consultation services to organizations on various financial matters regarding corporate mergers, loan syndication, underwriting new issue, etc.
- Providing finance to firms for purchasing industrial equipments on hire-purchase basis.
- Providing finance to household for purchasing durable consumer goods.
- Lending equipments on lease.
- Assessing and providing information regarding the credit-worthiness of various corporate houses.
- Providing factoring services.

Non-Banking Finance Companies are the major players in capital market. There are some specialized NBFCs whose function is only trading in securities. They are exclusively engaged in investing in capital market. They also provide loans to investor for capital market investments. Therefore, they are an important financial intermediary in capital market for providing liquidity in the market. Their role in capital market is summarized as below:

- Investment Company. They are financial institutions whose main business is trading and acquiring securities in capital market.
- Offer portfolio management services.
  NBFCs are required to invest at least 5 percent of their outstanding deposits in unencumbered approved Indian Securities such as State/Central Government securities and bonds at the close of business on the last working day of the second preceding quarter as specified by the RBI from time to time[1].

**11.6.4.3 Development Financial Institutions (DFIs)**

These financial institutions are established by governments or charitable institutions for providing funds to the economic development projects. They are also called as Development Finance Companies. They provide capital to specific types of industries on non-commercial basis. They do not raise funds by accepting public deposits but either they borrow from government or through sell of their bonds to general public. They provide services such as financial and technical support to various sectors, subscribers of securities like share, debentures, etc., company's guarantor to the bank, underwriting, consultancy services, etc. The various development financial institutions in India are: Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Development Bank of India (IDBI), Industrial Reconstruction Corporation of India (IRCI), Small Industries Development Bank of India (SIDBI), National Bank for Agriculture and

Rural Development (NABARD), Export-Import Bank (EXIM), State Financial Corporations (SFCs), National Industrial Development Corporation (NIDC), etc.

**11.6.4.4 Mutual Funds**

For small investors, people with very less or no knowledge of securities market, it is difficult to invest in securities market. Mutual funds provide that opportunities to these investors. Mutual fund is a financial intermediary which helps collective investment of pooled money from many investors in the securities. Investors get share in the securities such as shares, debentures, bonds, etc. pro rata of their invested amount.

"Mutual fund is a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments or gold or gold related instruments or real estate assets" – SEBI Regulations, 1996.

It is managed by professional managers, called fund managers and the objective is to help the investors' money to grow. These fund managers create a diversified set of securities to invest in and is called portfolio. Equity funds, debt funds, hybrid funds, balanced funds are some of the categories of mutual funds.

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1 Khan, M.Y., 'Indian Financial System', McGraw Hill Education (India) Pvt. Ltd., Chennai, 10th Edition, 2018.

### 11.6.4.5 Insurance Companies

Insurance companies have also become very important intermediaries in capital market. Along with life insurance, these companies are also offering various investment plans. The money collected from investors of these plans is invested in capital market. There are many public sector as well as private insurance companies providing their services in India. They have large amount of financial resources which are invested in money and capital market. Some of the well known insurance companies in India are Life Insurance Corporation of India (LIC), Oriental Insurance Company, General Insurance Corporation of India (GIC), United India Insurance Company Ltd., National Insurance Company, SBI Insurance, HDFC Life, etc.

### 11.6.4.6 Stock Brokers

Stock brokers are individuals or organisations who can sell or buy securities for retails as well as institutional investors/clients through a stock exchange they are registered with. They are the gateway to the recognised stock exchange they are member of. They charge fee for the services they provide. The various services they offer are trading platform, call and trade facility, buying and selling of securities on client's behalf, issuing contract notes for transactions, etc.

### 11.6.4.7 Underwriters

Underwriters are the individuals or institutions who undertake the risk with associated with the public issues of securities and distribution of securities from the issuing body. If the Initial Public Offering (IPO) issue is not fully subscribed by the public then underwriter guarantees to purchase a certain percentage of shares of that company.

In capital market, underwriter determines the price and risk associated with a particular stock.

In IPOs, investment banks first buy or underwrite the securities of the issuing entity and then sell them in the market. The underwriters get premium for this service and the issuers get his IPO fully subscribed.

Information provided by the underwriters help investors in making more informed and correct investment decision.

### 11.6.4.8 Depository and Depository Participants (DP)

Prior to 1996, the shares used to be in physical paper forms. Whenever an investor used to purchase shares of a company, he was issued physical paper form shares. It was difficult to maintain these shares and protect them from damage or loss. In 1996, these physical shares were converted into digital form, called dematerialised form. Just like bank accounts, these demat shares need an account to be held in. These accounts are called demat accounts where securities are held in digital form.

In depository, financial securities are held in digital or dematerialised form. It maintains the records of ownership and facilitates trading of securities in dematerialised form. In India, there are two depositories at present. They are National Securities Depository Limited

(NSDL) and Central Depository Services (India) Limited (CDS). Since 1996, it is mandatory to hold securities in digital form in demat account.

Depository Participants are agents of a depository who are intermediaries between depositories and investors. To avail the depository services, investors have to open demat account with a depository participant. Using demat account, investors can easy buy or sell securities online.

### 11.6.4.9 Clearing Corporations

Clearing corporations, also called clearing house, is the organizations established to supervise the handling of trade execution, settlement of money, and delivery of securities. To handle trading, clearing and settlement of transactions in the stock market, the Clearing Corporation of India Limited (CCIL) was established in the year 2001. CCIL is subsidiary of Bombay Stock Exchange (BSE). National Security Clearing Corporation Ltd (NSCCL) was established for clearing the trade settlements of National Stock Exchange (NSE) and is fully owned subsidiary of NSE. The function of clearing corporation is to facilitate smooth transaction process of purchase on one end and sale on the other and to ensure that trades closed successfully. It also ensures that the settlement takes place in short time period. It keeps check on the transaction risk and provides a counter-party risk guarantee. To carry out the transaction settlements efficiently and avoid the operational issues to protect the financial system from the risk arising out of it is the main function of CCIL.

Clearing corporations perform following functions:

- Guaranteed clearing and settlements of security transaction in capital market.
- Ensuring transparency in security transactions.
- Liquidity risk management by ensuring that buyer and seller will not default once the transaction of securities is made.
- Risk management to ensure negligible procedural losses to the investors in transactions in case of default by an investor.
- Improving market efficiency.

### 11.6.4.10 Registrars

Registrar is an institution or trust that maintains the detailed records of all the securities transactions offered by issuer to the public. Registrars maintain and update from time to time all the records of securities issued. The records include the name, address, number of securities bought, signature, etc. They shoulder various responsibilities such as paying debentures, issue of new share certificate in case of loss or damage to the original share certificate. The various roles and responsibilities undertaken by Registrars are given as below:

1. Maintain register of shareholders and update it from time to time.

2. Issue share certificate to new shareholders and the existing shareholders if anyone has misplaced or lost his/her certificate.
3. Organize Annual General Meetings (AGM).
4. Send annual reports to all the shareholders.
5. Supervise the dividend payouts to the shareholders.
6. Facilitate the transfer of shares in case an existing shareholder deceased and also if there is any mutual transfer.
7. Print broker's holdings and client's holding statements

#### 11.6.4.11 Stock Exchanges

To simplify the process of buying and selling of securities stock exchanges were established. It is a platform where people buy or sell stocks of companies.

As per the Section 2(3) of the Securities Contracts (Regulation) Act, 1956, "stock exchange is defined as any body of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities".

The main function of stock exchange is to facilitate the stock transactions and the entire process of stock trading. Stock exchanges levy transaction fees to earn revenue. There are regional stock exchanges, Bombay Stock Exchange (BSE), National Stock Exchange (NSE) in India where stocks are traded.

## 11 .7 SUMMARY

A financial system is set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy. Financial institutions, financial markets, financial instruments and financial services are four important components of a financial system.

Financial system can be broadly classified into two types: formal and informal financial system. The formal financial system is institutional, organised and regulated system while the informal financial system is non-institutional, unorganised and unregulated system.
The Indian financial system consists of formal financial system and informal financial system. The formal financial system is regulated by various regulatory bodies such as the Reserve Bank of India, which is the apex bank in India, the Ministry of Finance, the Securities and Exchange Board of India (SEBI), etc. An informal financial system is unregulated and mainly consists of moneylenders, chit-fund companies, etc.
Financial Intermediaries are those entities or organisations which act as a link between the lender and the borrower. They help in facilitating the financial transaction between the investors and the borrowers.

Financial market is a place where or a mechanism through which the participants deal in financial instruments such as equity, bonds, currency, etc. Financial markets are broadly classified as money markets and capital markets.

In capital markets financial securities of medium and long term maturity i.e. more than one year are traded. They are of two types: primary market or New Issue Market and secondary market or stock market.

The capital market financial intermediaries are individuals, financial or non-financial institutions or firms who act as a mediator to facilitate a negotiation, investment deal, business deal, etc. There are various financial intermediaries functioning in Indian capital market. They are commercial banks, NBFCs, stock brokers, underwriters, depository and depository participants, registrars, stock exchanges, mutual fund companies, insurance companies, clearing corporations, etc.

In India, RBI, SEBI and other such regulatory bodies monitor the financial markets regularly, set rules and regulations and amend them from time to time to protect the interest of all the investors. For a strong and robust financial system, all its components have to work in coordination. A strong financial system is very important for the growth and development of an economy and a country.

## 11.8 GLOSSARY

**Financial System** – It is a set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy.

**Financial Intermediaries** – Financial Intermediaries are those entities or organisations which act as a link between the lender and the borrower. They act as an intermediary between those who have excess fund and those who are need of funds.

**Financial markets –** Financial market is a place where or a mechanism through which the participants deal in financial instruments such as equity, bonds, currency, etc.

**Capital Markets –** In capital markets financial securities of medium and long term maturity i.e. more than one year are traded. They are of two types: primary market and secondary market.

**Capital market financial intermediaries** - The capital market financial intermediaries are individuals, financial or non-financial institutions or firms who act as a mediator to facilitate a negotiation, investment deal, business deal, etc.

**Money Markets** – In money markets financial securities of short term maturity i.e. less than one year are traded.

**Financial Instruments** – A financial instrument is a claim against a person or an institution for payment of a sum of money at a future date or a payment in the form of interest or dividend. It is a monetary contract between two parties.

**SEBI –** Securities and Exchange Board of India is a statutory regulatory body which regulates the securities and commodity markets in India.

**Clearing corporations** - It is the organisations established to supervise the handling of trade execution, settlement of money, and delivery of securities.

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## 11.11 TERMINAL QUESTIONS

Q1. Describe financial system.

Q2. What is financial market? What are the types of financial market?

Q3. Write short notes on:

a. Financial instruments
b. Capital Markets
c. Registrars to the issue

Q4. Explain the role of commercial banks in capital market

Q5. What is the role of clearing house in secondary market?

Q6. Explain the role of financial intermediaries involved Initial Public Offering (IPO).

Q7. Explain depository and depository participants.

# UNIT 12 RESERVE BANK OF INDIA

**12.1 Introduction**

**12.2 Objectives**

**12.3 Origin of RBI**

**12.4 Objectives of RBI**

**12.5 Organization & Management**

**12.6 Role of RBI**

**12.7 Functions of RBI**

**12.8 Board of Financial Supervision (BFS)**

**12.9 Credit Control by RBI**

**12.10 Departments of RBI**

**12.11 Training Institute of RBI**

**12.12 Summary**

**12.13 Glossary**

**12.14 Reference/ Bibliography**

**12.15 Suggested Readings**

**12.16 Terminal & Model Questions**

## 12.1 INTRODUCTION

The Reserve Bank of India (RBI) was set up as the central bank of the nation. It was established on 1 April 1935. It was emerged as a statutory organization by passing the Reserve Bank of India Act of 1934. It is the apex financial institution of Indian financial system.

The prime functions of the apex monetary institution ie. Reserve Bank of India are regulatory, supervisory, controlling and development orientation of the financial system of India. Other responsibilities on the institution is to maintain monetary stability, Currency Management and the supervision of systems in relation to financial and payment.

As the additional responsibility, the central bank also reviews and restructures the economic policies of the country depending upon the economic condition and need of the hour. In this regard the bank formulates and implements economic policies, at the same time it maintains proper exchange of currency.

Therefore, a comment can be quoted that there are multidisciplinary functions by its nature, performed by RBI. Managing currency circulation, identification of priority sectors and maintaining credit flow to these sectors, maintaining price stability and financial stability, and being the leader for development of potential markets and systems are the major functions of RBI in Indian economy as central bank. The head office of RBI is located at Mumbai.

In this unit, you will study about the roles & functions of RBI in details and also a major focus will be drawn to the quantitative and qualitative methods of credit control adopted by RBI in various economic situations.

## 12.2 OBJECTIVES

After reading this unit you will be able to know the following about RBI:

- Origin and Development.
- Organisation and Management structure.
- Objectives of RBI.
- Functions of RBI.
- Credit control methods adopted by RBI

## 12.3 ORIGIN OF RBI

Reserve Bank of India had its origin with the establishment of the Presidency Banks. On the ground of proposal given by Warren Hastings in 1786, the first presidency Bank 'Bank of Calcutta' was established in 1806 The. Further this bank was renamed as Bank of Bengal in 1809. In this continuation two other presidency banks Bank of Bombay in 1840 and Bank of Madras in 1843 were formed.

Further these three Presidency banks were amalgamated into the Imperial Bank of India that came into existence on January 20, 1921. Though Imperial Bank of India was engaged into certain central banking functions but it was not a central bank of the country.

In the year 1926, the Hilton Young commission had suggested the presence of Central Bank for the economy. The background objective of this suggestion was to create a separate institution which can control the currency and credit in the country and also can build a strong banking system in the economy. This proposal was taken seriously and in 1931 &

19933, by Central Banking inquiry committee and by the 'Round Table Conference' also same proposals had been put forth.

After the recommendations made by such committees on the creation of central bank theittees the Reserve Bank of India Act of 1934 established the Central Bank of the country and putting rigorous actions RBI commenced operations in 1935. The funational and operational role of RBI has witnessed many changes and many fronts since its establishment. Sources for such changes are dynamic nature of economy, changes around the globe, banking has become the major pillar of the economy etc.

The year wise mile stones in setting up a central bank – Reserve Bank of India are as follows;

**1926:** Proposal for Central Bank - The Royal Commission (Hilton Young Commission)

**1927:** A bill for the creation of central bank have been presented in the Legislative Assembly.

**1933:** Amended bill was introduced in the Legislative Assembly.

**1934:** The Bill was passed.

**1935:** Commencement of operation by RBI as central bank.

**1942:** RBI ceased to be the currency issuing authority of Myanmar.

**1947:** RBI no more banker to the Government of Myanmar.

**1948:** The Reserve Bank no more central bank of Pakistan.

**1949:** Nationalization of RBI.

**Source: Report on RBI's working and functions – RBI staff training institution**

## 12.4 OBJECTIVES OF RBI

The Preamble to the Reserve Bank of India Act, 1934 (the Act), under which it was constituted, specifies its objective as "to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage".

With the changes in national priorities and dvelopment objectives of the country, the role and functions of RBI have extended accordingly. In todays financial system RBI functions with the following primary objectives -

1. To regulate the bank note issuance.
2. To manage monetary and credit system.
3. To develop the money market of the country.

4. To develop a sound banking system.
5. To maintain reserves for monetary stability.
6. To manageme public debts efficiently.
7. To provide finance to agriculture and priority industries.
8. To monitor and work towards financial inclusion.
9. To spread financial literacy among population.

## 12.5 ORGANIZATION & MANAGEMENT

All the functions of the RBI are governed by central board. Appointments of the board members are done by the Government of India and the tenure of appointment is for a period of four years. The board comprised of two categories of officials ie. Central board of Directors as Full time officials and other directors nominated by Government of India.

The Full time officials are at the top of the organisational structure. All the appointments are done by the Government as per the statutory norms laid down under the Reserve Bank of India Act, 1934. The organizational structure of RBI is as under -

**Central Board of Directors**

The Central Board functions are central authority of the organization. The responsibility of the Board is to oversight the financial activities of the Reserve Bank. The board also delegates a number functions to the local boards. The composition of central board is as under-

**Full-time officials:**

1. **Governor** – The chief executive of the central bank is Governor. His role is to supervise and direct all the affairs and business of the central bank.
2. **Deputy Governors -** The central board of the organization also appoints Deputy Governors who alongwith Governor forms a core team of management. There are 4 Deputy Governors on the board.

**Nominated by Government:** For other team members in the board the Central Government proposes and nominates Directors on the Central Board. These directors are 14 in numbers and it includes four directors each from local boards. Other remaining directors of the board are the representatives of different priority sectors contributing to the economy. These sectors are mainly from agriculture, manufacturing industries, finance sectors etc. The tenure of appointments for all the directors is for a period of four years. As a general practice Finance Secretary to the Government of India is nominated as a Director representing the Government and remains on the Board 'during the pleasure of the Central Government'.

**Local Boards:**

In addition to the central board there exist other lower level structure in the form of Local Board. There are four local boards associated with central board representing four zones namely Western, Eastern, Northern and Southern zones of the country. These bpards are constituted by the Central Government under the RBI Act. The head offices of the boards are located in Mumbai, Kolkata, New Delhi and Chennai. The local boards have five members appointed by Government and the tenure of appointment is four years.

**Functions of Central Board & Local Board:**

**Central Board –** The central board of the bank supervises the banking activities in the economy and also it directs the future course of action.

**Local Board –** Locaal boards are the representatives of different zones which take into consideration various territorial and economic interest of their respective zones. As the additional function it also advises the central board on various matters pertaining to the local cooperation and indigenous management. Also many other functions are performed by the board as delegated by the central.

***Check Your Progress- A***

**Q1. Briefly explain the origin of RBI.**

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**Q2. What are the basic objective of RBI?**

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# 12.6 ROLE OF RBI

The fundamental role of RBI is to regulate the issuance of currency notes in the economy and maintain optimal reserves for securing money stability in the country. In this relation the role that becomes important for Central Bank is designing and implementation of regulatory framework in the form of policy for all banking and non-banking financial institutions. The prime objective of the design is to provide every individual and uniform and easy access to the banking system, protecting depositors' interest, and maintaining the overall health and efficiency of the financial system. The Reserve Bank addresses the requirements of evolving economy by maintaining a flexible system.

To maintain the efficiency and competitiveness in the banking system the Central Bank adopts banking practices from the globe. In order to standardize and bring the Indian banking system at par with international level, RBI brings in technology, variety of instruments, prudential norms, sector management, currency management etc.

In the recent past, RBI has given much thrust on financial inclusion. To include unbanked population in the main stream banking, it's very important to gain customer confidence in the system. This can be achieved by addressing customer grievances and for this RBI has set up administrative machinery. Other efforts made in the past by RBI are persuasion of clean note policy; ensuring development of secure and robust payment and settlement systems.

From the above discussion it can be drawn that from its establishment RBI has played many role in accordance with the changing need of economy for proper functioning of financial system and to maintain monetary stability. A glimpse of RBI's role can be listed as below -

1. **As Issuer of currency:** Under this role Central Bank issues and exchanges Indian currencies. Also the bank destroys those currencies which are not fit for the circulation. As the unfit currencies and coins reduces the size of the economy. So supply of currency becomes important.
2. **As Regulator and supervisor of the financial system:** Banking is the most important and complex system in Indian economy. It has many dimensions. Most importantly it has to match its pace with the international banking practices. In this regard RBI identifies, designs and implements various developmental policies mainly for gaining customers confidence; protecting the deposits; making banking accessible to everyone and providing the services at a cost effective manner.
3. **As Banker to banks:** RBI plays very important role of maintain bank accounts of all the scheduled commercial banks. Under this role RBI acts as the banker of all the scheduled banks and facilitates them for financial accommodation and lenders to the last resort.
4. **As Banker to the Government:** RBI acts merchant banker Indian government. Not only for central government but also to state government RBI extends it merchant banking services. RBI is the main banker of central and state governments and also acts as their advisor and agent.

5. **As Monetary Authority:** One of the key role played by RBI is to formulate, implement and monitor the monetary policy. It is the main policy that maintains price stability, keeps inflations check and ensures an optimum credit flow in the economy.
6. **As Regulator and supervisor of the Payment Systems:** RBI is the regulator of National Payment system of India. It supervises National Payments Corporation. As a regulator and supervisor of payment system RBI authorises payment systems, formulates standards for the payment system, implements policies for electronic payments, introducing new channels of payments, increasing customer convenience and inproving security and efficiency in the system.
7. **As Manager of Foreign Exchange:** Additional role of managing Forex under the FEMA- Foreign Exchange Management Act, 1999, is also played by RBI. This role covers the facilities at offer to external trade & payment and promote developmental activities in relation to foreign exchange management in the country.
8. **As Developmental role:** In lieu to the national objectives set under the economic five year plan RBI performs a wide range of promotional functions. Many development institutions such as NABARD, IDBI, SIDBI, NHB etc. were established under this role.
9. **As Agent of Government of India in International Institutions:** RBI represents the Government of India to many international financial institutions like World Bank, IMF etc.

## 12.7 FUNCTIONS OF RBI

The Reserve Bank of India was established as the central bank of the country. It is the apex monetary institution of the nation. The central bank primarily supervises, regulates, control and develop the financial system. As the central bank of the country RBI performs various monetary and non-monetary functions.

### 12.7.1 MONETARY FUNCTIONS

Monetary functions are the central banking functions. Through these functions RBI controls and regulates the volume of money and credit in the economy. RBI also maintains price stability and credit control for achieving this RBI formulates, implements and monitors the monetary policy. The monetary functions performed by RBI are as follows –

1. **Managing Currency Notes:** It is one of the core central banking functions. Under the section 22 of RBI Act; RBI owns the sole right to issue bank notes of all denominations. In this context RBI designs, produces and manages currency notes. The objective of this function is to adequate supply of clean and genuine notes.

Under this function RBI takes into consideration various currency security issues and propose and implements various measures to enhance security features. With these measures RBI tries to eliminate the risk of counterfeiting of currency notes.

Another dimension of this function is distribution of one rupee notes and coins across the country. RBI functions as the agent of the Government for this. Following are the activities performed under the function of managing currency notes –

A. Currency Management

B. Currency Distribution

C. Coin Distribution

D. Exchange of Notes

E. Combating Counterfeiting

2. **Acting as Bankers to Bank and Lenders to Last Resort:** RBI plays very important functions of maintaining bank accounts of all the scheduled commercial banks. Under this role RBI acts as the banker of all the scheduled banks and facilitates them for financial accommodation and lenders to the last resort.

   The Reserve Bank opens current accounts of banks with itself, enabling these banks to access the following facilities –

   A. Clearing and settlement of inter-bank obligations.

   B. Funds transfer facility for banks.

   C. Maintaining their accounts with it-self for statutory reserve requirements and transaction balances.

   D. Acts as the 'lender of last resort'.

3. **Banker to the Government:** RBI is the main banker of central and state governments and also acts as their advisor and agent. As a banker, it receives and pays money on behalf of the various Government departments. Under this function following are the activities carried out by RBI -

   A. Agency charges are paid by RBI to the commercial banks on behalf of Government.

   B. The Reserve Bank carry full obligation to transact Government business.

   C. RBI helps to float new loans and to manage public debt.

   D. RBI is the advisor of Government for monetary and banking matters.

8. **Custodian of Foreign Exchange:** RBI stabilizes the external value of the national currency. This function covers the facilities at offer to external trade & payment and promote developmental activities in relation to foreign exchange management in the country.

The activities are performed under this function:

A. Foreign Exchange Control.

B. Proper exchange rate system

C. Management of exchange rate

D. Management of exchange reserves.

4. **Controller of Credit:** One of the major functions of RBI is Credit control. It is one of the key measures of efficient and smooth functioning of the economy. Through the measure of credit control RBI makes an attempt to maintain monetary stability.

## 12.7.2 NON-MONETARY FUNCTIONS

1. **Promotional and Development Functions:** Promotional and developmental function of RBI is very important to increase the length and breadth of banking and financial services in the economy for a sustainable economic development. In this regard RBI tries to promote banking habit, extend banking facilities to rural and semi- urban areas, and establish and promote new specialized financing institutions.

   Some of the major mile stones achieved by RBI under this function are institutions like Industrial Finance Corporation of India, State Financial Corporations, Deposit Insurance Corporation, Unit Trust of India, Industrial Development Bank of India, Agricultural Refinance Corporation of Indian and the Industrial Reconstruction Corporation of India.

2. **Regulatory and supervisory functions:** Apart from the monetary functions RBI performs certain no-monetary functions also. These functions are of the nature of supervision of banking practices and promotion of sound banking in country.

   As the regulator and supervisor of the banking system in the country, RBI ensures system's safety and soundness on a regular basis. The prime objective of this function is to protect the interest of depositors through an effective prudential regulatory framework for orderly development and conduct of banking operations, and to maintain overall financial stability through various policy measures. Under this function RBI performs the following activities -

   A. Licensing

   B. Corporate Governance

   C. Statutory Preemptions

   D. Management and Fixation of Interest Rate

   E. Prudential Norms

*Check Your Progress- B*

**Q1. Briefly explain the different roles played by RBI.**

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**Q2. What do you mean by 'Lenders of last resort'?**

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## 12.8 BOARD OF FINANCIAL SUPERVISION

Board of Financial Supervision was coming into existence in November 1994 under the statutory regulation of Reserve Bank of India Act, 1934. BFS works as a committee of the Central Board and undertakes the responsibility of integrated supervision of different sectors of Indian economy related to the financial system. The organizations under the purview of BFS are majorly banks, financial institutions and non-banking financial companies.

Governor, Deputy Governors and ex-officio members constitute the board. Governor of RBI becomes the chairman, Deputy Governors are the in-charge of regulation and supervision. One of the Deputy Governor is nominated as the Vice-Chairperson and four directors from the Central Board are nominated as members of the Board by the Governor.

Meeting of the board is scheduled usually once in a month. The issues under consideration in meeting generally relates regulatory and supervisory policy issues. In specific it includes the findings of on-site supervision and off-site surveillance carried out departments and directs for policy formulation.

The Board is the most critical and important forum for the supervisory and regulatory discharge for Reserve Bank of India.

## 12.9 CREDIT CONTROL BY RBI

One of the major functions of RBI is Credit control. It is one of the key measures of efficient and smooth functioning of the economy. Through the measure of credit control RBI makes an attempt to maintain monetary stability. For the proper execution of the policy the measure has included many methods of credit control. These credit control methods can be broadly classified into two categories -

**Quantitative Method to credit control:** This method is applied to regulate the volume of total credit.

**Qualitative Method to credit control:** This method is applied to regulate the flow of credit. Both the methods of credit control involve different measures and techniques. Those measures are as follows -

**Quantitative Measures** The operation of the quantitative techniques or general methods will have a general impact on the entire economy regulating the supply of credit made available to different activities. The quantitative measures of credit control are as follows:

1. **Bank Rate Policy**: The rate at which RBI is willing to discount the bills is known as Bank Rate. The method has its scope in controlling the credit, inflation and money supply. As and when require RBI increases or decreases the Bank Rate according the economic movement.
2. **Open Market Operations**: The purchase or sale of government securities in the open market by central bank is known as Open Market Operations. The aim is to control volume of credit. As the contractionary measure RBI sells securities, so that cash balance with the commercial banks decline, and as expansionary measure RBI purchases securities and allow credit expansion.
3. **Varying Reserve Ratio:** Variations of reserve requirements affect the liquidity position of the banks and thus their ability to lend. In this method RBI changes various reserve requirements. Some of them are as below –
    **a. Cash Reserve Ratio (CRR)** - The portion of total cash deposits with banks kept with RBI as reserve ratio is known as Cash Reserve Ratio.
    **b. Statutory Liquidity Ratio (SLR)** - The portion of total cash deposits with banks kept with itself as reserve ratio in the form of liquid assets is known as Statutory Liquidity Ratio.

    As contractionary measure RBI increases reserve ratios and on the other hand it reduces the reserve ratios when following expansionary measures.

**Qualitative Measures:** Qualitative measures are used for selective purposes only. The various techniques associated with this method are as under –

1. **Margin requirements**: The difference between the securities offered and amount borrowed by the banks is called Margin Requirement. While lending money against securities banks keep a certain margin. RBI can issue directives to commercial banks

to maintain the level of margin. When it wants to reduce credit, a higher margin is prescribed and lower margin requirement is to expand the credit.

2. **Direct action:** It implies a coercive measure like, refusing to provide the benefit of rediscounting of bills for such banks whose credit policy is not in accordance.
3. **Consumer Credit Regulation**: Under this technique rules and norms for down payments and maximum maturities of instalment regarding the credit for purchase of consumer goods are laid down.
4. **Rationing of credit**: The credit is rationed by limiting the amount available to each applicant.
5. **Moral Persuasion:** It is a Psychological and informal means of selective credit control. It is a persuasion tactic. In this tactic an authority like RBI tries to influence and pressure, but not force, banks into adhering to policy.

***Check Your Progress- C***

**Q1. Write a short note on BFS.**

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**Q2. Define the following terms –**

a. **Bank rate.**
b. **Open Market operations.**
c. **Capital Rationing.**
d. **Moral Suasion**

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## 12.10 DEPARTMENTS OF RBI

In the year 1935 RBI had only three departments namely the banking department, the issue department and the agricultural. But as the role of RBI increased with the changing economy, the bank has the following departments -

1. Department of External Investments and Operations
2. Financial Markets Department
3. Financial Stability Unit
4. Internal Debt Management Department
5. Monetary Policy Department
6. Regulation Department of Banking Operations and Development
7. Supervision Department of Banking Supervision
8. Department of Non-Banking Supervision
9. Foreign Exchange Department
10. Rural Planning and Credit Department
11. Urban Banks Department
12. Research Department of Economic Analysis and Policy
13. Department of Statistics and Information Management
14. Services Customer Service Department
15. Department of Currency Management
16. Department of Government and Bank Accounts
17. Department of Payment and Settlement Systems
18. Support Department of Administration and Personnel Management

19. Department of Communication
20. Department of Expenditure and Budgetary Control
21. Department of Information Technology
22. Human Resources Development Department
23. Inspection Department
24. Legal Department
25. Premises Department
26. Rajbhasha Department
27. Secretary's Department

## 12.11 TRAINING ESTABLISHMENT OF RBI

The network presence of RBI is speeded all over the country in the form of 19 regional offices and 9 sub offices. Majority of its regional offices are there in the state capitals. In addition to this network RBI also has five training establishments. These training institutions of RBI is of different categories –

- College of Agricultural Banking.
- Reserve Bank of India Staff College.
- National Institute for Bank Management.
- Indira Gandhi Institute for Development Research (IGIDR).
- Institute for Development and Research in Banking Technology (IDRBT).

## 12.12 SUMMARY

The Reserve Bank of India (RBI) was set up as the central bank of the nation. It was established on 1 April 1935. It was emerged as a statutory organization by passing the Reserve Bank of India Act of 1934. It is the apex financial institution of Indian financial system.

All the functions of the RBI are governed by central board. Appointments of the board members are done by the Government of India and the tenure of appointment is for a period of four years. The board comprised of two categories of officials i.e. Central board of Directors as Full time officials and other directors nominated by Government of India.

The fundamental role of RBI is to regulate the issuance of currency notes in the economy and maintain optimal reserves for securing money stability in the country. In this relation the role that becomes important for Central Bank is designing and implementation of regulatory framework in the form of policy for all banking and non-banking financial institutions. The prime objective of the design is to provide every individual and uniform and easy access to the banking system, protecting depositors' interest, and maintaining the overall health and efficiency of the financial system. The Reserve Bank addresses the requirements of evolving economy by maintaining a flexible system.

It performs two major categories of functions monetary and non-monetary. Under the monetary function it manages currency notes, acts as bankers to the bank and government, acts as lender of last resort etc. Under no-monetary functions it acts as supervisor of banking practices and promotes financial activities in the economy.

Finally, the RBI controls the credit by adopting various quantitative and qualitative methods like bank rate, open market operations, direct action, moral suasion, capital rationing etc.

To monitor and perform various responsibilities RBI has 21 departments spread throughout the country starting from coin designing to distribution.

## 12.13 GLOSSARY

**RBI** – RBI is the central bank of India established on 1 April 1935.

**Issuer of Currency-** Under this role Central Bank issues and exchanges Indian currencies. Also, the bank destroys those currencies which are not fit for the circulation. As the unfit currencies and coins reduces the size of the economy. So, supply of currency becomes important.

**Monetary Authority** – One of the key roles played by RBI is to formulate, implement and monitor the monetary policy. It is the main policy that maintains price stability, keeps inflations check and ensures an optimum credit flow in the economy.

**Lender of last Resort** – An institution that extend loan facility to commercial banks when they are in difficulty is known as Lender of last resort.

**Cash Reserve Ratio –** The portion of total cash deposits with banks kept with RBI as reserve ratio is known as Cash Reserve Ratio.

**Statutory Liquidity Ratio** – The portion of total cash deposits with banks kept with itself as reserve ratio in the form of liquid assets is known as Statutory Liquidity Ratio.

**Credit Control** – A strategy adopted by business organizations in order to promote good credit among the individual having credit worthiness and deny it to otherwise is known as Credit control.

**Bank Rate** – The rate at which RBI is willing to discount the bills is known as Bank Rate.

**Open Market Operations** – The purchase or sale of government securities in the open market by central bank is known as Open Market Operations.

**Margin Requirement** – The difference between the securities offered and amount borrowed by the banks is called Margin Requirement.

**Capital Rationing** – Capital rationing is the act of placing restrictions on the number of new investments or projects undertaken by a company.

**Moral Suasion** – It is a persuasion tactic. In this tactic an authority like RBI tries to influence and pressure, but not force, banks into adhering to policy.

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7. Khan M Y - Financial Services (Tata Mc Graw Hill, 1998)

## 12.16 TERMINAL QUESTIONS

Q1. Write brief history about RBI and its evolution.

Q2. State different roles of RBI.

Q3. Discuss various functions performed by RBI as the central bank of India.

Q4. Draw the organizational structure of RBI.

Q5. What do you mean by credit control?

Q6. Discuss various qualitative and quantitative methods of credit control.

# UNIT 13 COMMERCIAL BANKS

**13.1 Introduction**

**13.2 Objectives**

**13.3 Evolution of Commercial Banks in India**

**13.4 Management of Commercial Banks in India**

**13.5 Organizational Setup of Commercial Banks in India**

**13.6 Role of Commercial Banks**

**13.7 Functions of Commercial Banks**

**13.8 Assets and Liabilities**

**13.9 Theories of Liquidity Management**

**13.10 Management of Reserves**

**13.11 Loan Management**

**13.12 Summary**

**13.13 Glossary**

**13.14 Reference/ Bibliography**

**13.15 Suggested Readings**

**13.16 Terminal & Model Questions**

## 13.1 INTRODUCTION

Commercial Banks are the institutions to provide banking services for individuals and business concerns via a network of branches. These banks operate with the objective of profit making. These institutions are generally public limited companies. In India, we have a combination of nationalized banks, private banks and foreign banks. In Indian economy Nationalized Banks own majority of the market share.

Commercial banks offer a wide range of services through its designated branch. Generally these services cater to all financial purposes of human being covering saving need, payment need, investment need and credit need. For availing these services banks include different nature of financial instruments like cheques, demand drafts, current and savings account, Plastic cards etc. In order to perform any financial transactions of their need an individual

needs to have a bank account in the form of savings, current, fixed deposit, Recurring deposit etc. These banks also disburse short term and medium term loans for various requirements of individuals as well as for business.

Accepting deposits from individuals are the basic functions performed by commercial in Indian. Further disbursing credit to all sectors of the economy after following necessary statutory provisions for reserves as per the central bank regulations is another important function. These basic functions are generally termed as primary functions of commercial bank.

In addition to their primary functions, various incidental functions like agency services and general utility services are also performed by commercial banks.

It can be claimed that commercial banks are the main financial institutions of the economy. They provide deposit, payment and credit services to its customers. And as the additional functions it assists various other projects as an agent. These banks are the back bone of the economy.

## 13.2 OBJECTIVES

After reading this unit you will be able:

- To describe the evolution and development of commercial banks in India
- To present the organisation and management structure of commercial banks.
- To explain the role and functions of commercial banks.
- To highlight various assets and liabilities a commercial bank.
- To learn various theories governing liquidity management.
- To know about banking reserves and loan management.

## 13.3 EVOLUTION OF COMMERCIAL BANKS IN INDIA

The commercial banking industry in India started in 1786, with a proposal given by Warren Hastings for establishment of a full-fledged. On the ground of such proposal in 1806 The Bank of Calcutta was established. Further this bank was renamed as Bank of Bengal in 1809. In this continuation two other presidency banks Bank of Bombay in 1840 and Bank of Madras in 1843 were formed.

Further these three Presidency banks were amalgamated into the Imperial Bank of India that came into existence on January 20, 1921. Though Imperial Bank of India was not a central bank of the country still was engaged into many central banking functions.

The Reserve Bank of India (RBI) was established on 1 April 1935 under the Reserve Bank of India Act of 1934. RBI was an apex institution, set up to serve as the central bank of the country. RBI comes under the category of statutory organization because it was constituted by passing an act.

In the duration between 1906 and 1913, few other banks like Central Bank of India, Bank of Baroda , Indian Bank, Bank of India, Canara Bank and Bank of Mysore were set up. State Bank of India (SBI) was established in 1955. Subsequently in 1959, the State Bank of India (subsidiary bank) Act was passed, that allows SBI to take over eight former state-associate banks as its subsidiaries.

Till 1969 India has few numbers of banks operating in the economy, majority with private ownership. 1969 was the year when nationalization process started and State Bank of India was nationalized first. In subsequent process 19 other banks have been nationalized and they have declared as government banks.

In 1990 Indian has seen banking reforms. The banking industry was restudied and many changes took place like entry of private players, liberalization for foreign players etc. One important feature of the reforms of the 1990s was that the entry of new private sector banks was permitted. As the reform allows, new banks like ICICI Bank, HDFC Bank, IDBI Bank and UTI Bank were set up.

Commercial banks in India have traditionally focused on mobilizing savings, meeting the short-term financial needs of industry, trade and agriculture. But in recent years inncrease in sophistication and diversification of the economy have led an increase in the range of services for commercial banks significantly.

## 13.4 MANAGEMENT OF COMMERCIAL BANK IN INDIA

**The management of commercial banks can be diagrammatically explained as:**

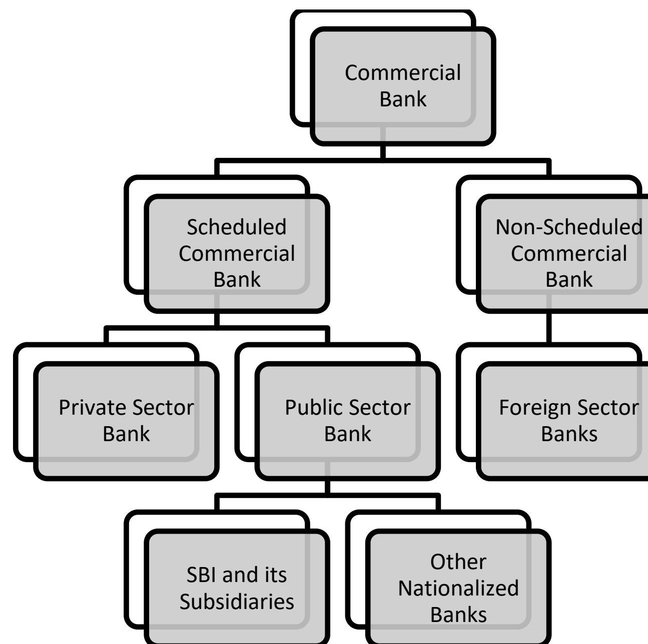


**Fig 13.1 The management of commercial banks**

1. **Scheduled Banks: "**A bank registered with Reserve Bank of India under the second schedule of RBI Act 1934 is known as Scheduled Commercial Bank." In Indian structure, these banks are of three types:

A. **Public Sector Banks:** These banks are also called government banks as these are owned and controlled by the government. The objective with which these banks were established is to provide services to the society instead of profit making. For example - State Bank of India, Punjab National Bank, and Corporation Bank etc. Public sector banks has two categories:

   i. SBI and its subsidiaries.

   ii. Other nationalized banks.

B. **Private Sector Banks:** These banks have private ownership and controlled by private entity. The private banks operate in the economy with the objective of profit making. ICICI Bank, HDFC Bank, IDBI Bank is some examples of private sector banks.

C. **Foreign Banks:** These banks are generally promoted by foreign players. The management control of such banks resides in the hand of foreign entity. The count of such banks has increased rapidly after the reform since 1991, when the process of economic liberalization had started in India. Bank of America, American Express Bank, Standard Chartered Bank are examples of foreign banks.

2. **Non-Scheduled Banks:** A bank which is allowed to do banking business but not included in the second schedule of RBI Acts 1934 is known as Non Scheduled Commercial Bank.

## 13.5 ORGANIZATIONAL SET UP OF COMMERCIAL BANKS

An organisational set up includes human resources who actually function in the organization carry out differentiated tasks which are performed incoordination to organization's goals It is defined as as a system in which different individuals and groups operating at different levels perform the tasks assigned to them within the frame work of delegated authority and responsibility which are rationally coordinated to achieve the desired organisational goals”.

Being an organization commercial banks have also such set up in which different people, team and group performs a coordinated task to achienve the predefined goal. The organizationa setup of a commercial bank is shown in the figure below –

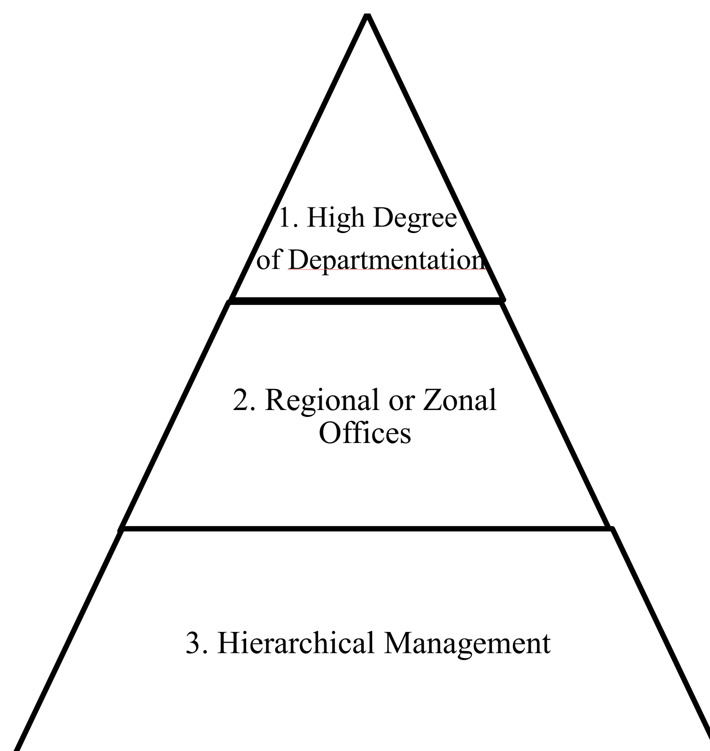


**Fig 13.2 Organizational Set Up Of Commercial Banks**

*Check Your Progress- A*

**Q1. Briefly explain the evolution of Commercial Banks in India.**

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**Q2. Discuss organizational structure of commercial banks.**

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**Q3. When did first phase of nationalization of banks take place in India?**

**a. 1965 b. 1969 c. 1974 d. 1975**

# 13.6 ROLE OF COMMERCIAL BANKS

A commercial bank performs the following role in the economy -

1. **As an accelerator of Capital Formation:** Commercial banks inculcate the habit of savings among the people. It mobilizes such savings and allocates them effectively to different credit or investment opportunities in order to get an efficient utilization out of those savings. In this way commercial banks are the accelerator of capital formation by savings from people.
2. **As a source of Finance and Credit:** Commercial banks can be considered as the pioneer source of advances and credit for business concerns. The lending activities of commercial banks are not only restricted to domestic trade and commerce, but extend to export-import also.

3. **As Developing Entrepreneurship:** Commercial banks have taken the initiatives of developing and promoting entrepreneurs in the market. In this context banks underwrites the shares of existing concerns and finance the new venture. These banks not only finances new ventures but also provide assistance in the promotion.
4. **As Promoter of Balanced Regional Development:** Commercial banks also cater their financial service in rural and backward areas by providing credit facilities through their rural branches. By this mean commercial banks also try to bank such individuals who are still unbanked and do not transact in the formal banking system.
5. **As financer to Consumer need:** Commercial banks advance credit for purchase of durable consumer items like Vehicles, T.V., refrigerator etc., which are out of reach for some consumers due to their limited paying capacity. In this way, banks help in creating demand for such consumer goods.

## 13.7 FUNCTIONS OF COMMERCIAL BANKS

The functions of commercial banks are as below:

**Primary functions**

1. **Collection of deposits:** Accepting deposit from the individual is the basic function of commercial banks. Deposits are collected through three main deposit instruments (accounts): current, saving and fixed.

   Current Account – In this type of account a customer can deposit and make payment. He/ She can overdraw the money available to his/ her account but for such facility the customer has to pay charges to the bank.

   Savings Account – In this account one can deposit money and can make the payment to a limit of availability of money in his account. This account comes with a provision of minimum balance in account.

   Fixed Deposit Account – In this account money can be deposited only once in beginning and then has to be freezed for a minimum amount of time chosen by the customer. After the maturity period customer gets the money with interest.

2. **Making loans and advances:** The basic banking business is to get deposits from the depositors and finance such mobilized deposits to the individuals and concerns are in need of credit against some rate of interest. Commercial banks have to keep a certain portion of their deposits as legal reserves. And the balance is used to run the business by offering different types of loans –

   Personal Loan

   Collateral Loan (Cash Credit)

Overdraft facilities

Loan by discounting bills of exchange..

**Secondary functions**

1. **Agency services:** In this form of function commercial banks play the role agent on behalf of his customer. For performing such functions, standing instructions should be given by customers to the banks for transactions. The relationship between the banker and customer is that of Principal and Agent. The following are the agency services provided by the bankers under this function:
    - Payment of utility bills like telephone bills, rent, insurance premium, instalments etc.
    - Collection services – collection of cheques, drafts, and bills on behalf of the customer.
    - Exchange Services – Exchange of domestic currency for foreign currencies as per the regulations.
    - The banks can act as trustees / executors.
2. **General utility services:** In order to have a complete range of financial service at offer commercial banks also help general utility services. Some of common services offered under this category are as below -

    Safeguarding money and valuables: customers consider bank lockers as the safest place to keep their valuables. It is service under which a customer is offered a locker at some annual charges and customers are allowed to keep safe their valuables.

    Transferring money: Under this service banks offer to transfer money from one place to another. Likewise, banks collect funds on behalf of customers from other banks.

    Merchant banking: The merchant bank services offers various services like corporate advisory, loan syndication and project advisory services etc.

    Automatic Teller Machines (ATM): These are specially designed machine that are capable of dispense cash when demanded. Through this service bank offers any time money and attains the liquidity position by addressing the demand for cash in real time.

    Traveller's cheque: It is an instrument of a specific denomination. A customer may purchase the instrument from the bank after paying the necessary payments.

    Credit Cards: These are another important means of payments, comes under plastic money category. The card offers services like cash withdrawal, card swipe for payment, point of sale service etc.

*Check Your Progress- B*

**Q1. Briefly explain the different roles played by Commercial Banks in India.**

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**Q2. Discuss the funtions of Indian commercial banks.**

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# 13.8 ASSETS AND LIABILITIES

The following items are reflected in the balance sheet of a commercial bank as Assets and Liabilities:

**Liabilities of Banks:**

1. Capital and Reserves: The owned fund of banks is comprised with Capital and Reserves. Here, Capital refers paid-up capital and Reserves are the retained earnings.

   The capital position of commercial banks can be improved by the help of the reserves of retained earnings. Unforeseen and unpredictable liabilities can be handled by CRR. It also provide a protection against unexpected losses. In the financial statement Reserves and Provisions should be reflected as different items.

   The exact amount of liabilities and assets cannot be predicted during the preparation of accounting statements. In this context an adequate provision for them is necessary. Capital functions to provide a shield against the losses incurred by banks.

2. Deposits: Commercial banks are considered as the premier financial institution in Indian financial system. Deposit mobilisation is a necessary requirement for stepping up the rate of economic growth.

3. Borrowings: Banks borrow from different banking and non-banking financial institutions to address its different array of needs. Individual banks borrow from each other as well as through the other means like call money market and other-wise.
4. Other Liabilities: Under this category various miscellaneous items like bills payable, participation certificates etc. appear.

**Assets of Banks:**

1. Cash: It is composed of two different elements in the balance sheet. One is cash in hand and another one is balances lying with other banking institutions including RBI. Every bank maintains statutory reserves with RBI and apart from these reserves they also hold extra cash to meet other day-to-day activities.
2. Money at Call at Short Notice: As credit is the prime business avenue for a bank. So after meeting its credit requirements if a bank is in a position of surplus cash then it tries to utilise the surplus by lending to other banks, financial institutions etc. for very short time period for 1 to 14 days.
3. Investments: The amount of money which parked for long term objective of growth of the fund is known as investment. Generally Indian commercial banks have three entry level investment option ie. (a) government securities, (b) other approved securities and (c) other securities.
4. Loans, Advances and Bills Discounted-or Purchased: The major components by which the basket of bank assets have been composed are loan, advances and bill discounted. These are the main source of income of banks. These all together called as total 'bank credit'. In India advances have two factors namely cash credit and overdrafts. Loans can be demand loans or term loans.

# 13.9 THEORIES OF LIQUIDITY MANAGEMENT

The liquidity management for a banking institution is very complex because a bank has to trade-off between liability of repaying deposited amount and earning capacity by extending credit. There are many contradiction as objective of liquidity contradicts the objective of credit. Similarly objective of safety is a constraint of profitability. There are theories related to the liquidity management which try to counter these contradictions. These are the following theories which help to explain the management of liquidity -

**Commercial Loan Theory**

This theory advocates that a commercial bank should take up only such loans which are for short time and self-liquidating in nature. The loans should cover a broader area of business ie. Production, storage, transportation, and distribution etc. and should focus on only one area.

This theory also states that the RBI should lend to the banks on the event of short term and self-liquidating productive loans by commercial banks, in view to add security of such short-term loans.

**Advantages**

The theory possess following advantages -

1. They acquire liquidity and automatically liquidate themselves.
2. Chances of accumulating bad loans can be zeroed.
3. These loans can earn handful income for the banks so can be considered as productive loan.

**Disadvantages**

The theory has following disadvantages -

1. A business concern cannot opt for second loan until he pays off the first one. This practice shrinks the economic activities.
2. The assumption of the theory is that loans are of self-liquidating in nature but it is not the case always.
3. This theory does not include the fact that the liquidity of a bank directly relies on the stability of its liquid assets.

**Shiftability Theory:**

This theory was propounded by H.G. Moulton. According to him if an asset is transferable without incurring any loss in case of demand of liquidity then it can be considered to be perfectly shiftable. This is specifically used for short term market investments, like treasury bills and bills of exchange which can be directly sold whenever there is a need to raise funds by banks.

**Advantage**

1. It is based on practical approach.
2. Shares and debentures of large enterprises are welcomed as liquid assets accompanied by treasury bills and bills of exchange.

**Disadvantage**

1. Theory emphasizes on only shiftability of assets which alone cannot be the determinant of liquidity.
2. In this theory the concept of acute depression is disregarded.
3. The adverse effects of selling of the shiftable assets have not been included.
4. If all the banks simultaneously start shifting their assets, it would have disastrous effects.

### Anticipated Income Theory

This theory was propounded by H.V. Prochanow in 1944. According to this theory, irrespective of the nature and feature of a borrower's business, the bank plans the liquidation of the term-loan from the expected income of the borrower. A term-loan is for a period exceeding one year and extending to a period less than five years.

**Advantages**

1. Theory includes more practicability than the commercial loan theory and the shiftability theory.
2. This theory emphasizes on the regular payment of instalments for combating against liquidity.
3. All the measures of safety principle is taken into consideration.
4. According to this theory the excess fund owned by bank can be utilised further to earn more.
5. Theory draws the attention towards term loan which can be a profitable product among all.

**Disadvantages**

1. This theory provides only a framework to the measure the creditworthiness of a borrower.
2. Theory does not signifies any measure to meet emergency liquidity requirement.

## 13.10 MANAGEMENT OF RESERVES

**Primary Reserves**

A sum total of Cash in hand and deposits (owed to it by other banks) is called as Primary reserves or Legal Reserves. Cash in hand component of primary reserves helps commercial banks to meet customer demands for withdrawals, exchanges, and loans. Other part of the reserve is invested in other banks in the form of the loans to earn extra. These Reserve is also known as "First line of Defense".Primary reserves cannot be loaned or invested, but may be used in a liquidity crisis caused by sudden and heavy cash withdrawals by bank's depositors.

**Secondary Reserves**

Those Assets which are invested in short-term marketable securities like treasury bill, short term government bonds etc. are together form secondary Reserves. These are the source of supplementary liquidity. These reserves are not entitled for earning interest, but they act as a source of supplementary liquidity. A market situation when low demand is observed for credit then deposit funds can be used as secondary reserves to earn interest. These reserves do not appear in the balance sheet as a separate item and are called as "Second line of Defense".

# 13.11 MANAGEMENT OF LOANS

One of the functional building block of banking business is the Lending service. It is the counter activity of deposit services which makes the banking business complete. It is oftenly viewed as profit making or revenue generating activity of the commercial bank against the deposit service which inccur cost. Theoretical concept of banking advocates that without the initiation of lending activities a commercial cannot record profit in its accounting statement. To maintain a uniform lending norms in the coutry, commercial banks have to design their Lending policy as per the monetary policy of reserve bank of India. As depositors deposit money for a specified time with the banks and more often deposit duration used to be of short nature and deposits become repayable on short notice or on demand, commercial banks cannot lend money for long period out of thses deposits. A commercial bank can be considered as a financial institution who lends medium or short term loans because it mobilizes money from individuals in form of short term deposits. So from such corpus they cannot lend for long term. The Indian banking industry has made a long journey since the independence and during the course of evolution it has gained many experiences of bank management. So these commercial banks utilize their assets in best possible way to earn profit. Three major services offered by commercial banks are – deposit, payment and credit. And all the three components have their importance in the profit of the bank.

The very basic and fundamental objective of loan management is to earn interest by identifying, studying credit worthiness and serving the credit need of the economy. Credit is the major source of income for a commercial bank. Through credit businesss a commercial bank is expected to generate near about 65 to70% of its income. Being a revenue genrating activity credit business is riskier at the same time, so the success of a bank is heavily dependent on its lending programmes.

There are many constraints associated with the credit management policy of a bank. The management is not that easy because a huge portion of bank deposits gets blocked in the form of banking reserves (CRR & SLR). So banks have to take optimum decision of lending so that he profit earned as interest on credit can suffice at leats the requirement of interest payable on deposit instruments and other operational needs.

Lending function should not be seen only for the revenue generating activity because apart from the revenue generation it has huge potential to increase employment opportunities. Banks also plays an important role in the market economics and it helps to increase the level of consumption through their consumer loans. Banking lending also plays an important role in the gross earning and net profits of commercial banks. It is the most profitable as well as risky function performed by commercial banks.

*Check Your Progress- C*

**Q1. Write a short note on banking assets and liabilities.**

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**Q2. Define the following terms –**

a. **Shifatability Theory.**
b. **Primary Reserves.**

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## 13.12 SUMMARY

Commercial Banks are the institutions to provide banking services for individuals and business concerns via a network of branches. These banks operate with the objective of profit making. These institutions are generally public limited companies. In India, we have an array of different categories of commercial banks like Nationalized Banks, Private Banks and Foreign Banks etc. But majority of the market share and financial assets in India is owned by Nationalized Banks.

The scenario of Indian Banking industry till 1969 was very narrow with limited number of banks operating in the economy and most of them were privately owned. 1969 was the year when nationalization process started and State Bank of India was nationalized first. In subsequent process 19 other banks have been nationalized and they have declared as government banks.

A commercial bank performs the following role in the economy –

- As an accelerator of Capital Formation:
- As a source of Finance and Credit:
- As Developing Entrepreneurship:
- As Promoter of Balanced Regional Development:

A commercial bank can be considered as a financial institution who lends medium or short term loans because it mobilizes money from individuals in form of short term deposits. So from such corpus they cannot lend for long term. The Indian banking industry has made a long journey since the independence and during the course of evolution it has gained many experiences of bank management. So these commercial banks utilize their assets in best possible way to earn profit. Three major services offered by commercial banks are – deposit, payment and credit. And all the three components have their importance in the profit of the bank.

## 13.13 GLOSSARY

**Commercial Bank–** Commercial Banks are the institutions to provide banking services for individuals and business concerns *via* a network of branches.

**Scheduled Commercial Bank - A** bank registered with Reserve Bank of India under the second schedule of RBI Act 1934 is known as Scheduled Commercial Bank.

**Non-Scheduled Commercial Bank** – A bank which is allowed to do banking business but not included in the second schedule of RBI Acts 1934 is known as Non-Scheduled Commercial Bank.

**Private Bank –** These banks have private ownership and controlled by private entity. The private banks operate in the economy with the objective of profit making. ICICI Bank, HDFC Bank, IDBI Bank is some examples of private sector banks.

**Cash Reserve Ratio** – The portion of total daily deposits kept with RBI by commercial banks as cash reserve is known as Cash Reserve Ratio (CRR)

**Statutory Liquidity Ratio –** It refers to that portion of deposits with the banks which it has to keep with itself as liquid assets (Gold, approved Government securities etc.)

**Agency Services –** In this form of function commercial banks play the role agent on behalf of his customer. For performing such functions customers gives standing instruction to the banks to transact on his/ her behalf.

**Utility Services –** Some of common services offered under this category are safeguarding money, transferring money, ATM facility etc

**Primary Reserves –** A sum total of Cash in hand and deposits (owed to it by other banks) is called as Primary reserves or Legal Reserves.

**Secondary Reserves –** Those Assets which are invested in short-term marketable securities like treasury bill, short term government bonds etc. are together form secondary Reserves. These are the source of supplementary liquidity.

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## 13.16 TERMINAL QUESTIONS

Q1. Write brief history about commercial bank in India.

Q2. State different roles of commercial banks.

Q3. Discuss various functions performed by commercial banks in India.

Q4. Discuss various theories of liquidity management.

Q5. Discuss how commercial banks manage their loans.

# UNIT 14 DEVELOPMENT BANKS

**14.1 Introduction**

**14.2 Objectives**

**14.3 Meaning & Definition of Development Bank**

**14.4 Features of Development Bank**

**14.5 Need of Development Banks**

**14.6 Evolution & Growth of Development Banks**

**14.7 Objectives of Development Banks**

**14.8 Types of Development Banks**

**14.9 Role of Development Banks**

**14.10 Functions of Development Bank**

**14.11 Structure and working of Development Banks**

**14.12 Commercial Bank Vs Development Banks**

**14.13 Summary**

**14.14 Glossary**

**14.15 Answer to Check your Progress**

**14.16 Reference/ Bibliography**

**14.17 Suggested Readings**

**14.18 Terminal & Model Questions**

## 14.1 INTRODUCTION

After World War II chronic poverty hit many underdeveloped economies specially Asia, Africa and Latin America. For the reconstruction of economy and to bring back a growth in industry these economies established special institutions for supplying capital, knowledge and entrepreneurship. The idea of specialized and development centric institution accelerate the economic development and due to the same reason the idea started gaining popularity in the global context and named as development bank or special development institution.

An institution established with the objective of financing development is known as Development Bank. These banks are specialized financial organization and deal in medium and long term finance.

These banks provide medium and long term finances, promote various developmental issues, assist rural population to bring in to formal finance for economic growth. Financial assistances are also at offer by this banks. The primary objective of Development Banks is to promote and develop important sectors like import - export, agriculture, industry, and other activities in the economy. These institutions allow term lending, investment in securities and other activities.

The prime goals of Development Banks are to finance the basic and fundamental needs of the society. These financing activities can accelerate growth and development of society and finally result in economic growth of the nation.

In India, Development Banks have been established with majority ownership of RBI. These institutions were set up to meet long term financing requirements of industry and agriculture. NABARD, SIDBI, FICCI are the major development banks of India. Different development institutions were started at different time interval to ascertain different economic objectives.

## 14.2 OBJECTIVES

After reading this unit you will be able:

- To understand the meaning of Development Banks
- To identify key characteristics of Development Institutions.
- To discuss the need and objectives of Development Banks in India.
- To highlight the roles and functions of Development Banks
- To learn the structure and working of development institutions.

## 14.3 MEANING & DEFINITION OF DEVELOPMENT BANK

The institutions which are engaged in the promotion and development of industry, agriculture and other key sectors are called Development Banks.

As an institution a development bank bears the responsibility of developing industrial enterprises. The Development Banks extend their services from the inception to completion of the the industrial projects.

D.M. Mithani states that, " A development bank may be defined as a financial institution concerned with providing all types of financial assistance (medium as well as long term ) to business units.

## 14.4 FEATURES OF DEVELOPMENT BANKS

A development bank is an institution of special nature. It should possess characteristics other than features of routine financial institutions. They key features of development institutions are as follows -

1. It is a financial institution of special category. The basic function of this type of institution is to provide finances of medium term and long- term.
2. This type of financial institutions is multipurpose in nature because the institution takes up promotional roles along with financing activities.
3. The service of financial assistance is extended to both public and private organizations by Development Banks.
4. A development bank fills the financing gap in different sectors.
5. These banks are the growth accelerator which helps in industrialization through specific and development activities.
6. The objective of these institutions is to achieve a healthy economic growth by bringing in new sectors in the economic performance.
7. The approach of these banks are based on socio economic requirements.

***Check Your Progress- A***

**Q1. What do you mean by development bank?**

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**Q2. Discuss various characteristics of development bank.**

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## 14.5 NEED FOR DEVELOPMENT BANKS

In contrast to the evolution of commercial banks in India, Development banks have evolved recently, soon after the independence. In the same one may argue against the existence of a separate entity called development bank. The arguments can be given that the functions of development banks could have been distributed among the existing banking structure instead of creating one more streamline of institution and making the financial system complex.

In this regard one need to understand that the functions performed by development banks are not related to profit making, whereas profit making was the very basic objective of commercial banks. And if such banks need to deal with developmental activities there would have been a conflict of interest.

In this context the following points explains the need for introducing concept of development banking -

1. To Lay foundations and open new opportunities for industrialization.
2. To Fulfill capital requirements.
3. To help in promotional activities.
4. To extend specific help to small and medium sectors.

## 14.6 EVOLUTION & GROWTH OF DEVELOPMENT BANKS

The first formal attempt in the line of setting up formal banking institutions in India can be traced back to 1773 with the proposal of Warren Hastings (Then Governor of Bengal). As a result of such effort the very first commercial bank of India was established in 1806 on the name of ‘Bank of Calcutta’ which was further renamed as ‘Bank of Bengal’ in 1809. In the galaxy of presidency banks two other banks namely ‘Bank of Bombay’ and ‘Bank of Madras’ were set up in 1840 and 1843 respectively. Since then many changes took place in Indian banking sector. One of the milestone of this journey was emergence of Reserve Bank of India as the central bank. Before independence setting up of formal banking system in the economy was the prime area of concern. With the establishment of central bank and formal banking institutions in the nation the need of rapid and sustainable economic development have been

felt and an urging need of industrialization was identified to address prevailing economic issues.

While assessing the role of commercial banks in the set of economic objectives, it was identified that the banking institutions present as commercial banks are majorly focused for short term credit and medium & long term financing requirements were neglected by greater extent. The reason for such negligence was the objective under which commercial banks have been set up and the operational constraints. But in the absence of medium & long term financing facility the desired economic growth could not be achieved. This economic need of the hour was rightly identified and addressed by Government through the establishment of Development Banks. With the identification of various key sectors the evolution of development banks took place by establishment of the following development institutions -

1. IFCI (Industrial Finance Corporation of India): IFCI was established in the year 1948 with a role to play as the gap filler for credit business. It was the first institution in the category of Development Bank. It was majorly concerned with industrial finances of medium and long term. The scope of its financing services are also extended for cooperatives.
2. State financial Corporations: After analysing that each state may have their own set of industries for their economic development, a decision has been made to give a free hand of finance to the states in the form of State Financial Corporations. These institutions will be governed by State Financial Corporation Act 1951.
3. ICICI: So far the instructions formed where focusing more on medium term financing and long term finances were still an untapped area. To counter such gap the Industrial Credit and Investment Corporation of India (ICICI) was established in 1955. At its establishment it was a joint stock company. The member institutions were private ownership and Government of India. Few other institutions like World Bank, Commonwealth Development Finance Corporation were in the role of supporting institutions.
4. LIC: The objective of Life Insurance Corporation of India (LIC) was to tap insurance services. It was nationalized in the year 1956 until then it was under private ownership. It lends money to government of India and also does long term industrial financing.
5. RCI: The abbreviation of RCI is Refinance Corporation for Industry (RCI). It was established in the year 1958 by the RBI, with an objective to facilitate refinancing services to the financial institutions like banks, LIC etc. against the medium and long term credit given by them.
6. IDBI: After the commencement of business by RCI, it was observed that the business model of the institution is very narrow and activities are very limited. So to extend the reach of financing services in 1964 a institution was formed as Industrial Development Bank of India and RCI was merged with it.

7. UTI: Till now all the development banks established were focusing on the long term financing. But with time it was realized that there exist a huge population with middle and low income. These population is interested to invest small ticket values to the economy. So to address such identification and to pool small value tickets in 1964 Unit Trust of India was established.
8. General Insurance Companies (GIC): Like LIC, GIC was also under private ownership and was nationalized in the year 1972. After the nationalization its started investing funds in industrial securities.
9. IRCI: In one hand government of India was making efforts to finance the industries so that industrialization can be brought in but at the same many of the industries were unable to perform well and got converted into sick units. This issue drew the attention of policy makers and in 1971, Industrial Reconstruction Corporation of India (IRCI) was formed to extend assistance services to the sick units for their revival.
10. EXIM Bank: With expansionary policy of development bank, government of India set up The Export Import Bank of India in 1982. This institution was formed by taking the international finance wing of the IDBI.
11. NABARD: To strengthen the financing needs of agriculture and rural based business sector the National Bank for Agriculture and Rural Development (NABARD) was set up in July 1982.

***Check Your Progress- B***

**Q1. Explore various significant reasons for which development banks have their existence.**

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**Q2. Discuss the evolution of development banks in India**

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**Q3. When did IFCI came into existence?**

**a. 1935 b. 1929 c. 1948 d. 1950**

**Q4. When did NABARD came into existence?**

**a. 1972 b. 1982 c. 1955 d. 1990**

## 14.7 OBJECTIVES OF DEVELOPMENT BANKS

As we know that the specialized institutions formed with the prime goal to finance basic needs of the society and economy are called Development Banks. The main objectives of the development banks are -

1. To develop rural and remote areas.
2. To generate employment.
3. To increase the rate of industrial growth in the country.
4. To emphasise on self employment.
5. To increase export and substitute import with domestic products.
6. To promote technology in business.
7. To revive sick units.
8. To provide training to large industries.
9. To eliminate regional imbalances.
10. To improve the performance of capital market.

## 14.8 TYPES OF DEVELOPMENT BANKS

In economy there exist some industrial and government institution who are engaged in financing long and medium term finaces to the industries. The instutions engaged in long term financing is oftenly known as development Banks in India. They are are as follows:

1. **Industrial Finance Corporation of India (IFCI), 1948:** IFCI was established in the year 1948 with a role to play as the gap filler for credit business. It was the first institution in the category of Development Bank. It was majorly concerned with industrial finances of medium and long term. The scope of its financing services are also extended for cooperatives. It has made significant contribution in modernization of Indian industries so far. It focuses on medium and large industries and make the credit available for their projects.

2. **State Finance Corporation (SFC), 1951:** After analysing that each state may have their own set of industries for their economic development, a decision has been made to give a free hand of finance to the states in the form of State Financial Corporations. These institutions will be governed by State Financial Corporation Act 1951.
3. **Industrial Credit and Investment Corporation of India (ICICI), 1955:** ICICI was established as an institution for financing long term industrial projects. It was to provide financial assistance to private industrial units only but later they extended their assistance to public, joint stock and co-operative sectors also. In 1990 it has transformed its business from project financing company to a company which offers financial services.
4. **Industrial Development of Bank of India (IDBI), 1964:** It is the apex institution for industrial finance in India. It coordinates with the activities of all financial institutions engaged in industrial finance, promotion and development. It focuses on financial support and credit to the industries.
5. **National Bank for Agriculture and Rural Development (NABARD) 1981:** It was set up under NABARD Act 1981 with an objective to provide credit to rural areas. The institution functions to provide financial services, credit planning and monitoring, development and promotional activities, supervisory functions, institutional capacity building, training in rural segment with a focus on agriculture.
6. **Export Import Bank (EXIM), 1982:** Exim bank bank was established with the objective of augemnting exports from the country and to join the foreign trade and investment with economic growth.
7. **Small Industries Development Bank of India (SIDBI), 1990:** The prime focus of SIDBI is to uplift the small industry in the country by fulfiling their financing need. It extends its services to Micro, Small and Medium enterprises. With financing facility it also provides pomotional assistance to small scale industries.

In addition to these institutions, there are also institutions such as Life Insurance Corporation of India, General Insurance Corporation of India, National Housing Bank, Unit Trust of India, etc., which are providing investment funds.

***Check Your Progress- C***

**Q1. Briefly explain the underlying objectives of development bank.**

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**Q2. Explain different types of development banks from Indian economy.**

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# 14.9 ROLE OF DEVELOPMENT BANKS

As we have already discussed that different forms of financial institutions are performed at different level under the category of development banks. These institutions have special motives of their inception in the economy. The roles of each institution are clearly defined as their stated objectives. In this segment we will focus on the general roles of development banks -

1. **Role in Capital Formation:** A Development Finance Institutions makes available the means to utilize savings generated in the economy. It helps in capital formation.
2. **Role in Supporting to the Capital Market:** In the context of a developing economy a development bank is accelerator of economic development. It accelerates the growth process by sealing the leakages and increasing the process of capital formation.
3. **Role in Rupee Loans:** Rupee loans constitute more than 90 per cent of the total assistance sanctioned and disbursed. These loans are also known as term loans. And for new start ups term loans are considered to be the most suitable loan form.
4. **Role in Foreign Currency Loans:** Foreign currency loans refer to the credit requirement for either establishing new industrial projects or project expansion, diversification, modernization or renovation of existing units. In these projects financing may require for import of machineries. Such financing needs are addressed under this role.
5. **Role in Bank Guarantee:** On purchasing of machinery or fixed assets or capital goods on credit, the purchaser has to furnish bank guarantee to ensure payment of instalments on a regular basis. The development bank plays the role of guarantor of purchaser and issues the bank guarantee on behalf of the purchaser. The scheme under which a development bank takes such responsibility is called ‘Deferred Payments Guarantee’.
6. **Role in Assisting to Backward Areas:** The primary pattern of operations of Development Banks is to assist lending activities to various portfolios of backward areas under various development schemes. Institutional finance to projects in backward areas is extended on concessional terms such as lower interest rate, longer

moratorium period, extended repayment schedule and relaxed norms etc. Besides, these routine roles of financing and assisting industrial activities in backward areas. In India development banks are also the torch bearers for identification, formulating and launching developmental programs in rural and remote areas of the country.

7. **Role in Promotion of New Entrepreneurs:** Development banks in India are responsible for remarkable success stories of entrepreneurs. The most important issue in entrepreneur development is that believing in the concept of an individual and financing the concept or idea. Due to these development banks who have shown the interest in such new ideas and took the risk to finance them, a new set of entrepreneurs are here in the country. These entrepreneurs are extending industrialization to the untouched areas among the weaker sections of the society. Special schemes like special capital and seed capital were introduced by Development banks to provide funding assistance to technically skilled entrepreneurs with new ideas but lack in financial resources. Development banks are given much importance and priority to the self-employment programmes. Through these developmental programs institutions try to build another set of institutions which can cater the training needs among the new entrepreneurs.

# 14.10 FUNCTIONS OF DEVELOPMENT BANKS

1. **Promotion of Small Scale Industries (SSI):** Promotion and development of small scale industries in the country is the prime function of development banks. To achieve this objective Small industries Development Bank of India (SIDBI) was established. The institutions are focused to provide medium and long-term credit to such small. SIDBI is involved in project finance and equipment finance to small business units. Another service provided by SIDBI is refinancing to such banks and financial institutions that operate in seed capital, equipment finance, etc.
2. **Development of Housing Sector:** Housing sector is one of the sector with huge opportunities. Therefore Development banks are also focused to provide loan for the development of the said sector. In this context government of India established The National Housing Bank (NHB) in 1988 which promotes the development in housing sector by promoting loans for housing and by refinancing banks and other financial institutions that provide credit in the same line.

3. **Large Scale Industries (LSI):** Under this function thrust has been given to the promotion and development of large-scale industries (LSI). Institutions like IDBI, IFCI, etc. provide different types of credits the business houses. Another dimension of

service for these industries is the assistance for project reports, feasibility study of projects, location analysis, project appraisal etc.

4. **Agriculture and Rural Development:** India being a primarily agricultural country needs attention to this sector. In every economic plan this sector is being given a high priority. The economic development of the country relies mainly on the growth this sector. To increase the efficiency of the sector National Bank for Agriculture & Rural Development (NABARD) was established in 1982. The institution design and instrumentalize development of agriculture. It provides refinance for such loans which have been extended to the agriculture sector and in return plays an important role for rural development. It also provides training to agricultural banks and helps to conduct agricultural research.
5. **Enhance Foreign Trade:** These banks also help in providing foreign trade. With the objective of addressing foreign trade, Export-Import Bank of India (EXIM Bank) was established in 1982. The function of this institution is to provide medium and long-term advances to exporters and importers from India. It also helps foreign Buyers in the form of credit to buy Indian capital goods. It also encourages banks in other countries to offer finance to the buyers in their country to buy capital goods from India.
6. **Review of Sick Units:** One of the other important function of Development bank is to help and assist to revive sick-units. In this regard an institution called Industrial investment Bank of India (IIBI) by Government of India to revive such units. The main function of IIBI is to disburse credit and to facilitate reconstruction assistance for the revival. It tries to modernize, restructure and diversify the sick unit under consideration.
7. **Entrepreneurship Development:** One of the important objective of development banks is to generate self-employment. To achieve this objective development banks do initiate entrepreneurship development programs. Many development institutions like SFCs, NABARD etc. facilitate entrepreneurial training to individuals. The training involves managerial skill, leadership, new business generation etc. Apart from training programs these institutions do conduct seminars and workshops.
8. **Regional Development:** Development of rural and regional areas is the foremost objective of the Development Institutions. These institutions finance start up companies in rural and remote areas. They not only help by extending finances but also gives them the expertise advice in terms of project management and sustainability.
9. **Participation to Capital Markets:** Development banks also tries to help capital market to grow. It actively participate in capital markets. These institutions invest in the securities and debentures of listed companies, mutual funds and other capital market instruments.

***Check Your Progress- D***

**Q1. Discuss various roles of development institutions.**

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**Q2. What are the basic functions performed a Development Bank?**

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# 14.11 STRUCTURE AND WORKING OF DEVELOPMENT BANKS

**Structure of Development Bank:**

The development banks in India are a post-independence phenomenon (except the land development banks). Their structure is shown in the Figure 14.1. Some of them are for promoting industrial development; some for the development of agriculture; and one for foreign trade. Some are all-India institutions; others are state or lower level institutions.

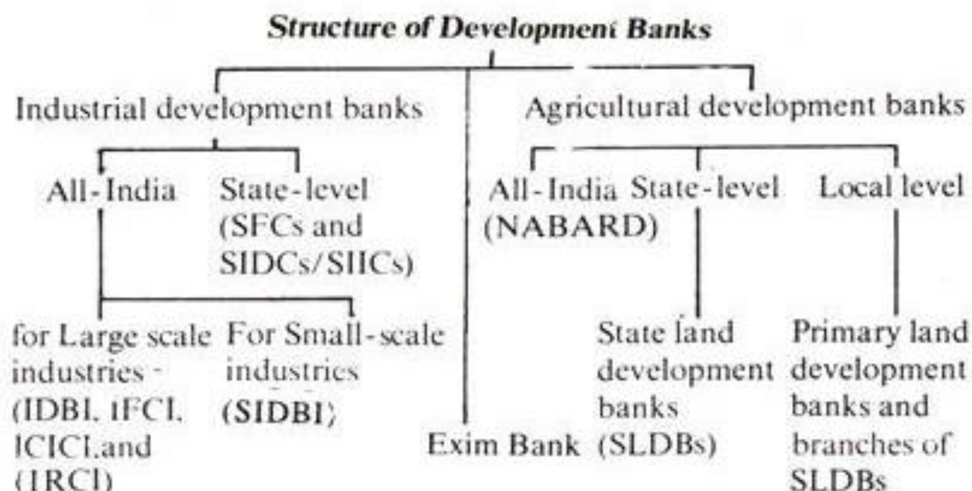


**Fig 14.1 Structure of Development Banks**

The important development banks present in Indian economy –

1. Industrial Finance Corporation of India, IFCI
2. State Financial Corporations
3. Industrial Credit and Investment Corporation of India, ICICI
4. Life Insurance Corporation of India , LIC.
5. Refinance Corporation for Industry, RCI
6. Industrial Development Bank of India, IDBI
7. Unit Trust of India, UTI
8. General Insurance Companies (GIC
9. Industrial Reconstruction Corporation of India, IRCI
10. EXIM Bank
11. National Bank for Agriculture and Rural Development, NABARD
12. The National Industrial Development Corporation (NIDC)

**Working of Development Banks:**

The post-independence period has witnessed a robust development in the financial sector through the massive growth of development banks in the country. These banks are considered as special institutions, performing two major functions of providing medium and long-term finance to entrepreneurs and of performing various promotional roles favourable to sustainable economic development.

As the name indicates, these are financial institution with development orientation. As banks, these institutions provide medium and long term finances. But in contrast to the commercial banks they have following major distinctions -

1. These banks do not operate as deposit seekers from customers.
2. Their specialization is in disbursing medium-and long- term finance, whereas commercial banks are specialized in short-term finance.
3. They are not only pedlar of long-term finance like ordinary lending institution.

As development banks, the main role of these financial institutions is to promote economic development by the promotion of investment and enterprise. In the chosen prioritized sectors like manufacturing, agriculture, or some other.

A development bank, , identifies investment projects, manages risk capital, arranges foreign exchange loans, underwrites new issues; prepares and evaluates project reports, provides technical advice, provides market information about both domestic and international markets, and management services.

The Indian development banks are still at its developing state so as to be able to provide a whole spectrum of development services. But the contribution of such developmental institutions is restricted only in channelizing finance to large-scale industry with a special focus on private sectors.

The financial assistance to industry is given in the following four main forms:

1. Term loans and advances.
2. Subscription to shares and debentures.
3. Underwriting of new issues.
4. Guarantees for term loans and deferred payments.

# 14.12 COMMERCIAL BANK VS DEVELOPMENT BANK

Commercial Banks and Development Banks differ in the following manner.

| COMMERCIAL BANKS | DEVELOPMENT BANKS |
|---|---|
| These banks provide short term loans. | These banks are mainly concern with providing long term loans. |
| Commercial Banks accept deposits from the public. | Development Banks accept deposits from commercial banks, Central and State governments. |

| These banks provide finance to customers. | These banks provide refinancing facilities to commercial banks. |
|---|---|
| These banks are important in the money market operations. | These banks play an important role in hire purchase, lease finance, housing loan. |
| In these type of banks share capital is contributed by Government and Private entities. | In this type of banks share capital is contributed by only Government. |
| Commercial Banks promote savings and help commercial activities. | Development Banks promote economic growth. |

## 14.13 SUMMARY

An institution established for the purpose to finance development is known as development bank. These are special financial institutions that cater medium and long term financing services to the industries of the nation.

In India, Development Banks are focused on the financing need of industries and agriculture. These institutions work under the supervision of RBI and majorly owned by RBI. Industrial Finance Corporation of India was the first development bank of India established soon after the independence. IFCI was formed with the objective to fill the gap of medium and long term financing for the industries.

While assessing the role of commercial banks in the set of economic objectives, it was identified that the banking institutions present as commercial banks are majorly focused for short term credit and medium & long term financing requirements were neglected by greater extent. The reason for such negligence was the objective under which commercial banks have been set up and the operational constraints. But in the absence of medium & long term financing facility the desired economic growth could not be achieved. This economic need of the hour was rightly identified and addressed by Government through the establishment of Development Banks.

In economy there exist some industrial and government institution who are engaged in financing long and medium term finaces to the industries. In India these long term lending institutions are collectively referred as development banks. They are IFCI, IDBI, NABARD, SFCs, ICICI, IRC, LIC etc.

Under the promotional role a development bank, manages risk capital, underwrites new issues, arranges foreign exchange loans, identifies investment projects, prepares and evaluates project reports, provides technical advice, provides market information about both domestic and international markets, and management services.

## 14.14 GLOSSARY

**DFIs –** Development Financial Institutions

**IDBI -** Industrial Development Bank of India

**ICICI** – Industrial Credit and Investment Corporation of India

**SIDBI** – Small Industrial Development Bank of India

**NABARD** – National Bank for Agriculture and Rural Development

**IFCI** – Industrial Finance Corporation of India

**SFCs** – State Financial Corporations

**IRC** – Industrial Reconstruction company

**NHB** – National Housing Board

**LIC** – Life Insurance Company of India

**UTI** – Unit Trust of India

**EXIM Bank** – Export Import Bank

## 14.15 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress –A**

Q3. 1948

Q4. 1982

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## 14.18 TERMINAL QUESTIONS

Q1. Discuss origin of Development Bank in India.

Q2. Highlight different objectives of Development Bank. Also explain the need of such

financial structure in India.

Q3. Discuss various functions performed by IDBI as a Development.

Q4. Draw the organizational structure of development financial institutions.

Q5. How development bank differ from a commercial bank?

Q6. Discuss various roles of development bank.

# UNIT 15 NON-BANKING FINANCIAL COMPANIES

**15.1 Introduction**

**15.2 Objectives**

**15.3 Non-Banking Financial Companies (NBFC**

**15.4 Mutual Benefit Financial Companies (MBFCs) and Mutual Benefit Companies (MBCs)**

**15.5 Summary**

**15.6 Glossary**

**15.7 Answer to check your progress/Possible Answers to SAQ**

**15.8 References**

**15.9 Suggested Readings**

**15.10 Terminal Questions**

## 15.1 INTRODUCTION

In the previous units you have understood the working and contribution of the commercial banks and the development banks in the economy. Though these institutions are contributing in a very good way, but our markets are so diverse and have uniqueness due to location, reach and literacy that we need other institutions to serve them.

Need of institutions was felt who play a crucial role of channelizing the small investor's funds to the corporate sectors and even to the unorganized sector and small local borrowers. These institutions are intermediary to some sectors with credit gap which is not filled by other financial intermediaries like commercial banks and development banks. So the birth of institutions had taken place that were not in the banking business but other services like housing finance, insurance, stock broking, venture capital/merchant banking, investment, mortgage guarantee, securitization, reconstruction, nidhis, chit funds etc.

In other words there operations were prominently for the unorganized and under-serviced part of the economy. As they had certain advantages which other players of the organized sectors don't have, like:

- Good reach and understanding of the needs of the customers at the local level

- Flexibility to design products for the convenience of customers
- Tailor made services and pricing as per the client needs
- Close interaction and relationships with the customers
- Low cost of operations

## 15.2 OBJECTIVES

After reading this you would be able to understand :

- Role and purpose of Non-Banking Financial Companies (NBFCs)
- What are the various other NBFCs operating in India
- How and in which way the Mutual Benefit Financial Companies (MBFCs) Functions and contribute in the economy.

## 15.3 NON-BANKING FINANCIAL COMPANIES (NBFC)

NBFCs are bridging the gap left by the commercial and development banks. This distinction between banking and non-banking institutions brings into light the characteristics of the NBFCs;

i. These institutions don't deal in pure form of borrowing and lending of funds as commercial banks functions in the financial system
ii. As per the Reserve Bank of India:
iii. It should be a company registered under Section 3 of the companies Act, 1956
iv. A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should comply with the requirements for registration with RBI.
v. NBFCs don't deal in the payment and settlement like banks as they cannot issue cheques drawn on itself
vi. Like the Deposit Insurance and Credit Guarantee Corporation deposit insurance facility is not been given by these institutions to depositors of NBFCs as it is with the banks;
vii. as per the norms set by the RBI a Non Banking Finance Entity can be a business like (a) Institutions that deals in Housing Finance as Housing Finance Companies, Merchant Banking activities, Providing of funds like Venture Capital, Stock exchange and stock broking activities, Insurance, Chit Fund, Equipment Leasing, Hire Purchase, Investment firms, Mortgage companies, Residuary Non Banking

Companies (RNBC), (b) Nidhi Companies or Mutual Benefit Financial Company (MBFCs) and (c) Potential Nidhi Company or Mutual Benefit Company (MBC)

## 15.3.1 REGULATORY FRAMEWORK IN WHICH THE NBFCS OPERATE

The presence of a regulatory framework for NBFCs serves many purposes;

- It primarily ensures the healthy competition and proper functioning of the participating intermediaries as NBFCs
- Social objectives of the government are served by these institutions while providing protection to the investors raised due to the presence of systemic risks. It also protects the consumers while providing efficient products and services.
- Ensuring the functioning of all these institutions in line with the monetary policy of RBI

In case of India the regulatory framework for the NBFCs is in place since 1963, in this year the Chapter III B of the Reserve Bank of India Act with Directions was issued. This chapter was introduced to effectively supervise, control and regulate the deposite acceptance activities of these institutions.

There are many amendments, study groups and committees who had been contributing in step wise development of the proper regulatory framework for NBFCs

A specific mention of study groups and committees formed in this directions include Bhabtaosh Datta study group (1971), James Raj study group (1975), Chakravarty Committee (1985), Vaghul Committee (1987), Narsimham Committee (1991) and Shah Committee (1992).

Bhabatosh Datta Study Group in 1971, was set up to examine the role and operations of NBFCs .

Similarly in 1974 the James Raj Study Group was made to study and suggest measures for keeping the magnitude of deposits accepted by NBFCs within reasonable limits and ensuring that they were in conformity with the objectives of monetary and credit policy of the economy.

The Chakravarty Committee in 1985 recommended for the introduction of a system of licensing for NBFCs so that the depositors interest can be protected. As he had a faith in the regulatory system of the country.

Adding to the regulatory framework in 1991 the Narasimham Committee argued that the supervision of these institutions should be with the agencies that may be set up under the guidance of the apex financial institution of the country the Reserve Bank of India. The introduction of suitable legislation was deemed as essential not only for ensuring sound and healthy functioning of NBFCs, but also for safeguarding the interests of depositors.

Dr. A.C.Shah committee in 1992 suggested regulatory and control measures to ensure healthy growth of these groups of companies.

These committees appropriate suggestions were incorporated and still effective measures are being taken stepwise and as per the changing needs of the economy and society. Based on these suggestions RBI was able to place a comprehensive regulatory and supervisory framework in January, 1998 with certain measures for protecting the interests of depositors and while ensuring the NBFCs function on sound and health lines while contributing in the Indian Financial System . Continuing in the same direction RBI time to time come out with amendments to NBFC regulations and make necessary statutory and prudential norms. As a result regulated deposits definition was widened, Registration of NBFCs with certain funds was introduced, and also the guidelines on prudential norms were issued to regulate the Balance sheet of NBFCs as a compulsory norm the NBFCs are to be registered with the RBI and they have to follow the norms set and regularly updated by it. There are separate agencies for each function and natures of business of an NBFC, hence are being regulated by different regulatory authority and act like;

National Housing Bank (NHB) for Housing Finance Companies, the Securities and Exchange Board of India (SEBI) regulates the Venture Capital Funds and business alike i.e., Merchant Banking and Stock Broking, while the Insurance Regulatory and Development Authority of India (IRDA) make conform the insurance business in India, Chit Fund Act, 1982 for Chit funds companies,

Ministry of Company Affairs defines the Nidhi Companies under section 620 A of the Companies Act, 1956.

In an institution wishes to business as a NBFC than it had to follow the conditionns as per this section, and it put the following statutory conditions:

1) To operate as a NBFC the company has to register itself as per Companies Act, 1956, Section 3. These institutions are different then other companies registered in this act as they are specifically engaged in the business of;

a) providing funds as loans and advances,

b) they purchase financial securities issued by Government or local authority or other marketable securities of a like nature,

c) deals in the leasing of machines and equipments or of a like nature,

d) deals in hiring and purchasing,

e) are in the insurance business,

f) does the chit business

Restriction is for the institutions having major business of;

- agriculture allied activity,
- industrial and production activity,
- purchase or sale of any goods (other than securities), or
- services and sale, purchase, construction of immovable property.

If a company receives and deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, by its members is considered as a non-banking financial company known as Residuary non-banking company (RNBC).

2) Secondly for functioning as a NBFC it had to follow the two criterions set by the Reserve Bank of India

i. It has to have more than 50 percent of the total assets as its financial assets, and

ii. The incomes arising from the financial assets should represent more than the 50 percent of the gross income.

The Section 45-IA of the RBI Act, 1934 put specific term with the other terms; the NBFC must have a Net Owned Fund of Rs. 25 lakhs (Rs. Two crore since April, 1999) to operate as a NBFC.

## 15.3.2 CHARACTERISTICS OF NBFC ( AS PER RBI)

A NBFC registered under Companies Act, 1956 and also registered with Reserve Bank of India can carry any business of non-banking financial institution.

Non-banking financial activities specifically differentiate these institutions from banks. The difference is due to following reasons;

i. They have specialized class of assets, like hire purchase finance companies operate mainly in financing of transport operations and consumer credit while housing finance companies provide loan for housing.
ii. Like Banks the NBFC can't accept demand deposits;
iii. As their primary business these institutions accept deposits from its members through different schemes or arrangement to that matter or in any other manner or lending in any manner;
iv. Like Banks the NBFCs do not make the payments and settlements. They cannot issue cheques drawn on itself like banks;

v. There is deposit insurance facility difference between the depositors of banks and NBFCs like Deposit Insurance and Credit Guarantee Corporation facility is not available to depositors of the NBFCs;

As they are non-banking financial institutions they primarily deal in businesses like housing finance, merchant banking, venture capital, stock exchanges, stock broking, sub broking, insurance (life and non-life), chit funds, equipment leasing, hire purchase, investment, mortgage guarantee, securitization, reconstruction, nidhi and principal nidhi to channelize funds amongst its members.

## 15.3.3 NBFC'S FUNCTIONS

Broadly the functions of the NBFC can be understood while differentiating them from the other participants of the financial system, i.e., banking and financial institutions. Majorly the NBFCs perform the following functions:

i. They provide services not well suited for banks (due to their organizational structure and policies)
ii. Responsible for channeling savings to investment and consumption purposes to allocate financial resources efficiently for socially desirable and productive purposes
iii. Maximization of convenience and minimization of transaction costs, and by maximization of marginal efficiency of capital for better fund utilization .
iv. Organizational flexibility leads to better response mechanism and hence efficiency .
v. They are often able to provide tailor-made services relatively faster than the once provided by the commercial banks and other financial institutions. And they are able to that these with flexibility, timeliness in meeting credit needs and low operating cost, and it helps them in beating their competitors.
vi. Fresh avenues of operations in areas, such as, hire purchase, housing, equipment leasing and investment.
vii. Now post 2002 with the introduction and implementation of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, NBFCs had entered into the business of asset reconstruction.
viii. Informational advantages over banks due to their narrowly defined fields of operation and with direct connectivity they fulfill the information gap between institution and the customer.

## 15.3.4 TYPES OF NBFCS

As defined by the apex financial institution and regulatory body the Reserve Bank of India, the NBFCs can be grouped into following broad heads:

a) As per there types of liabilities, they are termed as Deposit and Non-Deposit accepting NBFCs,

b) Non-deposit taking NBFCs are further grouped as per their size into systemically important (NBDC-NDSI) and other non-deposit holding companies (NBFC-ND), and

c) Also with their conducted activities.

Within this broad categorization the different types of NBFCs are

functioning in the financial system. For operations as a NBFC the institution has to get itself registered as a Company as per Companies Act, 1956 and with this they are also required to get themselves registered with RBI as FI (financial institution). Reserve Bank of India make available the list of NBFCs, like:

I. Asset Finance Company (AFC) : These institutions are into the primary business of the financing of physical assets. And with this they provide support to the society in production and economic activities. For this they fund for automobiles (including tractors), agri-based machines, power generator sets, heavy machines and equipments for earth moving and handling of materials, industrial machines for different uses. For this kind of financing of real or physical assets is due to its capability to support economic activities and income arising from these. Financing is not less than 60% of its total assets and total income respectively.

II. Investment Company (IC): are the categories of those FIs (financial institution) that carry the acquisition of securities as main business.

III. Loan Company (LC): they are the ones who operate as FIs who provide finance by creation of loans and advances or of such matter for any activity other than its own but they don't provide funds like the Asset Finance Company.

IV. Infrastructure Finance Company (IFC): are those registered NBFC who does follow the followings and called as IFC

a) Out of their total assets they arrange for at least 75 per cent for the infrastructure loans,

b) They have minimum Net Owned Funds of Rs. 300 crore,

c) Minimum credit rating of 'A' or equivalent is needed to become and IFC

d) The Capital to Risk (Weighted) Assets Ratio (CRAR) should be of 15%.

V. Systemically Important Core Investment Company (CIC-ND-SI): Those NBFC who are in the business of acquisition of shares and securities and they fulfill the following conditions:-

(a) Out of their Total Assets they posses not less than 90% as investments in financial instruments like equity shares, preference shares, debt or loans in group companies;

(b) Out of its total Assets they investment in the equity shares not less than 60% (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies.

(c) except in the course of block sale for dilution or disinvestment it does not trade in its investments in shares, debt or loans in group companies;

(d) except investment in bank deposits as per Section 45I(c) and 45I(f) of the RBI act, 1934, it does not carry on any other financial activity referred to.

(e) Their asset size has to be Rs. 100 crore or above, and

(f) They can accepts public funds

VI. Infrastructure Debt Fund (IDF-NBFC): Presence of these NBFCs is to ease the flow of long term debt for infrastructure projects. For this issuance of Rupee or Dollar denominated bonds of minimum 5 year maturity becomes the source. Merely Infrastructure Finance Companies (IFC) are allowed to become the sponsors of the IDF-NBFCs.

VII. Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI): This class of non-deposit taking NBFC are having not less than 85% of its assets in the nature of qualifying assets while satisfying the following criteria:

a. borrower of loan to a rural household with annual income should not be exceeding Rs 1,00,000 or urban and semi-urban household income not to be exceeding Rs.1,60,000;

b. loan amount generally does not go above Rs. 50,000 in the first cycle and Rs. 1,00,000 in following cycles;

c. total indebtedness of the borrower does not exceed Rs. 1,00,000;

d. term of loan should be more than 24 months for loan amount in excess of Rs. 15,000, option of prepayment is there without penalty clause;

e. loan can be extended without security;

f. aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;

g. loan is repayable on weekly, fortnightly or monthly installments at the choice of the borrower

VIII. Non-Banking Financial Company – Factors (NBFC-Factors): Is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring

business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

IX. Mortgage Guarantee Companies (MGC) – are NBFCs whose at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is Rs. 100 crore. Mortgage Guarantee Companies are notified as NBFC in terms of Section 45 I (f)(iii) of the Reserve Bank of India Act, 1934 (2 of 1934) with the prior approval of the Central Government, and a company registered with the Bank under the scheme for registration of Mortgage Guarantee Companies.

X. NBFC- Non-Operative Financial Holding Company (NOFHC) - Is a financial institution through which promoter / promoter groups will be permitted to set up a new bank .It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

***Check Your Progress- A***

**Q1. State the advantages of NBFCs over other financial institutions.**

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**Q2. Discuss the three broad criterion by RBI while differentiating NBFCs**

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**Q3. MCQs**

a) NBFC is;

i. Company
ii. Financial Institution
iii. Regulated by RBI
iv. All of above

b) Which of the company is not a NBFC
i. Hire Purchase Company
ii. Chit Fund Company
iii. Leasing Company
iv. Commercial Bank

c) CRAR stands for
i. Cash Ratio and Resources
ii. Capital to Risk Reverse
iii. Capital to Risk (Weighted) Assets Ratio
iv. Cash Retirement and Ratio

**Q4. Fill in the Blanks with appropriate word or words.**

a) _____________ companies are regulated by Insurance and Regulatory and Development Authority of India (IRDA)
b) Chit Fund Act, 1982 regulates _______________companies,
c) ____________________is a financial institution carrying on as its principal business the acquisition of securities.
d) SARFAESI Act stands for ______________________________.

## 15.4 MUTAL BENEFIT FINANCIAL COOMPANIES (MBFCS) AND MUTUAL BENEFIT COMPANIES (MBCS)

Existence of Nidhis can be traced long back in the history of our country, which originated with the mortgage of precious jewels and ornaments by the needy lower-middle income group of the society to the moneylenders. Moneylenders used to charge very high interest rates for this. At this juncture the need of the reasonable and affordable interest rate was felt, this lead to the birth of mutual benefit finance companies. The principal behind such institutions was to lend to its members from the savings mobilized by its own members (individuals), but at reasonable, affordable and acceptable terms and interest. The basic concept of Nidhi is "Principle of Mutuality"

Nidhis has played a very important role in the lives of many lower-middle income groups by providing credit facilities with minimum formalities and ease of repayment norms. But with

the increasing demand of such financial products these institutions usually branch out of their local territories. Due to this the monitoring and supervision becomes difficult which generally leads to becoming one of the major reason of their failure. In nineties we had seen the failure of many such institutions. As a result the Sabanayagam Committee with nine members was constituted on April 23, 2000 by Government of India to suggest appropriate policy framework for the overall improvements of Nidhi Companies while restoring the confidence of investing members. The committee had defined Mutual Benefit Financial Companies (Nidhis) as-

'Company which operates for mutual benefits of its members (individuals) or shareholders and for its operations it collects deposits from them and lend only to the individual members. It functions as per notifications and guidelines as prescribed by Department of Company Affairs (DCA)'.

Hence the Nidhis perform quasi banking functions so were under the supervision of RBI. Later notifications from RBI made it clear that their regulation has been taken over by Ministry of Company Affairs from the Reserve Bank of India for the deposit taking activities and by DCA for its operational matters including the deployment of funds.

Ministry of Corporate Affairs (MCA) on March 31, 2014 had issued the Nidhi Rules, 2014 and these rules are applicable for the Nidhi Companies or every company of such nature and following the below stated norms :

(a) Entities who are acknowledged as Nidhi or Mutual Benefit Society under sub-section (1) of Section 620A of the Companies Act, 1956;

(b) Nidhi company or Mutual Benefit Society performing without application for or had applied for but notification is awaited to become a Nidhi or Mutual Benefit Society under sub- Section (1) of Section 620A of the Companies Act, 1956; and

(c) incorporated as a Nidhi in accordance to the provisions of Section 406 of the Act.

For incorporation such companies should have to follow the following norms:

(1) to become a public company they should have a minimum paid up equity share capital of five lakh rupees.

(2) such Nidhi shall not issue preference shares, on the day or after the commencing of the Act.

(3) if preference shares were issued by a Nidhi before the commencement of this Act, such preference shares shall be redeemed in accordance with the terms of issue of such shares.

(4) Except the proviso to sub-rule (e) to rule 6, in its Memorandum of Association (MOA) Nidhi for mutual benefit shall be promoting the habit of thrift and savings amongst its members. And they should be receiving deposits and lending to its members only.

(5) Every Company incorporated as a "Nidhi" and they shall have it as the last words termed as 'Nidhi Limited' in its name.

(6) Within a period of one year from its commencement as Nidhi they should to have -

(a) members more than two hundred;

(b) it should have minimum ten lakh rupees or more as its Net Owned Funds;

(c) term deposits with not less than ten per cent of the outstanding deposits as specified in rule 14; and

(d) Net Owned Funds to deposits ratio shall not be more than 1:20.

(7) After incorporation a return is to be filled just after the closing of the financial year within 90 days, and where applicable in the second financial year by the Nidhi. Nidhi shall be filing this return as per the statutory compliances in Form NDH-1 along with prescribed fee provided in Companies (Registration Offices and Fees) Rules, 2014 to the Registrar. Return is to be certified by a practicing Company Secretary or Chartered Accountant or a Cost Accountant.

(8) In the case of Nidhi's not complying as per above mentioned clauses (a) or (d) of sub-rule (1) within thirty days from the close of the first financial year they have to make application to the Regional Director in Form NDH-2 along with fee specified in Companies (Registration Offices and Fees) Rules, 2014 for extension of time. In this case the Regional Director may consider the application and pass orders within thirty days of receipt of the application.

(9) In circumstances of the failure to comply with sub-rule (6) and extention beyond the second financial year, Nidhi are required to not accept any further deposits from the commencement of the second financial year till it complies with the provisions contained in sub-rule (6), besides being liable for penal consequences as provided in the Act.

While the notification of RBI on January 04, 2007 had made the provisions and it make directions which are not applicable for Mutual Benefit Financial Company and a Mutual Benefit Company (Potential Nidhi Company). Due to this regulation they are exempted from requirement of getting themselves registered and the maintenance of liquid assets while creation of reserve fund.

RBI Directions exempt those relating to interest rate on deposits, prohibition from paying brokerage on deposits, ban on advertisements and the requirement of submission of certain returns. Nidhi Rule, 2014 restricts Nidhi companies and puts prohibition to:

(a) act in the business of hire and purchase finance, leasing, chit fund, insurance or acquisition of securities issued by corporates;

(b) issue financial instruments like preference shares, debentures or debt instrument of such nature by such names or form whatsoever;

(c) open and business in current account for its members;

(d) they are not allowed to have acquisition of another company through purchasing of securities or manage the composition of the Board of Directors of any other company. They

can't enter into any arrangement for the change of its management. For this they have to pass a special resolution in its general meeting and obtained previous approval from the authority i.e., Regional Director for such Nidhi;

(e) in its name they can't do any business other than the business of borrowing or lending. Meanwhile they can provide the locker facilities on rent to its members, if it had followed all the provisions of these rules. Prerequisite is that the rental income from such lending should not exceed twenty per cent of its gross income at any point of time during a financial year.

(f) it can't accept deposits from or lend to any person, other than its members;

(g) they are not allowed to pledge any of the members assets lodged as security;

(h) they can't take deposits or lend money to corporate body;

(i) no partnership arrangement is allowed for its borrowing or lending activities;

(j) it can't issue or cause to be issued any advertisement as a request for deposit:

They can have private circulation of the details of fixed deposit Schemes among the members of the Nidhi carrying the words "for private circulation to members only". It should not be considered as an advertisement pleading for deposits.

(k) they can't pay any brokerage or incentive for mobilizing deposits from members or for deployment of funds or for granting loans.

**Mutual Benefit Company-**

Master Circular- Exemptions from the provisions of RBI Act, 1934 issued by RBI dated July 2, 2012 defines the "mutual benefit company". In this the MBC is defines it as a company not notified under section 620A of the Companies Act, 1956 (1 of 1956) and allows to carry the business of a non-banking financial institution-

(a) as on 9th January 1997; and

(b) as aggregate of net owned funds and preferential share capital it should not have less than ten lakhs of rupees; and

(c) on or before 9th July 1997 it should have applied for issue of certificate of registration to the Bank; and

(d) it should comply with the relevant provisions as per the directions issued by the central government under Section 637A of the Companies Act, 1956 to Nidhi Companies.

**Chamber of Nidhis**

It is the Associate Body of Nidhis incorporated on April 23, 1986 under section 25 of the Companies Act 1956. Reason for its existence is to support the member institutions and help them through grievance redressal. The main objectives of its existence are:

- It aids, stimulates and promotes the concept of the Mutual Benefit Societies, Permanent Funds, Saswatha Nidhis, Paraspara Sahaya Nidhis functioning as Nidhis.
- Ensures friendly relationship, feelings, understanding and unanimity among the member Nidhis.
- Consider and formulate opinion of member Nidhis and represent in front of concerned authorities at Central and State level .
- Collects, classifies and circulate member Nidhis information and statistics in a periodical bulletin.
- Provides information and guidance to Members through maintaining library.
- Through Chapters it motivate and propagate the concept of Nidhis at national level

***Check Your Progress- B***

**Q1. Define Nidhi companies based on Nidhi Rule 2014**

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**Q2. Discuss the requisite of becoming a mutual benefit company.**

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**Q3. MCQs**

a) Which statement(s) is/are true for Nidhis ?

i. They works on "Principle of Mutuality"
ii. Quasi banking institutions
iii. Are declared u/s 620A of the Companies Act, 1956
iv. All of the above

b) Nidhi Companies can't carry on the business of

i) chit fund
ii) hire purchase finance
iii) leasing financing
iv) All of the above

c) Chamber of Nidhis promotes

i) Mutual Benefit Societies

ii) Saswatha Nidhis

iii) Paraspara Sahaya Nidhis

iv) All of the above

**Q4. Fill in the Blanks with appropriate word or words.**

a) MBFC stands for ____________________________________________.
b) Basic concept of Nidhi is "Principle of ______________"
c) As per notification of RBI for Nidhis the regulation has been taken over by _______________________from ________________ for deposit taking activities.
d) Nidhi should make sure that within one year of its commencement, it shall ensure that it has not less than ___________members and Net Owned Funds of _________ rupees .
e) MBC stand for __________________________.

## 15.5 SUMMARY

Non-Banking Financial Companies with their unique products and functioning were able to integrate different financial markets and its participants. And become the integral part of our financial system. Reserve Bank of India and other regulatory authorities are able to promote Non-Banking Financial Companies. They have designed and delivered different products catering to the developed segment also to the unorganized and under-serviced segments of the society and economy.

On the other hand the Mutual Benefit Financial Companies and Mutual Benefit Companies are playing crucial role of channelizing the small investor's funds to the other needy individuals. These Nidhis are bringing peoples for mutual benefit of its members, for this they provide funds at reasonable and affordable rates to its needy members. RBI with notifications and recommendations of various working groups is able to promote and protect interest of Nidhis and the small investors.

Presence of the Chamber of Nidhis make its comfortable and make Nidhis able to formulate and communicate the opinion of member Nidhis to the concerned authorities at Central and State level.

## 15.6 GLOSSARY

**AFC** Asset Finance Company

**CRAR** Capital to Risk (Weighted) Assets Ratio

**IRDA** Insurance and Regulatory and Development Authority of India

**MBFC** Mutual Benefit Financial Companies

**MCA** Ministry of Corporate Affairs

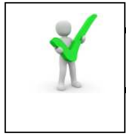
**NBFC** Non-Banking Financial Companies

**NHB** National Housing Bank

**RNBC** Residuary Non Banking Companies

**SARFAESI Act** Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

**SEBI** Securities and Exchanges Board of India



## 15.7 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress –A**

Q3. a) iv b) iv c) iii

Q4 a) Insurance

b) Chit funds

c) Investment Company

d) Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

**Check Your Progress –B**

Q3. a)iv b) iv c) iv

Q4 a)Mutual Benefit Financial Company

b) Mutuality

c) Ministry of Company Affairs and Reserve Bank of India

d) Two hundred and ten lakhs

e) Mutual Benefit Company

## 15.8 REFERENCES


- RBI Annual Reports
- Reserve Bank of India report and amendments for NBFCS
- Companies Act, 1956
- Securities and Exchange Board of India publications
- Ministry of Corporate Affairs for data and reports

- Ministry of Corporate Affairs Notification G.S.R. 258 (E) dated March 31, 2014

## 15.9 SUGGESTED READINGS

1. The Reserve Bank of India website www.rbi.org.in
2. Ministry of Corporate Affairs website www.mca.gov.in
3. Securities and Exchange Board of India website http://www.sebi.gov.in
4. Insurance Regulatory and Development Authority of India
5. website www.irdai.gov.in
6. National Housing Bank for Housing finance website www.nhb.org.in
7. Chambers of Nidhi website www.chamberofnidhis.org

## 15.10 TERMINAL QUESTIONS

Q1. Comment on the role of the securities market in the economic development of the country?

Q2. Discuss the role of RBI as monetary authority while performing role of regulator and supervisor of financial markets in India?

Q3. How SEBI ensures fair play of foreign portfolio investors in the Indian stock market?

Q4. Define a Mutual Benefit Finance Company and discuss its salient features?

Q5. Distinguish between Mutual Benefit Financial Company and Mutual Benefit Company?

Q6. Discuss the major recommendation of the expert group of Nidhis while discussing their growth in India?

# UNIT16 REGIONAL RURAL BANKS

**16.1 Introduction**

**16.2 Objectives**

**16.3 Regional Rural Banks**

**16.4 Major Regional Rural Banks Operating in India**

**16.5 Summary**

**16.6 Glossary**

**16.7 Answer to check your progress**

**16.8 References**

**16.9 Suggested Readings**

**16.10 Terminal and Model Questions**

## 16.1 INTRODUCTION

In the previous unit you have understood the working of Non-Banking Financial Companies, Mutual Benefit Financial Companies and Mutual Benefit Companies. With this we also tried to make you understand the theory and functioning of Non-Banking Financial Companies in Indian financial system.

They are able to contribute with the sound banking system and supplement it with their unique products. This way these institutions were able to become the integral component of the Indian financial system and contribute in the best way.

With extensive branch banking expected that every Indian at every part of the country would be having access to banking facility. Unfortunately, still a large segment of population remains unattended and without proper credit facilities and like other financial services provided by the banking industry. In an agrarian economy like India, a huge population lives in semi urban areas and villages. Post seventy years of independence there is dependency on agriculture directly or indirectly. Agriculture counts for 16% of overall GDP and provides employment of approximately 52% of the Indian population.

Agriculture as a sector is giving livelihood to many Indians, due to this reason they live and spend their life in rural areas. Commercial banks were not able to serve them so efficiently the lead to the birth of other participants of unorganized sector like moneylenders, traders, landlords etc, and cooperatives. They cater to their banking related needs but not to the maximum extent. Due to easy access, reach, illiteracy and customized products unorganized sector was able to exploit them with unreasonable interest charges and unstructured mortgage policy.

Motive behind the establishment of cooperative societies was to help improving the living standards of village residents. One of the view is these societies were not able to encourage the development of agriculture and associated areas, their inability to meet the requirements of village residents had forced to look for new ventures to meet this gap.

Five-year plans of Government of India emphasized on the development of rural infrastructure and credit facilities. With the nationalization of commercial banks, the expectations were that they will cater to the rural market needs. But this was not happening as was expected by policy makers due to diversity, population, illiteracy and regional needs of the rural markets. Mobilizing of rural savings which is generally crop dependent and credit facilities to rural masses was the motto behind the establishment of regional rural banks.

In this unit we will understand the working of Regional Rural Bank the

other important component of the Indian Financial System

## 16.2 OBJECTIVES

After reading this you would be able to appreciate:

- The different roles and functions of Regional Rural Banks (RRBs).
- Regulatory and supportive role of Reserve Bank of India towards the RRBs.
- Evaluation and goals achievements of RRBs.

## 16.3 REGIONAL RURAL BANKS

India is a country of different cultures, religions, beliefs and social structures. So fulfilling needs of all of them with few financial institutions at a broad level cannot be successful, as historically we had observed in the case of progress of Regional Rural Banks in Indian context. The commercial banks and cooperative societies were in existence and operating since pre-independence. But with few branches of commercial banks at rural and village level the needs of the needy poor households were not being met, as they were playing role at periphery only. Crop loan facilities were being extended by cooperative banks, mostly with

refinance backing by Reserve Bank of India. At that juncture the institutional credit for term loans were with limited provision and were under the head of agriculture like; minor irrigation support, tractors, land development etc. this was not sufficient. Reason being the needs were much larger than the support to agriculture only. On recommendation of the All-India Rural Credit Survey Committees in 1952 formation of the Agriculture Refinance Corporation was there, it was primarily setup for refinancing of the term lending cooperative institutions.

Reason for this was that for credit needs rural poor were still dependent on money lenders, traders, priests, churches, landlords and relatives.

Being an agrarian economy, the priority was to the develop the rural financing with the development of Five-year plan of Government of India and it was to be pursued by the nationalization of major fourteen banks in 1969. Under the aegis of the Lead Bank Scheme nationalized commercial banks were asked to have agricultural credit as a priority matter and were directed to expand in rural areas with their branch extension. Infrastructural development at rural level and promotion to agriculture and agriculture-based industries was the motive behind this step.

But the Banking Commission set up in 1092 had come out with its observations that even the massive extension of the branch banking at rural level was not able to serve the society to the greatest extent. The steps taken were not sufficient to bring the marginalized and deprived section of the rural society to the banking system of the Indian economy. On the same issue the Working Group on Rural Banks was formed under the headship of Mr. M. Narasimham. This group had came out with its recommendations and proposed for:

i) Having a state sponsored
ii) Professionally disciplined to bring new initiatives
iii) Low cost and efficient due to structure and presence
iv) Region Based who understands and fulfills the needs at regional level
v) Rural Oriented commercial banks to channelize funds in and for regional rural markets

They were proposed to cater to the needs of rural India with its unique rural touch, local feel and familiarity with the specific needs of poor and marginalized. They were expected to fill the existing regional and functional gap in the institutional credit system, specifically for the rural population in mind. This committee recommended for the ordinance known as Regional Rural Banks Ordinance in 1975 though it was later replaced by the act, the Regional Rural Banks Act, 1976.

The Government of India had set up these banks under Regional Rural Banks Act, 1976. As per the statutory norms of the country a Regional Rural Bank (RRB) is any bank that is established under Sec. 3 of the Regional Rural Banks Act, 1976 (21 of 1976) and functions accordingly.

Ownership pattern of these Regional Rural Banks is like:

Central Government 50%, Sponsor Bank (Scheduled Commercial Bank, Generally a Public Sector Bank) 35% and State Government 15%

Requirements in the form of provisions of the Regional Rural Bank Act, 1976 had permitted that RRBs should have the authorized capital of Rs. Five Crore and the issued capital of maximum Rs. One Crore. The sponsor bank is a Public Sector Bank; you may ask why they need to have another bank to operate in rural markets. Answer is the genesis of these cost effective financial institution with rural philosophy at its core, so that its prominent customers from rural markets can have a local feel and poor people oriented.

This is evident in the mission statements of the RRBs;

*'Uplifting of the rural economy through funding for commercial and economic activities associated with agriculture, trade, commerce, industry and other productive activities at the rural areas. Promotion would be for the facilities of credit specifically for the small and marginalized farmers, agricultural laborers, artisans and small entrepreneurs and for matters connected therewith and incidental thereto'.*

In other words, they primarily supported: i) Small farmers with less access and credit raising ability, ii) Agriculture dependent landless labors iii) Artists to produce and expand. iv) Small entrepreneurs for setup and expansion. As a policy matter the RRBs were supposed to lend to the weaker section of the rural society by opening branches in remote and rural areas, charge lower interest rates and keep a low-cost profile. They were working with characteristics of more of a development bank comparative to a commercial bank.

Though they were supported by the sponsoring bank (a scheduled commercial bank) but were working differently for a different clientele at regional and rural market level.

The sponsoring banks provide hand holding assistance to the RRBs. As per the Section 3 (3) of RRB Act, the sponsor banks have to give support to the RRBs in the following way:

1) The sponsoring bank subscribe to its share capital
2) Provisions of managerial assistance
3) Provision of other staff assistance
4) Assign Chairmen amongst their own officers or else, nominate two of the directors to the board of RRBs for their smooth functioning
5) Funds under refinance assistance

6) Investment guidance and help in maintaining liquidity

RBI can grant assistance to RRBs by way of loans and advances from the National Agricultural Credit (Stablisation) Fund under section 46A and 46B, while maintaining the cash reserve ratio.

Other stakeholder in these banks is National Bank for Agriculture and Rural Development (NABARD). Though NABARD don't have any share in the RRBs but it assists the Central Governments in relation to the functioning related to RRBs. It provides its support to RRBs through:

i) on behalf of GOI it puts representation on the Board of Directors
ii) Provides policy inputs to the RRBs
iii) Offers concessional refinance as a support to the resource base of RRBs
iv) Trains RRBs officers, conducts organization development initiative (ODIs) and exposure, for they need to have visits within and abroad
v) Helps in matters related to operational issues, promoting business development, micro-financing, push through policy matters etc.
vi) Statutory supervises the RRBs through conducting offsite surveillance and onsite inspections

The RRB concept was based upon the policy that they would lend only to the weaker sections of rural society, charging lower interest rates, opening branches in remote and rural areas and keep a low cost profile. In the later part of the unit we will learn that this become a barrier in the growth of their business and lend to the consolidation and amalgamation of RRBs.

## 16.3.1 ROLE OF REGIONAL RURAL BANKS

Regional Rural Banks helped in building the cost effective financial institutions to support customers in rural markets. With these supports they bridge the markets of rural India with the other developed parts of the country. For this they provide credit facilities at reasonable rates, with this step the banks are able to protect the poor from the malpractices adopted by the rich and influential money lenders. So the poor get opportunities to perform better and be competitive in the markets with their products (as farmer and entrepreneurs).

Other role of the RRBs can be like:

i) Providing customized credit facilities for the rural markets while considering their repayment conditions before designing the financial products and services for them.
ii) Customers are generally are small farmers, landless labors, artisans, marginalized entrepreneurs and other members of the society with less approach and access to the financial products and services from the organized financial sector.
iii) With their regional presence these banks are able to protect and promote the economic and financial growth.
iv) Safeguard rural poor from the unprofessional conduct of the rich and influential money lenders of the society.

v) These banks become instrumental in channelizing savings and credit facilities at the regional level and brining the non-connected citizens to the mainstream.
vi) This channelization of resources helps in the economic development at the regional and rural level.
vii) Developmental support to the marginalized is the channelized by these financial institutions more effectively than other institutions like banks and other NBFCs.
viii) Through this kind of support new and existing entrepreneurs get encouraged to come out and connect with the other better developed markets at local, national and even international level.
ix) New employment opportunities get generated with promotion to business activities in rural areas.
x) Up-liftment of marginalized and backward areas is catered by these RRBs as they are able to channelize the policies of government and become instrumental in providing credit based support to the needy.
xi) RRBs had been able to develop the economic conditions at the regional level by understanding the needs of the rural area and serving them better than others.
xii) These banks are able to bring the marginalized societies to the mainstream and help in reducing poverty, unemployment and economic disparities existing at regional level.
xiii) With their regional presence they had become an alternative channel to the cooperative credit structure to the marginalized.
xiv) They are able to provide sufficient institutional credit to the priority sectors at rural level like agriculture.

## 16.3.2 FEATURES OF REGIONAL RURAL BANKS

As we know that the Regional Rural Banks are sponsored by the Commercial Banks, hence automatically they are scheduled banks. As per the Banking Regulation Act 1949 section 5 (b) RRBs can engage into banking activities and as per section 6 (1) of the Act can engage in one or more forms of specified businesses. They perform normal banking businesses, while the section 18 (2) of the RRB Act, 1976 empowers them to undertake businesses in addition to these, are the specific feature of RRBs like:

i) They can provide loans and advances to small and minor farmers and agricultural laborers in personal capacity or in the groups for the purpose of agriculture and those related to agriculture the loans and advances can be given to the cooperative societies. Societies includes agricultural marketing societies, agricultural processing societies, co-operative farming societies, primary agricultural credit societies or farmers service societies for agriculture and purposes related to agriculture.
ii) They can grant loan and advances in the notified area for the trade, commerce and industrial activities.
iii) RRBs operate in an area of one to five revenue districts with same agricultural climatic conditions and rural client.

iv) Their branches used to operate in unbanked and markets with poor credit support to the agricultural credit.
v) Should bear and fulfill norms set by Reserve Bank of India
vi) Being deemed cooperative societies hence are not liable to pay income tax.
vii) They are allowed to maintain lower level of statutory and liquidity norms as Co-operative Banks does, i.e., 3% Cash Reserve Ratio and 25% Statutory Liquidity Ratio.
viii) For deposits with maturity of more than three years they are allowed to pay ½ percent more interest.
ix) NABARD provide short term refinancing to these banks upto 50% of their outstanding eligibility loans at 3% below the bank rate.
x) Even the sponsor bank provides upto to 30% to 35% of refinance at a rate of 8.5%.
xi) RRBs maintain their liquid assets (as current deposits) with the Sponsor bank to get interest at the rate upto 9%.
xii) For the first five years from 1979 or entering into agreement these banks use to get concession in fee for getting guarantee from Deposit Insurance and Credit Guarantee Corporation of India (DICGCI) on all eligible advance at the rate of 25% per annum.
xiii) They get refinance at 2% below the bank rate as per the RRB Act, 1976

### 16.3.3 REGULATORY FRAMEWORK FOR RRBS AND THE FORMATION OF BOARD OF DIRECTORS

Regional Rural Banks are regulated by the National Bank for Agriculture and Rural Development (NABARD) .

Establishment of NABARD was under the National Bank for Agriculture and Rural Development Act, 1981. It was formed to provide and regulate the credit related facilities specifically with a purpose of promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts. With a purpose of promoting integrated rural development it supports other allied economic activities in rural areas.

By agriculture it means horticulture, animal husbandry, forestry, dairy and poultry farming, pisciculture and other allied activities.

**Board of Directors (BOD):** As per Section 8 of the Regional Rural Bank Act, 1976 empowers the BOD to function as an authority for the wide-ranging superintendence, direction and management of the RRBs affairs and businesses.

Section 9(1) of the Regional Rural Bank Act, 1976 provides the norms for the establishment of the Board including the Chairman and 8 other directors. Their recommendation would be like:

i) Central Government recommends for the two directors, who are not the officers of Central Government or State Government or Reserve Bank of India or National Bank for Agriculture and Rural Development or Sponsor bank or any other bank.
ii) An officer of the Reserve Bank, would be recommended by the Bank as Director
iii) An officer of the National Bank, would be recommended by the Bank as Director; two officers of the Sponsor Bank, to be recommended by that bank for Directorship; and
iv) Concerned state governments recommends its two officers for the post of directors

Section 9 (2) allows the Central Government to raise the number of the members of the board. While the number of directors doesn't go beyond fifteen in the aggregate and also prescribes the manner in which the additional numbers may be filled up. RBI representation is on behalf of the Government of India on the boards of the RRBs to ensure proper functioning and stability.

**Organizational structure of RRBs:**

The RRBs can be different due to their local priorities, volume of business, staff strength, area of coverage, number and branches at local level etc. as per the RRB Act, 1976 Board of Directors has the powers and functioning on behalf of the Bank.

So other functionaries follow their decisions and perform accordingly. If we ignore the other things of differentiation amongst the RRBs the representative organizational structure of RRBs can be like following;

Organizational structure of Regional Rural Bank includes ;

**Organizational structure of Regional Rural Bank**

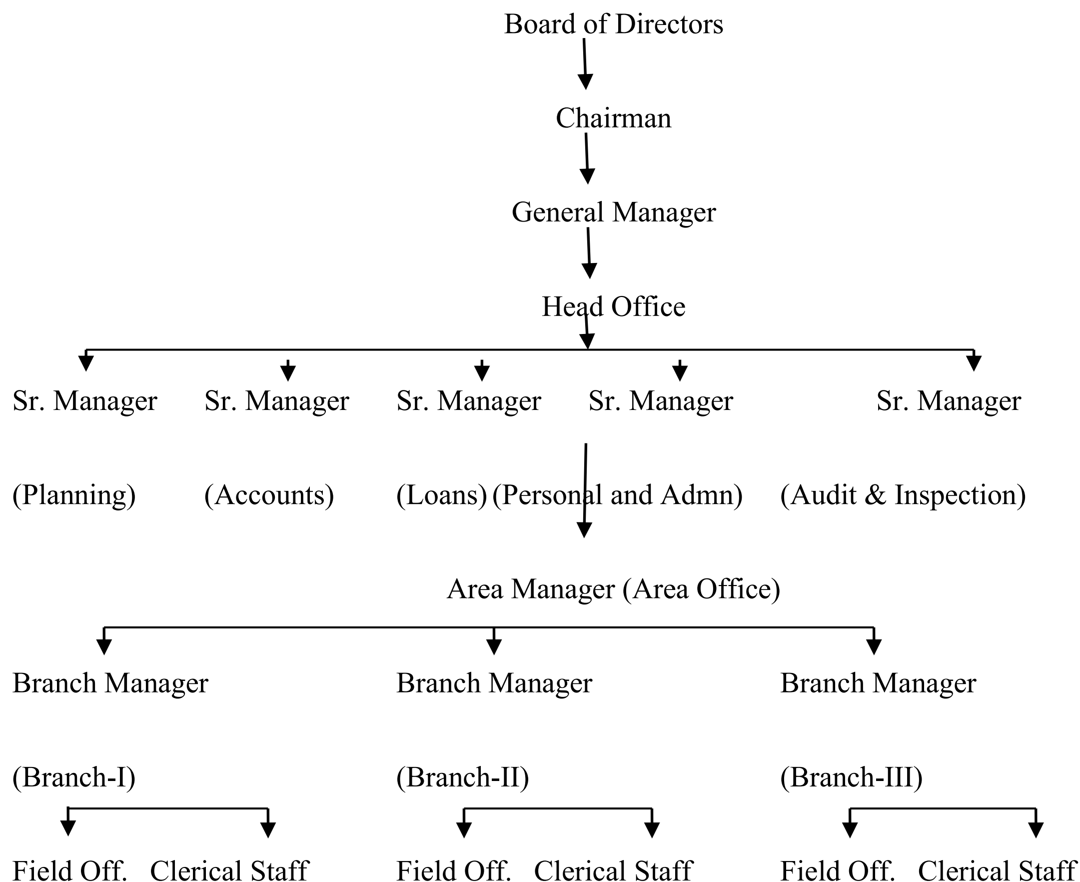



**Fig 16.1 Organizational structure of Regional Rural Bank**

The Area office is expected to cater to the 25-30 branches with the help of Branch Managers through the Field officers and the clerical staffs attached to the branch.

Irony to this kind of system was observed by the Task forces appointed by RBI. They found that the Board of Directors was not functioning independently and their dependency on the NABARD for the administrative and financial decision was making RRBs less effective and profitable.

Regional Rural Banks were empowered to appoint all the other staff except the Chairman, as he is appointed by the Sponsor Bank. So RRBs can decide about the staff members based on their rural knowledge and expertise in their domain. They generally appoint Branch managers, Accounts, Field Officers, Technical Officers, Field Assistants, Clerks, Cashiers,

etc. The sponsor bank use to provide the secretarial assistance and bears the responsibility of staff training at free of cost.

***Check Your Progress- A***

**Q1. State the mission of the Regional Rural Bank.**

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**Q2. Explain how does the sponsor bank aids the RRBs.**

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**Q3. MCQs**

a) NABARD does this/these for RRBs;
i) Conducts organization development initiative (ODIs)
ii) Regulatory Authority
iii) Provides policy inputs
iv) All of above

b) Which of the institution is the regulatory authority for RRBs
i) RBI
ii) NABARD
iii) Sponsor Bank
iv) GOI

c) Section 18 (2) of the RRB Act, 1976 empowers them to pay ___ percent more interest on deposits with maturity of more than three years

i) 1/5%

ii) ½%

iii) ¼ %

iv) None

Q4. Fill in the Blanks with appropriate word or words.

i. Sponsoring bank is a scheduled ___________________

ii. RRBs are deemed to be ________________so are not liable to pay income tax.

iii. ____________ acts as the regulatory body for the Regional Rural Banks in India.

iv. An officer of the _________, would be recommended by the Bank as Director; two officers of the _________, to be recommended by that bank for Directorship

## 16.3.4 RESERVE BANK OF INDIA ASSISTANCE TO REGIONAL RURAL BANKS

Reserve Bank of India is not only the apex financial institution of India but also the regulatory and supervisory body of the whole Indian financial system. With the presence of provision of the Regional Rural Bank Act, 1976 that empowers RBI as the representative of the Government of India while appointing directors on Board of RRBs.

Reserve Bank of India supports Regional Rural Banks through two ways:

1) For setting new governance standards through Empowered Committee (EC)
2) For credit support through NABARD

1) Through Empowered Committee (EC) RBI lay down new governance standards to make certain that RRBs should they abide by the prudential set of laws for receiving funds from the Government for their reorganization.

These ECs act on a State-wise basis, with following broad functions:

i. They scrutinize the flow of agricultural advances and advances approved by the Regional Rural Banks.

ii. They do planning for ensuring and achieving advances related targets with a monthly feedback by RRBs towards the agriculture sector
iii. They helps in designing innovative products for increasing credit in rural areas while ensuring reduction in barrier and routine problems faced at the RRBs level
iv. On operational issues it offer guidance to the RRBs
v. Aid in accomplishment of Lead Bank Scheme and Service Area Approach for the working of RRBs in their respective areas.
vi. Helps in the investment of Non-Statutory Liquidity Ratio surplus funds of RRBs.
vii. Guides RRBs in priority sector lending and lending credit support of the Government Supported programmes.
viii. Branch extension and rationalization programmes are guided by them.
ix. Periodical evaluation of financial performance of RRBs .
x. Initiatives by RRBs regarding financing of contract farming, financing of inputs suppliers and output purchasers of agricultural lending etc. is evaluated by them.
xi. Support RRBs by categorizing of branches, staffing norms and promotion policy in line with the increase of its business turnover.
xii. Review RRBs practices to promote financial inclusion

2) Credit facilities of RBI are channelized through the NABARD by the way of refinance, loans and advances. Financing of RRBs is done by NABARD on behalf of RBI for:

i. Financing of agricultural operations or the marketing of crops
ii. For the marketing and distribution of inputs necessary for agriculture or rural development
iii. Any other activity to support or in the field of agriculture or rural development
iv. Financing for bonafied commercial or trade transactions
v. The production or marketing activities of artisans and small-scale industries of the tiny and decentralized sector
vi. Provides funds for the village and cottage industries occupied in handicrafts and other rural crafts.
vii. In case of drought, famine or other natural calamities, military operations or enemy actions it support RRBs with financial support through making of loans and advances repayable on the expiry of fixed period not exceeding seven years on its terms and conditions.
viii. To RRBs through rescheduling of loans and advances made to artisans, small-scale industries, tiny and decentralized sector industries, village and cottage industries and those engaged in the field of handicrafts and other rural crafts; it support for the unforeseen circumstance.

ix. Through rediscount of bills of exchange and promissory notes made, drawn, accepted or endorsed by corporate body or financial institution concerning agriculture and rural development presented by RRBs

NABARD through Regional Rural Banks endorse sustainable and reasonable agriculture and rural development. They help in channelizing funds through successful credit support, institutional building and other innovative initiatives, as NABARD focuses its activities primarily on following issues:

**Credit functions:** at districts level in the country on annual basis it is involved in preparation of potential-linked credit plans. In this they identify credit potential, monitor the flow of rural credit at grass root level, issues policy and operational guidelines to other rural investment institutions. Also provide credit services to qualified institutions under various schemes.

**Development functions:** related to strengthening credit functions and making credit more fruitful.

**Supervisory functions:** functioning of cooperative banks and regional rural banks is supervised on regular basis.

## 16.3.5 APPRAISAL OF REGIONAL RURAL BANKS

Narasimham Committee recommendation became instrumental in establishment of first five RRBs on October 02, 1975. And by the end of 1979 there were more than 60 established RRBs with 2,420 branches and a total deposit of Rs. 123.22 crore and loan outstanding of Rs. 161.41 crore. Dantwala Committee recommendation to increase the number of RRBs supported the establishment of RRBs. By the end of December 1987 as a enhancement the number reached to 196 with 13353 branches and deposits of Rs. 2305.82 crore from 224 lakh accounts and loan disbursement of Rs. 2232.26 crore for 93 lakh accounts.

Despite such growth, in later stages these RRBs started facing problems due to:

i. Their limited target group operations at Rural markets
ii. Risk exposure only to a specific segment

iii. Public perception of being poor man's banks
iv. Losses escalated due to non- feasible level of operations at braches at resource poor areas.
v. Their dependence on sponsoring bank for investment opportunity with lesser returns
vi. Load of Government schemes
vii. Insufficient knowledge of customers results low quality asset class

viii. Lower commitment and unorganized staff resulted in lower profit and functional inefficiency, etc

Due to these reasons the Advisory Committee headed by Prof. V.S.Vyas in 2004 on Flow of Credit to Agriculture and Related activities recommended the merger of RRBs with the financial institutions at state level. Suggestions were in the direction of reduction of administrative cost, accomplish economies of scale and provide protection to the RRBs from other banks.

With this the RRBs will be effective with the efficient deployment of the financial and non-financial resources due to synergy because of combination and sharing of transactional cost. On its recommendations, Government of India had allowed the sponsored banks of the RRB to get them amalgamated in phased manner.

Result is evident from the following table Comparative Position of Performance of RRBs. The number of branches decreased from 196 in 1995 to 133 in the same period while the number of branches were 14509 and 14489 for the same period. With less number of branches the RRBs were able to raise deposits and borrowing to Rs.71327 crores and Rs. 7303 crores. Also the per branch productivity had increased from 1.20 to 7.66 in the same period.

**Comparative Position of Performance of RRBs (Rs. figures in Crores)**

| Sr. No | Parameter | Value | | |
|---|---|---|---|---|
| | | 1995 | 2005 | 2006 |
| 1 | Number of RRBs | 196 | 196 | 133 |
| 2 | Number of Branches | 14509 | 14484 | 14489 |
| 3 | No. of Districts covered | 425 | 523 | 525 |
| 4 | Owned funds | 268 | 6181 | 6647 |
| 5 | Deposits | 11141 | 62143 | 71327 |
| 6 | Borrowings | 274 | 5524 | 7303 |
| 7 | Investments | 6128 | 36762 | 41182 |
| 8 | Gross Loans and Advances | 6291 | 32870 | 39713 |
| 9 | CD Ratio | 56% | 53% | 57% |

| 10 | Investment Deposit Ratio | 555 | 59% | 56% |
|---|---|---|---|---|
| 11 | Per Branch Productivity | 1.20 | 6.56 | 7.66 |
| 12 | Per Staff Productivity | .25 | 1.38 | 1.61 |
| 13 | RRBs in profit (nos.) | 32 | 166 | 111* |
| 14 | Current Profit | 0.29 | 902 | 756* |
| 15 | RRBs in Losses (nos) | 164 | 30 | 22* |
| 16 | Current Losses (Rs. Lakh) | 423 | 154 | 191 |
| 17 | Banks wish Sustainable viability (nos) | 12 | 111 | 75 |
| 18 | Banks with Current Viability (nos) | 32 | 56 | 36 |
| 19 | Recovery (%) | 51 | 78 | 80 |
| 20 | Gross NPA (%) | 43 | 8.53 | 7.28 |

*Position after amalgamation

Source: RBI compiled data from reports

In this regard by 2007, 137 RRBs out of the 196 RRBs were amalgamated into 43 new entities. Presently there are 82 RRBs operating in India at different state level.

## 16.4 MAJOR REGIONAL RURAL BANKS OPERATING IN INDIA

As per recent available data from Reserve Bank of India, statewise there are about 82 RRB functional in India. These banks are sponsored by various national banks. Statewise Uttar Pradesh has the maximum of 10 RRBs followed by Madhya Pradesh (8), Karnatak (6) and Rajasthan (6).

The list of few RRBs and their sponsor bank is listed below

**Few State wise list of Regional Rural Banks with The Name of Sponsor Bank**

| State | Name of Regional Rural Bank | Name of Sponsor Bank |
|---|---|---|
| Andhra Pradesh (5) | Chaitanya Godavari Grameena Bank | Andhra Bank |
| | Saptagiri Grameena Bank | Indian Bank |
| | Deecan Grameena Bank | State Bank of Hyderabad |
| | Andhra Pradesh Grameena Vikas Bank | State Bank of India |
| | Andhra Pragathi Grameena Bank | Syndicate Bank |
| Karnataka (6) | Pragathi Gramin Bank | Canara Bank |
| | Chikmagalur Kodagu Grameena Bank | Corporation Bank |
| | Krishna Grameena Bank | State Bank of India |
| | Cauvery Kalpatharu Grameena Bank | State Bank of Mysore |
| | Karnataka Vikas Grameen Bank | Syndicate Bank |
| | Visveshvaraya Grameena Bank | Vijaya Bank |
| Madhya Pradesh (8) | Sharda Gramin Bank | Allahabad Bank |
| | Jhabua Dhar Kshetriya Gramin Bank | Bank of Baroda |
| | Narmada Malwa Gramin Bank | Bank of India |
| | Satpura Narmada Kshetriya Gramin Bank | Central Bank of India |
| | Vidisha Bhopal Kshetriya Gramin Bank | State Bank of India |
| | Madhya Bharath Gramin Bank | State Bank of India |
| | Mahakaushal Kshetriya Gramin Bank | UCO Bank |
| | Rewa Sidhi Gramin Bank | Union Bank of India |
| Rajasthan (6) | Baroda Rajasthan Gramin Bank | Bank of Baroda |
| | Mewar Anchalik Gramin Bank | ICICI Bank Ltd. |
| | Hadoti Kshetriya Gramin Bank | Central Bank of India |
| | MGB Gramin Bank | State Bank of Bikaner and Jaipur |
| | Jaipur Thar Gramin Bank | UCO Bank |

| | | |
|---|---|---|
| | Rajasthan Gramin Bank | Punjab National Bank |
| Uttar Pradesh (10) | Allahabad UP Gramin Bank | Allahabad Bank |
| | Baroda UP Gramin Bank | Bank of Baroda |
| | Aryavart Gramin Bank | Bank of India |
| | Shreyas Gramin Bank | Canara Bank |
| | Ballia Etawah Gramin Bank | Central Bank of India |
| | Sarva UP Gramin Bank | Punjab National Bank |
| | Purvanchal Gramin Bank | State Bank of India |
| | Prathma Bank | Syndicate Bank |
| | Kashi Gomti Samyut Gramin Bank | Union Bank of India |
| | Kshetriya Kisan Gramin Bank | UP State Cooperative Bank |
| Uttarakhand(2) | Nainital Almora Kshetriya Bank | Bank of Baroda |
| | Uttaranchal Gramin Bank | State Bank of India |

**( ) denotes no. of RRBs**
**Source: Reserve Bank of India**

***Check Your Progress- B***

**Q1. Reserve Bank of India support Regional Rural Banks through which two broad ways?**

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**Q2. Despite a good growth rate what were the problems faced by RRBs before amalgamation?**

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**Q3. MCQs**

a) NABARD provides which of the credit facilities of RBI,

i) by the way of refinance

ii) loans and advances

iii) cheque

iv) Only i) and ii)

b) amalgamation of RRBs into state level institutions was recommended by which advisory committee

i) Narasimham Committee

ii) Dantwala Committee

iii) Salunke Committee

iv) Prof. Vyas Committee

c) Which of the following options is not a Regional Rural Bank

i) Nainital Almora Kshetriya Bank

ii) Allahabad UP Gramin Bank

iii) Baroda Rajasthan Gramin Bank

iv) Canara Bank

Q4. Fill in the Blanks with appropriate word or words.

a) Credit facilities of RBI are channelized through the _______.
b) Reserve Bank of India sets new governance standards for supporting Regional Rural Banks through ________________________
c) _________helps in financing of agricultural operations or the marketing of crops.
d) Statewise the maximum numbers of RRBs are with ______________state.

## 16.5 SUMMARY

Gramin Banks or the Regional Rural Banks tried to sufficiently ensure the institutional credit to the marginalized and needy citizens at the rural level. With their local presence they meet the requirements of the small and trivial farmers, agricultural laborers, artisans and small entrepreneurs. They have unique set of problems due to their structure, business operations, clientele, location and norms set by the Government and new norms being imposed from time to time.

Amalgamation in phased manner had provided better standing to these banks and they are trying to compete with players of the banking sector like Private sector commercial banks and cooperative societies.

## 16.6 GLOSSARY

**DICGC** Deposit Insurance and Credit Guarantee Corporation of India

**EC** Empowered Committee

**NABARD** National Bank of Agriculture and Rural Development

**RRB** Regional Rural Bank

**RBI** Reserve Bank of India

## 16.7 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress –A**

Q3. a) iv b) ii c) ii

Q4 a) Commercial bank

b) Co-operative societies

c) NABARD

d) National Bank, Sponsor Bank

**Check Your Progress –B**

Q3. a)iv b) iv c) iv

Q4 a) NABARD

b) Empowered Committee (EC)

c) NABARD

d) Uttar Pradesh

## 16.8 REFERENCES


- NABARD Act, 1981
- RBI Annual Reports
- RBI Annual Report and Trends and Progress of Banking in India 1975-76
- Reserve Bank of India, report on Currency and Finance
- Reserve Bank of India Report of the Task Force on Empowering RRB Boards for Operational Efficiency , July 2007

## 16.9 SUGGESTED READINGS


1. The Reserve Bank of India website www.rbi.org.in
2. National Bank for Agriculture and Rural Development website www.nabard.org
3. Department of Agriculture & Cooperation and Farmers Welfare, Ministry of Agriculture and Farmers Welfare, Government of India http://farmer.gov.in/nabard.html

## 16.10 TERMINAL QUESTIONS

Q1. 'For Regional Rural Banks the origin is the rural philosophy at its core and to be a cost wise successful financial institution' Comment

Q2. Discuss the organizational structure of Regional Rural Banks

Q3. Elucidate the salient features of Regional Rural Banks in Indian Context

Q4. Discuss how does the NABARD promotes sustainable and impartial agriculture and rural development with the help of Regional Rural Banks.

Q5. Regional Rural Banks were promoted while keeping rural development in mind and had got support from government and commercial banks, still they have unique kind of problems. Discuss them in detail

# UNIT17 INSURANCE ORGANIZATIONS


**17.1 Introduction**

**17.2 Objectives**

**17.3 Insurance Organizations**

**17.4 Regulation for Insurance Companies**

**17.5 Summary**

**17.6 Glossary**

**17.7 Answer to check your progress**

**17.8 References**

**17.9 Suggested Readings**

**17.10 Terminal and Model Questions**


## 17.1 INTRODUCTION

In the previous unit you have understood the working of Regional Rural Banks and its contribution to the development of rural markets. Individual being risk averse tries to minimize his risk to the bare minimum. But life is full of unpredictability and unforeseen events which can distract the normal life of an individual mentally as well as financially. At this juncture we need an instrument or a product that can reduce or eliminate risk of loss to life and property.

And insurance is such product that spreads risks and losses amongst the policyholders. So one's risk is shared with lot many people by contributing to the pool of funds in the form of premium. Here the insurer or the insurance company collects funds from the policyholder or assurer and invests from this common pool to help in ensuring returns through reducing risk. One may be right that the insurance product can't get rid of risk but they can reduce the intensity of losses from the risk.

Insurance is not only beneficial for the individuals but for the economy as a whole. Insurance companies with other financial institutions and intermediaries promote the reliable and efficient credit system for the borrowers and the lenders. They complement the se institutions in development of the economy with other financial intermediaries or infrastructural development. And for such development these financial intermediaries provide long term funds with provision of risk sharing through risk pooling .

Insurance industry works in hand-in-hand with the government in social welfare, loss prevention and loss compensation during the unforeseen and unplanned events (natural or manmade). There are life insurance and non-life insurance products, these products provide various benefits to the customers ranging from tax saving and financial security to m eeting health care expenses, accidental benefits and retirement planning.

In India there are twenty-four life insurance and twenty-eight general insurance companies including ECGC (formerly Export Credit Guarantee Corporation of India Ltd.) and Agriculture Insurance Corporation are operating in India. It complements the banking industry in channelizing of financial resources from surplus to the deficit areas. It is expectedly growing at a rate of 15-20%.

With lots of cultural and climatic diversity India needs a well-developed insurance sector to cater to different needs. Not only products for the policyholders the Insurance sector helps in economic development by providing long term funds and strengthening the risk-taking ability of the country.

## 17.2 OBJECTIVES

After reading this you would be able to understand :

- Role and functions of Insurance Regulatory and Development of Authority (I
- RDA)
- How Insurance organization functions, promotes and protects policyholders
- Understanding the Indian Insurance Industry

## 17.3 INSURANCE ORGANIZATIONS

Insurance is a special type of legal contract between two parties. And the contracting parties are the insurer and assured. Insurer or insurance company offers insurance as a produ ct and by solicitation the policyholder or assured buys i t by paying premium to avail the said benefits . The agreement is that insurer will pay a specific amount of money if something happens as agreed for in the valid contract or the insurance policy. To get such money in future the assured had to bind himself with the contract by regularly paying the smaller amount or onetime payment in the form of policy premium. The amount as premium varies as

per the risk profile of the assured and the period of insurance policy. Individual or enterprise on his own discretion can decide about the sum insured based on his risk profile and while the premium is offered by the insurance company based on the risk profile of the assured.

**Development of Insurance in India:**

**Origin:**

Organized life insurance in India started with the inception of Oriental Life Assurance Company in 1818 in Calcutta (now Kolkata). While the non-life insurance business can be traced back to the year 1850, the year of establishment of Tritors (Tital) Insurance Company Ltd. in Calcutta by the British. Formally it was in 1912 with the passing of the Life Insurance Companies Act and the Provident Fund Act regulation of insurance business in India started.

**Legislation:**

The first comprehensive legislation in the Indian insurance industry was the Insurance Act, 1938 that was proposed to govern both the life and non-life insurance with strict control of state over the insurance business.

Life insurance got boost with the enactment of the Life Insurance Companies Act, 1956 and the formation of the Life Insurance Corporation.

Nationalization of Indian and non-Indian general insurance companies by the General Insurance Business (Nationalization) Act in 1972 the general insurance business of companies was amalgamated. Later on they were grouped into four general insurance companies;

i)National Insurance Company Ltd. ii) the New India Assurance Company Ltd. iii) the Oriental Insurance Company Ltd. and iv) the United India Insurance Company Ltd. while GIC was incorporated as a company.

It was in 1999 with the passing of IRDA Bill in Parliament reforms had started in Indian insurance business. As a result IRDA Act, 1999 and its provisions Insurance Regulatory and Development Authority of India (IRDA) was established on April 19, 2000. Now the insurance industry is being promoted and regulated by the IRDA in India. It is an autonomous and statutory agency working with the mission to:

"Protect the wellbeing of the policyholders, regulates, promotes and ensure methodical growth of the insurance industry and for matters connected therewith or supplementary to it”

As per the IRDA Act, 1999 private players can also enter into the insurance business, which was primarily the advantageous for the public sector insurance companies/corporations. But these private companies/corporations or players must satisfy certain set norms:

i. They should get themselves incorporated as a company registered under the Companies Act, 1956 (1 of 1956).
ii. in an Indian Insurance Company a foreign company, either by itself or through its subsidiary companies or its nominee, can't not exceed its stake more than twenty-six percent paid up equity capital.
iii. Companies solitary purpose should be to business as insurance company i.e., to carry on life insurance business or general insurance business or re-insurance business.
iv. such insurer should have a paid-up equity capital of rupees one hundred crores, for carrying on the business of life insurance or general insurance; or
v. for the business as a re-insurer the needed paid-up equity capital should be of rupees two hundred crores
vi. Prohibition of investment of funds outside India - No insurer shall directly or indirectly invest outside India the funds of the policy-holders.

Insurance company provides developmental services while promoting economic growth. Through insurance services like life insurance or general insurance policies to the persons residing in the rural sector, workers in the unorganized or informal sector or for economically vulnerable or backward classes of the society and other categories of persons as may specified by regulations made by the Authority and such insurance policies shall include insurance for crops.

Insurance companies should abide by the Insurance Act, 1978, the General Insurance Business (Nationalization) Act, 1972, Life Insurance Corporation Act, 1956, IRDA Act, 1999 and the following acts and amendments in future.

## 17.3.1 IMPORTANCE AND SCOPE

The key stakeholders in the insurance products are insured, insurer and the government of the country. So, the importance of the insurance can be understood by the following perspectives

i. Insured or Policyholder perspectives
ii. Insurer or the Insurance Companies perspective
iii. Government's perspective

**i) Insured or Policyholder perspectives**

a) Financial security: insurance provides financial security to the policyholder by sharing of risk with the other policyholders. Insurance company is responsible to ensure claims in future as and when need arises.
b) Peace of mind: Though it's a forceful saving method as we always plan for the good things but thinking bad about ourselves is a bit tough. But fear of insurance policy becoming void ensures regular payment of premiums. This further leads to peace of mind when someone else is going to act as friend in need.
c) Conservation for health issues: A Health policy takes care of one financial issue in need, which is of medical expenses. Otherwise the policyholder on one hand looses income or salary and on the other had to bear the medical/ hospital expenses.
d) Cover for legal liability: Legal heirs are entitled to avail the outputs of a insurance policy. Through this way someone can save money during his life for his legal heirs who will need it even in his absence . It acts as a protection from the loss of key earner individual or property.
e) Security for the mortgaged property : General insurance products ensure that the policyholders can take care of something which they had mortgaged.
f) Credit facility: Insurance product/policies helps individuals in availing credit facilities.
g) Tax exemption: with tax exemptions by the tax authorities insurance as a product becomes more attractive. It not only helps in savings but also in tax saving.

**ii) Insurer or the Insurance Companies perspective**

a) Source of credit: Insurance companies collect small premiums but its consolidation makes it bigger pool of funds. These funds can be distributed or invested for long periods while ensuring returns in future.
b) Earning from the small but regular premium: Premium are to be regularly paid by the policyholder. So selling of insurance policy can be tough but getting regular income for a long time is the fruit which every agent and the company wants to ensure.
c) Competing in market: with unique customer centric product the insurance companies are trying to take their share of business from the existing market. With the emerging technologies, informed customer through awareness and shrinking boundaries of nation due to internet selling of insurance is becoming easier but more competitive. Newness is to be ensured by each insurance company to tap the market potential.
d) Promote foreign trade: with the ease of doing business the shipping industry is flourishing. Insurance leads to peace of mind for the businesses who used to sell product internationally. With the help of insurance business can be sure of someone taking care of losses arising due to unknown reasons like fire, theft, or any accident of that nature. Products are being sold from one nation to the other. This needs insurance cover for the shipping of tangible products and the foreign visiting employees of such companies.

**iii) Government's perspective**

a) Employment: Insurance sector promotes employability directly as well as indirectly. Directly through the sales channel including insurance agents, brokers, sub-brokers etc. insurance companies help the government in development of employment opportunities.
b) Risk coverage: Through life and general life insurances government can rely on someone taking care of its citizens need as per age and stage. In one way they used to land hand to needy and support the government in the developmental activities.
c) Source of fund: Institutions like LIC used to provide funds to the financial system as well as to the government. For example during the recent financial crisis LIC was one of the lenders of funds to the Government of India.
d) Increase the national savings through insurance products/policies .
e) Insurance companies helps in generating development opportunities
f) Insurance companies help in developing the money markets

## 17.3.2 RATIONALE OF INSURANCE

As in intermediary Insurance helps in channelizing resources collected through premium from policyholders to industry and even to government when in need. This way they help in the growth and development of the economy.

Rationale of insurance is visible and considered before designing of a contract or insurance product which abides the parties, the Insurer and the Insured. Its guiding principles are:

i) **Principle of utmost good faith:** it's a principle of good faith between the insured and the insurer. So at the time of acceptance of insurance both the parties should share with each other the maximum truth. It specifically means all the material information is to be shared by the insurance company through the proposal as the insurance product, the insurance company or insurer offers to the acceptor of the insurance product, i.e. the assured. This insurance is in the form of contract that needs to be agreed and signed by the insured or policyholder of future. As this is a matter of solicitation, so the insured should read the document carefully and before putting his personal information for the insurance policy should ensure that he is sharing the right material facts about himself. Otherwise on knowing some unexpressed facts the insurer can cancel the contract (void the contract). This principle is also known as Principle of 'uberrimae fides'

**ii) Principle of Indemnity:** Insured is fully under writable or indemnified, but only to the extent of losses and not for the profits made. In case of serving insurance the insurer is liable only to the extent of losses that are covered as per the policy or the written contract. This contract was agreed by both the parties so it cannot be changed at the time of serving of the policy. As per this principle the insured in not entitled to make profits out of its losses.

**iii) Principle of Contribution:** This principle compliments the principle of indemnity. As per this principle the insured can claim his compensation only to the maximum of his losses either from one insurer or all insurers in total. In case of compensation being paid by two insurers, if one of the insurers pays full compensation then that insurer can claim proportionate amount from the other insuring party.

**iv)Doctrine of subrogation:** this principle becomes relevant in case of the involvement of negligent third party. This makes insurer to situate him in the place of the insured after settlement of the claims for the insured’s right to recover from an alternative source or third party is involved. So it stops the insured to collect twice the sum of loss claimed from two different parties.

**v) Principle of Causa Proxima (Nearest Cause): the** cause of loss to the insured should be directly associated with the claim for compensation. For example in case of accident of the insured or policyholder’s property takes place. Reasons for accidents can be different but at the time of claiming insurance, amount can be paid only due to existence of nearest cause and its being insured.

**vi) Principle of Insurable Interest:** to be called as a valid contract the presence of insurable interest is a must. It means that the insurance of something of life or non-life can take place only in the condition when there is a visible insurable interest. For example insurable interest exists in case of wife’s interest in the insurance of life of her husband and vice versa. But in other relationships personal, professional or business the insurable interest is to be proved before making a valid contract between insurer and insured.

**vii) Principle of Loss Minimization:** it puts the onus of taking care of insured assets on the insured. As per this principle it’s the duty of the policyholder to take utmost care of the assets and take all possible steps to minimize the loss to the asset on the happening of uncertain event. Lets us assume for a case of fire in an insured godown of a business. In this case the people responsible for operating the godown shall try their level best to stop fire by all possible means either by self or calling the fire station.

Insurance companies consider these principles while designing any of the insurance product or policies.

Insurance is a product with various features sold by the insurance company. But the uniqueness of such products is that they require the cooperation between the parties involve. They should support with their maximum contribution based on these principles.

Based on these principles both the parties are bound to respect and response accordingly. If the insured had followed the principle of utmost good faith then the insurer can’t deny the due amount at the time of maturity or as stated and agreed on as per the insurance policy contract.

## 17.3.3 FUNCTIONS OF INSURANCE

Definition of Insurance by D. S. Hansell "Insurance may be defined as a social device providing financial compensation for the effects of misfortune, the payment being made from the accumulated contributions of all parties participating in the scheme". And by Riegel and Miller, "Insurance is a social device where by the uncertain risks of individuals may be combined in a group and thus made more certain, small periodic contributions by the individuals providing a fund, out of which, those who suffer losses may be reimbursed".

These definitions also emphasized on insurance being a social device taking care of uncertainty and risk of the individuals.

The functions of the risk can be following:

i. Primary and
ii. Secondary

i) Primary functions of risk are:

**a) Protection against risk and uncertainty:** Individuals, Businesses and any other legal entity tries to safeguard itself from the predictable risks. But there are certain uncertainty issues which can't be planned in advanced. So for such uncertainty and protection from such risk they need insurance

**b) Promoting certainty:** Things never stop even after the mis-happenings in life or anything unplanned for. At this juncture there insurance products tries to compensate for the monetary support to the policyholder to take care of some expenses and planning for future.

c) **Sharing of risk:** Even with the help of payment of small amounts in the form of premiums a large pool of money is collected. By this pool the risk of an individual is shared with the community (other policyholders) of such policy. This helps in diversifying risk while ensuring returns in future.

ii) Secondary functions of the insurance are;

**a) Tax savings**: As per tax laws there are various sections that allow availing tax benefits to the policyholders. With the availability of features like tax savings the insurance is considered to be a good option for long term financial planning. This incentive to the policyholder helps in channelizing funds from individuals to the industry through insurance companies.

**b)** Prevent Losses: Accidents like fires can make financial losses to the insured. But with the presence of insurance policy the losses get compensated by the insurer. Though the growth get effected but not stopped. The businesses or individuals can start from the same point which was disturbed by events like fire, accidents, etc.

**c)** Economic Growth: The pool of funds collected by way of premiums is used by the companies for long term funding. Through such funding the economic and financial growth of the country takes place. Insurance companies acts as financial intermediaries and ensure that funds are invested at right place. As they have to ensure generation of cash flows to pay future claims.

Insurance companies and their products are being regulated by IRDA (Figure17.1 India Insurance Industry). But with this there are different products and service providers in the Indian insurance industry. Insurance as all of us know is a matter of solicitation so it is by choice and need of the policyholders that decides about the buying of the product. Insurance as a product is being sold by the insurance agents, brokers and sub- brokers on behalf of the

insurance company. Insurance companies are just facilitators in distribution of risk amongst the same interest group of policyholders.

They help in channelizing of funds from individuals or policyholder through insurer to be allocated judicially to ensure future returns for claims of future. The chain of risk sharing continues between the financial intermediaries and institutions with the presence of re-insurers in the system. Indian Reinsurers are General Insurance Corporation of India and ITI Reinsurance Limited. Foreign insurers are operating in India with joint ventures with Indian companies.

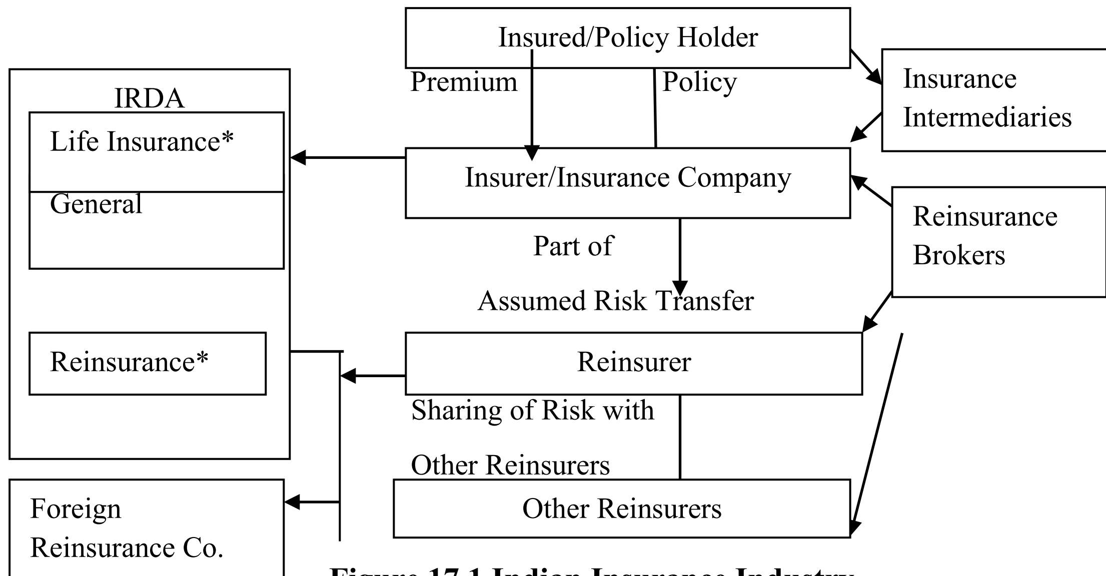


**Figure 17.1 Indian Insurance Industry**

*for companies see table 17.1, 17.2 & 17.3

### *Check Your Progress- A*

**Q1. Insurance is a legal contract of special type. Comment**

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**Q2. Explain the important perspectives behind a insurance product/policy**

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**Q3. MCQs**

**Q. Which is/are the rationale of insurance?**

i) Principle of utmost good faith

ii) Principle of Indemnity

iii) Doctrine of subrogation

iv) All of above

**Q. Insurance products are**;

i) Life Insurance

ii) Non-Life or General Insurance

iii) Medical insurance

iv) All of them

**Q. Indian Reinsurers are;**

i) General Insurance Corporation of India

ii) ITI Reinsurance Limited

iii) Life Insurance Corporation of India

iv) Only i and ii

**Q4. Fill in the Blanks with appropriate word or words.**

a) ECGC was formerly known as ________________________
b) Principle of utmost good faith is also known as______________
c) _________________the cause of loss to the insured should be directly associated with the claim for compensation.
d) Foreign insurers are operating in India with joint ventures with ___________.
e) Part of assumed risk is transferred from Insurer/Insurance Company to ________.
f) Reinsurers share their risk with ________________.

## 17.3.4 TYPES OF INSURANCE COMPANIES

Keeping this motto in view the insurance companies operate their business. Insurers are regulated by IRDA and are in the business of insurance primarily in:

i. Life Insurance
ii. General Insurance
iii. Reinsurance
iv. Health Insurance

i. Life Insurance

With 2,67,40,088 Policies/Schemes these life insurance companies ( Table 17.1 List of Registered Life Insurance Companies) they were able to collect Rs. 138657.31 Crore up to March 31, 2016. For the same period through Group schemes they had covered 17,20,33,153 lives.

There are five types of life insurance product/policies available in Indian Markets:

Term Life Insurance Policy: it provide policy cover to the policy holder for a specific time period only.

Whole Life Insurance Policy: for this policy the policyholder must pay regular premium until his death so that family can receive the total fund.

Endowment Policy: These policies pay the insured the sum assured as per the policy contract under both the scenarios-at the time of death and even on survival after the stated period in policy.

Unit Linked Insurance Policy: This is a unique life insurance product as it provides both the risk cover as well as the investment option to invest in any number of qualified investments.

Money Back Policy: as per the policy contract the policyholder is entitled to periodic returns as a percentage of sum assured as well as life insurance cover against his death.

There are twenty-four Life insurance companies operating in India

| Sr. No. | Life Insurance Product/Services Provider Company |
|---|---|
| 1 | Bajaj Allianz Life Insurance |
| 2 | Exide Life Insurance |
| 3 | Reliance Nippon Life Insurance |
| 4 | SBI Life Insurance |
| 5 | TATA AIA Life Insurance |
| 6 | HDFC Standard Life Insurance |
| 7 | ICICI Prudential Life Insurance |
| 8 | Birla Sun Life Insurance |
| 9 | Aviva Life Insurance |
| 10 | Kotak Mahindra Old Mutual Life Insurance |
| 11 | Max Life Insurance |
| 12 | PNB Met Life Insurance |
| 13 | Sahara Life Insurance |
| 14 | Shriram Life Insurance |
| 15 | Bharti Axa Life Insurance |
| 16 | Future Generali Life Insurance |
| 17 | IDBI Federal Life Insurance |
| 18 | Canara HSBC OBC Life Insurance |
| 19 | Aegon Life Insurance |
| 20 | DHFL Pramerica Life Insurance |
| 21 | Star Union Dai-Ichi Life Insurance |
| 22 | India First Life Insurance |
| 23 | Edelweiss Tokio Life Insurance |
| 24 | LIC |

Table 17.1 List of Registered Life Insurance Companies

### ii. General Insurance

Product of General insurance companies ( Table 17.2 List of General Insurance Companies) includes like Pradhan Mantri Fasal Bima Yojna, Two Wheeler Long Term Package Policy, Group Asset Protection Policy, Restructured Weather Based Crop Insurance Scheme, Commercial Vehicles Package Policy, Private Car Package Policy, Specific Shipments (Political/Comprehensive Risks) Policy, Political violence insurance policy, Clinical Trials Policy, Directors and Officers liability and Company Reimbursement Liability Insurance,etc.

A new class of General Insurance had come into existence with the new regulation i.e., Insurance Regulatory and Development Authority of India (Micro Insurance) Regulations, 2015 known as Micro Insurance. General micro insurance products include the insurance products deals in any health insurance, any contract cover the belongings, such as, hut, livestock or tools or instruments any personal accident contract, either on individual or group basis, as per terms mentioned in Schedule I of this act.

Schedule I provide insurance cover for:

a) Dwelling and contents, or livestock or tools or implements or other names assets or crop insurance-against all perils
b) Health Insurance Contract ( for Individual)
c) Health Insurance Contract (Family/Group)
d) Personal Accident (Individual/Family/Group)

| S.No. | General Insurance Product/Services Provider Company |
|---|---|
| 1 | Agriculture Insurance Co of India Ltd |
| 2 | Bajaj Allianz General Insurance Co. Ltd. |
| 3 | Bharti AXA General Insurance Company Limited |
| 4 | Cholamandalam MS General Insurance Co. Ltd. |
| 5 | Export Credit Guarantee Corporation of India Ltd. |
| 6 | Future Generali India Insurance Company Limited |
| 7 | HDFC ERGO General Insurance Co. Ltd. |
| 8 | ICICI Lombard General Insurance Co. Ltd. |
| 9 | IFFCO Tokio General Insurance Co. Ltd. |
| 10 | Kotak Mahindra General Insurance Company Limited |

| | |
|---|---|
| 11 | Liberty Videocon General Insurance Company Limited |
| 12 | Raheja QBE General Insurance Company Limited |
| 13 | Royal Sundaram General Insurance Co. Limited |
| 14 | SBI General Insurance Company Limited |
| 15 | Tata AIG General Insurance Co. Ltd. |
| 16 | The Oriental Insurance Co. Ltd |
| 17 | Universal Sompo General Insurance Co. Ltd. |

**Table 17.2 List of Registered General Insurance Companies**

iii. Reinsurance:

As per the Insurance Regulatory and Development Authority (General Insurance-Reinsurance) Regulations, 2013 are the two Indian re-insurers; a) General Insurance Corporation of India. and

b) ITI Reinsurance Limited (Registration No. 154, dated 30.12.2016

iv. Health Insurance

Product or policies of Health Insurance companies (Table 17.3 List of Registered General Insurance Companies providing health insurance) includes; Dengue Care, Edu care, Every Day Care, Critical Advantage Rider, Individual Personal Accident, Emergency Hotel Extension for insured and family members, Group Hospital Cash Policy, Accidental Hospitalization Cover, Global Personal Guard policy individual, Parivar Mediclaim policy, Parivar Mediclaim Plus policy, Grameen Care-Micro insurance product, Senior Citizen Red Carpet Health Insurance policy, etc.

Table 17.3 List of Registered General Insurance Companies providing health insurance

| S.No | Health Insurance Product/Services Provider Company |
|---|---|
| 1 | Apollo Munich Health Insurance Company Ltd |
| 2 | Bajaj Allianz General Insurance Company Ltd. |
| 3 | Cigna TTK Health Insurance Company Ltd |
| 4 | Cholamandalam MS General Insurance Company Ltd |
| 5 | Future Generali India Insurance Company Ltd |
| 6 | HDFC Ergo General Insurance Company Ltd |

| | |
|---|---|
| 7 | ICICI Lombard General Insurance Company Ltd |
| 8 | Iffco Tokio General Insurance Company Ltd. |
| 9 | Kotak Mahindra General Insurance Company Ltd |
| 10 | Liberty Videocon General Insurance Company Ltd |
| 11 | National Insurance Company Ltd |
| 12 | Raheja QBE General Insurance Company Ltd |
| 13 | Royal Sundaram General Insurance Company Ltd |
| 14 | Religare Health Insurance Company Ltd |
| 15 | SBI General Insurance Company Ltd |
| 16 | Star Health and Allied Insurance Company Ltd |
| 17 | Tata AIG General Insurance Company Ltd |
| 18 | The Oriental Insurance Company Ltd |
| 19 | United India Insurance Company Ltd |

## 17.4 REGULATION OF INSURANCE COMPANIES

Insurance companies in India had to abide the norms set under The Insurance Act, 1978, the General Insurance Business (Nationalization) Act, 1972, Life Insurance Corporation Act, 1956 and IRDA Act, 1999.

IRDA as an autonomous apex insurance statutory body functions with ten member body, consisting;

a) One Chairman (for 5 years as appointed by Government of India)
b) Five Whole-time Members (for 5 years)
c) Four Part-time Members (for not morethan 5 years)

This apex institutions helps in attracting more foreign investment in insurance sector by the overseas companies' government by adopting liberal policies. Ministry of Commerce & Industry, Government of India had liberalized the Foreign Direct Policy in Insurance sector through the 'Consolidate FDI Policy Circular 2015'. This circular states that any foreign legal entity can invest in equity upto 49% (raised from 26%) in insurance businesses like;

i. Insurance Company
ii. Insurance Brokers
iii. Third Party Administrators
iv. Surveyors and loss assessors

v. Other insurance intermediaries appointed under the provisions of Insurance Regulatory and Development Authority Act, 1999 (41, 1999)
without prior approval from Government of India.

But they have to satisfy the following conditions to make investments ;

a) No Indian insurance company shall allow the aggregate holdings by way of total foreign investment in its equity shares by foreign investors, including portfolio investors, to exceed forty-nine percent of the paid up equity capital of such Indian insurance company.
b) Automatic route subject to verification from the IRDA allows the Foreign Investment proposals up to forty-nine percent of the total paid up equity of the Indian Insurance Company.
c) Foreign investment in the sector is subject to compliance of the provisions of the Insurance Act, 1938 and the conditions that Companies bringing in FDI shall obtain necessary license from the IRDA of India for undertaking insurance activities.
d) An Indian insurance company shall ensure that its ownership and control remains at all times in the hands of residents of Indian entities.
e) Foreign portfolio investment in an Indian insurance company shall be governed by the provisions contained in sub-regulations (2), (2A), (3) and (8) of Regulation 5 of FEMA Regulations, 2000 and provisions of the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations.
f) Any increase of foreign investment of an Indian insurance company shall be in agreement with the pricing guidelines prescribed by Reserve Bank of India under the FEMA.

As a Regulatory and Development authority IRDA acts in ensuring interests of stakeholders and promotion of insurance products. This is visible in their mission statement that benchmarks in regulating and promoting insurance in India. As per its mission the following are the key reasons of its existence and functioning:

- IRDA protects the interest of the policyholders and provide fair treatment to policyholders;
- It promotes growth of the insurance industry (including annuity and superannuation payments), functions for the advantage of the common man, and to provide long term funds for speed up growth of the economy;
- High standards of integrity, financial soundness, fair dealing and competence is ensured by it;
- for the benefit of the insured and the assured it provides platform for fast settlement of genuine claims, avert insurance frauds and malpractices in the industry
- Ensures successful grievance redressal system in place;

- ensures a reliable management information system to enforce high standards of financial soundness amongst market players for transparent and orderly conduct in the financial markets;
- Law enforcement for ensuring proper following of standards;
- Self-regulatory day-to-day working in the industry steady with the requirements of prudential regulation.

***Check Your Progress- B***

**Q1. State the different types of life insurance product/policies available in Indian Markets.**

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**Q2. What is a Micro Insurance product/policy?**

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**Q3. MCQs**

a) Select amongst the following which is a general insurance company

i. SBI General Insurance Company Limited
ii. SBI Life Insurance
iii. PNB Met Life Insurance
iv. Only i and iii

b) ____________________had liberalized the Foreign Direct Policy in Insurance

i. IRDA
ii. Department of Industrial Policy & Promotion
iii. FEMA

iv. Ministry of Commerce & Industry

c) Foreign legal entity can invest in equity upto 49% in insurance businesses like;

i. Insurance Company
ii. Renewal of registration
iii. Insurance Brokers
iv. All of the above

**Q4. Fill in the Blanks with appropriate word or words.**

a) DIPP stands for ___________________________________________.
b) The two Indian re-insurers are ______________ and _____________.
c) Dengue Care, Edu care, Every Day Care, Critical Advantage Rider are product of ___________insurance.
d) ________ is the autonomous apex insurance statutory body .
e) Any increase of foreign investment of an Indian insurance company shall be in agreement with the pricing guidelines prescribed by Reserve Bank of India under the ______.

## 17.5 SUMMARY

IRDA of India promotes and protects the interest of insured as well as insurers. For economy it helps in channelizing financial resources as intermediary. As per the specific needs for life and non-life insurance of

the individuals and other legal entities like business the insurance companies offer unique products. These unique products help them in financial planning and hedging against risk and uncertainty.

Insurance companies used to sell product/policies of life and general insurance directly through websites and through insurance agents. Risk of the insurance companies is shared with the re-insurer companies.

IRDA the apex insurance institution acts as an autonomous statutory body in regulating and promoting insurance business in India. And also helps in attracting more foreign investment in insurance sector by the overseas companies' government by adopting liberal policies.

## 17.6 GLOSSARY

**DICGC** Deposit Insurance and Credit Guarantee Corporation of India

**DIPP** Department of Industrial Policy & Promotion

**ECGC** Formerly Export Credit Guarantee Corporation of India Ltd

**FEMA** Foreign Exchange Management Act

**GIC** General Insurance Corporation of India

**IRDA** Insurance Regulatory and Development Authority of India

**LIC** Life Insurance Corporation of India

**RBI** Reserve Bank of India

**SEBI** Securities and Exchange Board of India

## 17.7 ANSWERS TO CHECK YOUR PROGRESS

**Check Your Progress –A**

Q3. a) iv b) iv c) iv

Q4 a) Export Credit Guarantee Corporation of India Ltd.

b) principle of 'uberrima fides'

c) Principle of Causa Proxima

d) Indian companies

e) Reinsurer

f) Other reinsurers

**Check Your Progress –B**

Q3. a)i b) iv c) iv

Q4 a) Department of Industrial Policy & Promotion

b) General Insurance Corporation of India and ITI Reinsurance Limited

c) Health

d) IRDA of India

e) FEMA

## 17.8 REFERENCES


- Consolidated FDI Policy Circular 2015, Ministry of Commerce & Industry, GOI
- Handbook of Indian Insurance Statistics 2015-16
- IRDA Annual Reports (2015-16)
- IRDA of India ( Micro Insurance) Regulations, 2015
- IRDA of India (Investment) Regulations, 2016
- The Insurance Laws (Amendments) Act, 2015

## 17.9 SUGGESTED READINGS


1. Insurance Regulatory and Development Authority of India website www.irdai.gov.in
2. The National Insurance Company Ltd www.nationalinsuranceindia.com
3. The New India Insurance Company Ltd www.newindia.co.in
4. The Oriental Insurance Ltd.
5. www.orientalinsurance.nic.in
6. http://dipp.nic.in/English/acts_rules/Press_Notes/pn1_2016.pdf
7. http://www.thehindu.com/business/Industry/govt-allows-49-fdi-in-insurance-under-automatic-route/article8375048.ece

## 17.10 TERMINAL QUESTIONS

Q1. What are the different types of Life Insurance policies?

Q2. Discuss the different rationales of Insurance?

Q3. Mention and discuss the key players of Indian insurance industry?

Q4. What are the different types of insurances? Differentiate them while stating some important insurance companies offering such insurance products/policies.

Q5. How does IRDA ensure the interest of all the stakeholders while promoting insurance products?

Q6. What are the important roles that the insurance industry plays in an economy?

# Block IV
# Financial Instruments

# UNIT 18 FINANCIAL INSTRUMENTS

**18.1 Introduction**

**18.2 Objectives**

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## 18.1 INTRODUCTION

Financial instruments can be defined as monetary contract between two parties that can be created, traded, modified and settled. These are assets that can be traded. They provide an efficient flow and transfer of capital all throughout the world. In financial instruments, there should be net settlement instead of giving or taking delivery for a contract to buy or sell financial items.

Financial market is the market where the buyer and seller together trade the financial assets. The function of financial market is to set price for the trading, raise capital and transfer the liquidity and risk. Financial market is broadly classified into capital market and money market.

Capital Markets are used for trading long term assets which has the maturity of usually more than one year. Institutions that participate in capital market includes stock exchanges, commercial banks and all types of corporations. They help in raising funds for the companies for long term purposes. Capital market instruments include equity, preference shares, bonds, debentures, mutual funds and derivatives.

Money market is used for trading short term assets which has the maturity of less than a year. Institutions that participate in money markets are central banks, commercial banks and acceptance houses. Liquidity is one of the main function which helps in accessing the money market. This market helps in raising funds for short term purposes. Money market instrument includes Treasury Bills, Certificate of Deposits, Commercial Papers, Repurchase Agreements, Bankers Acceptance.

## 18.2 OBJECTIVES

After reading this unit you will be able to:

- Understand various types of financial instruments.

## 18.3 TYPES OF FINANCIAL INSTRUMENTS

The objectives of Financial Instruments are to provide a channel by which the net savers of an economy can pass on their savings to net spenders. Some times this transfer takes place directly for example Initial Public Offers (IPOs) of shares, all the post office instruments (Claim on Government) etc. The examples of indirect transfer are done through some financial intermediary like banks, mutual fund companies, insurance companies etc.

### 18.3.1 CAPITAL MARKET INSTRUMENTS

#### 18.3.1.1 Equity

Equities are a type of security that represents the ownership in a company. These shareholders are entitled to share the net profit and have residual claim over the assets of the company in the event of liquidation. Equities are traded (bought and sold) in stock markets. They can be bought from primary market through the Initial Public Offering (IPO) route, i.e. when the company sells its shares to the public for the first time. Investing in equities is a good long-term investment option as the returns on equities over a long time are generally higher than most other investment avenues. However, one should take greater risk while expecting greater return.

Pricing of equity shares:

1. Par or Face value: This is the value of share which is accounted in the books of accounts.

2. Issue price: It is the price at which equity share is actually offered to the investor. Generally face value and issue price will be same in case of new companies.

3. Share at premium: When the share is issued at the price higher than the face value, the excess amount is called premium.

4. Share at discount: When the share is issued at price lower than the face value, then this is said to be shares issued at discount.

5. Book value: This is the value of shares as entered in the balance sheet of the company. It is the ratio of the total of paid-up capital and reserves and surplus divided by total no. of shares.

6. Market value: When the shares of the company which is listed on stock exchanges are sold in the market, the price at which the share is sold currently in the market is called the market value.

Types of Equity shares:

1. Right share: These are the shares issued to the existing shareholders of a company. Such kind of shares is issued to protect the ownership rights of the investors.
2. Bonus Share: These are shares given by the company to its shareholders as a dividend.
3. Sweat equity share: These shares are issued to exceptional employees or directors of the company for their exceptional job in terms of providing know-how or intellectual property rights to the company.

**18.3.1.2 Preference Shares**

Preference shares are those shares which ensures that holders of those shares gets fixed dividend and these payments are done to preference shareholders in prior to that of ordinary shareholders. If the company becomes bankrupt, then the preference shareholders will be paid from the company's asset first. Preference shareholders do not hold any voting rights.

Types of Preference Shares:

1. Cumulative preference share: These are those shares which has provision to get paid all the dividends that were omitted in the past before the common shareholders are able to receive their dividends paid.

2. Non-cumulative preference share: They do not pay any omitted dividends and if the company decides not to pay dividends in any year, non-cumulative preference shareholders do not hold rights to claim such omitted divided in future.

3. Participating preference share: These shareholders have rights to get paid with the same dividends as that of the preference share dividend. In addition to this, they also get an additional dividend based on predetermined condition. This additional dividend is applicable only if the common shareholder gets dividends that are higher than that of predetermined per-share amount. If the company is bankrupt, participating preferred shareholders may also have the right to be paid back the purchasing price of the stock as well as a pro-rata share of remaining proceeds received by common shareholders.

4. Convertible preference shares: They have an option where these shares can be converted into a set number of common shares, usually after a pre-established date.

**18.3.1.3 Bond**

Bond is a long term agreement between two parties wherein the borrower agrees to make payments of both principal and interest on the specified dates to the bond holder. Bonds are generally issued by government agencies and corporates that look for capital through long term debts.

**Types of Bonds:**

1. Treasury Bonds: They are also called as government bonds. These bonds are issued by federal government. These bonds' price will decline as and when the interest rates rise. Thus they are not completely riskless.
2. Corporate Bonds: These are bonds issued by corporates or business firms. Business firms are generally exposed to default risk. If the bond issued company is in trouble, then the company will not be able to give back the assured interest and principal payments. Thus the bondholders may suffer loss. The default risk is also termed as credit risk.
3. Municipal Bonds: These bonds also called as munis are those issued by state government and local government. These bonds are also exposed to default risk. But one unique advantage over all other bonds is that the interest earned from these bonds are exempted from federal taxes and from state taxes if the holder is the resident of that particular issuing state.
4. Foreign Bonds: These are bonds that are issued by foreign government and foreign corporation. These foreign bonds are exposed to default risk. There is an additional risk if the bonds are denominated in a currency other than that of the investors' home currency.

Key Features of Bonds:

1. Par Value: It is the stated face value of the bond. Par value represents the amount of money the firm borrows and promises to repay on the maturity date.
2. Coupon Interest Rate: This is set at the time of issuing the bond and is valid during the life of that bond. Coupon Interest rate is the annual coupon payment is divided by the par value of the bond.
    a. Fixed Rate Bond: Here the interest rate is fixed throughout the lifetime of that bond.
    b. Floating Rate Bond: Here the interest rate of the bond fluctuates as and when the general level of the interest rate changes.
3. Maturity Date: Generally bonds have the specified date on which the par value of the bond must be repaid. This specific date is called maturity date.
4. Call Provision: This is the provision given to the bond contract where the issuer has rights to redeem the bond under specified terms before the actual maturity date. This states that if the bond is called off, then the issuer must pay the bondholders the amount generally higher than that of the par value of that bond contract.

### 18.3.1.4 Debentures

Debentures are a type of long-term bonds that are not secured. There is no specific collateral as security for the obligation. Debentures are used based on the nature of the firm's assets and their credit strength. One who buys the debenture is the creditor of the company and he is called the debenture holder.

Types of Debentures:

1. Secured or Mortgage Debenture: This is the type of debenture that is secured against the assets of the company. In case if the company is winding up, then the assets of the company will be sold and this will be paid back to the debenture holders.
2. Mortgage Deed: This includes all sort of information like the value of the security, date on which the interest payment has to be made and how much interest has to be paid, terms of repayments, debenture holder's rights in case if the company defaults to pay the interest or the principal amount. Thus in the event of default of the company, they can recover the money from the assets that are mortgaged.
3. Unsecured Debentures: As the name suggests, the debentures are not secured against any assets of the company. Thus in case if the company winds up, the assets of the company will not be sold in order to repay the interest or principal to the debenture holders.
4. Redeemable Debenture: These are types of debentures that have to be repaid to the debenture holder within the specified period of time.
5. Irredeemable Debentures: These are debentures which need not be repaid to the debenture holder within a specified time, instead they can be repaid back anytime during the lifetime of the company.

**18.3.1.5 Mutual Fund**

It is the pool of money from a group of people that is managed professionally, in keeping with a predetermined investment objective. One of the primary rules of investment is to diversify portfolio which can easily be accomplished by investing on mutual fund. Few advantages of investing on mutual fund are professional management, instant diversification, liquidity and also one can find a mutual fund which exactly matches what they are looking for from an investment.

Types of Mutual Fund:

Mutual fund can be broadly classified into open ended, closed ended and interval funds. We shall look into each categories in detail.

1. Open Ended: This scheme allows investors to buy or sell units at any point in time. This does not have a fixed maturity date.

- Debt: Major part of investment is invested on debentures, government securities, and other debt instruments. Although capital appreciation is low (compared to the equity mutual funds), this is a relatively low risk-low return investment avenue which is ideal for investors seeing a steady income.
- Money market / liquid: These are schemes where the investment is made on short-term debt instruments. These funds provide reasonable returns for the investors.
- Equity / Growth fund: The investment is completely made on equity. Though this is of high risk in short run, they give a better capital appreciation during long run.
- Balanced: This type of scheme provides both growth and income at regular intervals. Funds are invested in both equity and fixed income securities.

2. Closed Ended: This type of scheme has a stipulated maturity period and investors can invest only during the initial launch period known as the NFO (New Fund Offer) period.

- Capital Protection: Main objective of this scheme is to provide security to the principal amount invested while trying to deliver reasonable returns. Thus they are invested in high-quality fixed income securities and marginally to the equity. They mature along with the maturity period of the scheme.
- Fixed Maturity Plans (FMP's): This type of scheme is one which has a defined maturity period. These schemes normally comprise of debt instruments which mature in line with the maturity of the scheme, thereby earning through the interest component (also called coupons) of the securities in the portfolio.

3. Interval: Operating as a combination of open and closed ended schemes, it allows investors to trade units at pre-defined intervals.

**18.3.1.6 Derivative:**

Derivative is any security or financial asset whose value is derived from the value of some other underlying asset. There are various derivative instruments such as futures, forwards, swap and option. We shall look more in details.

Forward:

Forward contract is an agreement between two parties wherein one party agrees to buy a good or commodity at a specific price on a specific future date and the other party agrees to make the sale. Unless both the parties are financially strong, then there is danger for any one of them depending on the changes in price of the commodity after the agreement is made.

Future:

Futures are standardized contracts that are traded on exchanges, whereas forward contracts are usually tailor-made, that is negotiated between the two parties and not been traded after signing of agreement takes place. Futures are usually market to market on daily basis, i.e. the gain and losses are noted on daily basis and the money must be put up in order to reduce loss. Thus the risk involved is less when compared to forward contract. Other main difference is that in futures, there is no physical delivery of the underlying asset takes place. The two parties settle the cash for the difference between the actual price and the contracted price on the expiration date of the future contract.

Swap:

Swap is a contract between two parties where exchange of obligation (i.e.one financial instrument instead of another) takes place between two parties to make specified payment. This takes place at a predetermined time as specified in the contract.

Option:

Option is a contract that gives the option holder the right to buy or sell the asset at a predetermined rate within the specified period of time. When the option is excised, the price that is quoted in the contract which has to be paid for the share of common stock is called the strike or excise price.

Types of Option:

1. Call Option: It is the option to buy or "call" a share of the stock at a certain price within the specified period. If the stock fails to reach the strike price within the expiration date of the contract, then option expires.

2. Put Option: It is the option to sell a share of stock at a certain price within a specific period. The investor buys put option if they think the share price of the assets will fall or they buy put if they feel that the share price of the share would rise.

## 18.3.2 MONEY MARKET INSTRUMENTS

### 18.3.2.1 Treasury Bill

Treasury Bill or T-Bill is a short-term security (Debt instrument) which gets matured within a year. These are issued by the government when the money is needed for the short period. They are generally issued under 3 maturity periods namely 91 days, 182 days and 364 days. They are generally zero-coupon securities. They are issued at a discounted price and are redeemed at the face value at the time of maturity.

T-Bills can either be purchased at the government help auctions or purchase already issued T-Bill that is available in the secondary market. Main advantage of T-Bill is its low risk.

### 18.3.2.2 Certificate of Deposit

Certificate of Deposit or CD is a short to medium term debt instrument that has comparatively low risk. This can be purchased from any of the financial institutions directly. These are not traded in stock markets. But still these can be purchased from the stock brokers as they have greater access to CD's across various financial institutions across the countries.

Here a certain amount is deposited in the financial institution for a specific period of time at a specified rate of interest. One can invest on CD's if their focus is to save money with low risk and there is no want of that fund till it gets matured. They can be invested for a period of 3 months to 7 years. Incase if we want to redeem the CD prior to its maturity date, then that financial institution may charge a penalty which may vary from institute to institute. The interest on CD are fully taxable.

### 18.3.2.3 Commercial Paper

Commercial Paper ( CP) is issued in the form of promissory note to finance the short term credit need of the large institutional buyers who have high credit rating. They are unsecured money market instrument which was introduced in 1990.CP is issued by financial

institutions, corporates and primary dealers. These are short term instruments with the maturity period of minimum 7 days to maximum of one year. CP's are usually purchased at a discounted value by the investors and they receive its face value at its maturity.

#### 18.3.2.4 Repurchase Agreement

Repurchase Agreement also called REPO is the sale of security which is also combined with the agreement that the same security will be repurchased back at a higher price in the future date. Repo is usually a short term transactions which have a low risk on investing on them. At times repo are made for long time period which has a greater collateral risk due to market fluctuation. For the party at the other end of the agreement who buys the repo and agrees to sell the same in the future, it is called reverse repurchase agreement. Here buyer is the lender and seller is the borrower and the security is the collateral.

#### 18.3.2.5 Banker's Acceptance

Banker's acceptance is the short term debt instrument created by a nonfinancial firm and this is guaranteed by the banks. These are accepted by the banks for the purpose to finance their customers who undergo sale of goods or to buy the goods. They are similar to T-Bills where they are traded at discount value from the face value in the secondary market. Date of maturity of Banker's Acceptance usually varies from 30 days to 180 days.

***Check Your Progress- A***

**Q1. What are Equity Shares?**

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**Q2. What are the various types of Preference Shares?**

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**Q4. State the meaning of a Financial Derivatives?**

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**Q5. What are the various Money Market Instruments?**

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## 18.4 SUMMARY

Financial Instruments are like life blood of an economy. These play the same role in the economy, as the blood plays in a living creature. Financial Instruments ensures that the funds are moving from the party who has funds in surplus to the party who has the funds in deficit. Usually an economy can be divided into three sectors: Households, Business Organizations and Government. Out the three, householders are considered as surplus-spenders and the other two, business organizations and Governments are considered as deficit-spenders. Financial Instruments does the job of transferring the funds from surplus-spenders to deficit spenders.

## 18.5 GLOSSARY

**Equities** are a type of security that represents the ownership in a company. These shareholders are entitled to share the net profit and have residual claim over the assets of the company in the event of liquidation.

**Preference shares** are those shares which ensures that holders of those shares gets fixed dividend and these payments are done to preference shareholders in prior to that of ordinary shareholders.

**Debentures** are a type of long-term bonds that are not secured. There is no specific collateral as security for the obligation. Debentures are used based on the nature of the firm's assets and their credit strength.

**Mutual Fund-** It is the pool of money from a group of people that is managed professionally, in keeping with a predetermined investment objective. One of the primary rules of investment is to diversify portfolio which can easily be accomplished by investing on mutual fund

**Derivative** is any security or financial asset whose value is derived from the value of some other underlying asset

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## 18.8 TERMINAL QUESTIONS

Q1. What are the Financial Instruments?

Q2. What are the differences between capital market and money market financial instruments?

Q3. Explain the difference between Shares and Bonds.

Q4. Explain the difference certificate of deposits and commercial papers.

# UNIT 19 DERIVATIVES-OPTIONSAND FUTURES

**19.1 Introduction**

**19.2 Objectives**

**19.3 Introduction to Derivatives**

**19.4 Options**

**19.5 Futures**

**19.6 Summary**

**19.7 Glossary**

**19.8 Reference/ Bibliography**

**19.9 Suggested Readings**

**19.10 Terminal & Model Questions**

## 19.1 INTRODUCTION

In this unit, you will study about Financial Derivatives. The basic purpose of these instruments is to make certain commitments to prices for future dates for giving protection against adverse movements in future prices.

## 19.2 OBJECTIVES

After reading this unit you will be able to understand;

- Option and Futures
- Explanation of market Terminologies
- Pay-off Structure
- Basic Trading Strategies and weekly option.
- Membership requirements and clearing and settlement procedure
- Risk Management.

# 19.3 INTRODUCTION TO DERIVATIVES

Derivatives are type of instruments which are traded in the financial markets and which fundamentally derive their value from an original underlying. The underlying can be a commodity, stock, metals, currency, government bonds etc. There are various types of derivative mechanisms which are traded in the market, most common types are forwards, futures, options and swaps. As derivatives are based on an underlying asset, they derive their value from the asset and emulate the fluctuations which the asset experience in the commercial market.

Originally, derivatives instruments appeared for mitigation of risk in financial transactions. With the help of the derivative contract, parties who are part of the contract are striving to transfer the risk over a given time in the contract, to a party who is ready to bear the risk in the contract. Derivatives can be advantageous in financial transactions if they are judiciously used. The risk associated with the underlying asset which is associated with a derivative product is normally attached and bounded by the contractual agreements, thus this risk can be traded in financial markets. One more benefit of the derivative products is that the underlying asset, which is part of the derivatives instruments necessarily need not be acquired and the financial instruments can be settled without the physical transfer of the ownership of the asset, between the concerned entries which are part of the contract. This property of the derivative instruments helps in bifurcation of the ownership of the instrument and involvement of the parties, thus providing flexibility in designing the contracts for various types of derivative instruments.

The derivative instruments can be divided into two separate classes based on the where they are traded. Over the counter (OTC) products are derivative instruments which are operated between private entries without any intermediary. On the other hand, exchange-traded derivatives are standardised derivative instruments, which are freely traded in derivative exchanges or other exchanges, where the exchange acts as an intermediary between the parties to the contract, thus protecting the parties from any breach of the contractual agreements.

Derivative instruments can be classified depending on the underlying asset which it represents. The underlying asset belongs to various asset classes like equity, currency, interest rate, commodity, and credit. Further, derivatives instruments can be classified based on the type of relationship that exists between the underlying asset class and the instrument. e.g. forward contracts, option contracts and swaps.

Derivatives which primarily evolved as instruments to hedge the risk which is associated with the value of the underlying asset class to be transferred. But derivatives contracts are prone to risks which may originate from counterparties either violating the terms of the agreement or on the failure of the contract to consider some unforeseen risk which parties failed to consider when the contract was being formulated. To mitigate the parties from counterpart risk which originates due to violation of the terms of the agreement, numerous mechanisms has evolved.

One of the mechanisms are setting up a clearing house, which acts as intermediary and thus insures the parties from risk of default.

Derivatives contracts provide the opportunity to hedge the risk associated with an asset by selling the contract without selling the assets. Derivatives provide the owner of the asset to hold the asset for a specified time period and sell the asset at future date depending on the price arrived in the contractual agreement. With this arrangement owner of the asset can control the asset for a specified amount of time without compromising on the downside resulting from the abrupt movement of the price of the asset.

Derivative contracts play an important role in creation of an efficient market. Derivative markets help in shifting the risk from the entities or persons who are ready to take risk from the entities or persons who are risk averse, thus helping the rearrangement of the risk profile of the market participants.

Derivatives markets play a significant role in increasing the trading volume of the underlying assets. Market participants can take positions in the underlying asset due to the presence of flexible prospects of managing the risk exposure through derivative contractual agreements, thus providing market participants increased options to transfer the risk.

Derivative markets help in the efficiency of the markets by providing information of the future price of the assets, discounting the risk associated with assets class. Information of the prices of derivative contracts can be used by the market participants to forecast the future prices of the assets.

Derivative provides exposure to the underlying which may sometimes not be tradeable. Thus, derivatives instruments helps in commercialization of the underlying asset which are not commercially tradable. Derivates provide a means to redistribute the investments by reallocating the investment across different asset classes without actual reallocation of the underlying asset, thus providing transition options in portfolio rebalancing.

Derivatives markets are also not free from its share of critics. Derivative instruments can create substantial harm to the markets, because of the leverage enjoyed by the market participants due to small price movements. When the asset prices on which the derivates contracts are based shows substantial movements, the impact of this fluctuations are extensive because of the leverage enjoyed by the market participants. Derivatives markets exposes the market participants to an emergent risk, arising from the default of the counterparty to the transaction. The counterparty risk varies according to the risk profile of the underlying asset and have a contagion effect on the financial systems if due diligence has not been carried out in on the market participants who are party to those contractual agreements. Though various mechanisms have been devised by the financial regulators to control its contagion effect on the financial system, especially through the creation of derivatives exchanges and clearing houses, a large part of the derivation markets are exposed to this risk generated through the default of the counter party.

## 19.4 OPTIONS

It is to be noted that financial derivation are instruments which derive their value either from the underlying financial instruments, such as equity share bond or debenture etc or from the underlying prices/index of securities. Virtually, the financial derivatives don't possess any value of its own rather it is derived from the underlying financial asset.

These financial derivations are used in the financial market in a variety of ways. The most common types are : options,& futures.

Options: when a market participant is willing to possess any right without any liability; he enters into an option contract. In this case, the holder enjoys the right to buy or sell a particular asset without any liability. This means that if the holder is not interested to exercise his option, he can do this. For example, if Mr. X purchases an option to sell a particular share or index at any price he would like to exercise his option, if prevailing price is in his favour otherwise he would not like to exercise his option. If the option is not exercise, the only loss is the amount of option price paid up front.

When a market participant entered into an option contract and has the right to exercise it any time up to the date of expiration, it is called American option. But, if the holder has the right to exercise it only at the date of expiration, it is known as European option. The option terminology is given as under:

1. Index option- When the index such as, SENSEX or NIFTY is the underlying. The value of the option will be derived from the underlying index.

2. Stock option - when the underlying is a particular share for example share of Reliance. In this case the option holder has the right to buy or sell the share at the specified price but, has no liability.

3. Writer of an caption – This the person who sells the option at a price.The price is called as option premium.

4. Buyer of an option- The person who purchase the option to buy or sell a particular asset by paying option premium.

5. Call option- If the holder of the option has the right but not the obligation to buy an asset is called call option. Here right to buy an asset is important.

6. Put option- If the holder of the option has the right but not the obligation to sell an asset, it called put option. Here, right to sell an asset is important.

7. Option premium- It is the price at which option contract is purchased and sold.

8. Expiration Date- It is the date at which the option contract is exercised and specified in the contract. It is also known as maturity date.

9. Strike price- It is the price specified in option contract at which contract in carried out.

## 19.5 FUTURES

If an agreement is made between two person's to buy or sell an asset at a certain price and time in the future, it is termed as futures contract. These contract are standardised and hold on stock exchange. The future contract are standardised with respect to their underlying instrument, quality and timing of settlement. Thus if a person is entering into any futures contract, he cannot design his agreement with his own specification. He is supposed to finalised an agreement which contain standardised components.

Futures are different than forward contracts, the forward contract have flexibility in price and quantity etc. The parties can design agreement to suit to their requirements. However, they suffer from various drawbracks, such as liquidly and counter party risk etc which are almost eliminated by the futures.

The futures and option may be differentiated on its practical side. The buyer pays the option price initially, there after there is no possibility of any loss occurring to him. So, there is a possibility of loss of only initial money paid at the time of purchase however, in the case of futures, nothing is required to be paid by the parties initially, but there are possibilities of very heavy losses.

The important terminology used in the futures contract is as under:

Future price- The future contract is in future market settled at some future price. The date used at the time of settlement is said to be future price.

Contract cycle –It involves the total period over which a contract trade. For example, as a standard, one month, two month, three month expiry cycle is followed with respect to the index futures that expires on the last Thursday of the month. Therefore, an April expiration contract expires in the last Thursday of April. Similarly, May expiration contract ceases trading on the last Thursday of May. Thus a new contract consisting of three month expiry is introduced on the Friday following the last Thursday.

Expiry Date- Expiry date is the last day on which contract is finalised after which future contract will come to an end.

Contract Size- As a standard a fixed amount of asset is delivered under some contract. For Example, it may consist of zero shares of 200 NIFTIES.

Basis- The difference between future price and spot price is termed as basis. For each contract different basis max exist for each delivery month.

Cost of carry- The cost of carry explains the relationship between future price and spot prices.

Initial Margin- The initial margin is the amount which is futures deposited in the margin account when a contract is first initiated.

Making to market: In the case of marking to market every investor's margin account is adjusted to reflect gain or loss occurred on the basis of closing price, at the end of each Thursday.

Maintenance margin – In the case, the balance in the margin account is lower than initial margin Maintenance margin is required to be deposited.

***Check Your Progress- A***

**Q1. State the meaning of a Financial Derivatives?**

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**Q2. Explain the features of financial derivatives?**

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**Q3. Write a short note on forward contacts?**

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## 19.6 SUMMARY

This unit has introduced financial derivatives markets in India by briefly describing the need of derivatives markets in India. The need of derivatives in India has arisen due to economic liberalization. Since 1991 individuals and corporates were facing exchange risk, interest rate risk and other risks. The management of these risks is very important in the globalized world, and derivatives play an important role in this respect.

## 19.7 GLOSSARY

**Bid/offer spread-** The difference between quoted bid and offer prices.

**Buyer of an option-** The party who, through purchase, acquires the right conveyed by the option. Also commonly referred to as the option holder, where the purchase is to open a position.

**Buy-Write-** Purchase of stock and simultaneous writing of call options against stock position.

**Calendar Spread-** The sale /purchase of a near month call option /put option and the simultaneous purchase /sale of a longer dated call option /put option of the same exercise price.
**Call option-** An option that conveys to the option buyer the right but not the obligation to purchase shares at a fixed strike price per share at any time during the life of the option.
**Cash Market-**The market in the underlying instrument.
**Clearing House-** The organisation which guarantees the performance and settlement of exchange traded contracts to its members - NSCCL
**Intrinsic value-** The amount, if any, by which an option is currently in the money. An option that is not in-the-money has no intrinsic value.
**Last Trading Day-** The final day for dealing in options contracts for a particular expiry month.
**Long-** An open "bought" position.
Lot- One equity options contract. In case of Nifty Index, the lot size is 100 Nifty.
**Settlement price-**The price used for daily revaluation of open positions.
**Short-**An open "sold" position.
**Tick size-** The smallest permitted price movement in a particular contract.

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2. Varshney P.N., & Mittal D.K., 'Indian Financial System', Sultan Chand & Sons, New Delhi. 2002.
3. Verma J.C., 'Venture Capital Financing in India', Sage, New Delhi, 1997.
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## 19.10 TERMINAL QUESTIONS

Q1. Explain the term 'financial derivative'. What are its important features?

Q2. Explain the different types of financial derivatives along with their features in brief.

Q3. Compare and contrast between forward, futures, options and swaps.

Q4. Write a detailed note on uses of financial derivatives.

# UNIT 20 FOREIGN CAPITAL- FDI & FII

**20.1 Introduction**

**20.2 Objectives**

**20.3 FDI In Various Sectors**

**20.4 Importance of FDI**

**20.5 Guidelines for FDI**

**20.6 Steps Involved in Investment Through FDI**

**20.7 FIIs (Foreign Institutional Investors)**

**20.8 Initiatives by The Government to Promote FIIs**

**20.9 FIIs – Key Statistics**

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**20.14 Terminal & Model Questions**

## 20.1 INTRODUCTION

Foreign Direct Investment (FDI) is mode of investment of holding an ownership in a business in one country by business or institution located in another country. It is thus different from a foreign portfolio investment on the basis of direct control and management of the business in which an investor simply purchases equity instruments of foreign-based companies.

In a comprehensive sense foreign direct investment comprises of "mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations and intra company loans". In a limited sense, foreign direct investment refers to building new facility, and a lasting management interest (10 percent or more of voting rights) in an enterprise operating in a country other than that of the investing organization. FDI is the total of equity capital, long-term capital, and short-term capital as shown in the balance of payments. FDI generally involves participation in management, joint-venture of two enterprises, transfer of technology from one company to another etc.

Foreign direct investment (FDI) in India is the prime financial source for economic development. India is a country which is developing at a rapid rate and labor is also available at very low rates of wages which is a prime source of attraction for foreign Investors to invest in India. Liberalization and Privatization i.e LPG started in India in 1991 due to utter economic crisis with the objective of promoting Foreign Investment in India. It was Dr.Manmohan Singh and P. V. Narasimha Rao who brought the concept of FDI in India, which afterwards created more than one crore jobs in the nation craving for development and employment. According to the Financial Times, in 2015 India overtook China and the US as the top destination for the Foreign Direct Investment. In first half of the 2015, India attracted investment of $31 billion compared to $28 billion and $27 billion of China and the US respectively during the same time period.

The Government of India has modified FDI policy to increase FDI inflow in the nation. In 2014, the government increased foreign investment upper limit from 26% to 49% in insurance sector in order to further upgrade and attract foreign capital in this sector. It also launched Make in India initiative in September 2014 under which FDI policy for 25 primary focused sectors was further liberalized. As of April 2015, FDI inflow in India increased by 48% ever since the launch of "Make in India" initiative.In terms of FDI inflow India was ranking 15th in the world in 2013, it rose up to 9th position in 2014 while in 2015 India became top destination for foreign direct investment.

India received the maximum amount of FDI from Mauritius, Singapore, Netherlands and Japan in the year 2014-15, though Mauritius always remained a prime source of FDI inflows for India. 'Make in India' initiative was launched in India in the year 2014 by Government of India releasing norms in 25 sectors to promote FDI inflows further and thereby further raised the level of employability.

Foreign Institutional investors (FIIs) are institutions which are established outside the country and their motive is to invest in the securities of another country thus they are also called portfolio investors. Institutional investors generally include hedge funds, insurance companies, pension funds and mutual funds. The term is used mostly in India and refers to foreign companies investing in the financial markets of India.

## 20.2 OBJECTIVES

The various objectives of this unit are;

- To emphasize upon the concept of FDI and FII.
- To highlight various importance of FDI and FII.
- To briefly explain the guidelines of FDI and FII in Indian perspective.

## 20.3 FDI IN VARIOUS SECTORS

Generally, every economy follows the system of different guidelines for foreign investment in various sectors, similarly, in India the guidelines for FDI in different sectors of the economy are as follows:

**FDI in Infrastructure sector**

Construction activity provides 10 percent of India's GDP. Indian government has invested $1 trillion on infrastructure from 2012–2017 in order to boost the economy of this amount almost 40 percent is funded by private sector. 100 percent FDI under automatic route is allowed in construction sector for development of cities and township. Under the present government now, India is following the concept of developing "Smart cities" i.e the cities with all the amenities and facilities, for this purpose foreign capital is the main source of development thus FDI is much needed and sought for in infrastructure sector.

**FDI in Automotive sector**

FDI in automotive sector is increased from April 2014 to February 2015 and raised to the level of 89 percent. India stands at $7^{th}$ position in respect of largest producers of vehicles in the world with 17.5 million vehicles annually. 100 percent FDI is permitted in this sector via automatic route. 7% of India's GDP is shared by Automobiles sector. Therefore, it is yet another crucial sector for economic development.

**FDI in manufacturing sector**

Manufacturing is the most crucial sector for any rapidly developing economy due to its potential of employability, it is crucial for nations with very high population growth rate. Countries like China have achieved so much growth by focusing upon manufacturing sector. India is making progress transforming itself into a manufacturing based economy, the aim is to to increase the share of manufacturing in India's GDP from a declining 15-16% since 1980 to 25% by 2022 and thereby create an additional 100 million jobs. India is expecting a higher growth rate in manufacturing sector with government initiatives like "Make in India". India's success in manufacturing is because of electronics equipments to a great extent but still there remains a challenge in Foreign Direct Investment for India in this sector which is far less from the other competing economies like China. Recently, companies like Samsung have announced an investment of INR 5000 crore in India in its manufacturing plant at Noida.

**FDI in Pharmaceutical sector**

The Indian pharmaceutical market is 3rd largest in the world in terms of volume of production and 13th largest in terms of value generated. The Indian pharmaceutical sector is expected to grow at the rate of 20 percent CAGR. FDI in this sector is permitted to the extent of 100 percent but still there remains a lot to be done in terms of attracting giants of pharmaceutical sector towards bulk drug manufacturing and research and development as till date a number of large pharmaceutical giants are not manufacturing here rather they are outsourcing their manufacturing to a number of Indian manufacturers and are only involve

in marketing of their products. Like Glaxo gets many of its products manufactured at Aurobindo pharma plants.

**FDI in Service sector**

It is the highest GDP contributing sector in the Indian economy. Service sector covers banking, insurance, outsourcing, research & development, courier and technology testing. In 2014-15 FDI in service sector was increased by 46 percent. It stands at US $ 1.88 billion in 2017. FDI limit in insurance sector was raised from 26 percent to 49 percent in 2014 in order to provide more confidence and control to the foreign firms and thereby attract further FDI and create jobs.

**FDI in Railways sector**

100 percent FDI is allowed under automatic route in most of areas of railway, other than the operations, like High speed train, railway electrification, passenger terminal, mass rapid transport systems etc. Mumbai-Ahemdabad high speed corridor project is single largest railway project in India, other being CSTM-Panvel suburban corridor. Foreign investment more than 90,000 crore (US$14 billion) is expected in these projects. More recently, the government is working towards Bullet train technology and for that inflow of FDI from Japan is the primary source for which a MOU is also signed between the two nations.

**FDI in Chemicals sector**

In 2013 Chemical industry of India earned revenue of $155–160 billion. Under automatic route 100 percent FDI is permitted in Chemical sector. Except Hydrocynic acid, Phosgene, Isocynates and their derivatives, production of all other chemicals is de-licensed in India. India's share in global specialty chemical industry is expected to rise from 2.8% in 2013 to 6–7% by 2023.

**FDI in Textile sector**

Textile is one crucial contributor to India's export. Nearly 11 percent of India's total export is textile. This sector has attracted about $1647 million from April 2000 to May 2015. 100 percent FDI is allowed under automatic route. FDI in textile sector was increased by 91 percent in 2013-14 so that more foreign capital can be attracted and research and development in the area of textile industry can be increased along with generating sufficient employment opportunities for the citizens.

**FDI in Airlines sector**

Foreign investment in a scheduled or regional air transport service or domestic scheduled airline is permitted to 100percent, with FDI up to 49% permitted under automatic route and beyond 49percent through door existing airport under automatic route.

## 20.4 IMPORTANCE OF FDI

Foreign direct investment promotes many things, to diversify the base of investment in the country, as well as in solving the problem of unemployment through the creation of new job opportunities for the population, and the introduction of advanced technology, the state, and learning about the modern methods of management, communication and marketing, which lead to the population gaining higher skill and experience.

While foreign investors may desire at the thought of selling to a 1.3 billion population, retail trade in India is dominated by unorganized retail outlets. Those who oppose FDI in retail sector are of the opinion that opening the door to the giants of organized retail sector will draw away consumers from these tiny outlets to giant departmental stores, and squeeze their suppliers too.

The new proposal is a compromise solution which tries to protect such outlets while protecting the government from allegations of demerits from FDI in retail. The present policy authorizes the government to keep a check on the interference of the multinational giants. And given that many of the global single-brand retailers deal only in luxury goods, therefore it is expected that the Indian venture of such retail giants would not affect much the highly distributed unorganized retail market of India.

But there are certain loopholes, like these MNCs are allowed to deal not only in single premium product but also in products of mass consumption. Another point of concern can be that every retailer in the market is competing for spending done by the consumer so if the consumer spends more on luxury product that is also going to affect the unorganized sector indirectly. For example, a single trip to KFC can be equal to many small meals at Naresh Restaurant.

FDI's are crucial for growth of any economy, some of its importance are:

1. It helps in creating new job opportunities as a result of which unemployment is reduced which is very common phenomenon of developing countries just like that of India.

2. Foreign direct investment also impacts balance of payments through the inflow of foreign capital, which makes it a good source for hard currency and increasing physical capital in the host states.

3. Public sector could not arrange funds in the sector of power alone, FDI's in this sector promoted development. India is a country which has a vast scope of development in hydro power, nuclear power, solar power, thermal energy as well as in wind energy. Renewable sources of energy require vast amount of investments for research and development for which foreign capital and technology is required.

4. FDI also ensures higher wages for skilled and unskilled labor.

5. Increasing competition with foreign companies ensures better quality products and services from domestic companies also.

6. Foreign direct investment promotes exports. Like by establishment of plants of Ford Motors in Chennai, the exports of India as a nation has increased in the automobile sector.

8. It removes the problem of adverse balance of trade by promoting exports.

9. Foreign Direct Investment brings required capital to developing countries. The developing countries need higher investment to achieve increased targets of growth in national income in order to achieve the goal of sustainable development.

10. It improves the infrastructural conditions of the country.

Foreign Direct Investment (FDI) can be made through two routes that are:

Automatic Route: Indian companies engaged in various industries can issue shares to foreign investors up to 100% of their paid up capital in Indian companies depending upon the regulations framed by government.

Government Approval Route: Certain activities that are not covered under the automatic route require prior Government approval for FDIs.

*Investors are advised to check for government approval and other related sector condition in latest FDI Circular Section 5.

Category 1- Sectors in which FDI is permitted up to 100% under automatic route

Category 2- Sectors in which FDI is permitted up to 100% under Government Route.

Category 3- Sectors in which FDI is permitted beyond certain limit with Government approval.

Category 4- Sectors wherein FDI is permitted up to certain limit under both Government and Automatic routes subject to applicable laws/ regulations security and other conditional ties.

To facilitate Foreign Direct Investment the Foreign Investment Facilitation Portal (FIFP) is introduced, which is the new online single point interface, of the Government of India for investors. This portal is designed to facilitate the single window clearance of applications which are for approval. On the receipt of a FDI application, the concerned Administrative Ministry/Department will process the application as per the Standard Operation Procedure (SOP).

After abolition of the Foreign Investment Promotion Board (FIPB) by the Government, the work of granting government approval for foreign investment under the extant FDI Policy and FEMA Regulations has been entrusted to the concerned Administrative Ministries/Departments. Earlier FIPB was the main body granting such approvals and processing applications for investments.

## 20.5 GUIDELINES FOR FDI

The eleven notified sectors/activities requiring government approval are:-

- Mining, Defence/cases relating to FDI in small arms
- Broadcasting
- Print media
- Civil Aviation
- Satellites
- Telecom
- Private Security Agencies
- Trading (Single, Multi brand and Food Products)
- Financial services not regulated or regulated by more than one regulator/ Banking Public and Private (as per FDI Policy)
- Pharmaceuticals

Total FDI Equity inflow in India from various sectors was USD 2378.68 million in 2000-01, USD 4027.69 million in 2001-02, USD 2704.34 million in 2002-03, USD 2187.85 million in 2003-04, USD 3218.69 million in 2004-05, USD 5539.72 million in 2005-06, USD 12491.77 million in 2006-07, USD 24575.43 million in 2007-08, USD 31395.97 million in 2008-09, USD 25834.41 million in 2009-10, USD 21383.05 million in 2010-11, USD 35120.8 million in 201-12, USD 22423.58 million in 2012-13, USD 24299.33 million in 2010-14, USD 30930.5 million in 2014-15, USD 40000.98 million in 2015-16 and USD 43478.27 million in 2016-17, respectively. All these figures are based upon the data provided by the government from time to time through their portals.

There was a downfall in growth of total FDI Equity Inflow of -36.15% during 2012-13 over 2011-12 in India. There was a growth of total FDI Equity Inflow of 8.37% during 2013-14 over 2012-13 in India. There was a growth of total FDI Equity Inflow of 27.29% during 2014-15 over 2013-14 in India. There was a growth of total FDI Equity Inflow of 29.33% during 2015-16 over 2014-15 in India. There was a growth of total FDI Equity Inflow of 8.69% during 2016-17 over 2015-16 in India. More recently, India is doing quite good in terms of receiving FDI.

## 20.6 STEPS INVOLVED IN INVESTMENT THROUGH FDI

- Identification of the structure for investment.
- Central Government approval, if required, as discussed in the earlier part of the chapter.
- Establishment of the structure identified.

- Inflow of funds via eligible instruments and following pricing guidelines as imposed by the govt.
- Meeting reporting requirements of RBI and respective administrative authorities.
- Registrations/obtaining key documents like PAN etc.
- Project approval at State/UT level where the investment is going to be made.
- Finding ideal space for business activity based on various parameters like incentives, cost, availability of man power, legal guidelines of the judiciary etc.
- Manufacturing projects are required to file Industrial Entrepreneur's Memorandum (IEM), some of the industries may also require industrial license, depending upon the nature of production to be done.

 Construction /renovation of the business unit.

 Recruitment & selection of the human resource.

 Meeting annual requirements of a structure as imposed by the govt, paying regular taxes etc.

Aspects of taxation in FDI is as follows

**Direct Taxes:**

- It is an important aspect of revenue for the central government. The investor is required to pay tax on net income earned in India. The rates of taxes differ from structure to structure.

**Company:**

- The company which is incorporated in India is required to pay 30% tax + surcharge + education cess on net income earned. It is also required to deduct tax on profits distributed @ 15.5%+ surcharge+ education cess, as per the present guidelines of direct taxation; however it depends upon the annual finance bill.

**Branch office/ Project office/ Liaison office or permanent establishment:**

- The fixed place of business in India established through FDI or any route is treated as a permanent establishment and is required to pay tax @ 40% + surcharge + education cess. There is no tax on profits distributed to the owners.

**Limited Liability Partnerships (LLPs):**

- LLPs are required to pay tax @ 30% +surcharge + education cess. There is no tax on profits distributed to the partners.

**Minimum Alternate Tax (MAT):**

18.5%+SC+EC- Indian tax law requires MAT to be paid by corporations in cases where the tax payable according to the regular tax provisions is less than 18.5% of their book profits. However MAT credit (MAT-actual tax) can be carried forward in next 10 years for set-off against regular tax payable during the subsequent years subject to certain conditions.

However, the government nowadays is of the opinion that MAT must be liberalized or abolished and some better mechanism of taxation must be thought for.

From the above discussion we have seen that FDI helps in rapid development of the economy,since liberalization our economy has boosted and our GDP has also increased, new technologies have entered the economy ,efficiency has increased manifolds, competition has increased, all this is because of introduction of FDI's and many more positive impacts.

## 20.7 FIIS (FOREIGN INSTITUTIONAL INVESTORS)

FII's exert a deep impact on the total of all inflows coming in the economy. SEBI (Securities & Exchange Board of India) has over 1450 foreign institutional investors registered with it. Growth in financial market depends largely on them.

Economies like India and China, which offer relatively higher growth than the developed economies, have gained favour among investors as attractive investment destinations for foreign institutional investors (FIIs) that is one of the main reasons why we have witnessed a soaring stock index in both these economies. Investors are optimistic on India and sentiments are favorable following government's announcement of a series of reform measures in recent months.

According to Ernst & Young's (EYs) Global Capital Confidence Barometer (CCB) - Technology report, India ranks third among the most attractive investment destinations for technology transactions in the world so it is also acting as a prime attraction for the global financial institutions which invest their money in soaring upcoming economies to maximize returns.

India is the third largest start-up base in the world with more than 4,750 technology start-ups, and about 1,400 new start-ups being founded in 2016, according to a report by Nasscom.

Foreign Institutional Investments are important for a developing economy like India because they contribute a lot to the inflow of capital funds due to inadequacy of funds multilateral financial institutions. Until 1980's India's development strategy focused primarily on import substitution and self-reliance .Current Deficit was mainly financed by debt flows and official development assistance, these were two crucial resources, which were of course insufficient for such a big economy. It would be wise to say that there was in fact a general bend towards private commercial flows and foreign investment. India's policy reforms had changed since the commencement of the whole economic reforms process in the early 1980's and during the initiation of the liberalization era in the early 1990's, India managed to draw a lot of attention from foreign investor which eventually increased foreign institutional investments in India. FII was permitted in 1992 with reasonable restrictions as a result of the recommendation of the Narsimhan Committee Report on Financial System. The Committee highlighted on the need of opening up the domestic financial markets to foreign portfolio investments in order to boost the infrastructural requirements. Foreign Institutional Investors were permitted to invest in all the securities traded on the primary and secondary markets, which mainly consisted of

debentures, shares and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India. The then Finance Minister of India, while presenting the budget for the financial year 1992-93 proposed a motion to allow various reputed investors to invest in the Indian Capital Market for e.g. Pension Funds etc.

There are certain business and institutions which are allowed to invest in Indian markets as per the law of the country under the FII route. They can either invest as FII or as sub-accounts which are bifurcated as below:

1.Investment trust, mutual funds, asset management company, nominee company, overseas pension funds bank, institutional portfolio manager, university funds, endowments, charitable trusts, foundations, charitable societies, a trustee or power of attorney holder incorporated or established outside India intending to make proprietary investments are all examples of investments which can be termed as foreign institutional investments.

2. Sub Account: The sub-account is the underlying fund on whose behalf the FII invests. The business and institutions which are eligible to be registered as sub-accounts, viz. private company, public company, partnership firms, pension fund, investment trust, and individuals.

FII's are required to get their self registered so that they can get the certificate from SEBI to invest in Indian securities market as only registered FIIs are allowed to enter into Indian stock markets which are primarily two BSE and NSE. RBI, SEBI and FIPB are the regulators of FII's in India of which FIPB is now abolished by the government.

FII's are permitted to invest in securities of both primary and secondary market, units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed or not listed on a recognized stock exchange, security receipts, Commercial Papers, securities dated by the government and derivatives traded on a recognized stock exchange.

SEBI has the authority to set certain conditions which may be necessary with respect to the maximum amount which can be invested in the debt securities by an FII on its own account or through its sub-accounts.

FII play a crucial role in Indian financial market because they have huge corpus of funds for investment. Its importance is discussed below:

1. The demand and value of the company increases and FII float huge amount in the shares of the company and stock index grows which leads to creation of goodwill for the economy.

2. A positive image of the shares in which they invest is created due to which resident investors are also attracted towards investing into stocks.

3. They help the Indian market to grow which would otherwise not be possible because of lack of funds for investment. We can say that they supply the much needed funds for the Indian economy.

4. They help in increasing the forex reserves of the nation.

5. As the forex reserves of the nation increases the value of domestic currency is also improved.

# 20.8 INITIATIVES BY THE GOVERNMENT TO PROMOTE FIIS

The initiatives that the government has taken to promote FII's in the country are discussed below:

1) The FDI policy for the defence sector has been examined and as per the new policy, the composite foreign investment up to 49% is allowed through government route (FIPB) and if there are institutions looking for more than 49% investment it can be done on the prior approval of the Cabinet.

2) Preference to 'Buy (Indian)', 'Buy & Make (Indian)' initiatives of the govt. ensures that the interest of India is prioritize in FII investments also.

3) To establish a balance of power between Indian private sector and the public sector, the anomalies in excise duty/ custom duty have been removed. As per the revised policy, all Indian industries (public and private) are subjected to the same kind of excise and custom duty levies, now with GST this objective will further be better achieved.

4) In the Defence sector the govt has liberalized the list of products kept under the list of licensing requirement so as to promote more participation of private and public sector and thus attracting FIIs for investment also.

5) Process of applying for Industrial License (IL) and Industrial Entrepreneur Memorandum (IEM) has been made completely online and this service is now available to entrepreneurs on 24X7 basis at e Biz website without human interface, so that unnecessary delays and bottlenecks can be avoided.

6) Government has revised the validity timeline for Industrial Licensing so that the licenses can be issued for a longer duration of time and thus the confidence of FIIs in Indian organizations can be enhanced.

7) The 'Security Manual for Licensed Defence Industry' has been issued. With the issue of the Security Manual, the requirement of affidavit from the investor is no longer needed.

8) The provision for annual capacity license for defence sector is repealed.

9) Now for selling defence items to the government entities approval of department of defense is not required.

10) Requirement of multiple application forms have been repealed.

11) To promote the participation of private sector, particularly SMEs for defence manufacturing, outsourcing and vendor development guidelines for DPSUs and OFB have been formulated and circulated to them. The guidelines mandate that each DPSU and OFB to have a short-term and long-term outsourcing and vendor development plan to gradually increase the outsourcing from private sector including SMEs. The guidelines also include vendor development for import substitution.

12)The Standard Operating Procedure (SOP) for the issue of No Objection Certificate (NOC) for export of military stores has been revised and put on the website. Under the revised SOP, the requirement of End User Certificate (EUC) to be countersigned/ stamped by the government authorities has been done away with for the export of parts, components, sub-systems etc.

13) The list of military stores has been finalised and has been put in the public domain to make the process transparent and easy. The process of receiving applications for NOC for export of military stores and for issuing NOC has been made online to reduce the delay and to remove human interface in the process.

14) The advanced version of NIC Code (NIC 2008) has been adopted, which is a highly contemporary industrial classification.

15) Recognizing the need for promotion of defence exports to make the Indian defence industry economically sustainable; Defence Exports Strategy outlining the various steps to be taken, has been formulated and is put up in public domain.

The emergence in FII investment let to the cumulative net investment by FII into Indian equities to total US dollar 52.76 billion by the end of November 2008, since December 1993 when FIIs were permitted to enter the Indian economy. As of November 28,2008 1581 FIIs and 4284 sub accounts were registered with Securitize and Exchange Board of India(SEBI).According to the data given by Securities and exchange board of India the FII in investment in equities as on march 2009 stood at US dollar 50950.20 million and in debts, equalled 6541.50 million at exchange overseas investors have invested have infused US dollar 816.69 milliin into the stock market into the stock market in the first trading week of 2010,reflecting the a positive start for the year in the last few years. Foreign institutional investors (FIIs) were gross buyers of shares worth US$3.03 billion and sold equities valued worth US$ 2.2 billion, resulting in a net investment of US$ 823.74 million, according to the capital market regulator, Securities and Exchange Board of India (SEBI).FIIs were net investors of US$973.22 million in debt instruments in the first trading week of the year according to the data released by SEBI.

According to SEBI, FIIs transferred a record US$ 17.46 billion in domestic equities during the calendar year 2009.This FII investment in 2009 proved to be the highest ever inflow in the country in rupee terms in a single year, breaking the previous high of US$ 174.96 billion parked by foreign fund houses in domestic equities in 2007.FiiS infused a net US$1.05 billion in debt instruments during the said period.

During the October –December period 2009-10.FIIs made a net buy of shares worth US$ 5.19 billion, according to the data compiled from market regulator, The Securities and Exchange Board of India. In the quarter, December attracted the highest inflow of US$ 2.2 billion, followed by October US$ 1.95 billion and November US $ 1.18 billion .FIIs poured a net US$ 1.26 billion in debt instruments during the said period.

The number of FIIs who registered themselves with SEBI in the year 2009 was higher by & per cent over 2008.Data sourced from SEBI shows that number of registered sub-accounts rose to 5.403 as of march 31,2010.

## 20.9 FIIS – KEY STATISTICS

- In 2013, foreign investors infused a net Rs 1,130 billion (US$ 18.76 billion) in equities.
- Total number of FIIs registered in India was 1,710 in FY 14.
- An aggregate net investment of Rs 7.08 trillion (US$ 117.56 billion) have been made in shares by FIIs, since they entered the Indian market in 1992

FIIs invested around Rs 79,709 crore (US$ 13.23 billion) in the country's equity market in FY 14, according to data released by the Securities and Exchange Board of India (SEBI). During the year, foreign investors invested majorly in domestic equities markets as Indian equity markets gave some of the best returns among emerging countries, as per market analysts.

FIIs bought debt securities worth Rs 8,155 crore (US$ 1.35 billion) and sold bonds to the tune of Rs 4,609 crore (US$ 765.69 million) in the period January 1–10, 2014, which resulted in a net inflow of Rs 3,546 crore (US$ 589.10 million), according to data provided by SEBI. Their total investment in debt and equity in the period was about Rs 4,091 crore (US$ 679.49 million).

The Reserve Bank of India's (RBI) efforts to attract foreign exchange were rewarded at the end of 2013, with remittances from non-resident Indians (NRIs) reaching US $13.71 billion in November. Under foreign currency non-resident – banks [FCNR(B)] category, the deposits touched US$ 38.62 billion at end of November, 2013 up from US$ 24.70 billion in October, 2013, as per RBI data.

The RBI has allowed Hinduja Foundries to increase its foreign investment limit up to 60 per cent of paid-up capital. This increase in investment limit is under the Portfolio Investment Scheme (PIS). Hinduja Foundries is a group company of multi-billion dollar Hinduja Group which is headquartered in London.

Total FII investment in equity and debt in India crossed the US $10 billion mark on April 2, 2014. FIIs invested another US$ 100 million in Indian shares the same day, taking the FII purchases in the year (up to April 2, 2014) to US$ 4.18 billion. In the debt market, FII investments stood at US$ 6.13 billion.

A number of market analysis indicates that large part of FII inflows come from long only funds indicating that foreign investment quality is good.

*From the above discussion it is clear that FII has strong implication on Indian economy they not mere money but more than that,they are the sentiments which are related to the development of the country,they promote foreign investment without increasing foreign debt.They lead to appreciation in the currency as well as in the exports.*

With the support of the government and its policies in place, FIIs should continue to prosper in India's economy. At the present, the outlook is encouraging. Foreign investors' net inflows reached Rs 1 trillion (US$ 16.60 billion) in stocks in India during 2013, the third time FII investments have crossed the figure since they entered the Indian market in 1992. Total investments in the country's equity market also reached an all-time high of US$ 150 billion in 2013. Experts are equally bullish about 2014. According to market analysts, sectors such as food and beverages, financial services, pharmaceuticals and biotechnology, and software, among others, are attractive to FIIs.

***Check Your Progress- A***

**Q1. What is FDI?**

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**Q2. Who are FIIs?**

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**Q3. What is the role of foreign capital in economic development?**

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## 20.10 SUMMARY

Foreign Direct Investment (FDI) is an investment in the form of a holding ownership in a business in one country by business or institution based in another country. It is thus different from a foreign portfolio investment on the basis of direct control and in which an investor simply purchases equities of foreign-based companies.

In a comprehensive sense foreign direct investment comprises of "mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations and intra company loans". In a limited sense, foreign direct investment refers to building new facility, and a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. FDI is the total of equity capital, long-term capital, and short-term capital as shown in the balance of payments. FDI generally involves participation in management, joint-venture, transfer of technology and expertise.

FII's exert a deep impact on the total of all inflows coming in the economy. SEBI (Securities & Exchange Board of India) has over 1450 foreign institutional investors registered with it. Growth in financial market depends largely on them.

Economies like India, which offer relatively higher growth than the developed economies, have gained favour among investors as attractive investment destinations for foreign institutional investors (FIIs). Investors are optimistic on India and sentiments are favorable following government’s announcement of a series of reform measures in recent months.

According to Ernst & Young's (EYs) Global Capital Confidence Barometer (CCB) - Technology report, India ranks third among the most attractive investment destinations for technology transactions in the world.

Total FDI Equity inflow in India from various sectors was USD 2378.68 million in 2000-01, USD 4027.69 million in 2001-02, USD 2704.34 million in 2002-03, USD 2187.85 million in 2003-04, USD 3218.69 million in 2004-05, USD 5539.72 million in 2005-06, USD 12491.77 million in 2006-07, USD 24575.43 million in 2007-08, USD 31395.97 million in 2008-09, USD 25834.41 million in 2009-10, USD 21383.05 million in 2010-11, USD 35120.8 million in 201-12, USD 22423.58 million in 2012-13, USD 24299.33 million in 2010-14, USD 30930.5 million in 2014-15, USD 40000.98 million in 2015-16 and USD 43478.27 million in 2016-17, respectively.

There was a downfall in growth of total FDI Equity Inflow of -36.15% during 2012-13 over 2011-12 in India. There was a growth of total FDI Equity Inflow of 8.37% during 2013-14 over 2012-13 in India. There was a growth of total FDI Equity Inflow of 27.29% during 2014-15 over 2013-14 in India. There was a growth of total FDI Equity Inflow of 29.33% during 2015-16 over 2014-15 in India. There was a growth of total FDI Equity Inflow of 8.69% during 2016-17 over 2015-16 in India.

FIIs invested around Rs 79,709 crore (US$ 13.23 billion) in the country's equity market in FY 14, according to data released by the Securities and Exchange Board of India (SEBI). During the year, foreign investors invested majorly in domestic equities markets as Indian equity markets gave some of the best returns among emerging countries, as per market analysts.

FIIs bought debt securities worth Rs 8,155 crore (US$ 1.35 billion) and sold bonds to the tune of Rs 4,609 crore (US$ 765.69 million) in the period January 1–10, 2014, which resulted in a net inflow of Rs 3,546 crore (US$ 589.10 million), according to data provided by SEBI. Their total investment in debt and equity in the period was about Rs 4,091 crore (US$ 679.49 million).

The Reserve Bank of India's (RBI) efforts to attract foreign exchange were rewarded at the end of 2013, with remittances from non-resident Indians (NRIs) reaching US $13.71 billion in November. Under foreign currency non-resident – banks [FCNR(B)] category, the deposits touched US$ 38.62 billion at end of November, 2013 up from US$ 24.70 billion in October, 2013, as per RBI data.

## 20.11 GLOSSARY

**Foreign Direct Investment (FDI)** is mode of investment of holding an ownership in a business in one country by business or institution located in another country.

**Sub Account:** The sub-account is the underlying fund on whose behalf the FII invests. The business and institutions which are eligible to be registered as sub-accounts, viz. private company, public company, partnership firms, pension fund, investment trust, and individuals.

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## 20.14 TERMINAL QUESTIONS

Q1. Elaborate upon the importance of FDI.

Q2. What are the initiatives taken by government to promote FIIs?

Q3. What are the guidelines in India with regards to FDI?

Q4. Explain the Minimum Alternate Tax (MAT)?

Q5. What is the role of foreign capital in economic development?

# UNIT 21 INTERNATIONAL OPERATIONS IN THE SECURITIES MARKET

**21.1 Introduction**

**21.2 Objectives**

**21.3 Mechanisms for Inflow of Foreign Capital**

**21.4 Why ECBS**

**21.5 Source Of ECBS**

**21.6 Approvals Required for Raising ECBS**

**21.7 Maturity Period Of ECBS**

**21.8 Risks Involved In ECBS**

**21.9 Managing Exposure Arising From ECBS**

**21.10 Policy Changes for Encouraging ECBS**

**21.11 Euro Debts**

**21.12 Summary**

**21.13 Glossary**

**21.14 Reference/ Bibliography**

**21.15 Suggested Readings**

**21.16 Terminal & Model Questions**

## 21.1 INTRODUCTION

Over the years the stock markets across the globe have become increasingly popular amongst financial institutions for investments and wealth maximization. One of the major reasons for this approach of financial institutions is the rapid growth and technical development witnessed in the stock markets across the globe. Likewise the companies are also crossing borders and issuing their instruments in order to attract foreign capital which is needed by them for financial up gradation. Foreign funds along with domestic savings serve as a vital source of capital for the enterprises. However, there are various pro and cons of foreign capital, it not only affects the capital structure of a company but in a wider perspective it also has an impact on the political and economic sovereignty of a country. It is one of the prime reasons why the countries are extremely cautious in allowing the entry of foreign capital in a nation. India also followed the policy of limited access to foreign capital till 1991, until and

unless economic reforms in the country took place. However, the real increase in the inflow of foreign capital in India was witnessed during the first decade of 21st century. After the enactment of the policy of liberalization, privatization and globalization the government has made several successful changes in the policies related to management and control of foreign capital in the form of policies related to FDI (Foreign Direct Investment) and FII (Foreign Institutional Investment). These policy changes have made it easier for the companies to attract foreign capital. However, it is not only the policy of the government which has contributed in the growth and inflow of foreign capital in India rather it is also the performance of companies which have done superbly well during the past decades in terms of returns on investments. Since, foreign capital is required for growth of domestic firms it is allowed by the government but as strict monitoring is required transactions involving foreign capital is kept outside the ambit of SEBI and strict control by other regulatory enactments like FEMA and others is exercised by the government. During November 1993, the government announced a scheme for Indian companies guiding for issue of their securities in the foreign market in order to attract foreign capital. This scheme was called, "Issue of Foreign Currency Convertible Bonds and ordinary shares (through Depository based system) scheme of 1993". Since then this scheme was reviewed several times and several changes were made from time to time as per changing environment. Due to operation of this scheme the Indian companies are now authorized to attract foreign capital through the following two mechanisms:-

1. Foreign Currency Convertible Bonds (FCCBs) &,
2. Equity shares through Depository Receipts (ADRs and GDRs).

## 21.2 OBJECTIVES

Various objectives of this unit are;

- To elaborate upon international exposure of securities market.
- To elucidate upon various tools used for trading in international transactions.
- To detail upon the concept of FCCB and ECB.

## 21.3 MECHANISMS FOR INFLOW OF FOREIGN CAPITAL

**Foreign Currency Convertible Bonds (FCCBs):** It is a debt instrument issued in a foreign country in terms of foreign currency denominations and which can be converted into ordinary shares either in part or in full. Only a company having a proven track record of profitability of at least 3 years is entitled to issue FCCBs. This instrument is basically unsecured and carries a fixed rate of interest along with an option to convert into ordinary shares. Interest on FCCBs and the price on maturity both is payable in terms of US dollars. Generally the rate of interest on these bonds is much lesser as compared to similar nature debt instruments issued in India for fund raising.

FCCBs are popular amongst issuers because of the fact that the rate of interest chargeable is quite low and due to the options attached many a times the issuing organization may not be required to pay maturity amount. The instrument is also popular amongst investors for the simple reason that the interest as well as the maturity amount is payable in terms of dollars as a result there is not much exchange rate risk attached to the instrument.

One of the biggest limitations of FCCBs from the point of view of issuer is that due to the option attached to the FCCB they may not be sure about their capital structure as they are never sure about the quantum of conversion that may take place. Similarly, at the time of maturity also they may not be sure about the quantum of cash outflow.

**Depository Receipts (DRs):** It is an acknowledgement on the part of the issuing company that the receiver is being issued a certain number of ordinary shares of the company and is denominated in terms of US dollars. It is an ideal instrument for such issuers who want to expand their shareholding on global level. Such shares are in the form of negotiable instruments and are traded on various stock exchanges. These instruments can be of two types either American Depository Receipts (ADRs) or Global Depository Receipts (GDRs). When these negotiable instruments are issued in USA it is called ADRs and when these instruments are issued to the customers of any other country than USA it is called GDRs. As these instruments are valued on the basis of the underlying assets which are shares, the shares representing these instruments are put in the custody of a local bank who acts as a custodian.

When investors apply in the depository receipts, he gets the option of converting these receipts into ordinary shares after a cooling period of 45 days.

**External Commercial Borrowings (ECBs):** In case of developing economies there is dearth of availability of domestic capital, the funds generated by the government by way of taxation and savings of the people of the nation are too small when they are put in line with the requirement of capital for infrastructural and industrial development. This becomes one of the prime reasons why a developing nation looks for ECBs. The reasons behind allowing inflow of foreign capital via route of ECBs are:

- There is lack of enough domestic resources to finance development related activities of the nation.
- The savings of the people of which country is too less due to low per capita income.
- Adverse Balance of Payments is also one of the prime reasons as due to this there is always a lack of availability of foreign capital.
- Another reason is dismal amount of exports generated by these developing nations.
- Strong and constantly rising demands of infrastructural development in the developing nation is also one of the prime reasons.

Thus, the governments in the developing nations allow the big corporate houses to raise funds in the form of ECBs. ECBs includes, 1) Commercial Bank Loans 2)

Buyers' Credit 3) Suppliers' Credit 4) Fixed rate bonds and 5) other form of Euro bonds.

## 21.4 WHY ECBS

In the last decade the European markets have become more and more appealing to Indian companies for the purpose of meeting their financial requirements and finding an efficient market to issue their securities. One of the prime reasons behind this behavior of Indian companies is lower cost of debt in European markets as compared to the domestic Indian market where the cost of raising funds is much higher due to high floatation expenses and high Interest rates prevalent. In order to access the European funds however the companies are required to seek approval of Reserve Bank of India and other regulatory bodies.

Post liberalization of Indian economy the pattern of raising funds from European markets has increased. Pre-liberalization the companies are only allowed to raise funds from domestic market and at that time one of the major limitation in issuing debt instrument is lack of a ready market of debt, so there is limited marketability and liquidity attached to the debt instruments which makes them less popular amongst the investors as compared to others securities and that is why often to attract them it is required by the companies to pay comparatively a higher rate of interest which further increases the cost of such instruments. The other option was that of borrowing funds from the financial institutions which also involved a lot of paper work, formalities and yet at the same time was very costly. Further the financial institutions also start interfering in the working of the organizations which poses threat of leak of may vital information which the company may not want to share with them. As a result at times many good investment opportunities and expansion opportunities are lost by the companies for lack of money.

As a result after liberalization government allowed certain companies to raise funds by means of Euro issues so that the desired level of development can be achieved. Initially the corporate which turned to the European markets were only few partly due to restrictions imposed by the government and partly due to the fact that they lacked sufficient experience of the European markets however with passage of time the number of corporate seeking access to European capital kept on increasing.

One of the major reasons why corporate felt attracted towards the European markets for raising funds was due to the fact that the cost of raising fund from European markets was even lesser than the cost of raising funds from domestic market. A part from it another advantage which is attached to Euro issues is that it takes very less time to raise the money even lesser time as compared to domestic issues.

However, apart from all the advantages associated with Euro issues it has got certain limitations like this mode of borrowing is only available to certain companies which are allowed by the government and not all the companies are allowed to raise money from abroad. Another limitation attached to this mode of financing is exchange rate fluctuation.

In the past decade the Reserve Bank of India and government have revised the norms attached with Euro issues in order to allow more and more companies to raise funds from the European market.

## 21.5 SOURCE OF ECBS

External Commercial Borrowings can be done from many available sources which include various financial institutions like banks, foreign equity firms, capital markets, export credit agencies and even private equity firms. These sources are increasing in numbers day by day as the government is liberalizing its policy of raising funds from abroad and eligibility norms.

## 21.6 APPROVALS REQUIRED FOR RAISING ECBS

In order to raise money through ECBs the following approvals are required by a body corporate;

a. In case the maturity period of ECB is going to be less than a period of three years then in such a case only approval of Reserve Bank of India is required.

b. In case the ECBs are issued for a period of more than 3 years then first of all approval of Department of Economic Affairs (DEA) is required followed by approvals of Ministry of Finance (MoF) and Reserve Bank of India and then only it can be issued for raising money.

c. A part from obtaining clearance from these bodies once the ECBs are issued for the subscribers then a copy of debt agreement is also required to be submitted with Ministry of Finance (MoF).

## 21.7 MATURITY PERIOD OF ECBS

As per the guidelines and mandate of Ministry of Finance the ECBs that can be issued by the Indian body corporate can be of the following maturity period;

a. Minimum average maturity for ECBs upto US$ 15 million is 3 years;

b. Minimum average maturity for ECBs in excess of US$ 15 million is 7 years;

c. Government allows Export Oriented Units (EOUs) to raise ECBs for a period not exceeding 3 years and at a maximum level of US$ 15 million.

## 21.8 RISKS INVOLVED IN ECBS

The cost of raising ECB is definitely quite less as compared to the cost of raising funds in India that is why most of the firms these days chose to raise funds through ECBs. Due to the lower cost of ECBs at times it becomes quite challenging for Indian financial institutions to retain their big corporate houses to raising finance from them. However these ECBs are not

risk free though there are sufficient risks involved and that is why it is important for the firms to do cost-benefit analysis before going for raising money through ECBs.

First and the most important exposure of risk involved in ECBs is currency risk. For example, a company that is raising funds in the form of US$ may not necessarily have a source that yield returns in the form of US$. It may have a source of earning designated in INR but since the liability is in the form of US$ it is in requirement of US$. Therefore, at the time of payment it is required to convert INR into US$ which enhances the chance of exchange rate risk which might have resulted in the form of devaluation of INR in respect to US$ thereby enhancing the firm's cost of capital. As a result of this change in the scenario the firm is now required to spend more INR in order to buy per unit of US$.

Another, important risk to which a firm is exposed while dealing in ECBs is interest rate risk. This is so because in case of ECBs the interest is payable on the basis of fluctuating rate of interest, LIBBOR therefore any variation in the LIBOR affects the payment liability of the firm, as the LIBOR increases it has to pay more interest and vice-versa. The movement of the LIBOR is very difficult to predict for the firm as it is not related to the operations of the firm in any manner.

However, there are various hedging tools available through which a firm can manage these two risks that is why in spite of these risks prevailing ECBs are becoming popular amongst Indian companies day by day.

## 21.9 MANAGING EXPOSURE ARISING FROM ECBS

A company that is involved in raising of ECBs is basically affected by two types of risks namely, exchange rate risk and interest rate risk. To protect itself from these risks the company resorts to hedging exercises which includes buying a forward contract in US$ in order to prevent itself from currency fluctuation and in order to manage interest rate risk it enters into a swap transaction in order to protect itself from fluctuations related with LIBOR.

Though, the measures discussed above provide protection from exchange and interest rate risk but there is a requirement of entering into two different contracts and due to which it becomes at times too costly and not so feasible for the organization concerned therefore in order to overcome this limitation there are specialized contracts like interest-currency swaps which carry the feature of both a currency forward and an interest rate swap.

## 21.10 POLICY CHANGES FOR ENCOURAGING ECBS

Indian government over a period of years in order to promote its trade and commerce liberalized the policy related to ECBs so that more and more companies from India can have access to foreign funds available at a very attractive rate. Net ECBs in the year 1996-97 amounted to US$ 1.009 billion against a comparative US$ 1.275 billion in the year before it. However, post liberalization the government has always tried to remove the strict laws related

with external borrowings and as a result over a period of time the interest of Indian organizations towards ECBs has increased a lot.

**Table 4.3: Composition of India's External Debt**

| Year/ Components | Multilateral (1) | Bilateral (2) | IMF (3) | Export Credit (4) | ECB (5) | NRI Deposits (6) | Rupee Debt (7) | Long Term Debt (1 to 7) A | Short Term Debt (Original Maturity) B | Total External Debt (A+B) |
|---|---|---|---|---|---|---|---|---|---|---|
| 2000-01 | 30.7 | 15.8 | 0 | 5.8 | 24.1 | 16.4 | 3.7 | 96.4 | 3.6 | 100 |
| 2001-02 | 32.3 | 15.5 | 0 | 5.4 | 23.6 | 17.4 | 3.1 | 97.2 | 2.8 | 100 |
| 2002-03 | 28.6 | 16 | 0 | 4.7 | 21.5 | 22.1 | 2.7 | 95.6 | 4.4 | 100 |
| 2003-04 | 26 | 15.5 | 0 | 4.2 | 19.8 | 27.9 | 2.4 | 96 | 4 | 100 |
| 2004-05 | 23.8 | 12.7 | 0.8 | 3.8 | 19.7 | 24.4 | 1.7 | 86.8 | 13.2 | 100 |
| 2005-06 | 23.4 | 11.3 | 0.7 | 3.9 | 19 | 26.1 | 1.5 | 85.9 | 14.1 | 100 |
| 2006-07 | 20.5 | 9.3 | 0.6 | 4.2 | 24 | 23.9 | 1.1 | 83.6 | 16.4 | 100 |
| 2007-08 | 17.6 | 8.8 | 0.5 | 4.5 | 27.8 | 19.5 | 0.9 | 79.6 | 20.4 | 100 |
| 2008-09 | 17.6 | 9.2 | 0.5 | 6.5 | 27.8 | 18.5 | 0.7 | 80.7 | 19.3 | 100 |
| 2009-10 | 16.4 | 8.7 | 2.3 | 6.5 | 27.1 | 18.3 | 0.6 | 79.9 | 20.1 | 100 |
| 2010-11 | 15.2 | 8.1 | 2 | 5.9 | 31.6 | 16.3 | 0.5 | 79.6 | 20.4 | 100 |
| 2011-12 | 14 | 7.4 | 1.7 | 5.3 | 33.3 | 16.2 | 0.4 | 78.3 | 21.7 | 100 |
| 20012-13 | 12.6 | 6.2 | 1.5 | 4.3 | 34.2 | 17.3 | 0.3 | 76.4 | 23.6 | 100 |
| 2013-14 | 12 | 5.5 | 1.4 | 3.5 | 33.5 | 23.3 | 0.3 | 79.5 | 20.5 | 100 |
| 2014-15 | 11 | 4.6 | 1.2 | 2.7 | 38 | 24.2 | 0.3 | 82 | 18 | 100 |

*Notes: PR: Partially Revised* — *All figures in percentage*

*Source: Authors' calculations from GoI, Ministry of Finance - Report on India's External Debt, Various Years*

**Table 21.1 Composition of India's External Debt**

| Table 4.2: External Debt Position: India vis-à-vis Low and Middle Income countries | | | | | |
|---|---|---|---|---|---|
| Year | Country | External debt stocks | | External debt flows | |
| | | Long term debt | Short term debt | Long term debt | Short term debt |
| 2007 | LMIC | 2491 | 770 | 290 | 189 |
| | INDIA | 167 | 36 | 32 | 11 |
| | | (6.7) | (4.7) | (11.2) | (5.8) |
| 2008 | LMIC | 2742 | 787 | 216 | 16 |
| | INDIA | 182 | 44 | 15 | 8 |
| | | (6.6) | (5.6) | (7.0) | (47.3) |
| 2009 | LMIC | 2886 | 820 | 96 | 34 |
| | INDIA | 203 | 47 | 16 | 3 |
| | | (7.1) | (5.7) | (16.4) | (8.1) |
| 2010 | LMIC | 3133 | 1248 | 260 | 433 |
| | INDIA | 228 | 56 | 24 | 10 |
| | | (7.3) | (4.5) | (9.4) | (2.3) |
| 2011 | LMIC | 3574 | 1570 | 370 | 325 |
| | INDIA | 250 | 78 | 21 | 22 |
| | | (7.0) | (5.0) | (5.6) | (6.6) |
| 2012 | LMIC | 4005 | 1721 | 446 | 148 |
| | INDIA | 293 | 93 | 29 | 15 |
| | | (7.3) | (5.4) | (6.4) | (10.3) |
| 2013 | LMIC | 4438 | 2072 | 450 | 353 |
| | INDIA | 328 | 93 | 41 | -1 |
| | | (7.0) | (4.0) | (9.0) | (0.0) |
| 2014 | LMIC | 4754 | 2204 | 419 | 130 |
| | INDIA | 366 | 86 | 49 | -7 |
| | | (7.7) | (3.9) | (11.8) | (-5.5) |
| 2015 | LMIC | 4750.0 | 1805.6 | 209.2 | -398.4 |
| | INDIA | 392 | 82 | 29 | -4 |
| | | (8.3) | (4.5) | (13.8) | (1.0) |
| LMI: Low and Middle Income Countries | | | | | |
| All figures in USD billion and figures in parentheses denote India's share amongst LMI countries | | | | | |
| Source: The World Bank International Debt Statistics and authors' calculations | | | | | |

**Table 21.2 External Debt Position**

Hence on the basis of the tables above we can conclude that the contribution of ECBs in the borrowings of Indian organizations have increased over a period of time and in this the role of the government is quite important which has liberalized its policies and thereby have facilitated ECBs. The government has repealed the strict provisions of FEMA and substituted it with Foreign Exchange Management (Exports of Goods and Services) Regulations of 2015 in order to further facilitate Indian organizations to deal in foreign currency.

*Check Your Progress- A*

**Q1. What are FCCBs?**

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**Q2. Discuss various types of pure debt bonds.**

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**Q3. What are Depository Receipts?**

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## 21.11EURO DEBTS

The ECBs include;

a. Commercial Bank Loan

b. Buyers' Credit

c. Suppliers' Credit

d. Credit from official export credit agencies

e. Securities instruments such as fixed rate notes and floating rate bonds

f. Commercial borrowings from the private sector window of multilateral financial institutions such as IFC, ADB, AFIC, CDC etc.

g. Various forms of Euro bonds and Syndicated loans

## 21.11.1 FOREIGN CURRENCY CONVERTIBLE BONDS (FCCBS):

Most common form of instrument used by Indian companies for raising of funds from abroad is referred Foreign Currency Convertible Bonds (FCCBs). FCCBs are basically debt instruments which by virtue of their characteristics may be converted into equity shares or Depository Receipts after a fixed period of time. However, this conversion generally depends upon the discretion of the instrument holder that whether he wanted to convert the instrument into equity or not, since the FCCBs are convertible over a period of time that is why the rate on interest payable on them is lower as compared to other similar instruments. FCCBs are freely transferable from one person to another since they are bearer instrument. The biggest limitation that appears in case of FCCBs is that they are issued only a few major currencies and of these currency still a major portion of issued FCCBs are denominated in terms of US$. The other two currencies which acquire a place of prominence in case of FCCBs are Japanese Yen and Swiss Franc.

FCCBs are more beneficial for an issuing organization as compared to the other debt instrument due to the following reasons:-

a. The FCCBs carry a lower rate of interest as compared to the other instrument options.

b. The FCCBs are equally popular amongst the investors of debt instruments as well as the investors of equity instruments since it carries the features of both the instruments.

c. The benefits offered by FCCBs to the issuing organization are much more the GDR.

d. There is no immediate impact on the equity shareholdings and thereby on EPS (Earnings per share) which is calculated as PAT/Number of equity shares, though the instrument gets converted into equity but that happens only after a sufficient interval of time.

The biggest limitation of FCCBs is exchange rate risk associated with it.

## 21.11.2 PURE EURO DEBTS

Pure Euro debts are issued through syndicated bank loans whereby a certain bank or Financial Institution is appointed as the Lead manager, and it has the responsibility of raising funds for its clients from abroad. Indian companies are forced to resort to this route of syndication because very few global investors would be interested in investing into debt instruments of an Indian company which may not offer very high returns and yet at the same time do not enjoy a very high rating.

For example, in the year 1997, Tata Iron and Steel Company raised a debt of US$ 150 million with its lead managers ANZ Grindlays, State Bank of India, and HSBC, apart from them there was a syndicate of 21 banks which contributed the amount raised by TISCO.

Some of the types of pure debt bonds are:-

a. **Yankee Bonds:** These bonds are denominated in US$ and raised by a company which is not from USA.

b. **Bull Dog Bonds:** These bonds are denominated in Pound Sterling and are issued in UK by a company which is not from UK.

c. **Samurai Bonds:** These bonds are denominated in Yen and are issued in Japan by a company which is not from Japan.

d. **Dragon Bonds:** These bonds are denominated in various currencies and are primarily targeted at Asian investors.

e. **Deep Discount Bond:** These are the bonds which are having very high face value and are issued at a heavy discount in order to attract investors.

### 21.11.3 CHARACTERISTICS OF EURO DEBT:

The pricing pattern of Euro debts follow a U- shaped pattern whereby the loans of smaller denomination carry a high rate of interest and loans of high denomination carry a smaller burden of interest this happens because of high proportion of fixed cost of loan clearing which has to be there irrespective of the amount of loan so as we move towards a higher value from a lower value the economies of scale becomes much more visible and the benefit of the issuer is also more.

### 21.11.4 ADVANTAGES OF EURO ISSUES:

Investment in Euro issues offers the following advantages to the issuing organization:-

a. Since such issues are dealt with in the International arena rather than the domestic market hence the method of settlement is much more modernized and advanced.

b. Dividends and interest are payable in terms of US$ rather than home currency hence there is lesser impact of exchange rate fluctuation.

c. Since the Euro issues are in bearer form hence there is no need of declaring the name of the holder unlike in case of investment in the domestic equity market.

d. Rights Issues and payments of dividends are not required to be dealt by the company all these issues are dealt by the depository banks.

e. Listing of issues on the international exchanges better subscription to the issues than the issues which are only meant for local markets.

## 21.12 SUMMARY

Foreign funds along with domestic savings serve as a vital source of capital for the enterprises. However, there are various pro and cons of foreign capital, it not only affects the capital structure of a company but in a wider perspective it also has an impact on the political and economic sovereignty of a country. It is one of the prime reasons why the countries are

extremely cautious in allowing the entry of foreign capital in a nation. India also followed the policy of limited access to foreign capital till 1991, until and unless economic reforms in the country took place. However, the real increase in the inflow of foreign capital in India was witnessed during the first decade of 21$^{st}$ century. After the enactment of the policy of liberalization, privatization and globalization the government has made several successful changes in the policies related to management and control of foreign capital in the form of policies related to FDI (Foreign Direct Investment) and FII (Foreign Institutional Investment). These policy changes have made it easier for the companies to attract foreign capital. However, it is not only the policy of the government which has contributed in the growth and inflow of foreign capital in India rather it is also the performance of companies which have done superbly well during the past decades in terms of returns on investments. Since, foreign capital is required for growth of domestic firms it is allowed by the government but as strict monitoring is required transactions involving foreign capital is kept outside the ambit of SEBI and strict control by other regulatory enactments like FEMA and others is exercised by the government. During November 1993, the government announced a scheme for Indian companies guiding for issue of their securities in the foreign market in order to attract foreign capital. This scheme was called, "Issue of Foreign Currency Convertible Bonds and ordinary shares (through Depository based system) scheme of 1993". Since then this scheme was reviewed several times and several changes were made from time to time as per changing environment. Most common form of instrument used by Indian companies for raising of funds from abroad is referred Foreign Currency Convertible Bonds (FCCBs). FCCBs are basically debt instruments which by virtue of their characteristics may be converted into equity shares or Depository Receipts after a fixed period of time. However, this conversion generally depends upon the discretion of the instrument holder that whether he wanted to convert the instrument into equity or not, since the FCCBs are convertible over a period of time that is why the rate on interest payable on them is lower as compared to other similar instruments. FCCBs are freely transferable from one person to another since they are bearer instrument. In the last decade the European markets have became more and more appealing to Indian companies for the purpose of meeting their financial requirements and finding an efficient market to issue their securities. One of the prime reasons behind this behavior of Indian companies is lower cost of debt in European markets as compared to the domestic Indian market where the cost of raising funds is much higher due to high floatation expenses and high Interest rates prevalent. In order to access the European funds however the companies are required to seek approval of Reserve Bank of India and other regulatory bodies.

## 21.13 GLOSSARY

**Depository Receipts (DRs):** It is an acknowledgement on the part of the issuing company that the receiver is being issued a certain number of ordinary shares of the company and is denominated in terms of US dollars. It is an ideal instrument for such issuers who want to expand their shareholding on global level.

**Foreign Currency Convertible Bonds (FCCBs):** It is a debt instrument issued in a foreign country in terms of foreign currency denominations and which can be converted into ordinary shares either in part or in full. Only a company having a proven track record of profitability of at least 3 years is entitled to issue FCCBs. a. Yankee Bonds: These bonds are denominated in US$ and raised by a company which is not from USA.

**Bull Dog Bonds:** These bonds are denominated in Pound Sterling and are issued in UK by a company which is not from UK.

**Samurai Bonds:** These bonds are denominated in Yen and are issued in Japan by a company which is not from Japan.

**Dragon Bonds:** These bonds are denominated in various currencies and are primarily targeted at Asian investors.

**Deep Discount Bond:** These are the bonds which are having very high face value and are issued at a heavy discount in order to attract investors.

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## 21.16 TERMINAL QUESTIONS

Q1. What are the various mechanisms of inflow of foreign capital?

Q2. What are Euro Issues? What are the advantages of Euro Issues?

Q3. What are the various instruments included in the definition of Euro debt?

# UNIT 22 INDIAN FINANCIAL SECTOR REFORMS – A CORPORATE PERSPECTIVE

**22.1 Introduction**

**22.2 Objectives**

**22.3 The Need for Economic Reforms**

**22.4 The Committee**

**22.5 Main features of economic reforms: (L-P-G)**

**22.6 Highlights of the LPG policy**

**22.7 Targets of the financial sector reforms**

**22.8 Trade control and convertibility**

**22.9 Capital Markets**

**22.10 Corporate Governance**

**22.11 Monetary Policy and Debt markets**

**22.12 Effect on corporate sector**

**22.13 Summary**

**22.14 Glossary**

**22.15 Reference/ Bibliography**

**22.16 Suggested Readings**

**22.17 Terminal & Model Questions**

## 22.1 INTRODUCTION

In this unit, you will study about the impact of financial sector guidelines and reforms on companies, stock exchanges etc. i.e., the corporate outcomes of the reforms. The reform process envisioned a systemic shift to:

a) a more open economy with greater reliance upon market forces

b) a larger role for the private sector including foreign direct investment and

c) a restructuring of the role of Government.

These systemic shifts are termed as Economic Reforms.

## 22.2 OBJECTIVES

After reading this unit you will be able to;

- know the targets of financial sector reforms
- know its impact on trade control and convertibility
- learn its impact on capital markets, corporate governance, monetary policy and debt markets,
- know its overall effect on the corporate sector.

## 22.3 THE NEED FOR ECONOMIC REFORMS

The need for economic reforms were as follows:

- Increase in Fiscal Deficit
- Increase in adverse balance of Payment
- Fall in foreign Exchange Reserve
- Rise in Prices
- Poor Performance of Public Sector undertakings
- Drastic fall in economic growth of the nation

Hence the reform process focused at;

- **Fiscal correction**, which is a reduction in the government's primary budget deficit, and it can result from a reduction in government expenditures, an increase in tax revenues, or both simultaneously.
- **Industrial decontrol**, i.e., to remove controls, especially government or other official controls, and
- **Balance of payments**, which encompasses all transactions between a country's residents and its nonresidents involving goods, services and income; financial claims on and liabilities to the rest of the world; and transfers such as gifts.

## 22.4 THE COMMITTEE

Dr Manmohan Singh, the present Prime Minister of India, was then the Finance Minister of the Government of India. He assisted. Narasimha Rao and played a key role in implementing these reform policies.

**Narasimha Rao Committee's Recommendations:**

The recommendations of the Narasimha Rao Committee were as follows:

- Bringing in the Security Regulations (Modified) and the SEBI Act of 1992 which rendered the legitimate power to the Securities Exchange Board of India to record and control all the mediators in the capital market.
- Doing away with the Controller of Capital matters in 1992 that determined the rates and number of stocks that companies were supposed to issue in the market.
- Launching of the National Stock Exchange in 1994 in the form of a computerised share buying and selling system which acted as a tool to influence the restructuring of the other stock exchanges in the country. By the year 1996, the National Stock Exchange surfaced as the biggest stock exchange in India.
- In 1992, the equity markets of the country were made available for investment through overseas corporate investors. The companies were allowed to raise funds from overseas markets through issuance of GDRs or Global Depository Receipts.
- Promoting FDI (Foreign Direct Investment) by means of raising the highest cap on the contribution of international capital in business ventures or partnerships to 51 per cent from 40 per cent. In high priority industries, 100 per cent international equity was allowed.
- Cutting down duties from a mean level of 85 per cent to 25 per cent, and withdrawing quantitative regulations. The rupee or the official Indian currency was turned into an exchangeable currency on trading account.
- Reorganisation of the methods for sanction of FDI in 35 sectors. The boundaries for international investment and involvement were demarcated.
- The outcome of these reorganisations can be estimated by the fact that the overall amount of overseas investment (comprising portfolio investment, FDI, and investment collected from overseas equity capital markets ) rose to $5.3 billion in 1995-1996 in the country) from a microscopic US $132 million in 1991-1992. Narasimha Rao started industrial guideline changes with the production zones. He did away with the License Raj, leaving just 18 sectors which required licensing. Control on industries was moderated.

## 22.5 MAIN FEATURES OF ECONOMIC REFORMS: (L-P-G)

The process was started in July 1991. It had the following features:

- **Liberalisation**, the slackening of government regulations.
- **Privatisation**, the participation of private entities in businesses and services and transfer of ownership from the public sector (or government) to the private sector as well.
- **Globalisation**, the consolidation of the various economies of the world.

## 22.6 HIGHLIGHTS OF THE LPG POLICY

The following are the salient highlights of the Liberalisation, Privatisation and Globalisation Policy in India:

- Foreign Technology Agreements
- Foreign Investment
- MRTP Act, 1969 (Amended)
- Industrial Licensing
- Deregulation
- Beginning of privatisation
- Opportunities for overseas trade
- Steps to manage inflation
- Tax reforms
- Abolition of License or Permit Raj

## 22.7 TARGETS OF THE FINANCIAL SECTOR REFORMS

The fundamental goal of this financial sector reform is to outline the measures for increasing the financial position of a company and to make the organization monetarily more grounded. The reform procedure has completely changed the financing design which drives the organization to grow its long term and working capital financing. An organization's financial wellbeing can be best measured with the profit margin and its long term viability which enables a financial specialist to assess the stock. The four principle areas to be measured in a budgetary proclamation are the profitability, liquidity, solvency and working productivity. The other objectives are to efficiently allocate the resources, increase the return on investment in any activity and to help up the development of the economy.

## 22.8 TRADE CONTROL AND CONVERTIBILITY

One of the early accomplishments of the reforms was the speed with which extraordinary financing was activated from multilateral and bilateral sources to turn away what at one phase resembled an inescapable default on the nation's obligations. In this manner, devaluation, exchange reforms and the opening up of the economy to capital inflows fortified the balance of payments position. The significant reforms in this area were:

• Exchange controls on current account transactions were dynamically easy in current record convertibility.

• Foreign Institutional Investors were permitted to put resources into Indian values subject to confinements on most extreme property in a particular organization. Confinements stay on investment in debt, however these too have been logically relaxed.

• Indian organizations were permitted to raise up the equity value in worldwide markets subject to different confinements.

• Indian organizations were permitted to get from international markets subject to a minimum maturity, a threshold on maximum interest rate on loan , and yearly caps on total external business borrowings by all firms set up together.

• Indian mutual funds were permitted to contribute a little bit of their assets abroad.

• Indian organizations were offered access to long dated forward contracts and to cross currency choices.

## 22.9 CAPITAL MARKETS

The significant change in the capital market was the annulment of capital issues control and the presentation of free pricing of equity issues in 1992. At the same time the Securities and Exchange Board of India (SEBI) was set up as the peak controller of the Indian capital markets. Over the most recent five years, SEBI has encircled regulations on various issues with relation to capital markets.

A portion of the measures taken in the primary market include:

• Entry standards for capital issues were fixed

• Disclosure prerequisites were moved forward

• Regulations were framed and implicit rules were set down for dealer brokers, guarantors, mutual funds, financiers to the issue and different intermediaries.

In connection to the secondary market as well, a few changes were presented:

- Capital adequacy and prudential controls were presented for brokers, sub-brokers and several intermediaries
- Dematerialization of scrips was started with the making of an administrative structure and the setting up of the primary depository

- Online trading was started at all stock trades. Margining framework was thoroughly implemented.
- Settlement period was decreased to one week; convey forward trading was prohibited and after that reintroduced in confined frame; and conditional moves were made towards a moving settlement framework.

## 22.10 CORPORATE GOVERNANCE

In the area of corporate governance:

• Regulations were formulated for insider trading;

• Regulatory system for take-over was redone.

SEBI has been experiencing an extended learning stage since its beginning. The evident criticalness of immediate issues in the capital market has regularly appeared to divert SEBI from the more basic assignment of figuring and actualizing a vital vision for the improvement and control of the capital markets. In quantitative terms, the development of the Indian capital markets since the approach of reforms has been extremely great. The market capitalization of the Bombay Stock Exchange (which speaks to around 90% of the aggregate market capitalization of the nation) has quadrupled from Rs 1.1 trillion toward the end of 1990-91 to Rs 4.3 trillion toward the end of 1996-97. As a level of GDP, market capitalization has been more unpredictable, yet in general this proportion has additionally been rising. The overall volume at the Bombay Stock Exchange and the National Stock Exchange has risen more than ten times from Rs 0.4 trillion in 1990-91 to Rs 4.1 trillion in 1996-97. The stock exchange record has demonstrated a huge increment during the period regardless of ups and down, however the expansion is significantly less amazing in dollar terms in view of the considerable deterioration of the Indian rupee. It might likewise be seen from the graph that after achieved its crest in 1994-95, the share trading system record has been mulling at bring down levels separated from a short burst of euphoria that took after a speculator agreeable spending plan in 1997. For the primary equity market as well, 1994-95 was the greatest year with the aggregate equity issues of Rs 355 billion. From there on, the primary market crumbled quickly. Equity issues in 1996-97 tumbled to only 33% of 1994-95 levels and the decay gives an idea of being proceeding in 1997-98 too. All the more imperatively, the vast majority of the equity issues have been by the general public and by banks. Equity issues by private manufacturing units are not very many.

***Check Your Progress- A***

**Q1. Discuss the need for Economic Reforms.**

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**Q2. What are the Main features of economic reforms?**

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**Q3. Write a short note on Trade Control and Convertibility.**

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## 22.11 MONETARY POLICY AND DEBT MARKETS

In the mid nineties, the Indian debt market was best depicted as a dead market. Money suppression and over-direction were in charge of this circumstance. Changes have disposed of money related constraint and made the pre-conditions for the advancement of a dynamic debt market:

- The legislature lessened its pre-emption of bank supports and moved to advertise the interest rate on its borrowings. All the while, generous deregulation of financing costs occurred as portrayed before.
- Automatic adaptation of the Government's deficiency by the central bank was restricted and after that wiped out by cancelling the framework of treasury bills.

A few operational measures were likewise taken to build up the obligation showcase, particularly the market for government securities:

- Withdrawal of tax deduction at source on interest from government securities and arrangement of tax cuts to people putting resources into them
- Presentation of ordered securities where the essential reimbursement would be recorded to the swelling rate.
- Setting up of an arrangement of primary dealers and satellite merchants for trading government securities
- Authorization to banks to retail government securities
- Opening up of the Indian debt market including government securities to Foreign Institutional Investors.

In the meantime, a spate of very much subscribed retail obligation issues in 1996 and 1997 smashed the myth that the Indian retail speculator has no craving for debt. While just Rs 6 billion was raised through public debt issues in 1994 and Rs 11 billion of every 1995, the amount brought up in 1996 was Rs 56 billion. Debt represented the greater part of the aggregate amount brought through public issues up in 1996 contrasted with under 10% two years ago. In 1997, public debt issues tumbled to Rs 29 billion, yet with the crumple of the primary market for equity, the share of debt in public issue raised to 57%. In the mean time, private placement of debt (which is a significantly greater market than public issues) has developed. Private placement of debt bounced from Rs 100 billion in 1995-96 to Rs 181 billion of every 1996-97. India is maybe nearer to the advancement of an energetic debt market than at any other time, yet a few issues remain:

- The national bank has again and again shown its ability to turn to smaller scale direction and utilize the market contorting instruments of monetary and exchange rate approach as opposed to open market operations and mediations (Varma and Moorthy, 1996). For instance, as late as 1996, the national bank was depending on moral suasion and direct memberships to government securities to finish the administration's acquiring program. The RBI's response to the pressure on the rupee

in late 1997 and early 1998 also reveal an undiminished penchant for micro-regulation.

- Some of the dynamic quality of debt market in 1996 and 1997 was because of the discouraged conditions in the equity markets.
- Little advancement has been made on the major legitimate changes required in ranges like insolvency, abandonment laws, and stamp obligations.

**RISK MANAGEMENT:**

In the days when interest rate were fixed by the government and remained stable for long periods of time, interest rate risk was a relatively minor problem. The deregulation of interest rates as a part of financial sector reform has changed all that and made interest rates highly volatile. For example, the rate of interest on short term commercial paper was about 12-13% at the end of 1994, rose to about 17% by the end of 1995, peaked at about 20% in April 1996, dropped back to about 13% by the end of 1996, continued to fall through 1997 reaching about 8% in November 1997 before climbing back to double digits by the end of the year.

Companies which borrow short term to fund their new projects may face difficulties if interest rates go up sharply. It may turn out that at the higher cost of finance, the project is not viable at all. Worse, companies may find it difficult to refinance their borrowings at any price in times when money is tight. Many companies which borrowed in the Inter Corporate Deposit (ICD) market in 1994 to finance acquisitions and expansions faced this difficulty in 1995 and 1996 when the ICD market dried up. Large scale defaults (euphemistically described as rollovers) took place during this time.

On the other hand, companies which issue long term bonds may start regretting the decision when they find interest rates coming down. In the last few years, companies have tried to protect themselves from this risk by introducing a call provision in their bonds by which they can redeem the bonds prematurely under certain conditions. Of course, such call options make the bonds more expensive (in terms of a higher coupon rate) or more difficult to sell.

Companies have also tried to make the bonds more attractive to investors by giving them a put option to seek premature redemption of the bonds. This may make the bond easier to sell, but it exposes the issuing company to interest rate risk. If interest rates rise, many investors will exercise the put option, and the company will have to borrow from elsewhere at high cost to meet the redemption requirements. Put and call options do make a big difference to the pricing of some of these bonds (Varma 1996a) making the design of these instruments quite complex.

In the next few years, many of these companies would also be faced with the decision of the optimal exercise of the call options on the callable bonds that they have issued in recent years.

In the post reform era, corporates have also been faced with high volatility in foreign exchange rates. The rupee-dollar rate has on several occasions moved up or down by several percentage points in a single day as compared to the gradual, predictable changes of the

eighties. Indian companies have found to their dismay that foreign currency borrowings which looked very cheap because of a low coupon rate of interest can suddenly become very expensive if the rupee depreciates against the currency in which the bond is denominated.

Foreign currency convertible bonds issued by many Indian companies in 1993 and 1994 illustrate the devastating effects of volatility in interest rates, foreign exchange rates and stock prices. At the time of issue, the bonds carried a low coupon rate (often only 2 or 3% in US dollars), and were convertible into stock at prices which were at a modest premium (5 to 10%) over the then prevailing stock price. Issuers thought of them as deferred equity and found the instruments very attractive because they allowed equity to be priced at a premium to the market prices and offered the benefit of a low coupon till the conversion date. As it turned out, stock prices fell during 1995 and 1996, and investors chose not to convert the bonds.

Issuers then realized that they would have to redeem the bonds in dollars, and that the depreciation of the rupee has increased their effective borrowing cost substantially. To make worse, investors exercised put options wherever they had them, and companies had to raise money in the domestic markets to pay off the foreign bondholders. In some cases, this happened at a time when Indian monetary policy was extremely tight and interest rates were very high. In this case, volatility in three different markets combined to make things difficult for the companies concerned.

## 22.12 EFFECT ON CORPORATE SECTOR

In the mid-nineties, corporate governance turned into a vital territory of concern for controllers, industrialists and financial specialists alike. Indian industry considered the issue sufficiently imperative for them to propose a model corporate governance code (Bajaj, 1997). However, the pressure for better corporate governance originated from the capital markets (Varma, 1997). Capital markets have always had the potential to exercise discipline over promoters and management alike, however it was the auxiliary changes made by monetary reform that viably released this power. Minority speculators can bring the discipline of capital markets as a powerful influence for organizations by voting with their wallets. They can vote with their wallets in the primary market by declining to subscribe to any fresh issues by the companies. They can likewise sell their shares in the secondary market thereby bringing down the share price. Financial sector reforms get under way a few key forces that made these forces much more intense than before:

- **Deregulation:** Economic reforms have expanded development prospects, as well as made markets more aggressive. This means that in order to survive companies will need to invest continuously on a large scale. The most powerful effect of voting with the wallet is on organizations with huge development openings that have a steady need to approach the capital market for extra finances.
- **Disintermediation:** Meanwhile, budgetary segment changes have made it basic for firms to depend on capital markets to a more prominent degree for their requirements

of additional capital. As long as firms depend on directed credit, what mattered was the ability to manipulate bureaucratic and political processes; the capital markets, however, demand performance.

- **Globalization:** Globalization of our budgetary markets has uncovered guarantors, financial specialists and middle people to the higher measures of divulgence and corporate governance that prevails in developed capital markets.
- **Institutionalization:** Simultaneously, the increasing organization of the capital markets has immensely upgraded the restraining power of the market. When they vote with their wallets and their pens, they have a significant impact on the capacity of the organizations to tap the capital markets. Indian organizations that opened their ways to foreign financial specialists have seen this power of the minority investor in stark terms.
- **Tax reforms:** Tax reforms combined with deregulation and rivalry have tilted the balance away from black money transactions. It is not always understood that when an organization earns profits, it is tricking the administration, as well as the minority investors. Black money profits don't enter the books of record of the company; however they normally go into the pockets of the promoters. For the several years a quiet upheaval in Indian corporate governance where management have woken up to the power of capital markets is observed. Because of this power, the more dynamic organizations are willfully tolerating harder bookkeeping guidelines and more stringent divulgence standards than are ordered by law.

## 22.13 SUMMARY

The reforms currently under way in the banking sector and in the capital market, combined with the agenda for reform identified for the insurance sector, represent a major structural overhaul of the financial system. It will certainly bring India's financial system much closer to what is expected of developing countries as they integrate with the world economy
Finally, it is important to recognize that financial sector reforms by themselves cannot guarantee good economic performance. That depends upon a number of other factors, including especially the maintenance of as a favourable rnacro-economic environment and the pursuit of much needed economic reforms in other parts of the real economy. The impact of financial sector reforms in accelerating growth will be maximized if combined with progress in economic reforms in other areas.

## 22.14 GLOSSARY

**Fiscal correction**- It is a reduction in the government's primary budget deficit, and it can result from a reduction in government expenditures, an increase in tax revenues, or both simultaneously.

**Industrial decontrol**, i.e., to remove controls, especially government or other official controls, and

**Balance of payment-** It encompasses all transactions between a country's residents and its nonresidents involving goods, services and income; financial claims on and liabilities to the rest of the world; and transfers such as gifts.

**Liberalisation-** It is the slackening of government regulations.

**Privatisation-** The participation of private entities in businesses and services and transfer of ownership from the public sector (or government) to the private sector as well.

**Globalisation-** The consolidation of the various economies of the world.

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## 22.17 TERMINAL QUESTIONS

Q1. Discuss the key highlights of the LPG policy.

Q2. What are the targets of the financial sector reforms?

Q3. Write a detailed note on Monetary Policy and Debt Markets.

# UNIT 23 CURRENT DEVELOPMENT IN THE INDIAN FINANCIAL SYSTEMS

**23.1 Introduction**

**23.2 Objectives**

**23.3 Universal Banking**

**23.4 Financial Inclusion and PMJDY (Pradhan Mantri Jan Dhan Yogana)**

**23.5 Depositories**

**23.6 Corporatisation and Demutualization**

**23.7 Companies Act (Amendments) 2013**

**23.8 Small and Payments Banks**

**23.9 Online Wallets, UPI and BHIM App**

**23.10 NPCI and RuPay Cards**

**23.11 GST (Goods and Services Tax)**

**23.12 IBC (Insolvency and Bankruptcy Codes)**

**23.13 Cryptocurrencies**

**23.14 DBT (Direct Benefit Transfer)**

**23.15 MUDRA Banks**

**23.16 GIFT City**

**23.17 Summary**

**23.18 Glossary**

**23.19 Reference/ Bibliography**

**23.20 Suggested Readings**

**23.21 Terminal & Model Questions**

## 23.1 INTRODUCTION

After 1991, the country has undergone massive transformation in its financial and economic policy. The policies, which were hitherto considered as conservative, gradually became liberal and industry friendly. This helps in increasing the employability rate as well. In fact, 1991 was only the beginning of a long process of transformation of financial and economic policies which is still going on even after decades.

This unit covers such current changes or development in the Indian financial system. A financial system can be defined as a system where all the three sectors of the economy, viz. households, government and business organizations, play their respective roles to support the growth and development of any economy in terms of providing finance. Among the three sectors, the households are considered to be net-savers (they spend less than what they earn) whereas the government and business organizations are considered to be net-spenders (they spend more than what they earn). An efficient and effective financial system ensures that the surplus with the net-savers gets transferred to the Government and the business organization in the smooth and cost-effective manner.

A method or instrument by which this transfer of money/funds takes place from the net-savers to the net-spenders is termed as financial instruments or financial products or financial assets or financial securities. This financial system provides this transfer, as mentioned above, in the best possible manner. This transfer can be done directly in the form of post-office instruments and all the transactions in the primary market (primary market is a market where financial instrument is sold by the government or business organizations to household so that funds it directly gets transferred from net-savers to the net-spenders). On the other hand, all the other transfers of fund from net-savers to the net-spenders take place indirectly, through some financial intermediaries. The prominent financial intermediaries, via whom this transfer of funds takes place from net-savers to net-spenders in the indirect manner, are as follows: 1) All types of banks; 2) life-insurance companies; 3) mutual-funds; and 4) provident and pension funds, etc.

Over the period of time, especially since 1991, when country embarked upon a journey to reform and transform its financial and economic systems, developments have taken place in every part of Indian financial system.

## 23.2 OBJECTIVES

The main objectives of the unit are as follows:

- To introduces the readers with the concept of an efficient and effective financial system.
- To explain the current developments in the Indian financial system.
- To understand the impact of the current developments in the Indian financial system on the Indian economy in the short-term as well as in the long-run.
- To assess the requirements of the Indian financial system that can be the areas for change in the future.

## 23.3 UNIVERSAL BANKING

Universal banking, as a concept, is to offer all the financial requirement of the people under one roof. This includes, basic commercial banking, selling mutual funds, insurance, providing depository and brokerage facility for securities trading, extending investment banking services, etc.

In India, in 1997 and 1998, a working group under the chairmanship of Mr.S. H.Khan was constituted for universal banking concept in India. Later in 1998, Narasimham Committee (NC) gave the mention of Universal banking in India. The Universal banking is a concept which is, gradually, adopted in India. Other than the benefits of universal banking, it has its own limitations because different services being offered under a roof in a universal bank has to abide by different regulatory requirements.

## 23.4 FINANCIAL INCLUSION AND PMJDY (PRADHAN MANTRI JAN DHAN YOGANA)

There are two types of financial system existing in India: formal financial system and informal financial system. The formal financial system is availability of a bank account to deposit and provide loans. The informal system is existence of unorganized money lenders who provide the financial services but at a exorbitantly high interest rates.

Financial inclusion is providing formal financial services to the last person in the society so that he can be linked to mainstream. People may not go and avail services of unorganized and informal financial system and go for formal financial services, are the objectives of the financial inclusion.

Among many developments for financial inclusion in India, the Government of India started a scheme for opening up of the savings account in the commercial banks (mainly public sector commercial banks) with minimal documentary requirements. One of the main reasons for not having access to formal financial system by an individual is lack of documentary requirements to open a bank account in a bank. The banks were there, the people were there who needed the financial services but, owing to lack of documentary evidences (mainly identity proof and address proof) these people were unable to avail the formal banking system in India. Government of India, in 2014, started a massive drive to open the savings account of these people who even do not have basic documentary proofs under PMJDY. There accounts were not only no-frills account but also had a facility of overdraft upto Rs 5000. These accounts became a success storey for financial inclusion in India.

## 23.5 DEPOSITORIES

Financial systems are comprised of two parts: money market (mainly banks) and capital market (mainly stock markets). In the Indian capital market, developments were limited due to physical form of transactions in the securities. Physical form securities had many limitations. Among the limitations of physical form, loss of time was the biggest hurdle.

To overcome limitation in the development of the Indian capital market, in the year 1996, depository act was passed by the parliament in India to facilitate the dematerialized form of securities (demat form). Gradually, two depositories - the institutions which keep the securities safe in the demat form; very similar to the banks which keep the money safe, depositories keep the demat securities safe – stated operations in India.

NSDL (National Securities and Depositories Limited) promoted by National Stock Exchange and CDSL (Central Depositories and Securities Limited), promoted by Bombay Stock Exchange started their operations in India after 1996. They operate through DP (Depositories Participants), similar to the bank branches. Individuals open their demat accounts with DPs.

## 23.6 CORPORATISATION AND DEMUTUALIZATION

In India in 2012, Stock Exchanges (Corporatization, Demutualization and Integration) Act 2012 was enacted. According to this act, any stock exchanges in India should have ownership, management control and brokers to three different entities. This imply that nonce can play more than one role in the context of the stock exchanges.

## 23.7 COMPANIES (AMENDMENT) ACT, 2013

Companies Act 1956 needed some major updating. In the year 2013, an amendment was done to the existing Companies Act 1956 was done and a new act was passed Companies (Amendment) Act 2013. The important features of the amendments were as follows. This amendment has following features which has impacted the Indian financial system significantly.

- One Person Companies (OPC): It is a great innovative approach to club the concepts of sole-proprietorship and companies together. It is like the best of both the worlds. In OPC a company can be run by an individual as well as it can be an organization limited by shares. This is introduced in the 2013 through this amendment in the company's act.
- Appointment of Women Directors: Companies Act 2013, introduced the compulsory appointment of a woman director on the company's board (with the rider that the paid up capital should be more than Rs100 cr. or turnover to be more than Rs300 cr.). This provision will ensure gender equality in the companies.

- Corporate Social Responsibility (CSR): This is also one of the landmark provision introduced in this act. According to this provision, every company who is profitable for last three years has to donate 2% of their profit for CSR activities.
- Registered Valuers:
- Rotation of Auditors
- Class Action
- Dormant Company sec 455(1)
- Fast Track Mergers
- Serious Fraud Investigation Office

## 23.8 SMALL AND PAYMENTS BANKS

In India, to promote financial inclusion, two types of special banks were started in India: *Small Finance Banks* and *Payments Banks.*

In the year 2014, RBI issues a draft guideline for starting of small finance banks. The small finance banks are not the full commercial bank. Rather they have been allowed to carry the limited banking transactions of deposit and lending. The purpose of starting of small finance banks are to promote finance inclusion in the remote areas and to the smaller sole-proprietorship firms, which hitherto do not find a place in a normal commercial banking set-up.

In the year 2015, out of 72 applicants, RBI gave provisional licence to 10 following entities (mostly NBFCs and microfinance institutions).

1. Ujjivan Small Finance Bank
2. Jana Small Finance Bank
3. Equitas Small Finance Bank
4. AU Small Finance Bank
5. Capital Small Finance Bank
6. Fincare Small Finance Bank
7. ESAF Small Finance Bank
8. North East Small Finance Bank
9. Suryoday Small Finance Bank
10. Utkarsh Small Finance Bank

Reach and access of the formal banking system in the remote areas and to the last person of the society was a problem. In addition to small finance banks, another type of banking identity was conceptualized in 2013 by RBI to provide banking service to those left out people of the society. The idea is to start a banking system which will only provide basic deposit facility (with a restriction of taking deposit of less than of Rs 1, 00,000) and not lending will be extended through these banks. These banks are called **Payments Banks**.

In 2015, out of 41 applicants, 11 entities were issues the provisional licenses, including Indian Posts as one of the payments banks.

1. Aditya Birla Nuvo
2. Airtel M Commerce Services
3. Cholamandalam Distribution Services
4. India Post
5. Fino PayTech
6. National Securities Depository
7. Reliance Industries[12]
8. Vodafone M-Pesa
9. Paytm
10. Tech Mahindra
11. Sun Pharmaceuticals

# 23.9 ONLINE WALLETS, UPI AND BHIM APP

Online wallets are order of the day in India which is major change in the Indian financial system post demonetization. Demonetization had two pronged aims: controlling corruption and motivating digital (online) financial transaction. Digital transaction ensure that money is flowing in the formal system which is free from black money. To support this digital drive, many organizations including the Government started many initiatives to support the digitalization. In the online wallet, through any system, the money is stored in a digital system which can further be used for doing financial transactions. Online wallets become popular because of the following reasons.

- They are linked with the conventional banking and money can easily be added in these wallets. Further, these wallets are linked with retail transactions at different avenues.
- The acceptability of these wallets at different retail points, and their ease are the **first** reasons for their popularity.
- Hordes of freebies, reward points and other benefits like discounts are also linked with these wallets, which is the **second** reason for its popularity.

Following are a few popular wallets.

- PayTM
- PayUMoney
- Mobikwik
- Citrus
- Statebank buddy

- Lime
- Jiomoney
- BHIM

Among these Online wallets, BHIM is the initiative of the Government of India by NPCI (see the next section for detail on NPCI). BHIM is also an online wallet but works on the concept of **UPI** (Unified Payment Interface). UPI is a real time payment system managed by NPCI and regulated by RBI. UPI facilitate the real-time transaction (deposit and withdraw) from a bank account which is linked with a mobile number through other different KYC norms. The best part of UPI based system is that, it does not incur any cost for any transaction and it is a real time transition which works even on holidays and Sundays. BHIP uses the UPI platform and goes a step further and as any mobile application (app) it can be downloaded on a mobile and real-time without incurring any transactional cost, can be used as an online platform for the financial transactions. In India, as of now there are three methods by which online transactions can take place.

1. RTGS: It is Real-Time Gross Settlement system. Here the larger amount is transacted online though clearing mechanism by RBI.
2. NEFT: This is National Electronic Funds Transfer system. It is meant for lesser amount and works in batches. Normally, retail investor uses this channel to make/receive the payments.
3. IMPS: It is Immediate Payment Services. It is managed by NPCI. This is meant for lesser amount and it really works on the immediate settlement mechanism even on holidays.

BHIP works on IMPS mechanism but BHIM is a mobile online wallet and IMPS is an on-line system to make/receive transactions.

## 23.10 NPCI AND RUPAY CARDS

The Government established NPCI (National Payment Corporation of India) in 2008. Gradually they helped in the transformation of digital drives of Government of India. They made three major achievements: 1) Launching of BHIM; 2) Facilitating IMPS; and 3) Launching RuPay Cards.

RuPay cards are very strongly worded move by the Government of India to showcase India's digital and technological prowess. In the world, there are only four clearing companies, which work as the clearing agencies for plastic card transactions. It means, all the credit or debit card had to be cleared by any one of them (Visa, Master, American Express and Discover financial). NPCI launched RuPay cards which are cleared by NPCI in the straight competition to the Visa and Master cards etc. Indian, with such a huge population and

PMJDY making it virtually mandatory to have only RuPay cards, has really embarked a new era in the plastic money segement.

## 23.11 GST (GOODS AND SERVICE TAX)

India is a federal county comprised of 29 states and union territories, which have their own local governments besides having a central government above them. Constitution of India has divided powers and regulation between centre and the states.

GST (Goods and services tax) is bringing uniformity on the indirect tax system of India across manufacturing (Excise duty), sales (Sales Tax) and services (VAT). Instead of three taxes, there will be only one GST for all the three purposes. The uniformity of GST is not limited to bringing manufacturing, sales and services to a common rate (GST) but the same will be applicable across all the states, which was hitherto different in different states and union territories.

GST has further been divided into three subparts so that central and states governments may also get their shares. Moreover, GST has many features which ensures that it is not only simpler but ensures its successful execution.

***Check Your Progress- A***

**Q1. Write a detailed note on Online Wallets, UPI and BHIM App.**

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**Q2. What are the key features of GST?**

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**Q3. What are the functions of Depositories?**

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## 23.12 IBC (INSOLVENCY AND BANKRUPTCY CODE)

IBC 2016 is a revolutionary step in the right direction to take care of the rising NPA and malpractices existing in the corporate India. A few fraudulent corporate, in connivance with the bank officials are siphoning-off with the money with the intention of never returning the money. Such corporate is to be fixed with the new IBC 2016 Codes. These codes ensure that the promoters who take the money and do not return it, may lose the control their business. They have been gradually debarred from even regaining the control of their business in case of the business being sold as an open offer to recover the dues.

This law has gone to the extent of letting the house owner to treat the realtors equivalent to borrowers and house owners as lenders. If realtors do not keep their promises of delivery of the houses as per the plan, the assets can be sold in the open market, using law under IBC code.

## 23.13 CRYPTOCURRENCIES

Advancements in the technology is facilitating different avenues. Cryptocurrency is one such experiment. In this, a technological invention, blockchain is used. Currencies, but virtual in nature, is created using this technology. These virtual currencies are also called digital currencies. Another aspect of these currencies that these are not through any legal channel or they are not legal tender of any country. They are completely private type of currencies which work on mutual trust of the people who want use it.

They are becoming popular, but as yet their legal structure is not clear. There is no central bank which monitors these currencies, rather they are completely de-centralized as the technology (blockchain) behind its invention. A few popular cryptocurrencies are **bitcoins**, **swiftcoin**, **dash** etc.

## 23.14 DIRECT BENEFIT TRANSFER (DBT)

Direct benefit transfer (DBT) is an innovation taking place gradually in India. With the help of DBT GOI is making a successful attempt to disburse the subsidy or any other social benefit directly to the beneficiary's account. One of the serious challenges being faced by the governments was from the corruption in disbursal of the benefits to the beneficiary. This is fixed by the DBT scheme. The major challenge of this scheme was lack of financial inclusion by the down-trodden people of the country. By an estimate still more than 40% households are still unbanked in India in 2016-17. Despite that DBT has been a huge success and provided necessary impetus to people and Indian financial system.

## 23.15 MUDRA BANK

Mudra Bank stands for Micro Units Development and Refinance Agency Bank. It is a public sector financial institution in India. It provides loans at low rates to micro-finance institutions and non-banking financial institutions which then provide credit to MSMEs. It was launched in 2015. This bank is supposed to change the landscape of the loaning to the MSME sector in the long-run.

Mudra bank is expected to provide financing to those MSME organization which are hitherto remain cut-off from the main stream of banking. It is like micro-financing to the MSME sector. Mudra bank is going to assist banking to those businesses which are as yet unbanked. Moreover, loans through Mudra bank is linked to PMJDY accounts to provide double benefit to the cause of financial inclusion of the GOI. By an estimate, Mudra bank has disbursed the loan of Rs 1.53 trillion so far in 2016-17. The GOI is satisfied with the growth of Mudra bank loaning and targeting for much bigger targets for the time to come.

## 23.16 GIFT CITY

GIFT city stands for Gujarat International Finance Tec-city. The city is located at Gujarat state of India and near to Ahmadabad. This city is India's first International trade centre. GIFT aims to cater to India's large and increasing financial services potential. GIFT offers to the global firms a world-class infrastructure and facilities. It aims to attract the top talent in the country by providing the finest quality of life and facilities.

It is estimated that GIFT would provide 500,000 direct and an equal number of indirect jobs which would require 5.76 million square meter of real estate office and residential space. GIFT is planning to be a global Financial and IT Services hub. This will be designed to be equal or better than the globally established benchmarked financial centres such as Shinjuku, Tokyo, Lujiazui, Shanghai, La Defense, Paris, London Dockyards etc.

GIFT Master Plan facilitates Multi Services SEZ with IFSC (International Financial Services Centre) status, Domestic Finance Centre and associated Social infrastructure.

## 23.17 SUMMARY

An efficient and effective financial system ensures that the surplus with the net-savers gets transferred to the Government and the business organization in the smooth and cost-effective manner. Financial systems are comprised of two parts: money market (mainly banks) and capital market (mainly stock markets). In the Indian capital market, developments were

limited due to physical form of transactions in the securitiesTo overcome limitation in the development of the Indian capital market, in the year 1996, depository act was passed by the parliament in India to facilitate the dematerialized form of securities (demat form). Gradually, two depositories - the institutions which keep the securities safe in the demat form; very similar to the banks which keep the money safe, depositories keep the demat securities safe – stated operations in India. Further, Online wallets are order of the day in India which is major change in the Indian financial system post demonetization. Demonetization had two pronged aims: controlling corruption and motivating digital (online) financial transaction.
Digital transaction ensure that money is flowing in the formal system which is free from black money. GST (Goods and services tax) is bringing uniformity on the indirect tax system of India across manufacturing (Excise duty), sales (Sales Tax) and services (VAT). Instead of three taxes, there will be only one GST for all the three purposes. Direct benefit transfer (DBT) is an innovation taking place gradually in India. With the help of DBT GOI is making a successful attempt to disburse the subsidy or any other social benefit directly to the beneficiary's account.

## 23.18 GLOSSARY

**Universal banking**, as a concept, is to offer all the financial requirement of the people under one roof.

**Financial inclusion** is providing formal financial services to the last person in the society so that he can be linked to mainstream).

**UPI** is a real time payment system managed by NPCI and regulated by RBI. UPI facilitate the real-time transaction (deposit and withdraw) from a bank account which is linked with a mobile number through other different KYC norms.

**Cryptocurrency** is one such experiment. In this, a technological invention, blockchain is used.

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## 23.21 TERMINAL QUESTIONS

Q1. Discuss the importance of Universal Banking.

Q2. Write a note on Financial Inclusion and PMDJY (Pradhan Mantri Jan Dhan Yogana).

Q3. Write the benefits of using Online Wallets, UPI and Bhim App?

Q4. What are advantages and disadvantages of using Cryptocurrency?