LOVELY PROFESSIONAL UNIVERSITY

INDIAN FINANCIAL SYSTEM

Edited By

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SYLLABUS

Indian Financial System

Objectives: To analyze the role of a financial system in the development of an economy by understanding various constituents of a country's financial system and debate on whether and how each of these constituents should work together to have the right influence on the economy. Moreover, to understand the rules and regulations that governs the Indian financial markets, along with the steps taken by regulators to ensure stability.

DCOM503 Indian Financial System

Sr. No.	Description
1.	***Indian Financial System:*** Introduction, components, key elements, functions, nature and role of financial system and financial instruments.
2.	***Financial Market Reforms:*** Context, need and objectives; major reforms after 1991.
3.	***Financial Markets:*** Money market in India; nature, instruments, types, players, location, functioning and participation.
4.	***Indian Capital Market:*** Introduction, structure, functions and role.
5.	***Primary Market:*** Introduction, Book building, online IPOs, Green-shoe option.
6.	***Secondary Market:*** Introduction, stock exchanges, Listing of securities, trading and settlement and role of NSCCL.
7.	***Depositories and Custodians:*** Depository system, DMAT, NSDL,CDSL, custodians, the Stock Holding Corporation of India Ltd.
8.	***Financial Institutions:*** Banking and Non Banking Financial Institution, Development Financial Institution (including RRBs).
9.	***Introduction to Financial Services:*** Factoring, Mutual Funds, Venture capital, Insurance services, Commercial banking services, Merchant banking, Leasing credit rating and Consumer Finance.
10.	***Financial Regulations:*** Regulation of Financial Markets and Institutions, Regulatory Frame work; Securities and Exchange Board of India and Reserve Bank of India.

DCOM304 Indian Financial System

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1	**Indian Financial System:** Introduction, components, key elements, functions, nature and role of financial system and financial instruments.
2	Financial Market Reforms: context, need and objectives; major reforms after 1991.
3	**Financial Markets:** money market in India; nature and types of instruments.
4	**Indian Capital Market:** Introduction, structure, functions and role.
5	**Primary Market:** Introduction, Book building process and role in economic development.
6	**Secondary Market:** Introduction, stock exchanges, Listing of securities, Depository system and DMAT.
7	**Financial Institutions:** Banking and Non Banking Financial Institution, Development Financial Institution (including RRB's)
8.	**Mutual Fund:** Introduction, types, Net asset Value, organization of mutual funds, SEBI guidelines.
9.	**Introduction to Financial Services:** Factoring, Venture capital, Commercial banking services, Merchant banking, Consumer Finance.
10.	**Financial Regulations:** Regulation of Financial Markets and Institutions, Regulatory Frame work; Securities Exchange Board of India and Reserve Bank of India, IRDA.

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Unit 1: Indian Financial System

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Introduction

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Objectives

After studying this unit, you should be able to:

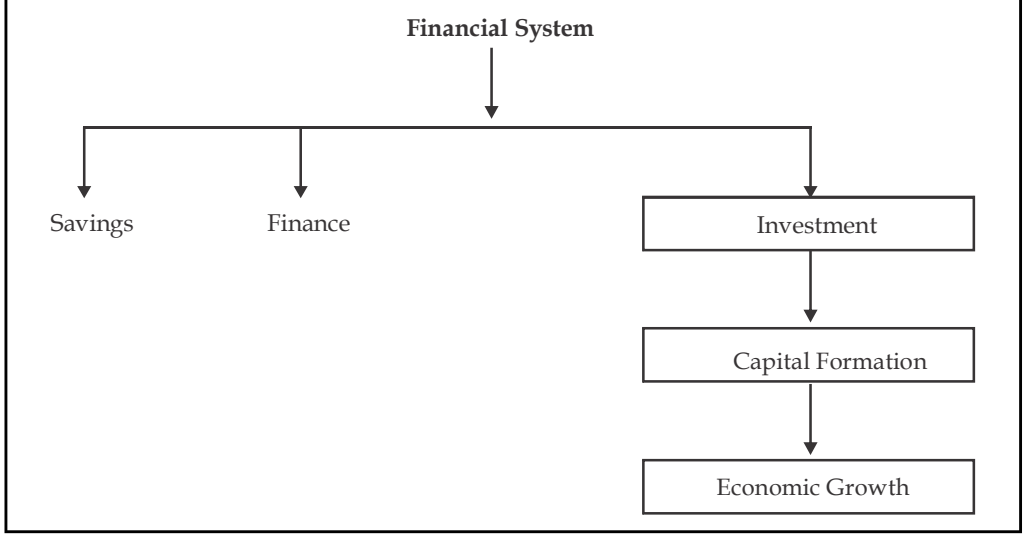
- Learn the concept of Indian financial system;
- Explain the key elements related to Indian financial system;
- Discuss the nature and functions of Indian financial system;
- Understand role of financial system and financial instruments;
- Understand components of Indian financial system.

Introduction

The financial system or the financial sector of any country consists of (a) specialized and non-specialised financial institutions (b) organized and unorganized financial markets and (c) financial instruments and services which facilitate transfer of funds. Procedures and practices adopted in the markets and financial interrelationships are also parts of the system. The financial system is concerned about money, credit, and finance-the terms intimately related, somewhat different from each other. Money refers to the returned medium of exchange or means of payment. Credit or loan is a sum of money to be returned normally with interest; it refers to a debt of economic unit. Finance is monetary resources comprising debt and ownership funds of the state, company or person. Figure 1.1 shows a typical structure of financial system in any economy.

Notes

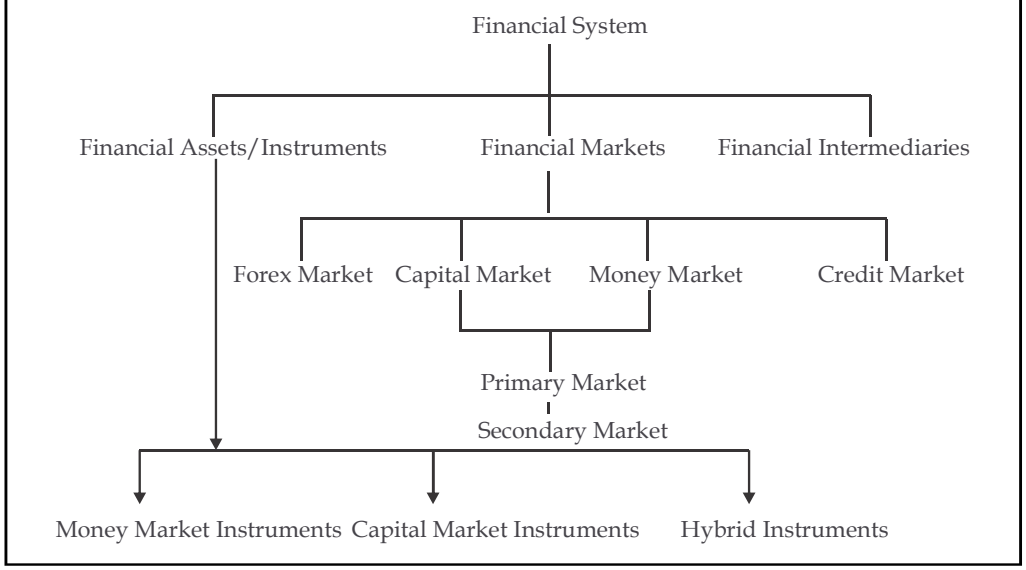
Figure 1.1 Overview of Financial System



1.1 Components/Key Elements of Indian Financial System

The financial system consists of the Central Bank, as the apex financial institution, other regulatory authorities, financial institutions, markets, instruments, a payment and settlement system, a legal framework and regulations. The financial system carries out the vital financial intermediation function of borrowing from surplus units and lending to deficit units. The legal framework and regulators are needed to monitor and regulate the financial system. The payment and settlement system is the mechanism through which transactions in the financial system are cleared and settled.

Figure 1.2: Components of a Financial System



- Regulatory Authorities
- Financial Institutions

Notes

- Financial Markets
- Financial Instruments
- Payment and Settlement Infrastructure

Let us get introduced to them one by one.

Regulatory Authorities

The main component of any financial system is the regulatory system it has. In any economy, the financial system is regulated by the central banking authority of that country. In India, the central bank is named as the Reserve Bank of India.

The Reserve Bank of India

The regulation and supervision of banking institutions is mainly governed by the Companies Act, 1956, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, Bankers' Books Evidence Act, Banking Secrecy Act and Negotiable Instruments Act, 1881

The regulation and supervision of finance companies is done by the Banking Regulation Act, 1949 which governs the financial sector.

Individual Institutions are regulated by Acts like:

- State Bank of India Act, 1954
- The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003
- The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993
- National Bank for Agriculture and Rural Development Act
- National Housing Bank Act
- Deposit Insurance and Credit Guarantee Corporation Act

Securities and Exchange Board of India

The Securities and Exchange Board of India was established on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992 to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto.

Insurance Regulatory and Development Authority

Insurance Regulatory and Development Authority regulates and supervises the insurance industry - insurance companies and their agents and insurance brokers 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.

Financial Institutions

The financial system consists of many financial institutions. While most of them are regulated by the Reserve Bank, there are some which it manages just indirectly.

Notes

Institutions Regulated by the Reserve Bank of India

The institutions regulated by the RBI are:

- Nationalised Commercial Banks
- Specialised Banks
- Registered Finance Companies
- Registered Finance Leasing Establishments
- Micro-Finance Institutions.

Institutions Not Regulated by the Reserve Bank of India

Certain financial institutions are not regulated by the Reserve Bank of India. These include securities firms, investment banks and mutual funds which come under the purview of the SEBI, Insurance Companies and Insurance Brokers which are regulated by the IRDA, etc.

Financial Markets

The Financial Market, which is the market for credit and capital, can be divided into the Money Market and the Capital Market. The Money Market is the market for short-term interest- bearing assets.

Example:

1. Treasury bills
2. Commercial paper
3. Certificates of deposits

The major task of the Money Market is to facilitate the liquidity management in the economy. The Capital Market is the market for trading in medium – long term assets.

Example:

1. Treasury bonds
2. Private debt securities (bonds and debentures)
3. Equities (shares)

The main purpose of the Capital Market is to facilitate the raising of long-term funds.

Did u know? The main issuers in the

1. Money Market are the Government, banks and private companies, while the main investors are banks, insurance companies and pension and provident funds.
2. Capital Market are the Government, banks and private companies, while the main investors are pension and provident funds and insurance companies.

The Financial Market can be also be classified according to instruments, such as the debt market and the equity market. The debt market is also known as the Fixed Income Securities Market and its segments are the Government Securities Market (Treasury bills and bonds) and the Private

Notes

Debt Securities Market (commercial paper, private bonds and debentures). Another distinction can also be drawn between primary and secondary markets. The Primary Market is the market for new issues of shares and debt securities, while the Secondary Market is the market in which existing securities are traded.

The Reserve Bank of India through its conduct of monetary policy influences the different segments of the Financial Market in varying degrees. The Reserve Bank's policy interest rates have the greatest impact on a segment of the Money Market called the inter-bank call money market and a segment of the Fixed Income Securities Market, i.e. the Government Securities Market.

Financial Instruments

The main financial instruments can be categorized as under:

Deposits

Deposits are sums of money placed with a financial institution, for credit to a customer's account. There are three types of deposits - demand deposits, savings deposits and fixed or time deposits.

Loans

A loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in instalments or all at once, on agreed dates and at an agreed rate of interest. In most cases, financial institutions require some form of security for loans.

Treasury Bills and Bonds

Treasury bills are government securities that have a maturity period of up to one year. Treasury bills are issued by the central monetary authority (the RBI), on behalf of the Government of India. Treasury bills are issued in maturities of 91 days, 182 days and 364 days.

1.2 Functions of Financial System

A resilient and robust financial system is an adjunct to economic and industrial development of a country because of the following critical functions that it performs.

1.2.1 Linking Surplus and Deficit Spending Units

A financial system facilitates transfer of funds from Surplus Spending Units (SSUs) to deficit spending units (DSUs) by providing means and mechanism to link the two groups. Surplus spending units, according to Goldsmith, 10 are those who have surplus of income over expenditure for a given period. Households are the main type of surplus units. Business enterprises and the government as well as foreigners and their governments also find themselves with excess funds. Deficit spending units represent those whose expenditures for the period exceed receipts. The most important deficit spending units are businesses, local and state governments and sometimes foreigners.

The financial system seeks to funnel funds from SSUs to DSUs in two basic ways: (i) Direct financing and (ii) Indirect financing.

1. ***Direct Financing:*** In the direct financing route, DSUs issue financial claims on themselves and sell them for funds to SSUs. The SSUs hold the financial claims in their portfolios on

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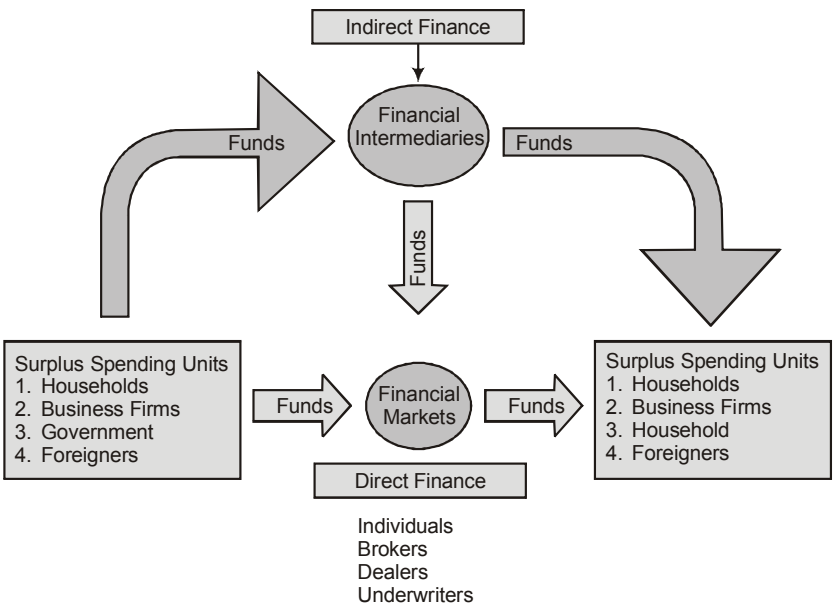
interest bearing assets. The claims issued by the DSUs are called direct claims and are typically sold in financial markets. For example, if Tata Motors needs to borrow money to fund building a car manufacturing plant, it might borrow the money from savers by selling the bonds, a debt security that promises to make payment periodically for a specified period of time. Direct financing allows SSUs an outlet for their savings, which provides an expected return and DSUs no longer needs to defer current consumption or promising investment opportunities for lack of funds. However, one problem involved in direct financing is that DSUs must scout SSUs that want primary claims with precisely the characteristics they can and are willing to sell. To aid in the search process there exists a number of market specialists such brokers who act purely as 'matchmakers' between SSUs and DSUs and charge a commission for their services. Dealers also provide search services and make markets in securities by maintaining an inventory from which they buy and sell for profit. They derive their income from providing search services and from the spread earned on the buying and selling price of securities held in inventory. Another market specialist is the underwriter who helps DSUs bring their financial claims to market. Underwriters primarily perform risk bearing function. They buy the entire block of securities to be issued by a DSU at a guaranteed price and then resell the securities to individual investors. Income of the underwriters is the spread between the fixed price paid for securities and the price at which they are resold in the open market. The bottom half of Figure 1.3 illustrates the flow of funds from SSUs to DSUs by way of direct financing.

Figure 1.3: Flow of Money in Indian Financial System



2. ***Indirect Financing:*** Another route to transfer funds from SSUs to DSUs is indirect financing. In indirect financing, financial intermediaries such as banks, insurance companies, pension funds, etc., are involved. Indirect financing has emerged to overcome the problems involved in direct financing. For direct financing to take place, the DSUs must be willing to issue a security with a denomination, maturity and other security characteristics that suit the desires of the SSUs. So long as their needs are not satisfied simultaneously, there will hardly be any transfer of funds. Financial intermediaries intervene in the process of transfer of funds. They buy securities with one set of characteristics (i.e., terms to maturity, denomination) from DSUs and transform them into indirect securities with a different set of features which they sell to the SSUs. This process of transformation is called

Notes

intermediation and institutions associated with this process are called financial intermediaries or financial institutions. The top half of Figure 1.3 figures out the flow of money through process of intermediation. Besides directing the pooled resources into productive outlets and facilitating the efficient life cycle allocation of physical capital in its most productive use in the business sector, the financial system makes possible efficacious separation of ownership from management. This, in turn, enables the efficient specialisations in production according to the principle of comparative advantage.

1.2.2 Providing Payment System

A financial system provides for effective system of payment for personal, business and government transactions through array of financial instruments and intermediaries.

1.2.3 Managing Risks

A well-developed, smooth-functioning financial system offers a wide variety of financial instruments that enable economic agents to pool, price and exchange risk. It provides adequate mechanism for risk-pooling and risk-sharing for both households and business firms. These mechanisms are built in hedging, diversification and insurance. While hedging is a technique to move from a risky asset to riskless assets, diversification provides for pooling and subdividing risks. Insurance enables the insured to retain the economic benefits of ownership while laying off the possible losses.

1.2.4 Price Information

Besides facilitating transfer of funds from savers to investors, financial system provides necessary information that plays significant role in coordinating decentralised decision-making. Information about existing interest rates and securities not only enable individuals in making their saving and investment decisions but also aid the managers of business enterprises in deciding about choice of investment projects and funding thereof.

Self Assessment

Fill in the blanks:

1. A well developed …….. provides adequate mechanism for risk-pooling and risk-sharing for both households and business firms.
2. …….. are government securities that have a maturity period of up to one year.
3. The …….. through its conduct of monetary policy influences the different segments of the Financial Market in varying degrees.
4. …….. intervene in the process of transfer of funds.
5. …….. primarily perform risk bearing function.

1.3 Nature and Role of Financial System

1. The price in financial markets is known as "rate of interest". Under conditions of perfect competition, the equality between total expected demand for funds and total planned supply of funds determines the equilibrium rate of interest.
2. The intervention between authorities in the form of administering interest rates results in excess demand or excess supply of funds, which in turn requires the official policy of direct allocation of financial resources.

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3. The supply of funds depends on aggregate savings and credit creation by the banking system, while the need for funds depends upon demand for investment, consumer durables, housing and so on.
4. The functions of a financial system are to establish a bridge between savers and investors and thereby encourage savings and investment, provide finance in anticipation of savings, enlarge markets over space and time and allocate financial resources efficiently for socially desirable and productive purposes. The ultimate goal of the financial system is to accelerate the rate of economic development.
5. Deficient financial markets are characterized by the absence of information-based game, by correct evaluation of assets, by maximization of convenience and minimization of transaction costs and maximization of marginal efficiency of capital.
6. In reality, the contribution of financial system to growth is highly constrained because it does not work efficiently and capital is not the most important barrier to growth. The role of finance in development is believed to be secondary by many experts.
7. A framework to evaluate the working of any financial sector must include economic, commercial as well as social and ethical criteria.
8. Financial innovations refer to wide ranging changes in the financial system. The introduction of new financial institutions, markets, instruments, services, technology, organization and so on.
9. Financial engineering connotes skillful development and use of new financial technology creates solutions and tools to cope with financial changes. It involves construction, designing, re-construction of innovative financial instruments, institutions and processes to reduce risk and to maximize profits quickly.
10. Financial revolution means that the magnitude, speed and spread of changes in the financial sector are simply phenomenal.
11. The markets that attract funds in large volume and from all types of investors are known as broad financial markets.
12. The markets which provide opportunities for sufficient orders at fine rates below and above the market price are called deep financial markets. The underdeveloped markets due to government regulations and controls are termed as swallow financial markets.
13. Financial repression exists when the regularity polices of the government distort interest rates, discourage savings, reduce investment and misallocate resources.

1.4 Nature and Role of Financial Instruments

Financial systems deal in financial services and claims and are many and varied in character. This is so because of the diversity of motives behind borrowing and lending. The general characteristics of these claims are given below:

Financial Assets

An asset, broadly speaking, is any possession that has value in an exchange. An asset may be tangible or intangible. A tangible asset is one whose value depends on particular physical properties, such as buildings, land, machinery, etc. An intangible asset, by contrast, represents legal claims to some future benefit. The intangible value does not bear relation to the form, physical or otherwise, in which these claims are recorded. Financial assets, also known as

Notes

financial instruments or securities, are intangible assets inasmuch as their value is a claim to future cash.

Equity shares, preference shares, corporate bonds, government security are examples of financial assets. The entity that offers future cash flows is called the issuer of the financial assets and the owner of the financial assets is called the investor.

Financial assets exist in an economy because the savings of various individuals, business firms, and governments during a period of time differ from their investment in real assets (physical assets). If savings equaled investment in real assets for all economic units in an economy over a period of time, there would be no external financing and no financial assets. A financial asset is created only when the investment of an economic unit in real assets exceeds its savings, and it finances this excess by borrowing or issuing equity securities. Of course, another economic unit must be willing to lend. In the economy as a whole, savings-surplus economic units provide funds to savings deficit units and this exchange of funds is evidenced by pieces of paper representing a financial asset to the holder and a financial liability to the issuer.

Wide range of financial instruments with varying maturity denominations, claims to income and assets and controlling power are traded in financial markets so as to cater to the diverse needs of both the supplier of funds and those who need them. Thus, there may be short-term as well as long-term financial assets. Among short-term instruments, Commercial bills, Treasury bills, Negotiable certificates of deposits, Commercial paper, Eurodollars are the important ones.

Commercial Bills represent an important short-term financial instrument that arises out of commercial transactions. When a buyer is unable to make the payment immediately, the seller may draw a bill upon him payable after a certain period. The buyer accepts the bills and returns to the seller who either retains till the due date or gets it discounted from some bank to get cash.

Treasury Bills are the most popular instrument used by the government to raise funds. They are direct obligations of the government and are almost risk free. They have maturities ranging from three months to one year. Financial institutions, corporations and individuals buy these securities from liquidity and safety of principal.

Notes The yields on Treasury bills and bonds are market determined and the market is both active and liquid.

Negotiable Certificate of Deposit (CD) is a special type of time deposit of a commercial bank. Negotiable CDs typically have maturities of one to twelve months and are issued in denominations ranging from $1,00,000 to $1million. CDs are sold only by the largest and most creditable banks and have a very low default risk.

A Commercial Paper is the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis. Commercial paper is typically issued by corporations and finance companies. The default risk of commercial paper is quite low because only well-established business firms can sell it. It is marketed through a handful of dealers or it may be issued directly to the issuing firm.

Eurodollars are a relatively new instrument. They are nothing more than U.S. dollar denominated liabilities of foreign banks or offices of U.S. banks located in foreign countries. Eurodollars are traded in Europe. American firms and banks can borrow in this market. Business firms usually borrow to finance their international operations. Banks use Eurodollars to make domestic loans and investment. The loans are generally from one month to six months, and transaction sizes are typically $10 million.

Notes

Besides, long-term financial instruments are employed to procure funds for longer period of time. Among various instruments, equity shares and bonds are the most popular.

Equity Shares represent the owner's equity. The holders of equity shares are residual owners who have unrestricted claim on income and assets of the firm and who possess the voting power in the firm.

Bonds are a long-term promissory notes with maturities ranging from 5 to 30 years. Holders of bonds have priority of claim to income over equity shareholders and have legal recourse for enforcing their rights. Further, the bondholders' claim to income is fixed and certain and the borrowing firm is under a legal obligation to pay it in cash regardless of the level of earnings of the firm. They have also priority over shareholders in respect of their claim on assets. Bonds may be secured by mortgages and other assets of the firm or they may be unsecured. Unsecured bonds are also known as debentures and are generally issued by firms of the highest credit quality. Corporate bonds are usually bought by institutions not requiring high liquidity of their financial assets.

Broadly speaking, financial assets perform two principal economic functions. One such function is to funnel funds from those who have surplus of income over expenditures to those who need funds to invest in tangible assets. Another function is reallocation of risk. Financial assets seek to transfer funds in such a manner as to redistribute the unavoidable risk associated with the cash flow generated by tangible assets among those seeking and those supplying the funds. The following illustration will explain these functions.

Example:

1. A, a retired executive, has got a license to manufacture TV sets. He estimated that ₹ 5 crores will be required to set up the plant and install machinery for the purpose.
2. A has lifetime savings of ₹ 1 crore. He does not want to invest it in plant and machinery.
3. B has recently inherited ₹ 3.5 crores. He plans to use ₹ 50 lakhs on some jewellery and invest the remaining ₹ 3 crores.
4. C, a chartered accountant, has savings after taxes of ₹ 2.5 crores. He desires to spend ₹ 50 lakhs to install a computer system and invest the balance ₹ 2 crores.

These persons met at a social gathering. In course of their meeting, they discussed their future plans and arrived at a deal. A agrees to invest ₹ 50 lakhs of his savings in the business and sells a 50% interest to B for ₹ 3.5 crore. C agrees to lend A ₹ 1 crore for 5 years at an interest rate of 15% p.a. A will be responsible for operating the business without the assistance of B and C. A now has ₹ 5 crores to manufacture TV sets.

In the above meeting, two distinct financial claims came out. The first is an equity instrument issued by A to B for ₹ 3.5 crore. The other is debt instrument issued by A and purchased by C for ₹ 1 crore. Thus, the two financial assets allowed funds to invest to A, who needed funds to invest in tangible assets. This transfer of funds is the first economic function of financial assets.

In this process of transfer of funds, it was noted that A was loath to invest his life savings of ₹1 crore in the venture and wanted to transfer part of that risk which he did by selling a financial asset to B giving him a financial claim equal to one-half of the cash flow from the business. He further managed to procure an additional fund from C, who is not keen to share the risk of the business, by way of an obligation requiring payment of a fixed cash flow, irrespective of the outcome of the venture. Thus, this shifting of risk is the second economic function of financial assets.

Notes

Task Find out the latest issue in secondary market and check the following:

- Underwriter
- Lead bank
- Investment banker

Self Assessment

Fill in the blanks:

6. …….are a long-term promissory notes with maturities ranging from 5 to 30 years.
7. ……..is created only when the investment of an economic unit in real assets exceeds its savings, and it finances this excess by borrowing or issuing equity securities.
8. …….represent an important short-term financial instrument that arises out of commercial transactions.
9. …….is the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis.
10. ……are usually bought by institutions not requiring high liquidity of their financial assets.
11. The commercial banking sector comprises of public sector banks, private banks and …….
12. RBI also regulates foreign exchange under the ……Act.
13. …… is the regulatory authority in the insurance sector under the Insurance Development and Regulatory Authority Act, 1999.
14. ……is one whose value depends on particular physical properties, such as buildings, land, machinery, etc.
15. Deposits are sums of money placed with a financial institution, for ……to a customer's account.

1.5 Summary

- The financial system is the system that allows the transfer of money between savers and borrowers. It is a set of complex and closely interconnected financial institutions, markets, instruments, services, practices, and transactions.
- India has a financial system that is regulated by independent regulators in the sectors of banking, insurance, capital markets, competition and various services sectors.
- In a number of sectors Government plays the role of regulator.
- RBI is regulator for financial and banking system, formulates monetary policy and prescribes exchange control norms.
- The commercial banking sector comprises of public sector banks, private banks and foreign banks.

Notes

- The public sector banks comprise the 'State Bank of India' and its seven associate banks and nineteen other banks owned by the government and account for almost three fourth of the banking sector.
- India has a two-tier structure of financial institutions with thirteen all India financial institutions and forty-six institutions at the state level.
- All India financial institutions comprise term-lending institutions, specialized institutions and investment institutions, including in insurance.
- State level institutions comprise of State Financial Institutions and State Industrial Development Corporations providing project finance, equipment leasing, corporate loans, short-term loans and bill discounting facilities to corporate.
- Non-banking Financial Institutions provide loans and hire-purchase finance, mostly for retail assets and are regulated by RBI.
- RBI also regulates foreign exchange under the Foreign Exchange Management Act (FEMA).
- SEBI) established under the Securities and Exchange aboard of India Act, 1992 is the regulatory authority for capital markets in India.
- Insurance sector in India has been traditionally dominated by state owned Life Insurance Corporation and General Insurance Corporation and its four subsidiaries.
- Insurance Development and Regulatory Authority (IRDA) is the regulatory authority in the insurance sector under the Insurance Development and Regulatory Authority Act, 1999.

1.6 Keywords

Commercial Paper: Are the unsecured promissory notes with a fixed maturity, usually, between seven days and three months, issued in bearer form and on a discount basis.

Deposits: Are sums of money placed with a financial institution, for credit to a customer's account.

Intangible Asset: By contrast, represents legal claims to some future benefit.

Loan: Loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in instalments or all at once, on agreed dates and at an agreed rate of interest.

Tangible Asset: Is one whose value depends on particular physical properties, such as buildings, land, machinery, etc.

Treasury Bills: Are government securities that have a maturity period of up to one year.

1.7 Review Questions

1. What is financial system? Discuss its salient functions.
2. Discuss, in brief, the structure of financial system.
3. Write a short note on the role of financial instruments in the Indian financial system.
4. "A financial system facilitates transfer of funds from Surplus Spending Units (SSUs) to deficit spending units (DSUs) by providing means and mechanism to link the two groups." Comment.

Notes

5. "Negotiable Certificate of Deposit (CD) is a special type of time deposit of a commercial bank." In the light of the statement discuss the importance of Certificate of deposits.
6. Write a brief note on the nature of Indian financial system.
7. What according to you is the role of Indian Financial system? Discuss in brief.
8. Highlight the major functions of Indian financial system.
9. "Commercial Bills represent an important short-term financial instrument that arises out of commercial transactions". Discuss
10. Throw light on the various constraints towards growth of Indian financial system?

Answers: Self Assessment

1. Financial System
2. Treasury bills
3. Reserve Bank of India
4. Financial intermediaries
5. Underwriters
6. Bonds
7. Financial asset
8. Commercial Bills
9. Commercial Paper
10. Corporate bonds
11. foreign banks
12. Foreign Exchange Management
13. Insurance Development and Regulatory Authority
14. Tangible asset
15. credit

1.8 Further Readings

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Online links

www.bis.org

This website provides information about world financial markets and international debt outstanding.

www.federalreserve.gov

This website provides information about financial markets securities holdings.

www.thebanker.com

This website provides information about the largest banks of the world

Case Study

Should Financial Systems be Rule-based?

After evaluating the pitfalls and advantages of both the systems, there is a view emerging that the financial system should be more rules-based.

The recent global meltdown has proved one thing: Neither a rules-based regulatory system nor a principles-based regulatory system is a guarantee against bank failure. However, after evaluating the pitfalls and advantages of both the systems, there is a view emerging that the financial system should be more rules-based; this is especially true in the UK.

In contrast, two committees set up in India – the Percy Mistry Committee (2007) and the Raghuram Rajan Committee (2008) – to look into financial sector reforms have recommended that India's regulatory regime should move from rules-based to a principles-based one.

Principles-based regulation (PBR) implies moving away, wherever possible, from dictating, through detailed prescriptive rules and supervisory actions, how firms should operate their businesses. Rules-based regulation, it is pointed out, is too rigid and prescriptive, and often the regulator and the regulated adopt adversarial and antagonistic postures. Some of the countries that follow principles-based regulatory systems are the UK, Australia, Canada and Ireland. Some of the leading countries whose regulatory regime is based on rules are the US, Spain and India.

However, as noted in the Turner Review, banks in countries following either of the systems have failed. For example, banks have failed in the US and the UK. So in a way, neither of the regulatory systems has proven to be robust. One way to draw lessons from the crisis would be to examine what countries such as India, Spain and Canada did right to insulate their financial systems from succumbing to the global crisis.

Spanish Method

It would be worthwhile to examine the approaches of the various regulators to housing or mortgage finance. Spain, which follows a rules-based system, has a clearly spelt out mortgage risk policy for its credit institutions. Banco De Espana (BE) lays down that lending policy of credit institutions for mortgage should take into account the repaying capacity of the borrowers and should not just be based on the collateral. BE also emphasises on the importance of the loan to value (LTV) ratio. It cautions its credit institutions against being too permissive about LTV as this typically increases the expected losses in a mortgage loan portfolio.

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The conservatism that insulated Spanish banks from crisis also played its role in keeping the banking system healthy in Canada, which follows a principles-based system of regulation. For example, mortgages with less than a 20 per cent down-payment have to be insured, and most of the securitised mortgage market consists of Canada Mortgage Bonds, which carry a government guarantee. The Canadian central bank also did not allow creation of complex, synthetic securitised instruments involving Canadian mortgage assets.

In India, the Reserve Bank of India (RBI) has strict rules regarding housing finance, specifying the risk weights to be attached to loans extended to borrowers. These risk weights vary according to the LTV ratios. The RBI also specifies the maximum sanctioned amount for LTV ratios as less than or equal to 75 per cent.

UK's System

In the UK, the Financial Services Authority (FSA) follows a principles-based regulation. However, in its proposed reforms for mortgage lending, it has categorically banned certain practices such as self-certified mortgages replacing it with those requiring verification of the income of the borrowers. It also now requires mortgage advisers to be personally accountable to the FSA.

Having realised that non-interventionist principles-based system need not always lead to the desired regulatory outcome, there appears to be a distinct shift in the UK from a non-interventionist stance to a more intrusive one.

The Federal Reserve has also notified a revision in its Regulation (which implements the Truth in Lending Act and Home Ownership and Equity Protection Act), prohibiting creditors from making higher-priced mortgage loans based on the "value of the consumer's collateral without regard to the consumer's repayment ability".

Thus, in the case of the US and the UK, at least with respect to mortgage lending, the bias is in favour of a rules-based system. But is this desirable?

One of the biggest criticisms levelled against the rules-based system is that it stifles innovation by being too interfering. In contrast, a principles-based regulation is more accommodative to innovation because it is pliant and flexible. But, as the recent meltdown has shown, while gains from financial innovation benefit a few, the losses affect a greater number through systemic instability. When it comes to a trade-off between profitability and financial stability, the choice is very clear. Financial stability creates conducive atmosphere for profitability and for carrying out banking. Therefore, a rules-based system clearly scores over a principles-based system.

A developing country like India has its own compulsions which make a rules-based system better suited when it comes to meeting our development objectives. For example, with respect to financial inclusion, unless it is specifically laid down that banks must offer no-frills accounts to their customers with zero or minimum balance and also relax criteria for identification and account opening, the goal of financial inclusion may not be achieved.

Also, there is nothing in the rules-based system that disallows innovation. If that were the case, Indian banks wouldn't have been allowed to offer several products that they now offer. The pace of innovation would be slow but if it ensures financial stability for the system, the trade-off would be well worth it.

Question

Discuss the importance of rules and regulation in financial system.

Source: http://www.thehindubusinessline.in

Notes

Unit 2: Financial Market Reforms

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Objectives

After studying this unit, you should be able to:

- Understand need for reforms;
- Understand the context and objectives of financial market reforms;
- Understand new issue market during pre-reforms period;
- Discuss the development in the new issue market;
- Explain Mode of distribution in the new issue market.

Introduction

The new issue market in India is not as much developed in terms of quantity and quality of activities as also financial depth and sophistication as in the US, UK and European countries. Nevertheless, it has over a period time, grown spectacularly in tandem with scorching pace of economic and industrial growth of the country and emerged as robust and resilient constituent of the financial market to cope with the competitive challenges across the economy. Dynamism in the new issue market in India, as perceptibly reflected in the volume of new issue activity, use of innovative instruments to garner funds, methods of distribution of securities, pricing of issues and broadening of market base over a period of time, is because of inexorable policy

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interventions, rapid industrialization of the country, path breaking technological developments, entry of financial institutions and foreign investors in the market, growing community of retail investors willing to take direct investment risks and strong support by Indian stock market.

As such, it would be appropriate to present a panoramic view of developments of Indian new issue market during the pre and post-reform period.

Coverage of Financial Sector Reforms

What constituents of the Financial Sector were covered by reforms? The components of the financial markets that were chosen for effecting measures under the reforms are:

1. Money Market
2. The Securities market.

Objective of Financial Sector Reforms by Government of India & RBI

To widen, deepen and integrate the different segments of financial sector, namely, the money market, debt market (particularly Government securities) and foreign exchange market.

2.1 New Issue Market during Pre-reform Period

2.1.1 An Overview

The new issue market in India was in its infancy at the time of independence because of a host of factors.

Example: Low demand for long-term funds due to feeble industrial base and low saving rate, reliance of many foreign companies on the London capital market for garnering funds, predominance of managing agency system with its rampant malpractices in promotion, management and underwriting of new capital issues, indifferent attitude of Indian corporates in accessing market for raising funds through shares and debentures and hazards of administered interest rate structure.

Even during the initial years of planning new issue activity remained subdued due to low level of household savings, absence of investing attitude among the individuals, retarded industrial and infrastructural development, inadequate support from the stock market and financial institutions, absence of underwriting facilities, and above all, the government control, which regulated everything from the size of the issue to its pricing and issuing of bonus shares.

Table 2.1: Amount of Issues During the First Plan to the Seventh Plan Period

Period	Amount of issues (₹ In crore)	Period	Amount of issues (₹ In crore)
First Plan (Yearly Average)	84.5 (16.9)	Fourth Plan (Yearly Average)	308.8 (61.8)
Second Plan (Yearly Average)	171.1 (34.2)	Fifth Plan (Yearly Average)	415.8 (83.2)
Third Plan (Yearly Average)	365.0 (73.0)	Sixth Plan (Yearly Average)	1090.80 (218.2)
Three Annual Plans (Yearly Average)	268.6 (89.9)	Seventh Plan (Yearly Average)	2793.0 (558.6)

Notes

Table 2.1, exhibiting data regarding amount of issues during the First Plan to the Seventh Plan period, shows that yearly average of the amount of new security floated in the market ranged between ₹ 17 crore and ₹ 83 crore during first plan period to fifth plan period. Phenomenal progress was, however, recorded during Sixth and Seventh plan periods which witnessed surge in yearly average volume of new issue business to ₹ 218 crore and ₹ 559 crore, respectively. The reasons attributable to this trend were establishment of considerably large number of new enterprises and expansion and modernization of a large number of existing undertakings leading to phenomenal spurt in demand for capital, increasing facilities in respect of underwriting of new capital issues and marketing of securities, participation of national and state level financial institutions in new issue activity and above all existence of favorable investment climate in the country. The liberalization of industrial and new capital issue policies in 1984-95 and relaxation of norms relating to foreign investments and incentives given by the government had given fillip to sustain the growth in the market.

2.1.2 Security-wise New Issue Activity

Table 2.2 exhibits information relating to security-pattern of issues floated by non-government public limited companies. It may be glanced from the table that equity shares predominated the new issue activity in the country especially till the end of 1970s, accounting for nearly three-fourths of the new capital issues. The position was, however, reversed during 1981-90 when the share of public debt floatation recorded a meteoric rise of over 66 percent. This was primarily due to enabling policy of the government in 1984 regarding the issue of secured convertible as well as non-convertible debentures by the Indian public limited and public sector companies and introduction of a new instrument called Public Sector Bonds (PSBs) and formulation of policy guidelines for the issue of such PSBs by the government. The Government of India further approved in January 1989 a new instrument called Partly Convertible Debenture (PCD).

Table 2.2: Issues Floated by Non-government Public Limited Companies

Period	Equity Shares %	Preference Shares %	Debentures %	Total
1951-60	67.9	13.7	15.4	100.0
1961-70	64.4	10.6	25.0	100.0
1971-80	75.2	5.6	19.2	100.0
1981-90	33.6	0.2	66.2	100.0

2.2 New Issue Market during Post-reform Period

2.2.1 Measures to Bolster up New Issue Market

In its endeavour to rev up new issue activity in India, the Government of India SEBI undertook the following reformatory measures during the post-reform period:

1. Pursuance of the policy of deregulation and delicensing;
2. Repeal of capital issue (Control) Act, and abolition of office of Controller of Capital issues in 1992;
3. Introduction of market-based pricing system;
4. Constitution of the SEBI to promote the development of the securities market and protect the interests of investors in securities;
5. Constitution of OTC Exchange of India and establishment of National Stock Exchange of India;

Notes

6. Permission to Indian companies to raise resources abroad through the issue of Global Depository Receipts (GDR) and Foreign Currency Convertible Bonds (FCCBs);
7. Disinvestments by the Government of India of its holdings in public sector undertakings;
8. Replacement of FERA by FEMA;
9. Opening up of the market for portfolio investments by FIIs and encouraging foreign private participation in financial services including stock broking;
10. Permitting entry of new institutions like merchant banks, leasing and hire purchase companies, and venture capital funds/companies;
11. Permitting commercial banks to raise equity share capital from the market;
12. Permitting public sector financial institutions to participate/underwrite debenture issues of MRTP/FERA companies up to 5% of each issue of debentures;
13. Permitting introduction of innovative financial instruments such as warrants, cumulative convertible preference shares, non-voting shares, sweet equity shares, and a host of hybrid bonds/debentures.
14. Permitting companies to issue Non-Convertible Debentures (NCDs') along with warrants to qualified institutional buyers.
15. Making it mandatory on the part of promoters to disclose the details of shares held by them in listed entities promoted by them.
16. According approval to the concept of "anchor investor" in public issues, whereby a person other than a promoter can be allocated as much as 30 percent of the portion reserved for qualified institutional buyers (usually 60 percent) in an issue through a bidding process. The minimum size of application for anchor investors would be ₹ 10 crore and their margin payable on application is 25 percent and the balance 75 percent to be paid within 2 days of the date of closure of the public issue.
17. Simplifying regulatory framework for issuance and listing of non-convertible debt securities by an issuer company, public sector undertaking or statutory corporation.

Self Assessment

Fill in the blanks:

1. Govt. of India approved a new instrument, called ……....., in 1989.
2. GDR stands for …….....
3. FCCB stands forv
4. NCD is the abbreviation for …….....

2.3 Developments in New Issue Market

Cumulative effect of the above, coupled with the surging economic growth and concomitant rise in household savings (about 30 percent) and increasing appetite of individual and institutional investors for investment brought about cataclysmic change in landscape of the new issue market and its related activities, heralding the emergence of matured and resilient market in the country, as is evident from the quantitative and qualitative dimensions of the new issue activity.

2.3.1 Quantitative Dimension

- Table 2.3 shows that new issue market on the whole exhibited spectacular performance in terms of garnering of resources through new issue floatation's.

Notes

- There is an almost eight fold increase from ₹ 1, 700 crore to over ₹ 13, 000 crore during the period 1990-91 to 1994-95, because of the floatation of a string of mega issues including SBI which made the largest ever issue in the history of the capital market (2,502 crore in 1993-94), also heralding the entry of banks into the capital market arena.
- The other steps taken by the government to strengthen the market for government securities was through an upward revision in interest rates and the introduction of a system of auction of securities and provision of refinancing facilities for these securities that gave impetus to the new issue activity in the country.

Table 2.3: Resources Mobilized through New Capital Issues

Period	No. of issues	Amount (₹crore)	Period	No. of issues	Amount (₹crore)
1990-91	141	1,704.35	2000-01	124	6,617.70
1991-92	196	1,898.25	2001-02	19	6,422.74
1992-93	528	6,251.83	2002-03	17	5,731.57
1993-94	770	13,443.19	2003-04	45	22,144.57
1994-95	1343	13,311.60	2004-05	59	25,506.34
1995-96	1428	11,822.18	2005-06	138	26,940.00
1996-97	753	11,686.56	2006-07	119	32,382.00
1997-98	62	3,061.22	2007-08	115	83,707.00
1998-99	32	7,910.14	2008-09	45	14,671.00
1999-2000	65	7,613.14			

Sources: Prime Data, Business Standard and RBI Annual Reports

- Because of economic and industrial recession, political instability, and the changing pattern of household financial savings the new capital issues gradually declines in 1997-98 to ₹ 3,061.22 crore.
- The nature of the new issue market also changed with the bank on 'carry forward' since January 1994 as also commencement of screen based trading at NSE and BSE.
- Some signs of revival were seen 1998-99 terms of resource mobilization. Total resources mobilized through prospectus and rights issues more than doubled to ₹ 7,910.74 crore from ₹ 3,061.22 crore in 1997-98.
- Despite a significant increase in the number of floatations there is a sharp decline in the primary market in resource mobilization during 2000-01, Although resources raised by both public and private sectors declined, the decline was much sharper in the case of the former with PSUs and government companies remaining absent from the public issues market for third consequent year. It is interesting to note that resources raised by banks and financial institutions after surging to ₹ 4,352 crore during 1996-97 continued to decline in the subsequent years touching an all time low of ₹ 1,472 crore in 2001. This is due to persistent depression in new issues market.

The sterling performance of the new issue market in India in recent years is the reflection of effectiveness of the measures initiated by the government/SEBI to develop the market and restore confidence. Some of such factors are:

- strong macroeconomic fundamentals and higher growth rate trajectory embarked upon by the Indian economy buoyancy in the secondary market
- encouraging both issuers as well as investors to enter the primary market
- countrywide enthusiasm in the community of entrepreneurs to enlarge and modernize manufacturing capacities to meet domestic as well as foreign demand
- higher rate of return on equity investments in the face of decline in interest rates on deposits

Notes

- Increased savings rate among individuals as well as big corpuses of funds available with insurance companies and mutual funds, and increase in the appetite of FIIs as well as retail investors also helped in stoking up demand for new issues.

2.3.2 Qualitative Dimension

Not only has there been quantum jump in new issue floatations, there has also been qualitative change in new issue activity, as manifest from the following discussions:

Security Pattern of New Issues

From the table 2.4 given below, we can observe that:

- Equity issues dominated new issue market, for about two-thirds of the total new issue floatations
- During the period 1981-82 to 1990-91, almost two-thirds of the total funds were raised from the market through bonds and debentures while equity shares lost its sheen, accounting for only 34 percent of the total.
- Prominence of debenture as a financial instrument continued during the next decade. Barring two years 1994-96, the Indian new issue market remained overwhelmingly debt market.
- The state of despondency witnessed in equity share market during 1981-82 to 1990-91 waned during the post reform period of 1991-92 to 1996-97 when new equity issues of the order of ₹ 56, 997 crore, out of the total issues of ₹ 98, 000 crore were offered in the market.
- The free pricing era (post-CCI), led to the revival of equity shares. Several large companies which were reluctant to issue equity shares in CCI era (because of the forced underpricing of issues under the prescribed CCI guidelines) found the freedom to issue and price equity issues as cheap option to garner resources. During 1994-95 when the primary market was in buoyancy, equity issues accounted for 73% of the total resources mobilized during the year.

Table 2.4: Security-pattern of New issue Floatation by Non-government Public Limited Companies

(₹ crore)

Period	Equity Shares	Preference Shares	Debentures	Total
1951-60	202	39	44	285
1961-70	462	77	188	727
1971-80	746	56	190	992
1981-82 to 90-91	7,857	40	15,459	23,356
1991-92 to 96-97	56,997	746	40,267	98,010
1997-98 to 02-03	10,405	206	15,152	25,763
2003-04	2,323	-	1352	3,675
2004-05	12,004	-	1478	13,482
2005-06	20,899	10	245	21,154
2006-07	29,756	-	847	30,603
2007-08	56,848	5,481	1309	63,638

Source: RBI, Annual Report on Currency and Finance for relevant years.

This robust growth of equity culture lasted for four years, i.e. from 1991-92 to 1994-95. Since 1995, predominance of debt as a source of corporate financing was noticeable. Debt instruments accounted for larger share of total funds raised from the market than equity shares because of following reasons:

- raising of the ceiling rate of interest on debentures,
- shorter redemption period of 7 years,

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- allowing redemption premium up to 5% of the face value and allowing the company to issue non-convertible debentures to have a buy-back at par from any debenture holder whose total holding does not exceed ₹ 40,000 crore and has held debentures for at least one year,
- permitting FIIs to invest in government securities (which account for more than 60% of the debt market),
- entry of profitable PSUs in new issue market with issues of bonds to mutual funds, commercial banks and other commercial institutions, permitting the public sector financial institutions to participate/underwrite debenture issues of MRTP/FERA up to 5% of each issue of debentures and relaxation of debt-equity norms from 1:1 to 2:1.

A long period of lacklustre activity in equity issue market was arrested in 2003-04 when new equity issues floated surged to ₹ 2323 crore as against ₹ 460 crore in the previous year. High tempo in the equity issue market tended to persist in the subsequent years so much so that funds mobilized through floatation of 136 equity issues soared to ₹ 29,756 crore in 2006-07 accounting for over 99% of the total resources raised during the year.

The main factors that contributed to the upsurge in new equity issues were:

- robust economic and industrial health of the country
- higher return on equity shares
- buoyancy in the secondary market
- increased enthusiasm among the investment community
- higher saving rate and
- participation of retail investors in the equity market, that have pumped in about ₹ 17,500-18,000 crore into the equities during 2006 as compared to ₹ 8000 crore in 2005.

However, retail investors' enthusiasm for equity offerings disappeared during 2008-09 because of their cautious approach and volatility in markets. Average subscription of retail investors to IPOs has dropped dramatically from 19 percent in 2004 to 3 percent in 2009. It is hoped that with recovery of economy and market stability they will be more inclined to invest.

Also garnering of resources by Indian corporates from international capital markets through ADRs and GDRs. Thus, funds raised through Euro issues soared to ₹ 26,556 crore in 2007-08 from ₹ 3,098 crore in 2003-04. Most of the Euro issues were made by private sector finance companies.

Size-wise New Issues

Another qualitative dimension of new issue market is size of the new issue. It may be noted from Table below that:

- annual average absolute amount of fresh capital raised by non-government public limited companies shot up significantly from ₹ 28.5 crore during 1951-60 to over ₹ 38,000 crore during 2003-08, clearly indicating burgeoning expansion of new issue activity in India during the post-reform period.
- In 1999-2000, the average size of IPOs was ₹ 100 crore which shot up to more than ₹ 700 crore by 2005-06.
- Also, the average size of issue, including listed as well as IPOs increased over five fold from ₹ 94 crore to 497 crore. Thus, companies came to the market with issues of large size.

Notes

(₹ crore)

Period	Amount	Period	Amount
1951-1960	28.50	1991-92 to 1996-97	9737.2
1961-1970	72.80	1997-98 to 2002-03	6226.09
1971-1980	99.20	2003-2008	38035.98
1981-82 to 1990-91	2335.70	2008-2009	326.00

2.3.3 Ownership Pattern of New Issues

Table 2.5 reveals the chequered trend in relative share of public and private sectors in new security offerings. However, the role of public sector in garnering public funds gained prominence especially after 1994-95 when public sector undertakings and financial institutions entered the primary market with issues of bonds. In recent few years, private sector dominated the new market because of bullish state of the economy and secondary market and investors' growing interest in equity issues of private enterprises.

It is interesting to observe that in both public and private sectors, banks and financial institutions mobilized larger proportion of resources by public issues. For instance, they garnered almost 39 percent of resources through public issues in 2007-08. The corresponding proportion was 52.0 percent in 2004-05.

Table 2.5: Exhibits Information about the Ownership Pattern of New Security Issues

(*Percentage*)

Period	Public Sector	Private Sector	Period	Public Sector	Private Sector
1990-91	56.8	43.2	2000-01	23.1	76.9
1991-92	50.0	50.0	2001-02	20.0	80.0
1992-93	7.8	92.2	2002-03	64.7	35.3
1993-94	34.4	65.6	2003-04	46.8	53.2
1994-95	14.2	85.8	2004-05	38.8	61.2
1995-96	30.3	69.7	2005-06	21.5	78.5
1996-97	44.5	55.5	2006-07	5.2	94.8
1997-98	48.7	51.3	2007-08	41.7	58.3
1998-99	45.0	55.0	2008-09	0	100.0
1999-2000	62.8	37.2			

2.4 Sectoral Pattern of New Issues

Preponderance of infrastructure sector in new issue market has been characteristic feature during the post-liberalization era. Thus, it may be seen from Table 2.6 that over 40 percent of the capital was raised in the infrastructure, resonating well with current national priorities. Financial services was another significant participant in the new issue market. The IT industry-driver of export revenues raised only 10.7 percent which is a reflection of the fact that the industry is now in the stable growth phase and internal generation is adequate to meet the capital requirements.

Another revealing point that can be noted from the table is the niggardly low share of the pharma and biotech sector. Given the strategic importance of bio-sector in future development of the country, it would be pertinent to make perspicacious analysis of the factors contributing to low share of this segment.

Notes

Table 2.6

Industry	No. of firms	Sum Raised (₹ crore)	% of Total
IT & ITES	28	72400	10.7
Financial Services	21	216700	25.0
Infrastructure	39	370200	42.7
Pharmaceuticals & Biotechnology	9	11700	1.3
Telecom & Media	28	72500	8.4
Manufacturing	40	50100	5.8
Consumer goods & services	14	37900	4.4
Miscellaneous	13	15400	1.8
Total	**192**	**867400**	**100.0**

Source: Based on the data for period January 1999-March 2007.

2.5 Mode of Distribution of New Issues

In India, methods commonly employed by companies to raise funds from the market are pure prospectus, offer for sale, private placement, rights issues, over-the-counter placement and stock option. In 1995, the SEBI introduced the concept of book building. Similarly, the SEBI introduced since September, 1995 compulsory 'market making' on the exchanges in the case of public issues below ₹ 5 crore.

Table 2.7 embodies information about mobilization of funds by Indian companies through prospectus and rights and private placement. It may be noted from the table that Indian corporate sector relies heavily on domestic private placement market, obviously to derive certain advantages like lower transaction costs limited disclosure requirements in the offer documents and mobilization of funds in a shorter time frame. Thus, in 1999-2000, private placement accounted for 89 percent of total resources mobilized during the year. However, in recent years, the pace of growth of the private placement has slackened leading to drop in the share of private placement to 61 percent of the total resources garnered during 2007-08. The dwindling trend in private placement has been due to the bullish state of economy and secondary market, which made the investing community responsive to public issues.

Table 2.7: Mobilization of funds by Indian companies through Prospectus and rights and Private Placement

(Percentage)

	1999-2000	2000-01	2004-05	2005-06	2006-07	2007-08	2008-09
A. Prospectus and Rights	11.0	8.7	21.1	11.0	22.2	39.0	13.9
B. Private Placement	89.0	91.3	78.9	89.0	77.8	61.0	86.1
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

The bulk of resources from the private placement market has been mobilized by private sector entities – both financial and non-financial. Within the financial intermediaries groups, banks (both public and private sectors) mobilized predominant share of resources.

Did u know? As regards subscription to the public issues, private sector companies have been found contributing major proportion to the public offerings, accounting for over three-fourths of the total issues offered through prospectus and rights issues during 2007-08.

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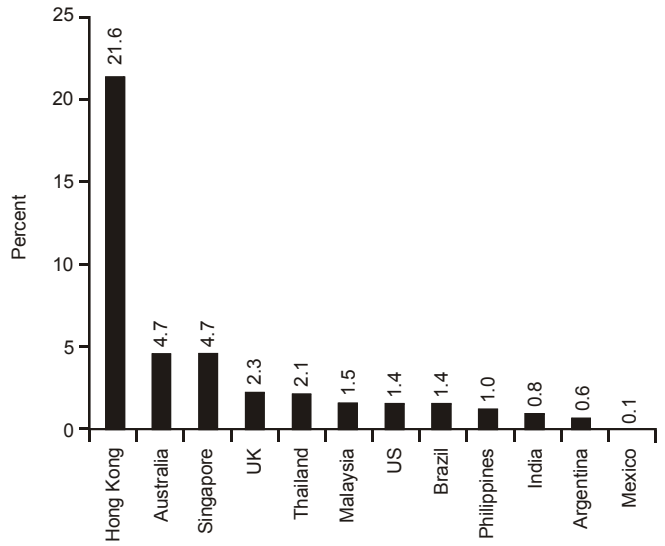
During 2008-09, over 90 percent of the resources was garnered through private placement and the balance (7%) was mobilized through Initial Public Offerings (IPOs). However, the domestic private placement, which has emerged as a major alternative source of funding for the Indian corporate sector in the recent years, witnessed a slowdown during the period due to adverse capital market conditions. Mobilization of resources through private placement was lower during 2008-09 than in 2007-08.

Despite tremendous progress made in Indian primary market during the post-liberalization period, size of the market remains much smaller than many advanced economies such as Hong Kong, Australia, the UK, the US and Singapore, as also emerging market economies such as Thailand, Malaysia, Brazil and the Philippines (Figure 2.1).

Figure 2.1



Task How far have the various policy measures taken by the government impacted the working of the new issue market in India?

Self Assessment

Fill in the blanks:

5. During 1994-95 when the primary market was in its initial phase, equity shares accounted for ..... of the total resources mobilized.
6. Debt instruments have a redemption period of ..... years.
7. In 1999-2000, the average size of IPOs was ₹ 100 and in 2006-06, it was ₹.....
8. In financial inter mediariaes group, ... mobilized predominant shares of resources.

2.6 Summary

- The new issue market in India until the pre-liberalization period remained undeveloped and lopsided in terms of quantum and kinds of new issues, participation of agencies in new issue activity and investors' apathy towards new security issues. However, the

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government undertook a range of measures during the post-liberalization period to rev up new issue market. Consequent upon these measures, the new issue market in India witnessed phenomenal changes, both quantitatively and qualitatively, increasing depth and sophistication of the operations of the market as also resilience of the market to cope with the new economic challenges.

- Although the Indian new issue market compares well with other emerging economies in terms of sophisticated market design of equity market, widespread retail participation and liquidity, participation of FIIs, mobilization of funds through Euro issues, the growth of the debt and equity markets remains low and largely skewed in comparison to the U.S., Malaysia and South Korea, indicating immense latent potential. Further, the new issue market of the country continues to be shallow. Despite inflation, only 2 percent of Indian household savings are invested in the market as against 20 percent in developed economies and about 51 percent in the US.
- A host of factors has stonewalled the full-fledged growth of the new issue market of the country. One such factor is inadequate disclosures of information needed by the investors to make informed decisions regarding investment in new offerings. Despite the SEBI's clear directives in this regard, Indian corporates are mostly indifferent in supplying the required details. This has ostensibly eroded the confidence of the investing community.
- Overpricing of issues is another pernicious weakness of the new issue market in India responsible for its stymied development. This created problem for the holders to exit from the market. The major concern for the issuing companies at present is to fix the right price of the issue. In fact, price discovery price is not perfect because of conflict of interests. At present, a Dutch auction process for the institutional bidders, where the price band is decided before the bidding begins, is followed. The French auction process works on the principle of "Winner takes all". This follows a top-down approach where the highest bidder gets the first allocation, followed by the second highest bidder and so on. The French method can be used to determine the price offered to retail investors who could be allotted shares at the lowest auction price or the average price. However, merchant bankers do not seem to like the idea. With proportionate allocation, a French auction does not make sense as there is no incentive for the institutional buyers. In a proportionate allocation, irrespective of the number of shares or the price one bids for, any institutional bidders that make the cutoff receive an equal number of shares among each other. The SEBI is attempting to find alternatives to improve the pricing process.
- High transaction costs, that drive companies to other avenues for mopping up capital, have also hampered the growth of the market.
- Due to the latest global financial meltdown, the new issue market has suffered grievously with investors' confidence at its lowest ebb. To rev up the new issue market and sustain its growth, it would be the much-needed measure to restore investors' confidence. For this purpose, it is necessary for the SEBI to protect the investors' interests by making listing requirements more stringent in phases so as to discourage the participation of unhealthy companies in the new issue activity, installing an efficient institutional arrangement, and directing the companies to adhere strictly codes of corporate governance.
- It will also be useful to offer a mechanism of safety net/exit option on new issues to retail investors so that the shares at the issue price of the price of a share drops below a certain level within a certain specified time. This will, besides exuding confidence among the investors, induce the market to move to a more realistic pricing.
- Market making spread should be made compulsory at least for a period of 6 to 12 months from the date of listing. This would go a long way in improving liquidity of the scrips. Issuing companies and the syndicates should be mandated to sell the IPOs. Making adequate

credit available to market makers would help ensure more active participation in the secondary market. They must be allowed to lend against shares.

Notes

2.7 Keywords

Financial institutions: Provide a variety of financial products and services to fulfil the varied needs of the commercial sector.

Money market: Is a market for short-term funds and covers money and financial assets that are close substitutes for money.

Primary market of a country renders three major services: investigating and processing of proposals for new issues, underwriting of new security issues and distribution of new securities to ultimate investors.

Secondary market is a market where the sale of previously issued securities takes place.

2.8 Review Questions

1. What were the primary reasons for undeveloped new issue market in India during the pre-liberalization period?
2. Discuss, in brief, various measures undertaken by the government and the RBI to develop new market in India.
3. Critically assess the performance of new issue market in India during the post-liberalization period.
4. What were the main reasons for the reforms in the Indian financial market?
5. Discuss the mode of distribution of new issues.
6. "Overpricing of issues is another pernicious weakness of the new issue market in India responsible for its stymied development." Comment.
7. What role has the public sector played in new issue market in India?
8. What measures would you suggest to further strengthen the new issue market in India?
9. Discuss the objectives of Financial Market Reforms.
10. What are the various measures taken towards the growth of new issue market?

Answere to Self Assessment

1. Partially Convertilde Debenture
2. Global Depository Receipt
3. Foreign Currency convertible Bonds
4. Non-Convertible Debentures
5. 73%
6. 7
7. ₹ 700
8. Banks

Notes

2.9 Further Readings

Books

RBI, Annual Reports, 2008-09

Business Today, September 21, 2008

Business Times, October 28, 2008

Business Standard, August 21, 2009

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Business Line, September 21, 2007

Caselet

Financial Reforms and Industrial Sector in India

Sushil Khanna

Indian financial sector reforms have failed to achieve their goal of making the sector more efficient, and there has been a hardening of interest rates 'instead of the cheaper credit that was promised. These reforms have had disastrous effects on the industrial sector leaving Indian firms vulnerable to the foreign competitor. While MNCs have been allowed to bring in funds, institutional long-term finance for Indian firms has been curtailed.

The economic reforms in India, initiated in 1991, were based on the premise that macro-economic crisis was a result of 'micro-economic' inefficiencies that distort the structure of incentives to producers [Bhagawati and Srinivasan 1993]. After a short period of IMF style 'stabilisation', with the usual package of devaluation, temporary import compression and fiscal and monetary contraction accompanied by a sharp increase in the interest rates in the economy, the main focus of the reforms programme has been confined to what is known as 'structural adjustment'.

The deregulation of the industrial and financial sectors has occupied the pride of place in India's structural adjustment programme (SAP). The financial reforms programme set in motion, follows the well known path of deregulating capital markets and banks, interest rates, with drawing directed credit and subsidies, and encouraging stricter income recognition norms and integrating the domestic financial markets with global financial flows, in conformity with the 'Washington consensus'.

Similarly, the major objective of the 'Statement of Industrial Policy 1991', is the 'dismantling of the regulatory system …(to facilitate) increasing competitiveness for the benefit of the common man" [Gol 1991b]. This was sought to be achieved through wholesale abolition of industrial licensing regime and major amendments to Monopolies and Restrictive Trade Practices Act (MRTP). The amendments to the latter have specially been far reaching. Thus, the new policy regime abolishes "pre-investment scrutiny of investment decisions by the so-called MRTP companies…and for prior approval of central government for expansion, establishment of new undertaking, mergers, amalgamation and takeover" of other firms. Moreover, the list of industries reserved for public sector were reduced from

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17 to six. In addition, private sector participation was allowed even in many industries reserved for small firms and public sector, and access to foreign technology was make much easier [GoI 1993]. The foreign investment restrictions were largely abolished with majority ownership for foreign investors in most industries, including industries hitherto reserved for public sector and now open to the Indian private sector. The new industrial policy was combined with reduction in tariff barriers and elimination of quotas in the import policy.

That the old industrial licensing regime was flawed and unable to achieve its stated objectives is now widely accepted. That the system of licensing was used arbitrarily and to strengthen the stranglehold of a small group of business houses and foreign firms was demonstrated by the enquiry into the system by Dutt Committee in the early 1970s [ILPIC 1969]. That the system resulted in rent-seeking behaviour from the private entrepreneurs and political elite has been the accepted paradigm amongst a number of economists [Ahluwalia 1985].

This paper is an exploratory attempt at tracing the crucial link between the financial sector and the industrial sector in India, both of which have been in the throes of restructuring due to far reaching and sometimes ill-conceived attempts at deregulation during the last seven years. It is grounded in the firm belief that the financial sector has no role other than to channelise domestic (and where applicable, foreign) savings to the entrepreneurs and managers in the real sectors of the form level response to these changes in the policy and regulatory regime. It seeks to explain the turmoil and the crisis in the Indian corporate sector to among other things, the changes in the financial sector and the macro-economic policies of the central bank to shocks provided to the economy from large cross border financial flows. Section I discusses the financial sector before and Section II after the reforms. Section III discusses industrial sector reforms and Section IV and V examine firm level response to internal and external deregulation of the industrial sector. Section VI seeks to draw some conclusions based on the interaction between the financial and the industrial sectors.

Reforms in Theory

Financial Sector

That the financial markets are markedly different from other markets and that market failures are likely to be pervasive in these markets has been the received wisdom for some time [Stiglitz: 1993]. The specific characteristics of the financial markets require government intervention, including the kind that was practised in India during the last four decades. This intervention helped raised investment and savings rate in Indian economy and supported the strategy of industrial growth.

Indian financial sector experienced rapid growth and deepening during the first four decades of economic development in India. India pioneered the concept of development banking to provide long-term finance to long gestation industrial projects, often at marginally subsidised rates of interest. Given the fact that capital markets in India were small and underdeveloped, these development financial institutions (along with state-owned insurance firms) helped to develop and deepen the capital market through their underwriting activity. The nationalisation of the banks in 1969 and the subsequent impetus given to branch expansion, especially in small towns and semi-urban and rural areas, fostered the banking habit and accelerated the monetisation of the economy [Ghosh 1979].

The critics of state intervention of financial markets characterize Indian financial sector as 'repressed' [following MCKinnon 1973; Shaw 1973] with high reserved requirements, interest rate controls, and direction of credit to priority sectors, the repression, it is argued is harmful to resource mobilisation and (efficient) resource allocation' (Joshi and Little 1996.

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Unit 3: Financial Markets

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Objectives

After studying this unit, you should be able to:

- Learn the concept of financial market;
- Explain the nature and composition of Indian money market;
- Discuss about the major players and functions of Indian money market;
- Discuss the money market instruments;
- Understand the risk involved in money market instruments.

Introduction

A financial market, as noted in the preceding unit, is a market where variety of financial assets are traded directly or indirectly to cater to the diverse saving notions of the savers and numerous

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investment preferences of the investors, and where financial institutions buy the financial claims of those who have surplus funds and sell their own claims. In view of a large number of different types of financial investments of diverse maturity issued by financial institutions and trading of wide range of securities, there exist different types of financial markets in a developed economy. Each market deals with a somewhat different type of securities in terms of instruments, maturity and the assets backing it. Also, different markets serve different parts of the country. A fair understanding of these financial markets provides insight into conceptual model of the financial system and intricate interrelationships that exist among various intermediaries. This, in itself, hones the decision-making skills of the market participants.

Broadly speaking, financial markets can be classified according to maturity structure and kind of securities traded in the markets.

3.1 Money Market in India

Money market, as noted earlier, is a market for short-term funds and covers money and financial assets that are close substitutes for money. The money market is concerned with intermediation of short-term funds from savers to those who need them for meeting their working capital requirements and allocation of the funds in an efficient manner among competing uses in the economy, thereby contributing to growth through increased investment and through enhanced efficiency in resource utilisation. A developed money market is critical for effective economy. Monetary transmission cannot take place without transmission of monetary policy impulses to the rest of the efficient price discovery, particularly with respect to interest rates and exchange rates. Deep and liquid money market contributes significantly to efficient price discovery in various segments of the financial market.

In recognition of the crucial role of the money market, structural reforms have been initiated in recent years in several countries of the globe leading to a regime characterised by market-determined interest and exchange rates, price-based instruments of monetary policy, current account convertibility, phased capital account liberalisation and an action-based system in the government securities markets. From the point of view of the economy as a whole, while developing money market, it is essential to keep in view how such development helps overall growth and development. The price discovery of interest rates and exchange rates and the integration of such prices across markets helps in the efficient allocation of resources in the real sectors of the economy. Financial institutions like banks also gain from better determination of interest rates in financial markets so that they can price their own products better. Further, their own risk management can also improve through the availability of different varieties of financial instruments. The access of real sector entities to finance is also assisted by the appropriate development of the financial market and availability of transparent information on benchmark interest rates and prevailing exchanges. All these considerations have influenced the central banking authority of different countries while taking measures to strengthen money market and its various constituents.

3.2 Nature of Money Market

Money market is a market where near money assets and not currency are traded. Near money assets are characterised by their liquidity, high marketability and low risk. Money market is distinct from other financial markets because of the short-term maturity of money market instruments, large denomination of transactions, low default risk, innovation and flexibility.

Money market typically trades in short-term securities having an original maturity of one year or less. Because of short-term maturity, adverse price movements resulting from interest rate fluctuations are smaller in money market securities which, in turn, lead to low risk.

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Another redeeming characteristic of money market is that money market instruments are generally sold in large denominations. The size of these transactions prevents most individual investors from participating directly in the money markets. Instead, dealers and brokers operating in the trading rooms of large banks and brokerage houses, bring customers together. Individuals generally invest in money market securities indirectly, with the help of financial intermediaries.

Low default risk is another feature of money market securities. The risk of late or non-payment of principal and/or interest is generally small. As cash lent in money markets must be available for quick repayment to the lender, money market instruments are usually issued by high-quality borrowers having low default risk.

Innovation and flexibility are the hallmark of the money market. Despite the wholesale nature of the money market, innovative securities and trading methods have been developed to provide opportunity to small savers to access to money market securities.

Money market securities are used to 'warehouse' funds until needed. The returns earned in these investments are low due to their low risk and high liquidity.

It is important to note that money market does not represent a single physical location. Money market transactions do not take place in any one particular place or building. Usually, traders arrange purchases and sales between participants over the phone and complete them electronically. Dealings may be conducted with or without the help of brokers. In view of this unique characteristic, money market securities typically have an active secondary market. An active secondary market makes it easy to find buyers who will purchase the security sold initially in the future. This provides flexibility to the instruments to use them for meeting short-term financial needs.

3.3 Functions of Money Market

Primary objective of money market is to facilitate the flow of short-term funds. To achieve these objectives, money market performs the following functions:

1. The most important function of money market is to establish linkage between supplies of short-term surplus funds and demanders of funds for meeting their short-term requirements. It provides convenient access to both providers and borrowers of short-term funds to satisfy their lending and investment requirements. In this process, money market provides an equilibrating mechanism to even out short-term liquidity.
2. Money market provides an ideal place for a firm or financial intermediary to 'warehouse' excessive holdings of cash balances until they are needed. In the real world, the immediate cash needs of individuals, firms and governments hardly synchronise with cash receipts. Further, corporations' daily patterns of receipts from sales do not match the pattern of their day-to-day expenses. Since holding surplus cash involves opportunity cost in terms of lost interest income, firms and other economic units use the money market as an interim investment that provides a higher return than holding cash or money in banks. They invest their excess cash funds in money market instruments that can be quickly liquidated in cash in times of need with little risk of loss of value. Thus, through the 'warehousing' function, money market provides efficient means to enable large amount of funds to be funneled from suppliers of funds to users of funds for a short period of time. Most investment funds and financial institutions held money market securities to meet investment or deposit outflows.
3. Money market provides an effective low cost source of temporary funds. Banks may issue certificate of deposits and other short-term securities in the money market to overcome the problem of reserve requirements shortages. Likewise, the government issues treasury bills to fund a large portion of its debt.

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4. Another function of money market is to facilitate the central monetary authority of the country to administer monetary policy to bring about financial stability through various money market instruments.

3.4 Players of Money Market

By nature, the transactions that take place in the money market are of high volumes, involving large amounts. Hence, the market is dominated by a relatively small number of large players. Given below is the list of intermediaries participating in the money market:

1. Government
2. Central Bank
3. Bank
4. Financial Institutions
5. Corporate Units
6. Other Institutions Bodies-MFs, FIIs, etc.
7. Discount Houses and Acceptance Houses
8. Market Makers (Primary Dealers, etc.)

The role and the level of participation by each type of player in the money market differs greatly from that of the other. Further, the institutional nature of operators indicates that the money market is a wholesale market. Government is an active money market player and in most economies, it constitutes the biggest borrower in the money market. The government needs to borrow funds mainly when the budgeted expenditure goes beyond the budgeted revenue. To adjust this budget deficit, it generally issues securities in the money market and raises funds. Apart from this regular deficit adjustment, the government still has to make certain short-term adjustments. For instance, consider the advance tax receipts of the government. In anticipation of these cash inflows, it incurs expenses thus creating a deficit. This deficit will later be adjusted with the advance tax receipts.

The government issues other securities of varying maturities to adjust its deficit borrowings. The central bank of a country generally operates in the money market on behalf of the government. It issues government securities based on the present and future requirements of the government and the market conditions. In certain cases, it also underwrites the issues of the government. Apart from functioning as a merchant banker to the government, the central bank also dons the role of a regulator in the money market and issues guidelines to govern the money market operations and operations. It is through these regulations, that the central bank keeps a vigil on the money market activities. Such regulatory mechanism becomes essential, especially since the impact of the money market is felt on the economy, as a whole and on money supply and interest rates, in specific. One of the most significant segments of the money market players is the banking industry. Banks mobilize deposits and utilize the same for credit accommodation. However, banks are not allowed to use the entire amount of deposits received for extending credit. Most of the developed economies/markets, in order to promote certain prudential norms for healthy banking practices, require all banks to maintain minimum liquid and cash reserves. Thus, banks should first ensure that these reserve requirements are met before deciding on their credit plans. If banks fall short of these statutory reserve requirements, they can raise the same from the money market since it is a short-term deficit. Sometimes, it so happens that the banks receive certain attractive loan proposals but do not have the funds for immediate disposal. In such cases too, banks will tap the money market to make temporary adjustment of funds for the loan. Further, banks also lend their short-term surplus funds into the money market rather than keeping them idle. The collective operations of the banks on a day-to-day basis are particularly

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predominant and hence have a major impact on the interest rate structure and the money position. Like banks, financial institutions also undertake lending and borrowing of short-term funds. Due to the large volumes these FIs transact in, they have a significant impact on the money market.

Corporates also transact in the money market mostly to raise short-term funds for meeting their working capital requirements. This segment partly utilizes both the organized and the unorganized sector of the money market.

Player	Role
Central Bank	Intermediary
Government	Borrower/Issuer
Banks	Borrowers/Issuers
Discount Houses	Market Makers
Acceptance Houses	Borrowers/Issuers
FIs	Lenders/Inventors
MFs	Investors
FIIs	Intermediaries
Dealers	Intermediaries
Corporates	Issuers

Money market operators also include other institutional players viz. Mutual Funds (MFs), Foreign Institutional Investors (FIIs), etc. The level of participation of these players varies largely depending on the regulations. For instance, the level of participation of the FIIs in the Indian money market is restricted to invest in government securities only. In addition to the various borrowers and lenders, few players act as intermediaries in the money market. Discount and acceptance houses and market makers/primary dealers/satellite dealers come under this category and have certain specific roles to play in the money market.

Discount houses perform the function of discounting/rediscounting the commercial bills and T-Bills. On the other hand, acceptance houses are specialized agencies which accept the bills of exchange on behalf of their clients for a commission. This service enhances the liquidity of the bill. However, an active bill market becomes a prerequisite for the services of the discount and acceptance houses. In addition, some of these intermediaries act as underwriters to the government securities and also have the option to be their market makers. The above mentioned various money market players, can be segregated into different categories based on their activity in the market, i.e., they can be only lenders, lenders and borrowers/issuers, investors or intermediaries. Certain players may have more than one role to play. Table above defines the role of the various players in the money market.

3.5 Types/Composition of Indian Money Market

Organised money market in India is composed of call/notice money market, term money market, treasury bill market, discount market and bill market.

3.5.1 Call/Notice Money Market

Call/Notice money market, as noted earlier, is a market where the day-to-day surplus funds, mostly of banks are traded. In India, there does not exist short-term money market along the pattern of the U.K. and the US. Call loans in India are provided; (i) to the bill market, (ii) for the purpose of dealing in the bullion markets and stock exchanges, (iii) between banks, and (iv) frequently to individuals of high financial status in Mumbai for ordinary trade purposes in

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order to save interest on cash credits and overdrafts. Among these uses, interbank loan has been the most predominant. Banks borrow from other banks to meet a sudden demand for funds, make large payments, large remittances, and to maintain cash with the RBI. To the extent, call loans that are given in India to security brokers tantamount to "outside" interbank loans in the UK. To the extent call money is used in India, it is akin to federal funds in the US and to the extent the call money is provided to security brokers, it tantamounts to call loans proper in the US.

Maturity period of call loans varies between one day to a fortnight while notice money deals in funds for 2-14 days.

Call loans are unsecured in India, unlike in other countries. Further, trading on the call money market is seasonal in character as is reflected in the volume of money at call and short notice. Thus, demand of money at call market is less during slack season as compared to that during busy season in a year. It is generally found that borrowings from call market tend to be highest around March every year ostensibly due to withdrawals of deposits in March to meet year-end tax payments and withdrawals of funds by financial institutions to meet their statutory obligations.

Call money markets are located mainly in high industrial and commercial centres like Mumbai, Kolkata, Chennai, Delhi and Ahmedabad. Among these, the Mumbai call market is the biggest both in terms of size and buoyancy. This is primarily because head offices of all the premier banks, the RBI, LIC and UTI are situated there. It has also the biggest stock exchange and highly developed communication system. The call money markets at Delhi, Kolkata, Chennai and Ahmedabad are geographically dispersed due to which different call rates prevail in these markets.

In addition to the above, there exists a large number of local call markets developed and operated by indigenous local bankers.

3.5.2 Term Money Market

The term 'money market' is another segment of the uncollateralised money market which deals with financial transactions of short-term duration ranging from 15 days to one year. This market has been somewhat dormant in India. It was also a strictly regulated market up to the late 1980s with the ceiling rates of interest (10.5-11.5%) across the various maturity periods. Historically, statutory pre-emptions on interbank liabilities regulated interest rate structure, cash credit system of financing, high degree of volatility in the call money rates, availability of sector-specific refinance, inadequate Asset Liability Management (ALM) discipline among banks and scarcity of money market instruments of varying maturities were cited as the main factors that inhibited the development of the term money market.

3.5.3 Treasury Bill Market

Treasury bill market deals with instruments of short-term borrowing of the government. It plays a vital role in cash management of the government. Being risk-free, their yields at varied maturities serve as short-term benchmarks and help pricing varied floating rate products in the market. Treasury Bills market has been most preferred by central banks for market interventions to influence liquidity and short-term interest rates, generally combined with repos/reverse repos.

There was an active Treasury Bills market in India's bank's history before the 1960s when 91-days Treasury Bills were auctioned weekly and the bills were widely held in the market. In the mid-1950s, the system of ad hoc 91-days Treasury Bills was introduced to replenish on automatic basis, the Central Government's cash balance with the RBI to restore to its minimum required level which opened up the era of uncontrolled monetisation of the central government's deficit.

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In mid-1960s, the auction system for issue of 91-days Treasury Bills to the market was replaced by the Tap sale of bills. Though the Tap bill rates were varied in sync with changes in the Bank Rate till 1974, the discount rate on ad hoc and tap bills continued unchanged since then at the uniform rate of 4.6 per cent.

Combined with the regime of administered interest rates, there was no congenial environment for Treasury Bills market to develop. However, the interest in development of Treasury Bills market came up with the introduction of 182-days Treasury Bill on auction basis in November, 1986 and the constitution of Discount and Finance House of India (DFHI) as a money market institutions in March 1988.

At present, the Treasury bill market in India deals in the treasury bill issues of weekly, 14-day and 91-day bill auctions and 364-day bill auctions on a fortnightly basis combined with 14-day intermediate bills available for state governments and foreign central banks.

3.5.4 Discount Market

Unlike the London discount market, Indian money market does not have discount house to provide discount facility. The RBI provided rediscounting facility to the commercial banks until 1988 so that banks get abundant liquidity in times of liquidity crisis.

The Banking Commission 1972 for the first time considered the question of establishment of discount houses in the country. The Commission was of the firm view that there was no need for specialised acceptance and discount houses though such institutions might be formed as joint-stock companies in course of time to offer and supply of short-term finance in the market.

The Chore Working Group to review the system of cash credit also looked into, in 1979, the question of setting up of a discount house in India. The Chore Group was of the considered view that discount houses along the pattern of the U.K. could be profitably adopted in India. It recommended that:

1. The proposed discount house should be the sole depository of the surplus liquid funds of the banking system as well as the non-banking financial institutions.
2. It should use surplus funds to even out the imbalances in liquidity in the banking system subject to the RBI guidelines.
3. It should create ready market for commercial banks, treasury bills and government securities by being ready to purchase from and sell to the banking system such securities.
4. The discount house should be sponsored by the commercial banks, LIC, UTI, GIC with participation by the IDBI, ICICI and SFCs.
5. The discount house should be an autonomous body which should be run strictly on commercial principles.
6. The RBI should have powers to issue directives to the proposed discount house.

However, the Chore Committee recommendations failed to elicit any response from the Government and the RBI. The Vaghul Committee after studying the working of the Indian monetary system and money markets from various angles recommended for the establishment of an autonomous public limited company, to be called the Finance House, jointly by the RBI, the public sector banks, and the all-India financial institutions.

Following the Vaghul Committee recommendations, the RBI set up the Discount and Finance House of India Ltd. in April 1, 1935 year with the solemn objective of deepening and activating money market. With the establishment of DFHI, discounting facilities are now provided by it, leading to reduction in the pressure for discounting services on the RBI. Institutions such as NABARD, Exim Bank, SIDBI and NHB also play an important role in the discount market.

Notes

3.5.5 Bill Market

Bill market is a market where short-term papers or bills are traded. These bills include bills of exchange and treasury bills. The Bill market in India has not been as well developed as in the U.S. and the U.K.

In its efforts to develop and activate the bill market, the RBI launched Bill Market Scheme in 1952. According to this scheme, the RBI provided advances to scheduled banks by way of demand loans against the security of eligible usance bills or promissory notes of their constituents. The facility was originally restricted to banks with deposits of ₹ 10 crores or more, which was later in 1953 extended to banks with deposits of ₹ 5 crores or more. In July 1954, all licensed scheduled banks became eligible for the facility. Initially, the minimum limit of advance was fixed at ₹ 25 lakhs and the minimum amount of each individual bill was fixed at ₹ 1 lakh. These minimum limits were subsequently in 1957 reduced to ₹ 5 lakhs and ₹ 50,000 respectively.

Initially, refinance facility under the Scheme was granted at a concessional interest rate, i.e., at a rate half a per cent below the bank rate. The RBI also agreed to bear half the cost of stamp duty incurred in converting demand bills into time bills. However, the concessions were reduced in stages after 1952 and they were all withdrawn by November 1956.

In October 1956, the scheme was extended to cover export bills so as to enable banks to extend credit facilities to exporters on or more liberal basis.

However, the Bill Market Scheme, 1952 failed to achieve its objectives and was withdrawn in 1970.

A number of reasons are ascribed to its failure. These are:

1. Borrowers' preference for cash credits to discounting of bills.
2. High stamp duty.
3. Absence of specialised institutions for discharging the functions of acceptance and discount houses.
4. Inadequate volume of usance bills.
5. Continuance of the old practice of drawing exports and import bills in foreign currency, restricting the scope for negotiation such bills in the country.
6. Lack of bill discounting practice with banks having excess liquidity.
7. Inadequate mechanism for evaluating the creditworthiness of traders so as to avoid risk of defaults of redemption on maturity of the bills.
8. Cumbersome procedures of discounting and rediscounting.
9. Loss of banks' interest in bill finance once the RBI granted refinancing against bills.
10. Growth of competing money market instruments such as interbank participants.

The RBI set up a study group under the Chairmanship of M. Narsimham to look into the forces hampering the growth and development of a healthy bill market in the country and suggest suitable measures. On the recommendations of the study group, the RBI introduced another Bill Market Scheme in 1970. This scheme was a major step towards developing a bill market.

Under Bill Market Scheme, 1970, the RBI provided facility of rediscounting of the bills to the eligible banks including scheduled commercial banks, selected urban cooperative banks, Export-Import Bank of India, LIC, Mutual fund, and SIDBI were also eligible to rediscount bills under the scheme.

Notes

The scheme covered only genuine trade bills. The following categories of bills were treated eligible for rediscounting purpose:

1. Bills arising out of the genuine trade transactions. Such bills should be drawn on and accepted by the purchaser's bank or drawn on the buyer and the buyer's bank jointly and accepted by them jointly. The bill should also bear the endorsement of a licensed scheduled bank if the purchaser's bank is not a licensed scheduled bank.
2. Bills drawn and accepted by the buyer under an irrevocable letter of credit and certified by the buyer's bank (which has opened the letter of credit) to the effect that such bill was drawn for supply of goods and that the terms and conditions of the letter of credit have been fully complied with by the seller.
3. Bills accepted by a licensed scheduled bank for a purchaser and discounted for a seller, if both are clients of the same bank.
4. Bills of exchange arising out of sale of goods to government departments or semi-government bodies, provided they satisfy other requirements of the same and bills of exchange drawn on and accepted by ICICI on behalf of its purchaser constituents.

The banks seeking rediscounting facility were authorised to keep with them, on behalf of their discounting institutions, individual bills up to ₹ 10 lakhs. The banks will have to submit return in the prescribed form to the discounting institutions providing details of such bills.

Notes The bills for rediscounting purpose should have usance of 90 days but in exceptional cases, it may have usance up to 120 days, provided at the time of offering to the RBI for rediscount, it has a usance not exceeding 90 days. For export bills, the maturity period was 180 days.

Initially, the minimum amount of a single bill was fixed at ₹ 5000 and the maximum limit of an advance was fixed at ₹ 50,000. With effect from November 1971, banks were not required to deliver bills to the RBI, but were authorised to retain bills with them. Hence, the regulation with respect to the minimum value of a single bill was dispensed with.

The new scheme did not help much to develop bill market in the country. The scheme was primarily directed to providing liquidity or accommodation to banks. There was poor response from public sector undertakings as also from big business house in availing of the bill financing facility. The restricted period of credit limit up to 90 days as against the normal credit period of 6 months to 9 months rendered the scheme unpopular. Commercial banks, instead of approaching other banks for rediscounting bills, approached the RBI whenever there was an urgent need of funds making bill-rediscounting cheaper than call loans. Thus, the RBI acted more as the lender of the first resort instead of lender as the last resort. Further, small business units found it difficult to get bills accepted by banks, which was an essential requirement under the new scheme. The continued insistence of the banks to treat bills only was a security and the availability of alternate, less cumbersome and cheaper means of finance have also restricted the growth of the bill market. Absence of quality bills is also responsible for the lack bill culture in India. The government and the public sector units did not evince much interest in developing bill culture.

In sum, both the bill market schemes failed to provide necessary dynamism and infrastructure to bill market in the country, such as ensuring availability of acceptance services, services of dealers and brokers, interbank rediscounting of bills, etc.

In November, 1981, the RBI stopped rediscounting the bills under the scheme and permitted the banks to rediscount the bills with one another or with the approved financial institutions. The reason for the change in the policy was that the amount of bills rediscounted with the RBI had

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declined drastically during 1975-80 and no bills appeared to have been rediscounted with the RBI after 1980-81. This new policy has, however, not worked well, as evidenced from the remarkable decline in the share of bill finance in the total bank credit.

Did u know? A number of committees, such as the Tandon Committee, Chore Committee, Chakravarti Committee and Vaghul Committee were appointed during the 70s and 80s to look into the issue of undeveloped character of bill market in the country and make recommendations for building strong and vibrant bill market. Keeping in view the recommendations of these committees, the RBI initiated several measures to develop the bill market in India. Some of these measures taken recently but before the reform period were as under:

Banks were directed to fix the CAS parties now coming under the credit Monitoring Scheme a minimum of 25 per cent of their inland credit purchases as bill acceptance limit and a bill discounting limit of the same order by suitably reducing the facility against financing inland credit sales.

1. The RBI approached the Government of India for the remission of stamp duty on bill of exchange which was readily accepted.
2. The RBI, in its endeavour to simplify the procedures and documentation for facilitating successive rounds of rediscounting and thereby developing the secondary market for bills, introduced in September, 1988, a derivative usance promissory note to be issued by the discounter on the strength of underlying bills having a tenor corresponding to or less than the tenor of the derivative usance promissory note and in any case not more than 90 days. The derivative promissory note has been exempted from stamp duty.
3. The RBI made access to the bill rediscounting market less restrictive and increased the number of participants in the scheme by permitting a large number of financial institutions including select urban cooperative banks eligible to rediscount bills.
4. The RBI set up jointly with banks and financial institutions, the DFHI as a major financial institution for the development of the money market including the market for commercial bills.

3.6 Participants of Indian Money Market

3.6.1 Participants in Call Money Market

Example: Examples of Players in call money market in India are:

1. Reserve Bank of India
2. Scheduled Commercial Banks
3. Non-Scheduled Commercial Banks
4. Foreign Banks
5. State, District and Urban Cooperative Banks
6. Discount and Finance House of India (DFHI)
7. Securities Trading Corporation of India (STCI)

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8. Primary Dealers (PDs)
9. Satellite Dealers (SDs)

Commercial banks and cooperative banks are the major participants operating as both lenders and borrowers, while a large number of financial institutions and mutual funds are operating only as lenders. The behaviour among banks in the market has not been found uniform. There are some banks, mainly foreign banks and new private sector banks, which are active borrowers and some public sector banks that are major lenders. Earlier, foreign banks operated in the call money market primarily as lenders. But subsequently, they extended their participation as borrowers for meeting CRR requirements. The problems faced by these banks in garnering deposits through branch expansion and increase in the cost of servicing deposits have also kept depositors away from call market till 1970 whereafter they have been participating in the market on a regular basis.

In order to widen the participation of call money market and increase its depth, the RBI permitted special institutions such as GIC, IDBI and NABARD to operate in the market as lenders with effect from May 2, 1989, and 13 more institutions already operating in the bills rediscounting market, were allowed in call money market as lenders from October 1990. The RBI also set up new institutions, viz., DFHI, STC and money market mutual funds (MMMFs). DFHI was set up in 1988 to take active part in the call money market operations by borrowing and lending call funds. Call money rates were partially freed up in October 1988, when DFHI was permitted to operate outside the purview of the ceiling rates fixed by the Indian Bankers Association (IBA). The rates were made totally free and became market determined with effect from May 1, 1989. So as to develop a secondary market in Government securities, DFHI started buying and selling securities to a limited extent. The RBI decided to provide rediscounting facility to DFHI for this purpose.

3.6.2 Participants in Treasury Bills Market in India

The participants in the Treasury bills market include the RBI, SBI, Commercial banks, State governments and other approved bodies, DFHI, STCI, other financial institutions such as LIC, UTI, GIC, NABARD, IDBI, IFCI, ICICI, etc., corporate entities and general public and foreign institutional investors.

Among the above, the RBI plays predominant role in Treasury bill market buying/holding over three-fourths of the total outstanding bills. Commercial banks are the next important player as subscribers to such treasury bills followed by State governments and others. Treasury bills are least popular among the corporate entities and the general public.

3.6.3 Participants in Commercial Bill Market in India

The following are the players of Indian bill market:

1. All Scheduled Commercial Banks
2. LIC and its subsidiaries
3. GIC and its subsidiaries
4. ICICI bank
5. UTI
6. IRCI
7. ECGC

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8. IDBI bank
9. SBI Mutual Fund
10. Select UCBs
11. Can bank Mutual Fund
12. IFCI
13. DFHI
14. NABARD
15. NHB
16. SCICI
17. TFCI
18. Exim Bank
19. LIC Mutual Fund
20. SIDBI, etc.

Among these, DFHI is a major player in providing rediscounting facility to the institutions discounting trade bills. DFHI obtains refinance from the RBI. The DFHI offers two-way quotes for buying and selling rediscounted bills.

3.7 Financial Instruments of Indian Money Market

Indian money market at present has wide variety of instruments with varying maturity denominations, claims to income and assets and controlling power traded in the market so as to satisfy the diverse needs of both supplier of fund and those who need them. These instruments are:

- ***Commercial Bills:*** Commercial bill is an instrument used in the Indian money market to finance the movement and storage of agricultural and industrial goods in domestic and foreign trade. Bill finance has not been popular in India mainly because of the absence of adequate number of genuine bills and lack of discounting facilities. Until 1981-82, the RBI provided rediscounting facility to the banks whereafter this task was assumed by DFHI.
- ***Treasury Bills:*** Treasury bills constitute an important instrument of short-term borrowing of the government. Treasury bill market, as noted earlier, has had chequered growth history. At present, the Treasury issues consist of weekly 14-day and 91-day bill auctions and 364-day bill auctions on a fortnightly basis combined with 14-day intermediate bills available for state governments and foreign central banks. With the introduction of the auction system interest rates on all types of Treasury bills are determined by the market forces.

  The 91-day Treasury bills are purchased by the RBI, commercial banks, state governments and other approved bodies and financial institutions like the LIC, UTI. The RBI and banks together account for about 90% of the sales of this bill every year. Other types of treasury bills are purchased by foreign banks, Indian scheduled banks, cooperative banks, financial institutions, companies, DFHI and others.
- ***Certificate of Deposits:*** Certificates of Deposits (CDs), representing essentially securitised and tradable term deposits, were introduced by the RBI in June 1989 permitting banks to issue CDs. This scheme was modified from time to time to soften the terms and conditions

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of the issue of CDs. Thus, the minimum denomination of CDs was reduced from ₹ 25 lakh to ₹ 5 lakh, minimum size of a single issue reduced from ₹ 1 crore to ₹ 10 lakh further to ₹ 1 lakh in June 2002, having maturity period of 91 days to 1 year (earlier maturity period was 3 months to 1 year). CDs can be issued at a discount and rate of discount is determined by market forces. These CDs are freely transferable after a lock-in-period of 30 days (earlier 45 days) after the issue. All scheduled banks other than RRBs and term-lending institutions can issue them. CDs are subject to CRR and SLR requirements. CDs cannot be bought back by issuing institutions, nor can they lend against CDs. CDs can be purchased by anyone.

Despite tremendous potentiality, CDs as instrument of money market could not gain an importance primarily because of absence of an active secondary market, high price of CDs, preference of the holders in primary market to hold them to maturity and lack of information to the investors.

- ***Commercial Paper:*** Commercial Paper (CP) was introduced by the RBI in India in 1989 to enable highly rated corporate borrowers to diversify their sources of short-term borrowing and also to provide an additional instrument to investors. The RBI stipulated terms and conditions for issuing CP like, eligibility, modes of issue, maturity periods, denominations and issuance procedure. The guidelines in respect of the above were revised time and again keeping in view the experience of the working of the CP.

  Thus, corporates, PDs and SDs are eligible for issuing CP for a minimum period of maturity of 7 days and maximum period of 1 year. It is significant to note that there is no lock-in period for CP. The issuing company must have tangible net worth of ₹ 4 crore. The fund-based working capital limit of the company should not be less than ₹ 4 crore. A company can issue CPs to the extent of 75% of working capital limit. The minimum size of an issue to a single investor is to be ₹ 25 lakh and in denomination of ₹ 5 lakh each. The company should have a minimum credit rating of P2 from CRISIL and A2 from ICRA.

  CP can be issued as a promissory note or in a dematerialized form. Underwriting is not permitted. The maximum amount that can be issued by issue of CP will be 30% of fund-based working capital. The RBI permission is required for issue of CP.

- ***Derivative Promissory Notes:*** The RBI introduced an innovative instrument termed as 'derivative usance promissory note', in September 1988. Under this instrument, banks were permitted to issue derivative usance promissory note for a period not exceeding 90 days under the strength of underlying bills. This instrument was introduced with a view to developing the secondary market in bills by simplifying the procedures and documentation involved in rediscounting the bill. This instrument was exempt from stamp duty.

- ***Repurchase Options:*** REPO has, of late, emerged as an important innovative instrument in the developed money markets of the world. Repo is a versatile and perhaps the most popular among market instruments. Repo refers to a transaction in which a participant acquires fund immediately by selling securities and simultaneously agreeing for repurchase of the same or similar securities after specified period of time at a given price. The transaction combines elements of both a securities purchase/sale operation and also a money market borrowing/lending operation. Typically, it signifies lending on a collateralised basis. The term of contract is in terms of a 'repo rate' representing the money market borrowing/lending rate. The transaction is called a repo when viewed from the perspective of the buyer of the securities. Thus, a given agreement, called as a repo or reverse repo, would depend on which party initiates the transaction. Like other money market instruments, repos also help equilibrating between demand and supply of short-term funds.

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Notes In India, two types of repos are in vogue, viz., interbank repos and the RBI repos. Interbank repos are permitted under regulated conditions. After the detection of the irregularities in securities transactions in 1992, eligible participants and instruments were restricted but subsequently liberalised in a gradual manner. The Reserve Bank repos are used for absorption/injection of liquidity.

Banks and primary dealers are allowed to undertake both repo/reverse repo transactions. Non-bank participants have also been allowed recently to lend money through reverse repos to other eligible participants. The RBI has lately removed the restriction of a minimum period of 3 days for interbank repo transactions. This will help the banks and other participants in the repo market to adjust their liquidity in a more flexible manner.

Money Market Instruments & Denominators

Money Market Instruments	Principal Borrowers	Principal Investors	Common Denominations
Treasury bills	Federal government	Individuals, non-financial and financial corporations, money market funds, foreign and domestic governments	$10,000 an d higher
Federal agency discount notes	Federally sponsored agencies	Individuals, money market funds, governments	$10,000, $25,000, and higher, depending on the issuing agency
Municipal notes	State and local governments	Insurance companies, individuals	$5,000 for interes t-bearing notes; $50,000 - $100,000 for discount notes
Fed funds	Banks	Depository institutions	Flexible
Negotiable certificates of deposit	Large banks and thrifts	Non-financial corporations, money market funds, individuals	$100,000 and higher
Commercial paper	Financial and non-financial corporations	Non-financial corporations, money market funds	$25,000 minimum
Repurchase agreements	Banks, securities dealers, other owners of government securities	Non-financial financial institutions	$10 million and higher
Bankers' acceptances	Financial and non-financial corporations	Non-financial and financial corporations, money market funds, governments	$100,000 minimum
Money market funds	Financial and non-financial corporations	Corporations and individuals	$1,000 retail, $100,000 wholesale

- ***Refinance from the Reserve Bank of India:*** The system of refinance provided by the RBI to scheduled commercial banks has generally been functioning as an active instrument of monetary and credit regulation in India. This monetary policy instrument is used by central banks to relieve liquidity shortages in the system, control monetary and credit conditions and direct credit to selective sectors. The relative significance of this policy instrument in different periods depends upon the degree of liquidity in the banking system and the need for ensuring credit flow to select sectors. The quantum and cost of refinance play significant role in the liquidity management.

  Over the years, the RBI has sought to regulate and gradually reduce the access to refinance facilities through a combination of lowering/raising the cost of such accommodation

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and/or regulating the availability in terms of quantum by adjusting the formula for fixation of eligible limits. With the emergence of the Bank Rate as the signaling rate of monetary policy stance, the present policy has been to keep the refinance rate linked to the Bank Rate.

3.8 Risk Exposure in Money Market Instruments

Apart from ensuring appropriate liquidity, investors should also consider the risks present in the money market investments. Investments in the money market are basically unsecure in nature. While the unsecured nature does indicate a higher risk, the risks associated with money market, however, are not necessarily due to the unsecured nature but more due to the fluctuation in the rates. The level and the type of risk exposures that can be associated with money market instruments/investments are discussed below.

- ***Market Risk/Interest Rate Risk:*** These risks arise due to the fluctuations in rates of the instruments and are of prime concern in money market investments. Due to the large quantum of funds involved in the money market deals, and the speed with which these transactions are executed, the value of the assets are exposed to fluctuations. Further, if these fluctuations are wide, it may lead to a capital loss/gain since the price of the instruments, including the government securities, declines. This risk can be minimized by enhancing liquidity since easy exit can help curb the capital loss.
- ***Reinvestment Risk:*** Reinvestment risk arises in a declining interest rate scenario. Investors who park their funds in short-term instruments will, at the time of redemption, have to reinvest these funds at a lower rate of interest. And since the existing securities will be having higher coupons/YTMs, their value generally rise in such situations to bring down the yields. All money market instruments are exposed to this risk.
- ***Default Risk:*** Lending decisions primarily focus on assessing the possibility of repayment since the first risk that the lender will be exposed to is the default risk. Except for the sovereign securities, all other investment/lending activities have the probability of default by the borrower in the repayment of the principal and/or interest. It is due to the absence of the default risk, that the government securities are considered as risk-free securities.
- ***Inflation Risk:*** Due to inflation, the average prices for all goods and services will rise, thereby reducing the purchasing power of the lender. The risk that arises due to the inflationary effect is known as inflation risk/purchasing power risk. All money market instruments are exposed to this risk. Lenders will generally ensure that their contractual rate of interest offsets this risk exposure. Though the capital market has designed instruments to hedge against this risk, they are yet to be introduced into the money market. However, considering the short-term nature of the money market instruments, their level of exposure to this inflation risk can be minimal when compared with other long-term instruments. The Capital Indexed Bond (CIB) issued by the RBI is an instrument designed to minimize/eliminate the inflation risk. With a maturity of 5 years, these CIBs earn a 6 per cent return on the investments. The principal amount is adjusted against inflation for each of the years and the interest is then calculated on this adjusted principal. Further, upon repayment, the principal amount is adjusted by the Index Ratio (IR) as announced by the RBI.
- ***Currency Risk:*** A risk of loss is inherent in the multi-currency dealings due to the exchange rate fluctuations. Currency risk refers to this type of risk exposure. The money market players operating in overseas money market instruments will be exposed to this risk. Also, when the institutional investors, like banks sell foreign currencies to play in the money market, they may be exposed to currency risk.

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- ***Political Risk:*** Most of the measures adopted to bring economic stability will have a direct/indirect implication on the money market instruments and operations. This is due to the fact that the money market activity reflects the money supply position in the economy, the interest rate and the exchange rate structures, etc. Thus, any policy decisions adopted by the Central Government will have an impact on the money market. In the Indian context, it is the policy measure taken by the RBI, and sometimes the Ministry of Finance (MoF) that have an impact on the money market. For instance, in order to build up forex reserves, the government may prevent repatriation of investments made by FIIs/ NRIs in the money market. This measure will have a definite impact on the operations of these players in the money market. Depending on the guidelines issued by the government, all or few of the instruments will be affected. Though the above mentioned risks that the money market instruments are exposed to, seem to be similar to the risk profile of other financial markets, their level of exposure varies. For instance, due to the short-term nature of the market, reinvestment risk and default risk will be minimal.

Money Market

The money markets provide the funds for market participants with maturity starting from one day to one year. The RBI, commercial banks, financial institutions and the primary dealers are prominent players in this market, each operating for a specific purpose. The Call/notice money market makes available funds for banks with a maturity range of 1 to 14 days. The market with a maturity of 15 days to one-year is the term money market. Following are some features of the money market:

1. The working of the money market offsets the demand supply imbalance of short-term funds.
2. The money market is a hub of activities, which influences the liquidity and general level of interest rates in the economy.
3. The money markets enable the lending/borrowing activities at fair and competitive rates.

Evolution of Money Markets in India

The Vaghul Committee, a working group on money market, appointed by the RBI under the Chairmanship of N Vaghul, had suggested measures to develop the money market in India. The following are some initiatives taken up by the RBI as a follow up of those recommendations:

1. DFHI (Discount and Finance House of India) was formed in March 1988, to enable liquidity of the money market instruments.
2. Widening the range of money market instruments; introduction of the new instruments like CP, CD and interbank participation certificates during 1988-89.
3. Interest rate regulations in call money markets were gradually removed to make it a market determined one.

The bank rate has become the reference rate in the money market and the minimum limit is set usually by the call rates and the repo rates and the bank rate act as a ceiling. The other benchmark instruments are government securities and the Treasury bills.

There is yet another important and rather interesting feature of the money market that explains the lower level of the default risk. Money market players have to honour obligations as a universally accepted code of conduct. Irrespective of the volume of transactions in the market, the quantum involved in such transactions, and the mode in which these transactions take place, this code of conduct will be strictly adhered to by the participants in the money market. Since defaulting in the money market virtually expels the player from the market, in spite of being unsecured transactions, the obligations are definitely met. However, as observed earlier, the money market players are mostly large institutional players, having a good standing in the market with a good rating. Of the risks that the money market instruments are exposed to, the volume and the quantum of transactions generally put the market/interest rate at a higher level.

Notes

Task Do a research and list all the instruments of money market in India.

Self Assessment

Fill in the blanks:

1. ……..refers to a transaction in which a participant acquires fund immediately by selling securities and simultaneously agreeing for repurchase of the same or similar securities after specified period of time at a given price.
2. Banks and ……are allowed to undertake both repo/reverse repo transactions.
3. The maximum amount that can be issued by issue of CP will be …… of fund-based working capital.
4. ……is an instrument used in the Indian money market to finance the movement and storage of agricultural and industrial goods in domestic and foreign trade.
5. …….plays a vital role in cash management of the government.
6. Maturity period of call loans varies between one day to a …….while notice money deals in funds for……...
7. Money market provides an effective low cost source of ……funds.
8. ……and flexibility are the hallmark of the money market.
9. …….assets are characterised by their liquidity, high marketability and low risk.
10. Under ……..banks were permitted to issue derivative usance promissory note for a period not exceeding 90 days under the strength of underlying bills.

True or False:

11. Money market, as noted earlier, is a market for short-term funds and covers money and financial assets that are close substitutes for money.
12. Money market typically trades in short-term securities having an original maturity of one year or less.
13. Money market securities are used to 'warehouse' funds until needed. The returns earned in these investments are low due to their low risk and high liquidity.
14. Acceptance houses perform the function of discounting/rediscounting the commercial bills and T-Bills.
15. Discount houses are specialized agencies which accept the bills of exchange on behalf of their clients for a commission.

3.9 Summary

- A financial market is a market where variety of financial assets are traded directly or indirectly to cater to the diverse saving notions of the savers and numerous investment preferences of the investors, and where financial institutions buy the financial claims of those who have surplus funds and sell their own claims.

Notes

- The money market is concerned with intermediation of short-term funds from savers to those who need them for meeting their working capital requirements and allocation of the funds in an efficient manner among competing uses in the economy, thereby contributing to growth through increased investment and through enhanced efficiency in resource utilisation.
- By nature, the transactions that take place in the money market are of high volumes, involving large amounts. Hence, the market is dominated by a relatively small number of large players. Market Makers (Primary Dealers, etc.)
- Discount houses perform the function of discounting/rediscounting the commercial bills and T-Bills.
- On the other hand, acceptance houses are specialized agencies which accept the bills of exchange on behalf of their clients for a commission.
- An active bill market becomes a prerequisite for the services of the discount and acceptance houses. In addition, some of these intermediaries act as underwriters to the government securities and also have the option to be their market makers. The various money market players, can be segregated into different categories based on their activity in the market, i.e., they can be only lenders, lenders and borrowers/issuers, investors or intermediaries. Certain players may have more than one role to play.

3.10 Keywords

Acceptance Houses: Are specialized agencies which accept the bills of exchange on behalf of their clients for a commission.

Bill Market: Is a market where short-term papers or bills are traded. These bills include bills of exchange and treasury bills.

Call/Notice money market: Is a market where the day-to-day surplus funds, mostly of banks are traded.

Commercial Bill: It is an instrument used in the Indian money market to finance the movement and storage of agricultural and industrial goods in domestic and foreign trade.

Commercial Paper: It enable highly rated corporate borrowers to diversify their sources of short-term borrowing and also to provide an additional instrument to investors.

Derivative Promissory Notes: Under this instrument, banks were permitted to issue derivative usance promissory note for a period not exceeding 90 days under the strength of underlying bills.

Discount Houses: It performs the function of discounting/rediscounting the commercial bills and T-Bills.

Money Market: Is a market for short-term funds and covers money and financial assets that are close substitutes for money.

Repo: It refers to a transaction in which a participant acquires fund immediately by selling securities and simultaneously agreeing for repurchase of the same or similar securities after specified period of time at a given price.

3.11 Review Questions

1. What are the various money market instruments available in India?
2. What is the role of the money market in a financial system?

Notes

3. What is repo and reverse repo? Explain with an example.
4. Discuss the composition of Indian Money Market in Detail with the help of suitable examples.
5. What are the various kinds of risk that are involved in money market instruments?
6. Write short notes on:
   (a) Bill Market
   (b) Acceptance House
   (c) Discount house.

Answers to Self Assessment

1. Repo
2. Primary dealers
3. 30%
4. Commercial bill
5. Treasury Bills
6. Fortnight, 2-14 days
7. Temporary
8. Innovation
9. Near money
10. Derivative Promissory Notes
11. True
12. True
13. True
14. False
15. False

3.12 Further Readings

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Unit 4: Indian Capital Market

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Objectives

After studying this unit, you should be able to:

- Learn the concept of Indian capital market;
- Explain the role of Indian capital market;
- Discuss the structure and functions of Indian capital market;
- Discuss various participants in the securities market;
- Explain Exchange platforms.

Introduction

Capital market – an important segment of financial market of a country - is the market for long-term finance, concerned with funneling long-term funds from Surplus Spending Units (SSUs) to Deficit Spending Units (DSUs) through long-term financial instruments like stocks and bonds. In it, investors hand over funds today in exchange for promises of money far in the future. The long delay in repayment involves two basic problems of lending, viz., increase in risk and decrease in liquidity. The entire discussion on today's capital market centers around these two problems.

There has been a tectonic change in recent years in strategies, structures and role of institutions and instruments associated with capital market across the globe. While financial market boomed dramatically in the 1990s, those in South East Asia, South America and Russia plummeted. More recently, in the early 2000s, Argentina's economic and financial system collapsed and its currency nosedived to more than 30 per cent in value relative to the US dollar.

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Meanwhile, spectacular developments occurred all over the world in financial markets during the last decade in terms of increased integration of financial markets of different countries, rapid pace of financial innovation, emergence of completely new type of instruments through the process of financial engineering, growing importance of institutional investors in financial markets, wondrous expansion of the role of financial institutions and emergence of a wide array of specialized institutions both in developed and developing countries. Financial services industries continue to undergo dramatic changes. Not only have the boundaries between traditional industry sectors, such as commercial banking and investment banking broken down but competition is becoming increasingly global in nature.

Taking cognizance of the above developments and burgeoning opportunities in emerging markets coupled with high risk exposure due to volatile environment, different countries undertook several policy measures in recent years to shore their capital markets, rendering the institutions and instruments associated with the capital market more resilient and vibrant so as to cope with future competitive challenges.

Governments - central, state and local - in their effort to bridge the fiscal deficit (gap between budgetary receipts and payments) frequently resort to public borrowings. There are three sources of public borrowings-internal borrowings, external borrowings and others. Internal borrowings of governments are managed by the central bank of a country. Internal borrowings are made through wide variety of instruments, collectively designated as 'Government Securities' and the market where these securities are traded are termed as 'Government securities market'. Thus, government securities serve as the financial vehicles of central government, state governments, semi-government bodies and PSUs to raise funds from the market.

4.1 Evolution

Indian Stock Markets are one of the oldest in Asia. Its history dates back to nearly 200 years ago. The earliest records of security dealings in India are meager and obscure. The East India Company was the dominant institution in those days and business in its loan securities used to be transacted towards the close of the eighteenth century.

By 1830s business on corporate stocks and shares in Bank and Cotton presses took place in Bombay. Though the trading list was broader in 1839, there were only half a dozen brokers recognized by banks and merchants during 1840 and 1850.

The 1850s witnessed a rapid development of commercial enterprise and brokerage business attracted many men into the field and by 1860 the number of brokers increased into 60.

In 1860-61 the American Civil War broke out and cotton supply from United States of Europe was stopped; thus, the 'Share Mania' in India begun. The number of brokers increased to about 200 to 250. However, at the end of the American Civil War, in 1865, a disastrous slump began (for example, Bank of Bombay Share which had touched ₹ 2850 could only be sold at ₹ 87).

At the end of the American Civil War, the brokers who thrived out of Civil War in 1874, found a place in a street (now appropriately called as Dalal Street) where they would conveniently assemble and transact business. In 1887, they formally established in Bombay, the "Native Share and Stock Brokers' Association" (which is alternatively known as "The Stock Exchange "). In 1895, the Stock Exchange acquired a premise in the same street and it was inaugurated in 1899. Thus, the Stock Exchange at Bombay was consolidated.

Indian Stock Exchanges – An Umbrella Growth

The Second World War broke out in 1939. It gave a sharp boom which was followed by a slump. But, in 1943, the situation changed radically, when India was fully mobilized as a supply base.

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On account of the restrictive controls on cotton, bullion, seeds and other commodities, those dealing in them found in the stock market as the only outlet for their activities. They were anxious to join the trade and their number was swelled by numerous others. Many new associations were constituted for the purpose and Stock Exchanges in all parts of the country were floated.

The Uttar Pradesh Stock Exchange Limited (1940), Nagpur Stock Exchange Limited (1940) and Hyderabad Stock Exchange Limited (1944) were incorporated.

In Delhi two stock exchanges – Delhi Stock and Share Brokers' Association Limited and the Delhi Stocks and Shares Exchange Limited – were floated and later in June 1947, amalgamated into the Delhi Stock Exchange Association Limited.

4.2 Broad Structure in the Indian Capital Markets

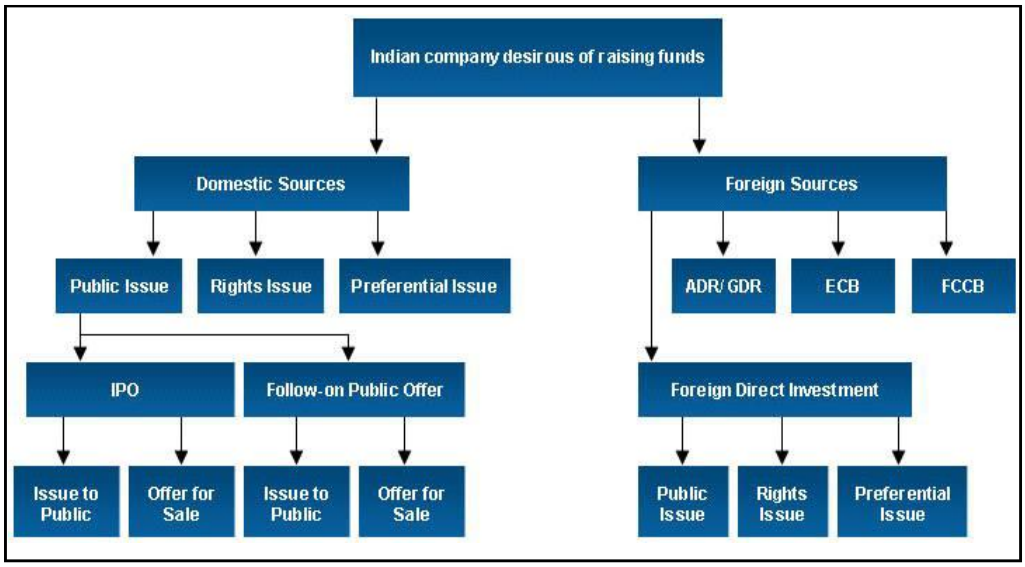
Fund Raisers are companies that raise funds from domestic and foreign sources, both public and private. The following sources help companies raise funds:

Fund Providers are the entities that invest in the capital markets. These can be categorized as domestic and foreign investors, institutional and retail investors. The list includes subscribers to primary market issues, investors who buy in the secondary market, traders, speculators, FIIs/ sub accounts, mutual funds, venture capital funds, NRIs, ADR/GDR investors, etc.

Intermediaries are service providers in the market, including stock brokers, sub-brokers, financiers, merchant bankers, underwriters, depository participants, registrar and transfer agents, FIIs/sub accounts, mutual Funds, venture capital funds, portfolio managers, custodians, etc.

Organizations include various entities such as BSE, NSE, other regional stock exchanges, and the two depositories National Securities Depository Limited (NSDL) and Central Securities Depository Limited (CSDL).

Market Regulators include the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), and the Department of Company Affairs (DCA).



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4.3 Functions and Role of Indian Capital Market

Like the money market capital market is also very important. It plays a significant role in the national economy. A developed, dynamic and vibrant capital market can immensely contribute for speedy economic growth and development.

Let us get acquainted with the important functions and role of the capital market.

1. ***Mobilization of Savings:*** Capital market is an important source for mobilizing idle savings from the economy. It mobilizes funds from people for further investments in the productive channels of an economy. In that sense it activates the ideal monetary resources and puts them in proper investments.
2. ***Capital Formation:*** Capital market helps in capital formation. Capital formation is net addition to the existing stock of capital in the economy. Through mobilization of ideal resources it generates savings; the mobilized savings are made available to various segments such as agriculture, industry, etc. This helps in increasing capital formation.
3. ***Provision of Investment Avenue:*** Capital market raises resources for longer periods of time. Thus it provides an investment avenue for people who wish to invest resources for a long period of time. It provides suitable interest rate returns also to investors. Instruments such as bonds, equities, units of mutual funds, insurance policies, etc. definitely provides diverse investment avenue for the public.
4. ***Speed up Economic Growth and Development:*** Capital market enhances production and productivity in the national economy. As it makes funds available for long period of time, the financial requirements of business houses are met by the capital market. It helps in research and development. This helps in, increasing production and productivity in economy by generation of employment and development of infrastructure.
5. ***Proper Regulation of Funds:*** Capital markets not only helps in fund mobilization, but it also helps in proper allocation of these resources. It can have regulation over the resources so that it can direct funds in a qualitative manner.
6. ***Service Provision:*** As an important financial set up capital market provides various types of services. It includes long term and medium term loans to industry, underwriting services, consultancy services, export finance, etc. These services help the manufacturing sector in a large spectrum.
7. ***Continuous Availability of Funds:*** Capital market is place where the investment avenue is continuously available for long term investment. This is a liquid market as it makes fund available on continues basis. Both buyers and seller can easily buy and sell securities as they are continuously available. Basically capital market transactions are related to the stock exchanges. Thus marketability in the capital market becomes easy.

Self Assessment

Fill in the blanks:

1. Capital market is the market for …….. finance, concerned with funneling long-term funds from Surplus Spending Units (SSUs) to Deficit Spending Units (DSUs).
2. …….are companies that raise funds from domestic and foreign sources, both public and private. The following sources help companies raise funds.
3. Fund Providers can be categorized as domestic and ……. investors, institutional and retail investors.

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4. …….are service providers in the market, including stock brokers, sub-brokers, financiers, merchant bankers, underwriters etc.

5. A developed, dynamic and vibrant capital market can immensely contribute for speedy economic ……..and…….

4.4 Participants in the Securities Market

SAT, regulators (SEBI, RBI, DCA, DEA), depositories, stock exchanges (with equity trading, debt market segment, derivative trading), brokers, corporate brokers, sub-brokers, FIIs, portfolio managers, custodians, share transfer agents, primary dealers, merchant bankers, bankers to an issue, debenture trustees, underwriters, venture capital funds, foreign venture capital investors, mutual funds, collective investment schemes.

Government Securities Market

The government securities market is at the core of financial market in most countries. It deals with tradable debt instruments issued by the government for meeting its financing requirements. The development of the primary segment of this market enables the managers of public debt to garner funds from the market in a cost effective manner with due recognition to associated risks. A vibrant secondary segment of the government securities market helps in the effective operation of monetary policy through application of indirect instruments such as open market operations, for which government securities act as collateral.

Immanent Features of Government Securities Market

The government securities (g-securities) market is distinct from other constituents of financial market because of the following characteristics:

1. The g-securities market represents the most significant segment of financial market all over the world in as much as funds garnered through the issue of these securities account for major portion of the total funds mobilized on the stock exchanges. Since the 1970s, the g-securities market witnessed phenomenal growth. However, fiscal consolidation exercised by many countries in the 1990s led to sharp shrinking of the bond markets, especially the US. In contrast, the bond market in Japan soared by 150 percent of GDP by 2005. During the period 2000-2005, the size of the g-securities market in different countries including India surged.

2. The g-securities market deals in securities that are highly liquid and risk free. The g-securities are liquid because they are marketable debt instruments. These securities (especially central government bonds) are absolutely secured financial instruments, guaranteeing certainty of income and capital. This is why such securities are also called 'gilt-edged' securities. The interest rate on government securities is the risk-free rate against which all other interest rates are measured.

   It is interesting to note that the g-securities markets in different countries have, except the US, been least liquid. That is why; these countries have focused on improving trading liquidity of the market through various measures.

3. The primary objective of the government securities market in various countries has been to reduce the cost of government borrowings. However, in recent years, the focus is on managing risks inherent in the debt portfolio. Many countries have, of late, pursued a strategy of managing the cost of government borrowing in the medium to long-term with

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a view to reducing the roll over risk and other market risks in the debt stock, although this may entail higher debt service costs in the short run.

4. The supply of government securities in the government securities market is generally exogenous to the market, determined essentially by the fiscal policy of the government. The demand for government securities from banks, insurance companies, pension funds and other is fragmented into several components implying that the demand curve is not uniformly downward slopping but is rather kinked. For instance, the demand by investors such as insurance companies and superannuation funds is in the nature of "buy and hold" as the revenue streams from government securities generally match with their liability payment stream. These investors may have very few substitutes and hence, their demand is less price-sensitive. Mandated investments in government securities by banks and other institutions would also fall into the category of "buy and hold". The demand from other investors in government securities is more for active trading and portfolio management. These investors may have many substitutes for government securities and hence, their demand is generally more price elastic. The overall demand elasticity is, therefore, determined by the balance between these groups of investors. Increased volume of government securities may increase concerns of a default by the government which may affect the risk characteristics of the instrument. This may result in a fall in prices as yields steepen. At the other end of the spectrum, very limited supply of government securities may generate concerns over liquidity. Illiquidity premium can then drive down the prices, although there could be some resistance to the downward bias, if "buy and hold" investors dominate the market.

5. The government securities market in India deals in government securities of three kinds, viz., inscribed stock, or stock certificate, promissory note and bearer bond. In inscribed stock, the holder of stock is issued a certificate to the effect that he/she is registered in the books of Public Deposit Office of the RBI. This certificate is sent to the applicant directly by registered post by the PDO. The inscribed stock is not transferable by mere endorsement as the execution of a transfer deed is necessary for its transfer. Stock can be held jointly by more than one person but these will have to be transferred by all the surviving joint holders. These certificates are the only form of government security which can be held by trustees of specified trusts or holders of offices other than public offices.

   Through Promissory Note Form (PN) of government securities, the government-central/ state-promises to a person named therein to pay a specified amount at a specified date and to pay interest at a fixed rate at periodical intervals at a particular office of the RBI. The PN is a negotiable instrument payable to the order of a specified person. The title of the PN is transferable by endorsement and delivery.

   A bearer bond is that kind of government bond that certifies that the bearer is entitled to specified sum stipulated in rupees on the date indicated in accordance with the terms of a particular loan to which the bond relates. Printed coupons for interest payable to the bearer are attached to the bond. The interest is paid to the holder of the coupon and the bond is discharged on the due date of the debt to which it relates by physical presentation of the bearer. A change of ownership is effected by simple delivery of bonds by the transferor to the transferee.

   Among the three forms of government securities, the stock certificates are most advantageous from the point of view of security and convenience of bid holders of government debt. As between PN and bearer bonds, the former is more secure while the latter is more convenient to transfer and getting interest and repayment with the least difficulty. Despite all the advantages, stock certificate has not been popular because of the problems involved in respect of transferability and negotiability. Stock certificates are generally bought by investors like LIC, PF, etc., while banks prefer PNs.

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6. As regards mode of distribution of g-securities, these securities are distributed through competitive public auctions. The conventional auctions of g-securities follow multiple price auction system for issuance of conventional securities and uniform price auction system for securities with special features such as inflation-indexed bonds where there is market uncertainty.

   Most countries adopt a system of Primary Dealers (PDs) to ensure that auctions are well-bid. PDs also act as a regular source of liquidity in the secondary market and provide useful information to public debt managers on market developments and debt management issues. Further, competition among PDs facilitates efficient price discovery in the g-securities market.

7. Regarding the maturity structure of g-securities traded in the market, it has been observed that depending on the funds requirements of the government, securities of different maturities ranging from short-term to long-term are issued. Governments issue securities with maturities spanning from less than a year to a very long-term stretching up to 50 years. Typically, securities of short-term maturities up to one year, viz., Treasury Bills, form a part of the money market and facilitate the government's cash management operations. Bonds having maturities of more than one year facilitate the government's medium to long-term financial requirements.

8. The government securities in India are ordinarily issued in the denominations of ₹ 100 and ₹ 1000. Earlier, the face value of the security was ₹ 100. But after 1985, the denomination was raised to ₹ 1, 000.

9. As for interest on government securities, it is payable half-yearly and is exempt from income tax subject to a limit. The value of investments in these securities and other investment specified in the Wealth Tax Act is exempt from wealth tax up to a limit.

10. As regards participants in the government securities market, central government, state governments, semi-government authorities, e.g., city governments and municipalities, autonomous institutions such as metropolitan authorities, port trusts, improvement of developments trusts, state electricity boards, PSUs and other government agencies like IFCI, NABARD, SIDCs, housing boards, etc., represent suppliers of the market while the demand essentially comes from banks, financial institutions and other investors, joint stock companies, individuals and non-residents.

Notes Banks are required by law to invest a proportion of their deposits as determined by statutory liquidity ratio.

11. Like other countries where central banks as managers of public debt play crucial role in developing the government securities market, the RBI plays an important role in management of the government securities market for the purpose of keeping the cost of financing to the minimum consistent with the offer of market-related interest rates on government securities, maintaining the market stable and smooth for meeting the portfolio requirements of all investors to the extent possible and for maintaining a minimum level of activity in the market with a view to providing liquidity to the securities in the market so as to develop the market. For this purpose, the RBI acts as consultant to the government, manager, underwriter, and custodian.

    As a banker to the government, the RBI tenders advise on the matters relating to the amount of issues to be floated, timing and terms of new issues and facilitates such issuances through its various market infrastructure.

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As a manager of the public debt, the RBI manages the issue including notification of the issues, opening and closing of the issues, appointment of participants to the issue, determination of the maximum rate of yield or the minimum offer price, as the case may be.

The RBI acts as an underwriter for central government securities and manages the government debt by holding a large chunk of central government debt. It conducts open market operations to stabilize the market and help the institutions, banks, etc., operating in the market.

It also acts as custodian of the government securities. The matter of servicing of loans registered in its office is the responsibility of the PDO of the RBI.

As a manager of public debt, the RBI is always keen to have a well-developed government securities market as it provides flexibility to exercise various options for optimizing maturity as well as interest cost to the government. It also helps in minimizing the market impact of large or lumpy government debt operations and ensuring better coordination between monetary policy and debt management policy.

In the management of the market, the RBI besides traditional tools adopts a blend of non-traditional tools, like auctions of securities of various maturities, funding of Treasury bills and Zero Coupon bonds, to reduce the cost and improve the operational efficiency. The Repo technique as an instrument of operations is employed to regulate liquidity and facilitate trade in government securities with least fluctuations in yield. The system of fixed coupon rates is still in vogue for state government securities.

Role of Government Securities Market

The g-securities market plays crucial role in overall economic development of a country. A country's g-securities market enables the managers of public debt to raise resources from the market in a cost effective manner with due recognition to associated risks. It also helps in effective operation of monetary policy through application of indirect instruments such as open market operations, for which government securities act as collateral. The g securities market is also regarded as the backbone of fixed income securities markets as it provides the benchmark yield and imparts liquidity to other financial markets. The existence of an efficient g-securities market is seen as an essential precursor, in particular, for development of the corporate debt market. Furthermore, the g-securities market acts as a channel for integration of various segments of the domestic financial markets and helps in establishing inter-linkages between the domestic and external financial markets.

The g-securities market constitutes a key segment of the financial market, offering virtually credit risk-free highly liquid financial instruments which market players are more willing to transact and take positions. The willingness of market participants to transact in government securities, in turn, imparts liquidity to these instruments, which benefit all segments of the financial market. Consequently, g-securities are employed by dealers on a major hedging tool for interest rate risk and as underlying assets and collateral for related markets, such as repo, futures and options.

Activity in the g-securities market can affect overall investments in the economy by enabling the development of private bond market in two ways: (i) by putting in place a basic financial infrastructure, including laws, institutions, products, services, repo and derivative markets, and (ii) by playing a role as an informational benchmark.

The development of the g-securities market is essential for establishing the risk-free benchmark in financial markets and ensuring their functioning in an efficient manner. This market, which is often the predominant segment of the overall debt market, plays a key role in the monetary

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policy transmission mechanism. Thus, regardless of whether the central bank acts as manager of public debt or not, there are three major channels through which government debt structure might influence monetary conditions, viz., and quantity of debt, composition of debt and ownership of debt.

Self Assessment

Fill in the blanks:

6. Government securities market deals with tradable ……..instruments issued by the government for meeting its financing requirements.
7. The primary objective of the ……..market in various countries has been to reduce the cost of government borrowings.
8. A ……..is that kind of government bond that certifies that the bearer is entitled to specified sum stipulated in rupees on the date indicated in accordance with the terms of a particular loan to which the bond relates.
9. As a banker to the government, the …….tenders advise on the matters relating to the amount of issues to be floated, timing and terms of new issues.
10. The development of the g-securities market is essential for establishing the ……benchmark in financial markets and ensuring their functioning in an efficient manner.

Primary Government Securities Market

The primary market is that part of the capital markets that deals with the issue of new securities. Companies, governments or public sector institutions can obtain funding through the sale of a new stock or bond issue. This is typically done through a syndicate of securities dealers. The process of selling new issues to investors is called underwriting. In the case of a new stock issue, this sale is an initial public offering (IPO). Dealers earn a commission that is built into the price of the security offering.

Measures relating to Primary Market

1. The Reserve Bank introduced in June 1992, the auction system for issuance of central government securities at market determined rates. Since the inception of the auction system, multiple price auction system was used for dated securities. The uniform price auction, followed for the issuance of 91-day Treasury Bills from November, 1998, was extended to auctions of central government dated securities on a selective basis from 2001.
2. Apart from allotment through auction, a system of non-competitive bidding was introduced in January 2002 to encourage retail investors who do not have sufficient expertise in such bidding. The scheme provides for allocation up to 5 percent of the notified amount in the specified auctions of dated securities.

   The investor is permitted to make only a single bid for auction and the size of the bid can vary from a minimum of ₹ 10,000 to ₹ 2 crores.
3. As the captive investor base was viewed as constraining the development of the market, the statutory prescription for banks' investments in government and other approved securities were scaled down from the peak level of 38.5 percent of NDTL in February, 1992 to the statutory minimum level of 25 percent by April, 1997. Apart from mandatory investments, banks and other financial institutions may also hold government securities as part of their trading portfolio.

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4. A system of market intermediaries in the form of PDs was made functional in 1996 with the objectives of supporting the market borrowing programme of the government, strengthening the securities market infrastructure and improving the secondary market liquidity in government securities. The PD system was revamped to ensure a more dynamic and active participation of PDs in view of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 whereby the Reserve Bank was prohibited from participating in the primary market effective from April, 2006. The Reserve Bank permitted banks to undertake PD business.

5. The system of automatic monetization through ad hoc Treasury Bills was abolished in March 1997 by a historical agreement between the RBI and the Government.

6. In order to promote retail holding in government securities and broaden the investor base, the Reserve Bank decided to provide since April 1996, liquidity facility to mutual funds which invest exclusively in government securities. Liquidity support to eligible gilt funds is provided by way of repo at the Bank Rate up to a limit of 20 percent of the outstanding value in government securities for a maximum period of 14 days.

7. In order to encourage foreign participation, FIIs were allowed in January 1997 to set up 100 percent debt funds to invest in Central and state government securities, both in the primary and secondary markets, within the overall debt ceilings announced from time to time. Equity funds set up by FIIs are permitted to invest in debt up to a maximum of 30 percent of their total investments.

8. In order to cater to parse market preferences, and hedging needs of investors, the Reserve Bank decided since 1994 to issue a range of new instruments with innovative features including Zero coupon bonds, capital indexed bonds, floating rate bonds and bonds with call and put options.

   Zero Coupon Bonds (ZCBs), introduced on January 17, 1994, do not have regular interest (coupon) payments like traditional bonds.

   A Capital Indexed Bond (CIB), issued on December 29, 1997 with a maturity of 5 years, provided for inflation hedging for the principal while the coupons of the bond were not protected against inflation.

   Floating Rate Bonds (FRBs), introduced initially in September, 1995 and discontinued after the first issuance and reintroduced in November, 2001, had to be discontinued due to lack of market response.

   Government securities with embedded call and put options were introduced in July, 2002 for a 10-year maturity using uniform price based auction method.

9. In its quest to facilitate efficient distribution of auctioned stock by stretching the actual distribution period for each issue and allowing the market more time to absorb large issues without disruption and also facilitate an efficient price discovery process both for the issuer and the investor, the RBI issued policy guidelines for trading in-When Issued (WI) market in May, 2006. A limit of 5 percent (only buy side) of notified amount was prescribed for banks and 10 percent (both buy and sell) for PDs.

10. In order to increase the transparency in the auction process, issuance procedures for government securities were detailed in general notification issued by the government from time to time. In addition, features of each issue are also notified to the public three to seven days prior to the auction of government securities. In order to provide clear and timely information about the borrowing programme, the RBI introduced an issuance calendar for auctions in Central Government Securities from the financial year beginning April, 2002.

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Secondary Government Securities Market

A secondary market facilitates the original investor in new government debt securities to sell his securities before maturity, and to do so with ease and without undue cost. In an active and efficient secondary market, it is possible for investors to buy and sell existing issues on demand, at mutually acceptable prices, and to upshot exchanges rapidly and with low transaction costs. Such a market requires a clear structure and clearly established rules so that the parties to each transaction know their responsibilities. The efficient operation of a secondary market also needs a system by which buyers and sellers can become conscious of each other, and through which the prices of securities can be advertised. Finally, a secondary market needs a way of ensuring that the transfer of securities against money takes place efficiently, at the correct time and between the correct participants, which is the function of a settlement organism.

Benefits of a Secondary Market

An active and efficient secondary market for government securities adds to a great extent to the attractiveness of government bonds to investors, at no cost to the government. Investors will be more ready to buy government securities if they know that they can reduce (or increase) their personal holdings quickly, inexpensively and at a time of their choosing by trading in the secondary market. Thus the liquidity and efficiency of the market contributes towards the successful trade of primary securities and hence towards achieving financing of government by ensuring the government's continued access to the financial market in the long run. Extensive and well-functioning secondary markets are particularly important where the government's borrowing needs are substantial.

Secondary markets in addition contribute towards achieving objectives other than funding the government's borrowing needs. These include obtaining the best possible issue terms in each operation, and therefore minimising the cost of the outstanding amount of government debt in absolute terms. Investors will be willing to pay a higher price for government debt where the secondary market is liquid than otherwise. Supplementary objectives, including minimising the market impact of government debt operations and coordination between the authorities' monetary policy and debt management, are also facilitated if the government debt supervisor is able to operate in an efficient secondary market in government securities. Lastly, a liquid government debt market contributes to financial market development in broad-spectrum, through familiarising the financial community, and ultimately the broader community, with the use of longer-term debt instruments as a means of financing and investment.

In short, the autonomous debt manager will not leave the development of the secondary market in government bonds to the private sector only since, fundamentally, such a loom would be likely to conflict with the normal goal of minimising above the long-term the cost of government funding.

Measures Relating to Secondary Market

1. The Reserve Bank has, since the late 1990s, pursued a strategy of passive consolidation of debt by raising progressively higher share of market borrowings through re-issuances. However, due to lack of liquidity, a large proportion of the banks' holding of Central Government domestic debt remained thinly traded. Accordingly, a debt buy back scheme was introduced on July 19, 2003 on a purely voluntary basis for banks in need of liquidity. In February, 2007, the RBI introduced a debt buy back scheme for Specified Development Loans (SDLs) of two state Governments, viz., Orissa and Rajasthan.
2. In order to keep the markets liquid and active and to provide the participants a tool to better manage their interest rate risk, the RBI permitted intra-day short selling in

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government securities among eligible participants, viz., Scheduled Commercial banks and PDs in February, 2006. The introduction of short selling paved their way for 'when issued' trading in August, 2006.

3. Recognizing that transparency and information dissemination with the minimum time lag are imperative for development of the secondary market, the RBI has been making efforts to disseminate trade information on a real time basis to a wider market. The price information on the trades is made accessible through the RBI's website.

Cardinal Principles for Efficient Government Securities Market

It has been strongly felt in the recent past across the globe that for the g-securities market to function efficiently, it is necessary to develop deep and liquid government securities market. The size is a key determinant of trading liquidity of the market. Amplitude of liquidity in a market can be judged in terms of width (width of the bid-ask spread), depth (the ability to carry and large trading promptly without significant changes in price levels), immediacy (the ability to carry out large trading promptly without significant changes in price levels) and resilience (the ability of prices to quickly return to normal).

While designing and developing efficient and liquid g-securities market, five fundamental principles, as identified by the Bank for International Settlements, should be factored in. These principles are: principle of competitiveness, principle of substitutability, principle of low transaction costs, principle of sound infrastructure and principle of heterogeneity.

Principle of Competitiveness

So as to facilitate efficient price discovery, it is ineluctable to develop and maintain competitive market structure in the g-securities market where the dominant market players can be challenged by new entrants. A government security, like any financial instrument, can be traded through a wide variety of mechanism like Over-the-Counter (OTC) markets, organized exchanges and other platforms. A fundamental strategy is to infuse competition among the dealers which would narrow bid-ask spreads and enhance liquidity of the market. In case of exchanges, dynamic competition between the leading exchange and other exchanges and between the OTC market and organized exchanges can contribute to market liquidity.

Principle of Substitutability

High degree of substitutability improves market liquidity of financial instruments including g-securities through enhancing trading supply of securities. This calls for the market to have a low level of fragmentation offering instruments which can be substituted for other instruments. However, there is also a need to have some degree of heterogeneity in instruments for catering to specific needs of investors. A tradeoff between homogeneous product of large volume and some heterogeneity has, therefore, to be struck by having a system of issuing government bonds at several 'key maturities' from the short end to the long end of the yield curve.

Principle of Low Transaction Costs

Adherence to the principle of low transaction costs including taxes cost of sustaining necessary infrastructure and compensation for liquidity provision services can improve liquidity of the g-securities market. Higher transaction cost leads to low market liquidity because it widens the gap between the effective price received by sellers of the instrument and that paid by the buyers, making it difficult to match sell and buy orders. It is, therefore, necessary to minimize transaction costs as long as this does not reduce the security of the market in question.

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Principle of Sound Infrastructure

A sound, robust and safe market infrastructure in terms of payment and settlement systems, regulatory and supervisory framework and market monitoring and surveillance is essential to enhance resilience of the government securities market against external shocks. It also contributes to continuous price discovery, thereby enhancing market liquidity.

Principle of Heterogeneity

For promoting liquidity in the g-securities market, the principle of heterogeneity of market should be followed so as to take care of varied transaction needs, risk assessments and investment horizons. This is also necessary to attract foreign investors and NRIs who have risk preferences different from those of domestic investors. However, liberalization to encourage foreign participation has to be calibrated suitably keeping in view sequential development of domestic markets.

4.5 Exchange Platform

Domestic Exchanges

Indian equities are traded on two major exchanges: Bombay Stock Exchange Limited (BSE) and National Stock Exchange of India Limited (NSE).

Bombay Stock Exchange (BSE)

BSE is the oldest stock exchange in 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 pivotal and pre-eminent role in the development 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.

T+2 settlement cycle (payments and settlements).

Depositories for share custody (dematerialization of shares).

Internet trading (e-broking).

Governance of the stock exchanges (demutualization and corporatisation of stock exchanges) and internet trading (e-broking).

BSE has a nation-wide reach with a presence in more than 450 cities and towns of India. BSE has always been at par with the international standards. It is the first exchange in India and the second in the world to obtain an ISO 9001:2000 certification. It is also the first exchange in the country and second in the world to receive Information Security Management System Standard BS 7799-2-2002 certification for its BSE Online Trading System (BOLT).

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Benchmark Indices futures: BSE 30 SENSEX, BSE 100, BSE TECK, BSE Oil and Gas, BSE Metal, BSE FMCG.

National Stock Exchange (NSE)

NSE was recognised as a stock exchange in April 1993 under the Securities Contracts (Regulation) Act. It commenced its operations in Wholesale Debt Market in June 1994. The capital market segment commenced its operations in November 1994, whereas the derivative segment started in 2000. NSE introduced a fully automated trading system called NEAT (National Exchange for Automated Trading) that operated on a strict price/time priority. This system enabled efficient trade and the ease with which trade was done. NEAT had lent considerable depth in the market by enabling large number of members all over the country to trade simultaneously, narrowing the spreads significantly.

The derivatives trading on NSE commenced with S&P CNX Nifty Index futures on June 12, 2000. The futures contract on NSE is based on S&P CNX Nifty Index. The Futures and Options trading system of NSE, called NEAT-F&O trading system, provides a fully automated screen based trading for S&P CNX Nifty futures on a nationwide basis and an online monitoring and surveillance mechanism. It supports an order-driven market and provides complete transparency of trading operations.

Benchmark Indices futures: Nifty Midcap 50 futures, S&P CNX Nifty futures, CNX Nifty Junior, CNX IT futures, CNX 100 futures, Bank Nifty futures.

International Exchanges

Due to increasing globalization, the development at macro and micro levels in international markets is compulsorily incorporated in the performance of domestic indices and individual stock performance, directly or indirectly. Therefore, it is important to keep track of international financial markets for better perspective and intelligent investment.

NASDAQ (National Association of Securities Dealers Automated Quotations)

NASDAQ is an American stock exchange. It is an electronic screen-based equity securities trading market in the US. It was founded in 1971 by the National Association of Securities Dealers (NASD). However, it is owned and operated by NASDAQ OMX group, the stock of which was listed on its own stock exchange in 2002. The exchange is monitored by the Securities and Exchange Commission (SEC), the regulatory authority for the securities markets in the United States.

NASDAQ is the world leader in the arena of securities trading, with 3,900 companies (NASDAQ site) being listed. There are four major indices of NASDAQ that are followed closely by the investor class, internationally.

NASDAQ Composite: It is an index of common stocks and similar stocks like ADRs, tracking stocks and limited partnership interests listed on the NASDAQ stock market. It is estimated that the total components count of the Index is over 3,000 stocks and it includes stocks of US and non-US companies, which makes it an international index. It is highly followed in the US and is an indicator of performance of technology and growth companies. When launched in 1971, the index was set at a base value of 100 points. Over the years, it saw new highs; for instance, in July 1995, it closed above 1,000-mark and in March 2000, it touched 5048.62. The decline from this peak signaled the end of the dotcom stock market bubble. The Index never reached the 2000 level afterwards. It was trading at 1316.12 on November 20, 2008.

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NASDAQ 100: It is an Index of 100 of the largest domestic and international non-financial companies listed on NASDAQ. The component companies' weight in the index is based on their market capitalization, with certain rules controlling the influence of the largest components. The index doesn't contain financial companies. However, it includes the companies that are incorporated outside the US. Both these aspects of NASDAQ 100 differentiate it from S&P 500 and Dow Jones Industrial Average (DJIA). The index includes companies from the industrial, technology, biotechnology, healthcare, transportation, media, and service sectors.

Dow Jones Industrial Average (DJIA): DJIA was formed for the first time by Charles Henry Dow. He formed a financial company with Edward Jones in 1882, called Dow Jones & Co. In 1884, they formed the first index including 11 stocks (two manufacturing companies and nine railroad companies). Today, the index contains 30 blue-chip industrial companies operating in America. The Dow Jones Industrial Average is calculated through the simple average, i.e., the sum of the prices of all stocks divided by the number of stocks (30).

S&P 500: The S&P 500 Index was introduced by McGraw Hill's Standard and Poor's unit in 1957 to further improve tracking of American stock market performance. In 1968, the US Department of Commerce added S&P 500 to its index of leading economic indicators. S&P 500 is intended to be consisting of the 500 largest publically-traded companies in the US by market capitalization (in contrast to the FORTUNE 500, which is the largest 500 companies in terms of sales revenue). The S&P 500 Index comprises about three-fourths of total American capitalization.

LSE (London Stock Exchange)

The London Stock Exchange was founded in 1801 with British as well as overseas companies listed on the exchange. The LSE has four core areas:

Equity markets: The LSE enables companies from around the world to raise capital. There are four primary markets; Main Market, Alternative Investment Market (AIM), Professional Securities Market (PSM), and Specialist Fund Market (SFM).

Trading services: Highly active market for trading in a range of securities, including UK and international equities, debt, covered warrants, exchange-traded funds (ETFs), exchange-traded commodities (ETCs), REITs, fixed interest, contracts for difference (CFDs), and depositary receipts.

Market data information: The LSE provides real-time prices, news, and other financial information to the global financial community.

Derivatives: A major contributor to derivatives business is EDX London, created in 2003 to bring the cash, equity, and derivatives markets closer together. It combines the strength and liquidity of LSE and equity derivatives technology of NASDAQ OMX group.

The exchange offers a range of products in derivatives segment with underlying from Russian, Nordic, and Baltic markets. Internationally, it offers products with underlying from Kazakhstan, India, Egypt, and Korea.

Frankfurt Stock Exchange

It is situated in Frankfurt, Germany. It is owned and operated by Deutsche Börse. The Frankfurt Stock Exchange has over 90 percent of turnover in the German market and a big share in the European market. The exchange has a few well-known trading indices of the exchange, such as DAX, DAXplus, CDAX, DivDAX, LDAX, MDAX, SDAX, TecDAX, VDAX, and EuroStoxx 50.

DAX is a blue-chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. Prices are taken from the electronic Xetra trading system of the Frankfurt Stock Exchange.

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4.6 Regulatory Authority

There are four main legislations governing the securities market:

1. The SEBI Act, 1992 establishes SEBI to protect investors and develop and regulate the securities market.
2. The Companies Act, 1956 sets out the code of conduct for the corporate sector in relation to issue, allotment, and transfer of securities, and disclosures to be made in public issues.
3. The Securities Contracts (Regulation) Act, 1956 provides for regulation of transactions in securities through control over stock exchanges.
4. The Depositories Act, 1996 provides for electronic maintenance and transfer of ownership of demat securities.

In India, the responsibility of regulating the securities market is shared by DCA (the Department of Company Affairs), DEA (the Department of Economic Affairs), RBI (the Reserve Bank of India), and SEBI (the Securities and Exchange Board of India).

Did u know? The DCA is now called the ministry of company affairs, which is under the ministry of finance. The ministry is primarily concerned with the administration of the Companies Act, 1956, and other allied Acts and rules & regulations framed thereunder mainly for regulating the functioning of the corporate sector in accordance with the law.

The ministry exercises supervision over the three professional bodies, namely Institute of Chartered Accountants of India (ICAI), Institute of Company Secretaries of India (ICSI), and the Institute of Cost and Works Accountants of India (ICWAI), which are constituted under three separate Acts of Parliament for the proper and orderly growth of professions of chartered accountants, company secretaries, and cost accountants in the country.

SEBI protects the interests of investors in securities and promotes the development of the securities market. The board helps in regulating the business of stock exchanges and any other securities market. SEBI is also responsible for registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, and such other intermediaries who may be associated with securities markets in any manner.

4.7 Instruments in Indian Capital Market

A capital market is a market for securities (debt or equity), where business enterprises and government can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (e.g., the money market). The capital market is characterized by a large variety of financial instruments: equity and preference shares, fully convertible debentures (FCDs), non-convertible debentures (NCDs) and partly convertible debentures (PCDs) currently dominate the capital market, however new instruments are being introduced such as debentures bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc.

Secured Premium Notes

SPN is a secured debenture redeemable at premium issued along with a detachable warrant, redeemable after a notice period, say four to seven years. The warrants attached to SPN gives the holder the right to apply and get allotted equity shares; provided the SPN is fully paid. There is a lock-in period for SPN during which no interest will be paid for an invested amount. The SPN

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holder has an option to sell back the SPN to the company at par value after the lock in period. If the holder exercises this option, no interest/premium will be paid on redemption. In case the SPN holder holds it further, the holder will be repaid the principal amount along with the additional amount of interest/premium on redemption in installments as decided by the company. The conversion of detachable warrants into equity shares will have to be done within the time limit notified by the company.

Example: TISCO issued warrants for the first time in India in the year 1992 to raise 1212 crore.

Deep Discount Bonds

A bond that sells at a significant discount from par value and has no coupon rate or lower coupon rate than the prevailing rates of fixed-income securities with a similar risk profile. They are designed to meet the long term funds requirements of the issuer and investors who are not looking for immediate return and can be sold with a long maturity of 25-30 years at a deep discount on the face value of debentures.

Example: IDBI deep discount bonds for ₹ 1 lac repayable after 25 years were sold at a discount price of ₹ 2,700.

Equity Shares with Detachable Warrants

A warrant is a security issued by company entitling the holder to buy a given number of shares of stock at a stipulated price during a specified period. These warrants are separately registered with the stock exchanges and traded separately. Warrants are frequently attached to bonds or preferred stock as a sweetener, allowing the issuer to pay lower interest rates or dividends.

Example: Essar Gujarat, Ranbaxy, Reliance issue this type of instrument.

Fully Convertible Debentures with Interest

This is a debt instrument that is fully converted over a specified period into equity shares. The conversion can be in one or several phases. When the instrument is a pure debt instrument, interest is paid to the investor. After conversion, interest payments cease on the portion that is converted. If project finance is raised through an FCD issue, the investor can earn interest even when the project is under implementation. Once the project is operational, the investor can participate in the profits through share price appreciation and dividend payments.

Equipref

They are fully convertible cumulative preference shares. This instrument is divided into 2 parts namely Part A & Part B. Part A is convertible into equity shares automatically /compulsorily on date of allotment without any application by the allottee.

Part B is redeemed at par or converted into equity after a lock in period at the option of the investor, at a price 30% lower than the average market price.

Sweat Equity Shares

The phrase `sweat equity' refers to equity shares given to the company's employees on favorable terms, in recognition of their work. Sweat equity usually takes the form of giving options to

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employees to buy shares of the company, so they become part owners and participate in the profits, apart from earning salary. This gives a boost to the sentiments of employees and motivates them to work harder towards the goals of the company.

The Companies Act defines `sweat equity shares' as equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing knowhow or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

Tracking Stocks

A tracking stock is a security issued by a parent company to track the results of one of its subsidiaries or lines of business; without having claim on the assets of the division or the parent company. It is also known as "designer stock". When a parent company issues a tracking stock, all revenues and expenses of the applicable division are separated from the parent company's financial statements and bound to the tracking stock. Oftentimes, this is done to separate a subsidiary's high-growth division from a larger parent company that is presenting losses. The parent company and its shareholders, however, still control the operations of the subsidiary.

Example: QQQQ, which is an exchange-traded fund that mirrors the returns of the Nasdaq 100 index.

Disaster Bonds

Also known as Catastrophe or CAT Bonds, Disaster Bond is a high-yield debt instrument that is usually insurance linked and meant to raise money in case of a catastrophe. It has a special condition that states that if the issuer (insurance or Reinsurance Company) suffers a loss from a particular predefined catastrophe, then the issuer's obligation to pay interest and/or repay the principal is either deferred or completely forgiven.

Example: Mexico sold $290 million in catastrophe bonds, becoming the first country to use a World Bank program that passes the cost of natural disasters to investors. Goldman Sachs Group Inc. and Swiss Reinsurance Co. managed the bond sale, which will pay investors unless an earthquake or hurricane triggers a transfer of the funds to the Mexican government.

Self Assessment

Fill in the blanks:

11. ……. is that part of the capital markets that deals with the issue of new securities.
12. Apart from allotment through auction, a system of ……. bidding was introduced in January 2002 to encourage retail investors who do not have sufficient expertise in such bidding.
13. ……. protects the interests of investors in securities and promotes the development of the securities market.
14. SPN is a ……. debenture redeemable at premium issued along with a detachable warrant, redeemable after a notice period, say four to seven years.
15. ……. refers to equity shares given to the company's employees on favorable terms, in recognition of their work

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Mortgage Backed Securities (MBS)

MBS is a type of asset-backed security, basically a debt obligation that represents a claim on the cash flows from mortgage loans, most commonly on residential property. Mortgage backed securities represent claims and derive their ultimate values from the principal and payments on the loans in the pool. These payments can be further broken down into different classes of securities, depending on the riskiness of different mortgages as they are classified under the MBS.

- Mortgage originators to refill their investments
- New instruments to collect funds from the market, very economic and more effective
- Conversion of assets into funds
- Financial companies save on the costs of maintenance of the assets and other costs related to assets, reducing overheads and increasing profit ratio.
- Kinds of Mortgage Backed Securities:

1. *Commercial mortgage backed securities:* backed by mortgages on commercial property Collateralized mortgage obligation: a more complex MBS in which the mortgages are ordered into tranches by some quality (such as repayment time), with each tranche sold as a separate security.

   Stripped mortgage backed securities: Each mortgage payment is partly used to pay down the loan's principal and partly used to pay the interest on it? Residential mortgage backed securities: backed by mortgages on residential property.

2. *Residential mortgage backed securities:* backed by mortgages on residential property.

Global Depository Receipts/ American Depository Receipts

A negotiable certificate held in the bank of one country (depository) representing a specific number of shares of a stock traded on an exchange of another country. GDR facilitate trade of shares, and are commonly used to invest in companies from developing or emerging markets. GDR prices are often close to values of related shares, but they are traded and settled independently of the underlying share.

Listing on a foreign stock exchange requires compliance with the policies of those stock exchanges. Many times, the policies of the foreign exchanges are much more stringent than his policies of domestic stock exchange. However a company may get listed on these stock exchanges indirectly – using ADRs and GDRs.

If the depository receipt is traded in the United States of America (USA), it is called an American Depository Receipt, or an ADR. If the depository receipt is traded in a country other than USA, it is called a Global Depository Receipt, or a GDR.

But the ADRs and GDRs are an excellent means of investment for NRIs and foreign nationals wanting to invest in India. By buying these, they can invest directly in Indian companies without going through the hassle of understanding the rules and working of the Indian financial market - since ADRs and GDRs are traded like any other stock, NRIs and foreigners can buy these using their regular equity trading accounts!

Example: HDFC Bank, ICICI Bank, Infosys have issued both ADR and GDR.

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Foreign Currency Convertible Bonds (FCCBs)

A convertible bond is a mix between a debt and equity instrument. It is a bond having regular coupon and principal payments, but these bonds also give the bondholder the option to convert the bond into stock. FCCB is issued in a currency different than the issuer's domestic currency.

The investors receive the safety of guaranteed payments on the bond and are also able to take advantage of any large price appreciation in the company's stock. Due to the equity side of the bond, which adds value, the coupon payments on the bond are lower for the company, thereby reducing its debt-financing costs.

Derivatives

A derivative is a financial instrument whose characteristics and value depend upon the characteristics and value of some underlying asset typically commodity, bond, equity, currency, index, event etc. Advanced investors sometimes purchase or sell derivatives to manage the risk associated with the underlying security, to protect against fluctuations in value, or to profit from periods of inactivity or decline. Derivatives are often leveraged, such that a small movement in the underlying value can cause a large difference in the value of the derivative.

Derivatives are usually broadly categorised by:

1. The relationship between the underlying and the derivative (e.g. forward, option, swap).
2. The type of underlying (e.g. equity derivatives, foreign exchange derivatives and credit derivatives).
3. The market in which they trade (e.g., exchange traded or over-the-counter) futures.

A financial contract obligating the buyer to purchase an asset, (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price. Futures contracts detail the quality and quantity of the underlying asset; they are standardized to facilitate trading on a futures exchange. Some futures contracts may call for physical delivery of the asset, while others are settled in cash. The futures markets are characterized by the ability to use very high leverage relative to stock markets.

Some of the most popular assets on which futures contracts are available are equity stocks, indices, commodities and currency.

Options

A financial derivative that represents a contract sold by one party (option writer) to another party (option holder). The contract offers the buyer the right, but not the obligation, to buy (call) or sell (put) a security or other financial asset at an agreed-upon price (the strike price) during a certain period of time or on a specific date (exercise date).

A call option gives the buyer, the right to buy the asset at a given price. This 'given price' is called 'strike price'. It should be noted that while the holder of the call option has a right to demand sale of asset from the seller, the seller has only the obligation and not the right.

Example: If the buyer wants to buy the asset, the seller has to sell it. He does not have a right. Similarly a 'put' option gives the buyer a right to sell the asset at the 'strike price' to the buyer.

Here the buyer has the right to sell and the seller has the obligation to buy. So in any options contract, the right to exercise the option is vested with the buyer of the contract. The seller of the

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contract has only the obligation and no right. As the seller of the contract bears the obligation, he is paid a price called as 'premium'. Therefore the price that is paid for buying an option contract is called as premium.

Exchange Traded Funds

An exchange-traded fund (or ETF) is an investment vehicle traded on stock exchanges, much like stocks. An ETF holds assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets over the course of the trading day.

Most ETFs track an index, such as the S&P 500 or MSCI EAFE. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features, and single security can track the performance of a growing number of different index funds (currently the NSE Nifty).

Gold ETF

Gold Exchange Traded Fund (ETF) is a financial instrument like a mutual fund whose value depends on the price of gold. In most cases, the price of one unit of gold ETF approximately reflects the price of 1 gram of gold. As the price of gold rises, the price of the ETF is also expected to rise by the same amount. Gold exchange-traded funds are traded on the major stock exchanges including Zurich, Mumbai, London, Paris and New York There are also closed-end funds (CEF's) and exchange-traded notes (ETN's) that aim to track the gold price.

4.8 Summary

- A capital market is a market for securities (debt or equity), where business enterprises and government can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (e.g., the money market).
- The capital market is characterized by a large variety of financial instruments: equity and preference shares, fully convertible debentures (FCDs), non-convertible debentures (NCDs) and partly convertible debentures (PCDs) currently dominate the capital market, however new instruments are being introduced such as debentures bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc. The g-securities market is at the core of financial markets in most countries.
- The earliest securities markets in the globe were markets for government securities and relatively more prominent.
- The g-securities market is distinct from other market because of its immanent features, such as size, turnover, liquidity and security. Central banks play a significant role in managing public debt of their respective countries.
- The g-securities market plays crucial role in overall economic development of a country. For effective functioning of the market, certain fundamental principles and strategies need to be factored in while designing and developing the market.
- The lack of an advanced and vibrant capital market can lead to underutilisation of financial resources. The developed capital market also provides access to the foreign capital for domestic industry. Thus capital market definitely plays a constructive role in the overall development of an economy.

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4.9 Keywords

Deep discount bonds: A bond that sells at a significant discount from par value and has no coupon rate or lower coupon rate than the prevailing rates of fixed-income securities with a similar risk profile.

Equity shares with detachable warrants: A warrant is a security issued by company entitling the holder to buy a given number of shares of stock at a stipulated price during a specified period.

Fund Raisers: Are companies that raise funds from domestic and foreign sources, both public and private.

Government securities market: Deals with tradable debt instruments issued by the government for meeting its financing requirements.

Intermediaries: Are service providers in the market, including stock brokers, sub-brokers, financiers, merchant bankers etc.

Market Regulators: Include the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), and the Department of Company Affairs (DCA).

NASDAQ: Is an American stock exchange. It is an electronic screen-based equity securities trading market in the US.

Primary market: Is that part of the capital markets that deals with the issue of new securities.

Secondary market: It facilitates the original investor in new government debt securities to sell his securities before maturity, and to do so with ease and without undue cost.

SPN: Is a secured debenture redeemable at premium issued along with a detachable warrant, redeemable after a notice period, say four to seven years.

Sweat equity: Refers to equity shares given to the company's employees on favorable terms, in recognition of their work.

4.10 Review Questions

1. Discuss the evolution and growth of Indian Capital Market.
2. What is the structure of Indian Capital Market? Discuss.
3. What is the role of Indian capital market?
4. With reference to the participants in the securities market write a brief note on government securities market.
5. The primary market is that part of the capital markets that deals with the issue of new securities". In the light of above statement discuss the measures relating to primary market.
6. "An active and efficient secondary market for government securities adds to a great extent to the attractiveness of government bonds to investors, at no cost to the government." Comment.
7. What do you mean by cardinal principle for efficient growth of government securities market?
8. Write a brief note on:
   (a) GDRs
   (b) ADRs

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9. What are the measures relating to secondary market?
10. Discuss the implications towards the growth of capital market in India.

Answers to Self Assessment

1. long-term
2. Fund Raisers
3. Foreign
4. Intermediaries
5. Growth, development
6. Debt
7. government securities
8. bearer bond
9. RBI
10. risk-free
11. Primary market
12. non-competitive
13. SEBI
14. Secured
15. sweat equity'

4.11 Further Readings

Books

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Online links

www.bis.org

www.federalreserve.gov

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Unit 5: Primary Market

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Objectives

After studying this unit, you should be able to:

- Learn the concept of primary market;
- Understand functions of primary market;
- Discuss the structure of primary market in India;
- Understand the method of distribution of securities;
- Understand Intermediaries in the primary market of India.

Introduction

The securities markets of our country, where securities of corporate enterprises are traded, comprise two main markets, viz., primary market and secondary market. In the primary market, new securities are floated and exchanged for cash, credit or other securities. New security issues are floated both by the newly set up organizations and by the existing ventures. This market is popularly designated as new issues market. Contrary to this, in the secondary market buying

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and selling 'second hand' or existing securities are transacted. Stock market is the nickname of the secondary market.

5.1 Functions of Primary Market in India

The major function being performed by primary market in India is to facilitate transmission of funds of those who have surplus income and are willing to invest to entrepreneurs seeking to set up new undertakings or expand, modernize and diversify the operations of the existing enterprises. Since activity of the primary market connects savings and investment, the primary market is indispensable for economic and industrial development of the country. Besides, the primary market has directed the flow of investment into long-term channels. The capacity of the market machinery to reach down all potential savers irrespective of size of their savings and investing institutions existing in the market has a direct bearing on volume of savings that may be channelled into industry.

To perform its functions, the primary market renders three main services, viz.,

1. investigating and processing of proposals for new issues,
2. underwriting of new security issues, and
3. distribution of new securities to ultimate investors.

These services are rendered by the specialized agencies like financial institutions, brokers and dealers in securities.

5.2 Structure of Primary Market in India

The agencies associated with functions of originating underwriting and distributions constitute the organization of the primary market in India. Subscribers also form part of the market. Issuers of new securities include agencies connected with the floatation of initial issues and those concerned with the floatation of existing issues. These agencies are known as promoters who conduct detailed investigations about the venture to be set up, formulates financial plan, prepares prospectus for capital issues, approaches underwriting and brokerage firms for underwriting the issues and makes arrangements for advertising and circulating the prospectus to procure subscriptions. Thus, a promoter is the issuer or supplier of new companies in the market. In the case of existing enterprises, they themselves are the suppliers of new issues when they float further issues. However, when the existing companies offer new security issues only to their existing stockholders, they will not constitute the suppliers of new issues in the new issue market. On the contrary, if they offer issues to public through prospectuses, they are regarded as the suppliers of new issues in the market. In the case of existing enterprises, it is the Board of Directors who take decisions as to why, how and when new issues will be floated. They also enter into agreement with underwriters and brokers before floating public issues.

Underwriting is another important activity of primary market. In our country, all financial institutions and brokers undertake this business. Commercial banks have also entered into this market recently in a big way through their subsidiaries. Insurance and investment companies are also important underwriters. Underwriters in India have been found to have subscribed more for preference shares and debentures than for equity shares as the latter are more suited to the investing public and thus devolve less on the underwriters. Brokers help in the floatation of new issues not only through underwriting or as managing brokers but also as financial consultants, advising on the proper capital structure, methods of raising capital and requirements of the Companies Act and the Securities Contracts (Regulation) Act, and listing requirements.

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In India, underwriting for public issues was compulsory till October 1994 in the sense that an issue had to be underwritten if the issuer opted for it while applying for permission to make an issue, or if the SEBI felt that it has to be underwritten. The underwriting business was quite lucrative and development on underwriters were small due to good public response till 1992-93. But around 1992-93, many underwriters lost their money as many issues turned out to be dual; development became enormous and underwriters backed out of their commitments. Since October 1994, the SEBI has made underwriting optional.

Notes The distribution function of the primary market facilitates the sale of securities to ultimate investors. This function is performed by specialized agencies like brokers and dealers in securities. They maintain a constant and close link with the issuers and the ultimate investors on the one hand, and issuers and other agencies of capital market, on the other. Finally, subscribers, who buy new issues floated in the market, constitute a significant segment of the new issue market.

5.3 Methods of Distribution of Securities

Distribution of securities to prospective investors to mop up their surpluses is a highly specialized activity that requires a lot of expertise and experience. As such, companies seeking to garner funds from a large number of investors-both individuals and institutions-have to hire the services of the specialized agencies such as underwriters, brokers, merchant bankers, etc. Besides, there are other ways which can be employed for selling securities to the investing public. In India, following methods are usually employed to garner funds from the public through floatation of securities:

5.3.1 Public issue Through Prospectus

In this method, a public limited company invites the public at large through prospectus to subscribe to the issue of securities. According to the SEBI norms, a minimum of 49% of the total issue at a time is to be offered to public. A prospectus is a document that provides information about the company and its proposed issue. The company and the directors signing this document are personally liable for any false statement or misrepresentation of material facts in the prospectus.

Public issue through prospectus may take the form of direct selling, sale through investment intermediaries and underwriting of issues. Direct selling of securities method can be used when a company intends to approach a small number of large individual or institutional investors. However, there is no certainty of procuring the desired funds from investors through direct selling. This is why companies may take the help of intermediaries and specialized agencies such as brokers, merchant bankers, for selling such securities. These agencies charge commission for their service. However, they do not provide any guarantee to the issue regarding the sale of securities. To remove this deficiency and to ensure certainty of procurement of the desired funds, companies approach underwriting firms who, in lieu of commission, undertake the guarantee of buying the unsubscribed portion of the offer. Thus, an underwritten placement method is relatively more safe method of acquiring funds from the public at large.

The pure prospectus method of selling securities is very popular method because it is useful to both to the issuers as well as to the investors. The issuers have the benefit of wider diffusion of ownership of securities, thus avoiding the possibility of concentration of controlling power in the hands of a few. Investors have the advantage of getting detailed information about the company and its issue through prospectus as per the SEBI requirements. This method also

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promotes confidence of investors through transparency and non-discriminatory basis of allotment. There is hardly any scope of artificial jacking up of prices if the issue is made public. However, this method can be gainfully employed by large companies offering big issues because of high costs involved in raising capital. Further, it is a time-consuming method as a lot of legal formalities need to be complied with before floating an issue.

5.3.2 Offer for Sale

This method involves outright sale of shares enbloc by the company to issue houses or a group of brokers at an agreed price who in turn resell them to the public at large. In such cases, the issuing houses may act as agents of the company. The difference between the resale price and purchase price is termed as spread and represents the profit of the issue houses. In the US, issuing companies cannot approach the public directly. They are under obligation to sell their shares in the first instance to underwriters, who then issue these shares to the investing public. In India, this method has been employed on an experimental basis under the name 'bought out deals' wherein the shares are first sold to the sponsor under an agreement that the sponsor shall sell them to public within a specified period of time.

This method of distribution of securities has the advantage of ensuring success of the issue and economizing on cost of new issues and thus the issuing company is relieved of the botherations involved in selling securities to the public. The issue houses also stand to gain by charging higher prices.

5.3.3 Private Placement

In this method, the issuing company offers issue privately to a select group of investors without the prospectus. In this process, the issuer may call upon the services of brokers or issue houses. This method works in a manner similar to the 'offer for sale method' whereby securities are first sold to issue houses, etc., who then sell them at higher prices to individuals and institutions.

The SEBI has laid down certain restrictions on the reservation of securities in any public issues.

For example, the maximum permissible allotment through reservation is restricted to 10% for permanent employees, 10% for shareholders of promoting companies, 20% for Indian mutual funds, 24% for FIIS and 20% for Indian and multilateral development financial institutions.

This method of selling securities is very economical and less troublesome. As such, it suits the requirements of small companies. To others, this method is useful especially when the stock market is in bearish state and the public response is poor. However, the disadvantage of this method is that the investor cannot resell the security for a specific period of time. This method may also lead to concentration of securities in a few hands. There is also scope for creating artificial scarcity for the securities, thus jacking up the prices temporarily and misleading the general public.

5.3.4 Rights Issue

Rights issue method is an important method of distributing securities in which the existing company offers shares to its existing shareholders in proportion to their existing ownership. As per Section 81 of the Companies Act, 1956, existing shareholders get a right of 'pre-emption' and they have the option to exercise the right to renounce it or throw away. For that purpose, a company intending to increase its subscribed capital by the issue of new shares either after two years of its formation or after one year of the first issue of shares whichever is earlier will have to offer the shares to the existing shareholders with the right to reserve them in favour of a nominee.

Notes

Rights issue is the cheapest and convenient method of raising funds and protects the interest of the existing shareholders against the dilution of their ownership.

Case Study

TOUAX Success of Rights Issue

TOUAX is a French company and is currently Europe's no.1 in shipping containers and river barges, and no. 2 in modular buildings and freight railcars. The Group provides operating leases to customers around the world, both on its own account and for third-party investors.

On June 24, 2009, TOUAX announced that its capital increased by waiving preferential subscription rights but with priority for existing shareholders, launched on 18 June 2009 for a total of E17,851,519.76 (gross) through the issue of 936,596 new shares which were subscribed in the entirety. Following partial application of the extension clause, 952,747 shares were placed or 101.72% of the issue; total proceeds were E18,159,357.82.

This rights issue has enabled the Group to strengthen its financial structure, to position itself with advantage for possible acquisitions of tangible stock, and to grasp opportunities thrown up by the crisis (purchase of shipping containers, modular buildings, river barges and railcars, for hiring out on mainly long-term leases). 370,062 new shares allotted under absolute entitlement were subscribed or 39.51% of the total number of new shares on issue. Another 555,685 shares were applied for subject to cutting back in the event of over-subscription, and orders for these were all filled. Another 27,000 shares had been applied for by the general public, and following partial application of the extension clause it proved possible to fill orders for all of these.

As the result of the rights issue, TOUAX is well placed to respond to the boom in corporate outsourcing of non-core assets, and every day provides over 5,000 customers with quick and flexible leasing solutions. TOUAX is now listed on Euronext in Paris - NYSE Euronext Compartment C (ISIN Code FR0000033003), and features in the SBF 250 Index.

Questions:

1. After analyzing the case, do you think all the companies that can afford, should opt for rights issue to improve their financial status?
2. What do you analyse as the 2 main advantages of the rights issue?
3. What do think can be the risks posed by rights issue?

5.3.5 Over-the-Counter placement

This method has come to be employed in recent years, especially after the commencement of the operations of Over-the-Counter Exchange (OTCE) in 1992. The OTC permits small companies to raise funds through its exchange. Under this method, the company intending to raise funds through OTCE appoints a member of the OTCE as sponsor. The sponsor appraises the project and values the shares of the company. The shares are placed by the sponsor with itself and other members and dealers of the OTCE. The sponsor ensures the success of the issue even if it is required to subscribe to all the shares by itself. The OTCE members and dealers operate counters to facilitate trading with investing public. The distribution of shares through OTCE has to be made as per the SEBI guidelines. This method of selling securities is most suited to small enterprises.

Notes

5.3.6 Initial Public Offer through Stock Exchange Online System (E-IPO)

In addition to other requirements for public issues as given in the SEBI guidelines wherever applicable, a company proposing to issue capital to public, through the online system of the stock exchange for offer of securities, has to comply with the requirements discussed below. They are applicable to the fixed price issue as well as for the fixed price portion of book-built issues. The issuing companies would have the option to issue securities to the public either through the online system of the stock exchange or through the existing banking channel.

Agreement with Stock Exchange

The company should enter into an agreement with the stock exchange(s), specifying, inter alia, their mutual rights/duties/responsibilities and obligations inter se. It may also provide for a dispute resolution mechanism between them.

Appointment of Brokers

The stock exchange(s) would appoint the SEBI registered stockbrokers of the exchange to accept applications and place orders with the company, considering them as collection centres. They would collect the money from the clients for orders placed and in case clients fail to pay for shares allocated, the brokers would have to pay the amount. The company/lead manager should ensure that the appointed brokers are financially capable of honouring their commitments if their clients default. The company would pay the brokers a commission/fee for their services and the stock exchange should ensure that they do not levy a service fee on their clients in lieu of their services.

Appointment of Registrar to Issue

The company should appoint a registrar to the issue with electronic connectivity with the stock exchange(s) through which the securities are offered under the system.

Listing: The company may list its securities on an exchange other than the one through which it offers its securities to the public via the online system.

Responsibility of Lead Manager

The lead manager would be responsible for coordination of all the activities among various intermediaries connected on the issue system. The names of the appointed brokers, along with other intermediaries (i.e. lead manager, registrar to issue), should be disclosed in the prospectus and the application form.

Mode of Operation

The company should, after filing the offer document with the ROCs and before opening of the issue, publish an advertisement each in an English and Hindi daily with nationwide circulation and also in a regional daily with circulation at the place where its registered office is situated. The advertisement should contain the salient features of the offer document as specified in form 2A of the Companies (Central Government's) General Rules and Forms, 1956. In addition to other required information, it should contain (1) the date of opening/closing of issue, (2) the method and process of application allotment and (3) the names/addresses/telephone numbers of the brokers/centers for accepting applications.

Notes

During the period the issue is open to public for subscription, the applicants may:

1. Approach the brokers of the stock exchange(s) through which the securities are offered through the online system, to place an order for subscribing to the securities. Every broker should accept orders from all clients who place orders through him;
2. Directly send the application forms, along with the cheque/demand draft for the sum payable towards the application money, to the registrar to the issue or place the order to subscribe through a broker under the online system. In the case of issue of capital of `10 crore or above, the registrar to the issue should open centres for collection of direct applications at the four metropolitan centres situated at Delhi, Chennai, Kolkata and Mumbai.

The broker should collect the client registration form from the applicants, duly filled and signed, before placing the order in the system as per the "Know Your Client" rule as specified by the SEBI and as may be modified from time to time. He should, thereafter, enter the buy order in the system on behalf of the clients and enter details including the name, address, telephone number and category of the applicant, the number of shares applied for, beneficiary ID, DP code and so on, and give an order number/order confirmation slip to the applicant.

The applicant may withdraw applications according to the Companies Act, 1956.

The broker may collect an amount to the extent of 100 per cent of the application money as margin money from the client before he places an order on their behalf. He should open a separate bank account (Escrow Account) with the clearing house bank for primary market issues in which the amount collected from clients as margin money should be deposited. At the end of each day, while the issue is open for subscription, he should download/forward the order data to the registrar to the issue. On the date of closure of the issue, the final status of orders received should be sent to the registrar to the issue/company.

On the closure of the issue, the designated stock exchange, along with the lead merchant banker and registrars to the issue, should ensure that the basis of allocation is finalized in a fair and proper manner according to the basis of allotment norms. These may be modified from time to time. After the finalization of the basis of allocation, the registrar to the issue/company should send the computer file containing the allocation details, that is, the allocation numbers, allocated quantity and so on of the successful applicants to the exchange to be processed, generate the broker-wise pay in obligation and send the file to member brokers. On receipt of the basis of allocation data, the brokers should immediately intimate the fact of allocation to their clients/ applicants. They should ensure that each successful client/applicant submits the duly filled in and signed application form to them along with the amount payable towards the application money. The amount already paid by the applicant as margin money would be adjusted towards the total allocation money payable. The broker should, thereafter, hand over the application forms of the successful applicants, who have paid the application money, to the exchange to submit the same to the registrar to the issue/company for their records.

The broker would refund the margin money, collected earlier, within three days of receipt of basis of allocation to the applicants who did not receive allocation. He should give details of the amount received from each client and the names of clients who have not paid the application money, and also give a soft copy of this data to the exchange. On the pay-in day, the broker should deposit the amount collected from the clients in the escrow account opened for primary issues with the clearing house/bank. The clearing house would debit the primary issue account of each broker and credit the amount so collected from each broker to the 'Issue Account'.

In the event of successful applicants failing to pay the application money, the broker through whom such clients placed the order should bring in the funds to make good the latter's default. The broker who does not bring in the funds would be declared defaulter by the exchange and

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action, as prescribed under its bylaws, would be initiated against him. In such a case, if the minimum subscription as disclosed in the prospectus is not received, the issue proceeds would be refunded to the applicants.

The subscriber should have an option to receive the security certificates or hold the securities in dematerialized form as specified in the SEBI guidelines.

The exchange concerned should not use the Settlement/Trade Guarantee Fund of the exchange for honouring the brokers' commitment in case of failure of a broker to bring in funds.

On payment and receipt of the sum payable on applicants for the amount towards minimum subscription, the company should allot the shares to the applicants as per these guidelines. The registrar to the issue should post the share certificate to the investors or, instruct the depository to credit the depository account of each investor. The allotment of securities should be made not later than 15 days from the closure of the issue, failing which interest at 15 per cent would be paid to the investors.

The cases of applicants who have applied, directly or by post, to the registrar to the issue and have not received allocation, he (the registrar) should arrange to refund the application monies paid by them within the time prescribed.

The brokers and other intermediaries engaged in the process of offering shares through the online system should maintain the following records for a period of five years: (i) orders received, (ii) applications received, (iii) details of allocation and allotment, (iv) details of margin collected and refunded, and (v) details of refund of application money.

Notes The SEBI would have the right to carry out an inspection of the records, books and documents relating to the above, of any intermediary connected with the system and every intermediary in the system should at all times cooperate with the inspection. In addition, the stock exchange(s) has/have the right of supervision and inspection of the activities of its connected member brokers.

5.3.7 Book-Building

Book-building means a process 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. A company proposing to issue capital through book-building has to comply with the requirements as given in the following pages:

75 Per cent Book-building Process

In an issue of securities to the public through a prospectus, the option for 75 per cent book-building is available subject to the following:

1. The option of book building is available to all body corporates that are otherwise eligible to make an issue of capital to the public as an alternative to, and to the extend of, the percentage of the issue, which can be reserved for firm allotment. The issuer company can either reserve the securities for firm allotment or issue them through the book-building process. The issue of securities through the book-building process should be separately identified/indicated as 'placement portion category', in the prospectus. The securities available to the public should be separately identified as "net offer to the public". The

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requirement of minimum 25 per cent of the securities to be offered to the public is also applicable. Underwriting is mandatory to the extent of the net offer to the public. The draft prospectus containing all the information, except the information regarding the price at which the securities are offered, should be filed with the SEBI. One of the lead merchant banker(s) to the issue should be nominated by the issuer company as a book runner and his name should be mentioned in the prospectus. The copy of the draft prospectus, filed with the SEBI, should be circulated by the book runner to the (i) institutional buyers, who are eligible for firm allotment, and (ii) intermediaries, eligible to act as underwriters, inviting offers for subscription to the securities.

2. The draft prospectus circulated should, however, indicate the price band within which the securities are being offered for subscription. The book runner on receipt of the offer should maintain a record of the names and number of securities ordered and the price at which the institutional buyer/underwriter is willing to subscribe to the securities under the placement portion. The underwriter(s) should maintain a record of the orders received by him for subscribing to the issue out of the placement portion. He should aggregate these offers and intimate the same to the book runner. The situational investor should also forward its orders, if any, to the book runner, on receipt of the compaction. The book runner and the issuer company determine the price at which the securities should be offered to the public the issue price for the placement portion and offer to the public could subscribe to the securities, The book runner should, however, have an option to require the under writers to pay all monies with respect to their underwriting commitment in advance. Within two of determination of the issue price, the prospectus should be filed with the ROCs and the issuer company should open two different accounts for collection of application money(ies) - one for the private placement portion and the other for the public subscription. A day prior to the opening of the issue to the public, the book runner should collect the application forms along with the application money(ies) from the institutional buyers and the underwriter to the extent of the securities proposed to be allotted to them/subscribed by them. The allotments for the private placement portion should be made on the second day from the closure of the issue. However, to ensure that the shares allotted under the placement portion and public portion are pari passu in all respects, the company may have a new date of allotment, which should be deemed as the date of allotment for the issue of securities through the book-building process. In case the book runner has exercised option to require the underwriter to pay in advance all money(ies) required to be paid with respect to their underwriting commitment by the 11th day of the closure of the issue, the shares allotted as per the private placement category would be eligible to be listed. In case of under-subscription in the net offer to the public, a spillover to the extent of under-subscription should be permitted from the recumbent portion subject to the condition that preference would be given to individuals investors. In case of under-subscription in the placement portion, spillover would be permitted from the net offer public. The issuer company may pay interest on the application money(ies) till the date of allotment or the deemed date of allotment uniformly to all the applicants. The book runner and other intermediaries should maintain records of the book-building process. The SEBI has the right to inspect such records.

Offer to Public through Book-building Process

An issuer company may make an issue of securities to the public through a prospects in the following manner:

1. 100 per cent of the net offer to the public through the book-building process or
2. 75 per cent of the net offer to the public through the book building process and 25 per cent at the price determined through book building. Reservation or firm allotment to the

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extent of the percentage specified in the relevant SEBI guidelines can be made only to promoters, permanent employees of the issuer company and, in the case of a new company, to the permanent employees of the promoting companies. It can also be made to the shareholders of the promoting companies in the case of a new company and shareholders of group companies in the case of an existing company, either on a competitive basis or on a firm allotment basis.

The issuer company should appoint eligible merchant banker(s) as book runner(s) and their names should be mentioned in the draft prospectus. The issuer company should enter into an agreement with stock exchange(s) which have the requisite system of online offer of securities specifying, inter alia their rights, duties, responsibilities, and obligations. It should also provide for a dispute resolution mechanism between them. However, the company may apply for listing of its securities on a stock exchange other than the one through which it offers its securities to the public through the online system.

The lead merchant banker(s) should act as the lead book runner and the other eligible merchant banker(s) are termed as co-book runners. In case the issuer company appoints more than one book runner, the name of all such book runners who have submitted the due diligence certificate to the SEBI may be mentioned on the front cover page of the prospectus. A disclosure to the effect that "the investor may contact any of such book runners for any complaint pertaining to the issue" should be made in the prospectus after the risk factors.

The primary responsibility of building the books is that of the lead book runner. The book runners may appoint SEBI registered intermediaries who are permitted to carry on activity as 'underwriters' as syndicate member.

The book runner(s)/syndicate members should appoint SEBI-registered brokers of the stock exchange who are financially capable of honoring their commitments arising out of defaults of their clients/investors to accept bids, applications, application money and placing orders with the company. However, in case of Application Supported by Blocked Amount (ASBA), Self Certified Syndicate Banks (SCSBs) should accept and upload details of such applications in electronic bidding system of the stock exchange. The ASBA means an application for subscribing to an issue containing an authorization to block the application money in a bank account. ASCSB is a SEBI-registered banker to an issue offering the services of banking an ASBA and recognized by the SEBI. Such brokers and SCSBs would be considered as 'bidding/collection centres'. They should collect the money from client(s) for every order(s) placed by them. On failure of the investors to pay for the allotted shares, they would have to pay the amount. In case of ASBAs, the SCSBs should follow the procedure specified but the SEBI in this regard. They would be paid a commission/fee by the company for the services and the stock exchange(s) must ensure that the broker(s) do not charge a service fee from their clients/investors.

The draft prospectus containing all the disclosures, as laid down by the SEBI in respect of securities to be offered to the public, should be filed by the lead merchant banker with the SEBI. The total size of the issue should, however, be mentioned in the draft prospectus. The red herring prospectus should disclose either the floor price of the securities offered through it or a price band along with the range within which the price can move. The issuer may, however, not disclose the floor price/price band in red herring prospectus if the same is disclosed in case of (1) initial public offer, (2) further public offer at least two and one working day(s) respectively before the opening of the bid by way of an announcement in all newspapers in which the pre-issue advertisement was released. The announcement should contain the relevant financial ratios, computed for both upper and lower end of the price band and also a statement drawing attention of investors to the section titled Basic of Issue Price in the offer document. However, if the issuer opts not to make the disclosure of the price band/floor price, the following additional disclosures should be made in the red-herring prospectus: (1) a statement that the floor price/

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price band would be disclosed one day in case of further public offer and two working days in case of IPO before the opening of the bid and the investors may be guided in the meantime by the secondary market prices in case of further public offer; (2) names and edition of the newspapers/names of websites, journals, other media where/in which the announcement of the floor price/price band would be made. Where the issuer decides to opt for price band instead of floor price, the lead book runner should ensure compliance with the following conditions:

1. The cap of the price band should not exceed 20 per cent of the floor, that is, cap of the price should be less than, or equal, 120 per cent of the floor price of the band.
2. The price band can be revised during the bidding period. The maximum revision on either side should not exceed 20 per cent. In other words, floor price of the band can move up or down to the extent of 20 per cent of floor of the price band disclosed and the cap of the revised price should be fixed as indicated in (1) above.
3. Any revision in the price band should be widely disseminated by (i) informing the stock exchange, (ii) issuing press releases and (iii) indicating the change on the relevant website and the terminals of the syndicate member.
4. The bidding period should be extended by 3 days subject to a maximum of bidding period of 13 days.
5. The manner in which the shortfall in the project financing resulting from lowering of price band to the extent of 20 per cent would be met should be disclosed. It should also be disclosed that allotment would not be made unless the financing is tied up.

In the case of appointment of more than one lead merchant banker or book runner, the rights, obligations and responsibilities of each should be delineated. If there is under-subscription in an issue, the shortfall would have to be made good by the book runner(s) to the issue and the same should be incorporated in the inter se allocation of responsibility given by SEBI regulations.

The pre-issue obligations of the lead merchant banker and disclosure requirements as specified earlier, would be applicable to the issue of securities through book-building unless stated otherwise. The book runner(s) and the issuer company should determine the issue price based on the bids received through 'syndicate members' and the SCSBs.

On determination of the price, the number of securities to be offered should be determined (issue size divided by the price that has been determined). Once the final price (cut-off price) is determined, all those bidders whose bids have been found to be successful (i.e. at and above the final price or cut-off price) would be entitled for the allotment of securities. On determination of the entitlement, the information regarding the same (i.e. the number of securities to which the investor becomes entitled) should be intimated immediately to the investors. No incentive, in cash or kind, should be paid to the investors who have become entitled for the allotment of securities. The broker may collect up to 100 per cent of the application money as margin money from the clients/investors before he places and order on their behalf. The margin collected from categories other than QIBs should be uniform across the book runner(s)/syndicate member(s)/ SCSBs for each such category. The broker/syndicate member should collect not less than 10 per cent of the application money as margin money in respect of bids placed by the QIBs. Bids for securities beyond the investment limits prescribed under relevant laws should not be accepted by the syndicate members/brokers from any category of clients/investors. The lead book runner may reject a bid placed by a QIB at the time of acceptance of the bid. The reasons for rejection should be disclosed to the bidder(s) and included in the offer document. On determination of the entitlement, the number of securities to which the investor becomes entitled should be immediately intimated to him. The final prospectus containing all disclosures as per the relevant SEBI guidelines, including the price and the number of securities proposed to be issued, should be filed with the ROCs. The issuer should arrange for the collection of the applications from all

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the mandatory collection centres as per the relevant SEBI guidelines. The bidding terminals should contain an online graphical display of demand/bid prices updated at periodic intervals not exceeding 30 minutes. The lead manager should ensure the availability of adequate infrastructure with syndicate members for data entry of the bids in a timely manner. The investors who had not participated in the bidding process or have not received information of entitlement of securities may also apply.

Additional Disclosures

Apart from meeting the disclosure requirements as specified in the guidelines discussed earlier, the following disclosures should also be suitably made:

1. The particulars of syndicate members, brokers, SCSBs, registrars, bankers to the issue and so

   The following statement under the "basis for issue price":

   (i) "The issue price has been determined by the issuer in constitution with the book runner(s),

   (ii) the basis of the assessment of market demand for the offered securities by way of building".

2. The following accounting ratios should be given under the basis for issue price for each of accounting periods for which the financial information is given:

   (i) EPS, pre-issue for the last 3 years (as adjusted for changes in capital),

   (ii) P/E pre-issue

   (iii) Average return on net worth in the last 3 years,

   (iv) Net asset value per share based on last balance sheet,

   (v) Comparison of all the above accounting ratios of the issuer company with industry average and those of the peer group, that is, companies of comparable size in the industry. The source from which industry average and accounting ratios of the peer has been taken should also be indicated.

   (vi) The accounting ratios disclosed in the offer document should be calculated after effect to the consequent increase of capital on account of compulsory conversions standing, as well as on the assumption that the options outstanding to subscribe for additional capital would be exercised.

3. The proposed manner of allocation among respective categories of investors in the event of under-subscription.

Task How is price determined under this method?

5.3.8 Green Shoe Option

A Company making an initial public offer of equity shares can avail of the Green Shoe Option (GSO) for stabilizing the post-listing price of its shares. The GSO means an option of allocation of shares in excess of the shares included in the public issue and operating a post-listing price stabilizing mechanism through a Stabilizing Agent (SA). The concerned issuing company should seek authorization for the possibility. If allotment of further issues to the SA at the end of the

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stabilization period together with the authorization for the public issue in the general meeting of its shareholders. It should appoint one of the merchant bankers/book runners from amongst the issue management team as the SA who would be responsible for the price stabilization process. The SA should enter into an agreement with the issuer company, prior to the filing of the offer document with SEBI, clearly stating all the terms conditions relating to GSO including fees charged expenses to be incurred by him for this purpose. He should also enter into an agreement with the promoter(s) or pre-issue shareholders who would lend their shares, specifying the maximum number of shares that may be borrowed from them, but in no case exceeding 15 per cent of the total issue size. The details of these two agreements should be disclosed in the draft prospects, draft red herring prospectus, red herring prospectus and the final prospectus. They should also be included as material documents for public inspection. The lead book runner or the lead merchant banker in consultation with the SA, would determine the amount of shares to be over-allotted with the public issue within the ceiling specified above (i.e. 15 per cent of the issue size). Over-allotment refers to an allocation of shares in excess of the size of the public issue made by the SA out of shares borrowed from promoters in pursuance of a GSO exercised by the issuing company.

The draft prospectus draft red herring/red herring prospectus/final prospects should contain the following additional disclosures:

1. Name of the Stabilizing Agent (SA).
2. Maximum number of shares as well as the percentage of the proposed issue size.
3. Period for which the company proposes to avail of the stabilization mechanism.
4. Maximum amount of funds to be received by the company in case of further allotment and the use of these additional funds in final document to be filed with the ROCs.
5. Details of the agreement/arrangement between the SA and the promoters to borrow shares including, inter alia, (i) name of promoters, (ii) their existing shareholding, (iii) number and percentage of shares to be lent by them, (iv) rights/obligations of each party and so on.
6. The final prospectus should additionally disclose the exact number of shares to be allotted pursuant to the public issue, stating separately the number of shares to be borrowed from promoters and over-allotted by the SA and their percentage in relation to the total issue size.

In case of an IPO by an unlisted company/public issue by a listed company, the promoters issuing shareholders holding more than 5 per cent shares may lend shares which are in debenture form only. The SA would borrow to the extent of the proposed over-allotment. The allocation of these shares should be on pro rata basis to all the applicants.

The stabilization mechanism would be available for the period disclosed by the company in prospectus up to a maximum of 30 days from the date when the trading permission was granted by the stock exchange(s).

The money received from the applicants against the over-allotment in the GSO should be kept in the GSO bank account (as distinct from the issue account) to be used for the purpose of buying shares from the market during the stabilization period. These shares should be credited to the GSO Demat a Account. They should be returned to the promoters immediately within two working days after close of the stabilization period.

To stabilize the post-listing prices of the shares, the SA would determine the timing of both of them, the quantity to be bought, the prices at which bought and so on. In case the SA does not allot shares to the extent of their over-allotment from the market, the issuer company should allot them to the extent of the shortfall in dematerialized form to the GSO Demat Account within

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five days of closure of the stabilization period. These would be returned to the promoters by the SA in lieu of those borrowed from them and the GSO Demat Account would be closed. The company would be making a final listing application in respect of such shares to all the concerned stock exchanges where the shares allotted in the public issue are listed. The provisions relating to preferential issues are (discussed later) would not be applicable to such allotment. The shares returned to the promoters either case would be subject to the remaining lock-in period.

The SA would remit the issue price (i.e. further shares allotted by the issuer company to the Demat Account) to the company from the GSO bank account. The remaining balance, (net of addition of expenses incurred by the SA, would be transferred to the investor protection fund of concerned stock exchange and the GSO Bank Account would be closed.

The SA should submit a daily report to the stock exchange(s) during the stabilization period, should also submit a final report signed by him/company to the SEBI in the specified form together with (1) a depository statement for the GSO Demat Account for the stabilization period indicating flow of shares into and from the account and (2) an undertaking by the SA and countersigned by depository(ies) in respect of confirmation of location in shares returned to the promoters in lieu of shares borrowed from them for stabilization purposes.

The SA should maintain for at least 3 years from the date of the end of the stabilizing period a register in respect of each issue with GSO, in which he acts as a SA containing the following details: (1) price, date and time of each transactions, (2) promoters and the number of shares borrowed find each and (3) allotments made.

5.3.9 Share Auction For QIBs

The SEBI decided on November 9, 2009 to introduce an additional method of book building for Qualified Institutional Bidders (QIBs). Under this method, bidders will be free to bid at any price above the floor price and allotment would be at differential prices against the current practice of bidding within a price band. Retail investors, however, would be allotted shares at the floor price.

Self-Assessment

Fill in the blanks:

1. The ……function of the primary market facilitates the sale of securities to ultimate investors.
2. In ……through prospectus a public limited company invites the public at large through prospectus to subscribe to the issue of securities.
3. ……..of securities method can be used when a company intends to approach a small number of large individual or institutional investors.
4. …….method involves outright sale of shares enbloc by the company to issue houses or a group of brokers at an agreed price who in turn resell them to the public at large.
5. The lead manager would be responsible for coordination of all the activities among various ……..connected on the issue system.
6. Under OTC method, the company intending to raise funds through OTCE appoints a member of the OTCE as……..
7. In case of an IPO by an …….company/public issue by a ……..company, the promoters issuing shareholders holding more than 5 per cent shares may lend shares which are in debenture form only.

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5.4 Primary Market Intermediaries in India

A number of intermediaries are associated with activities of the primary market in India. They are: Merchant Bankers, Underwriters, Bankers to an Issue, Brokers to an Issue, Registrars and Share Transfer Agents and Debenture Trustees. A brief discussion of tasks and obligations of each of these participants, as per the SEBI guidelines,1 is brought out below:

Merchant Bankers

Merchant bankers in India, akin to 'accepting and issue houses' of the U.K. and 'Investment banks' of the US, offer a package of financial services relating to the issue. According to the SEBI (Merchant Bankers) Regulation Act, 1992, "a merchant banker is any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advisor or rendering corporate advisory service in relation to such 'issue management'.

The SEBI has classified 'merchant bankers' into four categories:

1. ***Category I Merchant Bankers:*** These merchant bankers can act as issue manager, advisor, consultant, underwriter and portfolio manager.
2. ***Category II Merchant Bankers:*** These merchant bankers can act as advisor, consultant, underwriter and portfolio manager. They cannot act as issue manager on their own but can act as co-manager.
3. ***Category III Merchant Bankers:*** These bankers can act as advisor, consultant and underwriter only. They can neither undertake issue management business on their own nor act as co-manager.
4. ***Category IV Merchant Bankers:*** These bankers can merely act as consultant or advisor to an issue of capital.

As per the SEBI guidelines introduced on September 5, 1997, all the merchant bankers below the Category I would stand abolished. The guidelines obligated the merchant bankers functioning below the Category I to upgrade themselves to Category I. Accordingly, the merchant bankers, presently engaged in underwriting, portfolio management, besides issue management, would have to get separate registration as portfolio managers, while underwriting business could be carried on without additional registration.

Tasks and Responsibilities of Merchant Bankers

The SEBI has laid down the following guidelines regarding duties and obligations of the merchant bankers:

1. Merchant bankers shall have to be compulsorily registered with the SEBI. The following conditions have to be fulfilled for registration by the SEBI:
   (a) Merchant bankers must have a minimum net worth of ₹ 5 crores. Those acting only as portfolio managers must have a net worth of ₹ 50 lakhs. Those acting only as underwriters must have a net worth of ₹ 20 lakhs.
   (b) Merchant bankers should have adequate and necessary infrastructure for effective performance of their activities.
   (c) Merchant bankers should have expertise in the areas of finance, law and management and are not involved in any litigation relating to the securities market.

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(d) Every merchant banker shall pay a sum of ₹ 5 lakhs as registration fees within 15 days of receipt of intimation from the SEBI.

2. The merchant banker shall enter into agreement with the issuing company, spelling out their mutual rights, obligations and liabilities pertaining to the issue. A copy of the agreement is to be submitted to the SEBI at least one month before opening of the issue for subscription.

3. The merchant banker will have to undertake a minimum underwriting obligation of 5% of total underwriting commitment or ₹ 25 lakhs; whichever is less, on his own or through its associate.

4. The merchant banker cannot carry on any business other than that of the securities market.

5. The merchant banker is required to submit to the SEBI 'Due Diligence Certificate' at least two weeks before the opening of the issue for subscription. The Certificate has to be given with respect to the following:

   (a) That the documents contains all the details relevant to the issue.

   (b) That all legal requirements pertaining to the issue have been fully compiled with.

   (c) That all disclosures are true, fair and adequate to enable the investors to make a well-informed decision regarding investment in the proposed issue.

   The above certificate should be based on the basis of the verification of the contents of the prospectus/letter of offer regarding the issue and the reasonableness of the views expressed therein.

6. The merchant banker is under obligation to submit to the SEBI various documents relating to the issue, draft prospectus/letter of offer and other literature to be circulated to the investors/shareholders, etc., at least two weeks before the date of filing them with the Registrar of Companies and regional stock exchanges. It has to ensure that all the modifications and suggestions made by the SEBI regarding the above documents have been duly incorporated.

7. The merchant banker shall keep and maintain a copy of balance sheet at the end of each accounting period, profit and loss account for that period, a copy of the auditor's report on the accounts for that period and a statement of financial position. It has to intimate to the Board the place where the books of accounts, records and documents are maintained. Such documents shall have to be preserved for a minimum period of 5 years.

8. The merchant banker shall have to furnish to the Board half-yearly unaudited financial results when required by the SEBI so that the former's capital adequacy is monitored.

9. The merchant banker is required to make disclosure of the following to the SEBI:

   (a) Its responsibilities regarding the management of the issue.

   (b) Any change in the information/particulars previously furnished with the SEBI having a bearing on certificate of registration granted to it.

   (c) Details regarding breach of capital adequacy norms.

   (d) Names and addresses of the companies whose issues it has managed or has been associated with.

   (e) Information pertaining to its activities as manager, underwriter, consultant or advisor to the issue.

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10. The merchant banker shall have to submit to the SEBI complete details of the acquisition of securities of the company whose issue the merchant banker is managing.

The SEBI has laid down codes of conduct which a merchant banker has to observe in the conduct of his business. The codes include observance of high standards of integrity and fairness in its dealings with the client and other merchant bankers, adequate disclosures to the investors about the applicable regulations and guidelines so as to enable them to make a rational decisions, provision of all professional services to the client in a prompt, efficient and cost-effective manner, making available to the investors all the information relating to the issue, copies of prospectus, memorandum and related documents, taking adequate measures for fair allotment of securities and refund of application money without delay, prompt redressal to the grievances of the investors, etc.

Underwriters

A company intending to garner funds from the market is not certain about the availability of the desired quantum of funds through subscription of securities. To ensure the certainty, some sort of institutional arrangement needs to be made whereby the issuing company is given the guarantee of purchase of all unsubscribed securities. This arrangement is akin to insurance that provides protection against the failure of an issue of capital to the public. Such an insurance arrangement to ensure success of the issue is termed as 'underwriting'. Underwriters, therefore, undertake the guarantee of buying the shares placed before the public in the event of non-subscription of the securities. Thus, an issuing company has to enter into an agreement with an underwriter who may be individual or institution for underwriting the issue. The obligation of the underwriter as per the agreement arises when the event of non-subscription of issues by the public takes place.

Underwriting may take different forms depending on nature of the agreement entered into between the issuer and the underwriter. Thus, there may be standby underwriting, outright purchase, joint underwriting, syndicate underwriting and sub-underwriting.

Under standby underwriting, underwriters enter into an agreement with an issuing company to take all such securities as are not subscribed in the market or to buy certain portion of the security issue. This type of underwriting is very popular in India.

In outright purchase, underwriters buy the entire issue outright and make the payment thereof. Thereafter, they arrange to sell them to investors through their own organization. This type of underwriting is very popular in the US.

Joint underwriting takes place where capital issue is large and risk is too high and in such cases, the issuing company approaches more than one underwriter. Each underwriter undertakes to guarantee for the issue of a certain portion of the whole issue offered to the public and thereby shares the risk proportionately.

In syndicate underwriting, a number of underwriters enter into an agreement among themselves to underwrite an issue particularly the one which is quite large and/or potentially risky. Syndicate underwriting seems to be akin to joint underwriting. But actually this is not so. In the case of joint underwriting, underwriters are approached by the issuer for underwriting an issue and no agreement takes place among the underwriters themselves. In contrast, in the case of syndicate underwriting, underwriters enter into a formal agreement among themselves to undertake the guarantee of buying shares of debentures of a public issue.

Sub-underwriting of an issue takes place when an underwriter enters into agreement with some other underwriters to underwrite the whole or part of the issue underwritten by him. In this case, sub-underwriters do not enter into agreement with the 'issuing company'.

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Tasks and Responsibilities of Underwriters

The SEBI has laid down the following guidelines regarding tasks and responsibilities of underwriters:

1. An underwriter is required to get itself registered with the SEBI and procure a certificate of registration for undertaking the business. The SEBI issues the certificate on being satisfied with the following conditions:
   (a) Availability of necessary infrastructure like, sufficient office space, equipments, and manpower to carry out the duties effectively.
   (b) Experience in underwriting or having a minimum of two persons equipped with the underwriting experience.
   (c) Capital adequacy norm of a minimum net worth of ₹ 20 lakhs.
   (d) No conviction of the applicant (director, principal officer or partner) in any offence.
   (e) Underwriting to fulfil obligations under the SEBI Act, rules and regulations.
   (f) Underwriting to abide by the prescribed code of conduct.
   (g) Payment of the prescribed fee of ₹ 2 lakhs for the first and second years for grant of registration certificate and ₹ 20,000 p.a. for its renewal.
2. An underwriter is under obligation to comply with all the formalities with regard to registration with the SEBI, agreement with the issuing company and all other responsibilities as spelt out by the SEBI. These include disclosures in the prospectus and its filing with the Registrar of Companies (ROC) before signing the underwriting agreement with the issuer, ensuring that the prospectus is delivered to the ROC within 30 days of the underwriting agreement or within such an extended time as approved by the underwriter in writing, subject to the limits within the law, complying with any additional disclosures that may be made in the interests of investors or stipulated by SEBI/lead managers.
3. An underwriter cannot take up total underwriting obligations, at any point of time, under all underwriting agreements, exceeding 20 times its net worth.
4. An underwriter will have to subscribe to securities under the agreement within 45 days of the receipt of intimation from the issuing company.
5. An underwriter is required to observe codes of conduct which the SEBI has prescribed in respect of the conduct of the business. The codes include observing high standards of integrity and fairness in the conduct of the business, undertaking all efforts to protect the interest of its clients, rendering high standards of service, exercising due diligence and ensuring proper care and exercise of independent professional judgement, not making untrue statement or suppressing any material fact in any documents, reports, papers or information furnished to the SEBI, and not deriving any other direct or indirect benefit from underwriting the issue except receiving the underwriting commission at the agreed rate, the ceiling for which is 5% in case of underwriting of shares and 2.5% in case of debentures.

Bankers to an Issue

Bankers represent an important segment of Indian primary market. They carry out the function of accepting applications and application moneys from investors in respect of securities and refunding of application money to the applicants to whom securities could not be allotted. They also participate in the payment of dividends by companies.

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Tasks and Responsibilities of Bankers to an Issue

The following guidelines with respect to duties and responsibilities of bankers to an issue have been laid down by the SEBI:

1. A banker intending to act as banker to an issue can do so by getting itself registered with the SEBI and obtaining a certificate of registration to that effect. The SEBI issues the certificate on being satisfied about the availability of the necessary infrastructure, communication and data processing facilities with the applicant and the adequacy of manpower to effectively perform activities relating to the issue.
2. An annual registration fee of ₹ 2.5 lakh for the first two years from the date of initial registration and ₹ 1 lakh for the third year has to be paid by the banker to an issue to the SEBI. The renewal fees are ₹ 1 lakh annually for the first two years and ₹ 20,000 for the third year.
3. A banker is required to enter into an agreement with the issuing company, specifying number of centres at which applicants from investors will be collected and the time within which statements regarding applications and money received will be sent to the registrars to the issue by the designated branches of the banker to the issue.
4. A banker to the issue has to maintain books of accounts, records and documents for a minimum period of at least 3 years regarding number of applications, names of investors, time within which applications received were forwarded to the issuing company/registrar to the issue and dates and amount of refund to investors.
5. A banker to the issue is required to furnish to the SEBI detailed information pertaining to number of applications received, number of issues for which he acted as banker to the issue, the dates on which applications from investors were forwarded to the issuing company/registrar to the issue and amount of refund to investors.
6. A banker to the issue has to observe all the codes of conduct ordained by the SEBI for the merchant bankers and underwriters. Besides, it has to adhere to the following norms laid down by the SEBI:
   (a) Make all efforts to protect the interests of investors;
   (b) Observe high standards of integrity and fairness in the conduct of the business;
   (c) Exercise due diligence, ensure proper care and exercise independent professional judgement;
   (d) Not to keep blank application forms bearing broker's stamp at the bank premises or at the entrance of the bank;
   (e) Not to accept applications after office hours, on bank holidays or after the date of the closure of the issue;
   (f) Not to act any time in collusion with other agents in a manner detrimental to the interest of small investors; and
   (g) Abide by all acts, rules, regulations, notifications, directions, circulars, instructions and guidelines issued by the Government, the RBI, Indian Banks' Association and SEBI that are relevant to his operation as banker to an issue.

Brokers to an Issue

Brokers to an issue represent intermediaries who are concerned with procuring the subscription to the issue from prospective investors across the country. In this way, they serve as a vital link

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between the issuer and the prospective investors and assist in speedy subscription of the issue by the public.

An issuing company can appoint as many number of brokers as it wants provided the stock exchange of which the issuer is a member permits and the listing requirements are fulfilled. A copy of the consent letter should be filed with the Registrar of Companies along with a copy of the prospectus stating the names and addresses of the brokers to the issue.

The brokers to the issue must be endowed with the expertise, professional competence and must be honest so as to be able to carry out the various functions of an issue.

The issuing company has to pay brokerage according to the provisions of the Companies Act and rules and regulations the agreement between the brokers and the company and guidelines prescribed by the SEBI. Maximum brokerage rate, applicable to all types of industrial securities, whether underwritten or not, is 1.5 percent. The brokers will have to meet all mailing costs, canvassing expenses and all other out-of-pocket expenses relating to the subscription of the issue out of their brokerage. On private placement, the listed company can pay brokerage at the maximum rate of 0.5%.

Registrar to an Issue and Transfer Agent

Registrar and transfer agent are the two categories of intermediaries who actively participate in the new issue activity of a company. The Registrar performs the functions of collecting applications from prospective investors, keeping a record of the applications and moneys received from the investors, assisting the issuing company in the determination of the basis of allotment of securities, processing and dispatching of allotment letters and refund orders, share and debenture certificates and other documents related to the issue and acting as Depository Participants (DPs).

Transfer Agent, on the other hand, carries out the activities, such as maintaining the records of holders of securities of the company for and on behalf of the company, handling all matters relating to transfer and redemption of securities of the company and acting as Depository Participants (DPs).

Tasks and Responsibilities of Registrar and Transfer Agent

The SEBI has prescribed the following rules regarding duties and responsibilities of registrar and transfer agent:

1. Both registrar and transfer agent have to obtain certificate of registration from the SEBI. The SEBI issues the certificate on being satisfied about their ability to perform their functions efficiently and honestly, adequacy of their infrastructure and capital. Capital adequacy norm for Category I registrar (one who acts as registrar to an issue and transfer agent) is ₹ 6,00,000 and for Category II registrar (one who acts as registrar or as a transfer agent) ₹ 3,00,000. An annual fee of ₹ 50,000 and ₹ 30,000 has to be paid for initial registration by Category I and Category II Registrars, respectively. Renewal fee for every 3 years for Category I registrar is ₹ 40,000 and for Category II registrar ₹ 25,000.
2. The registrar and transfer agent are required to maintain for a minimum period of 3 years records, books and documents containing details about the issue, rejected applications together with the reasons for rejection, basis of allotment, terms and conditions of purchase of securities, allotment of securities, list of allottees and non-allottees, names of transferors and transferees and the dates of transfer of securities. They have to provide for periodic reporting to and inspection by the SEBI.

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3. Registrar and transfer agent are under obligation to observe various codes of conduct prescribed by the SEBI for merchant bankers and underwriters. Alongside this, they have to ensure that enquiries from investors are promptly dealt with and adequate steps are taken for proper allotment of securities and quickly refund of excess application money as per law.

Debenture Trustees

A company contemplating to issue debentures to raise long-term funds from the market has to appoint a trustee to safeguard the interests of the debenture holders. The following may be appointed as debenture trustee:

1. A scheduled bank, or
2. A public financial institution, as defined in Section 4A of the Companies Act, 1956, or
3. An insurance company, or
4. A body corporate.

Tasks and Responsibilities of Debenture Trustees

The SEBI has laid down the following guidelines with respect to tasks and responsibilities of debenture trustees:

1. A debenture trustee must get certificate of registration from the SEBI for acting as trustee. The SEBI issues the certificate on being satisfied about the adequacy of the infrastructure of the applicant, its expertise and experience and professional qualification for a debenture trustee from an institution recognized by the government in finance, accountancy, law or business management.
2. A debenture trustee must accord consent in writing to the body corporate to act as debenture trustee before the debenture trustee.
3. A debenture trustee shall take possession of the trust property as per provisions of the Deed.
4. A debenture trustee shall carry out inspection of books of accounts/records/documents and registers and trust property.
5. A debenture trustee shall enforce security in the interest of debenture holders.
6. A debenture trustee shall have to abide by various codes of conduct issued by the SEBI on 1-10-2003. Important among these codes are:
   (a) Make all efforts to protect the interests of debenture holders;
   (b) Maintain high standards of integrity, dignity and fairness in the conduct of the business;
   (c) Fulfil its obligations in a prompt, ethical and professional manner;
   (d) Exercise due diligence, care and independent professional judgement;
   (e) Avoid conflict of interest and make adequate disclosure of its interest;
   (f) Put in place a mechanism to resolve any conflict of interest;
   (g) Not indulge in any unfair competition, which is likely to harm the interest of other trustees or debenture holders;

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(h) Ensure full and adequate disclosures to the debenture holders so as to enable them to make a balanced and informed decision;

(i) Not to make untrue statement or suppress any material fact in any documents, reports, or information furnished to the SEBI; and

(j) Ensure that good corporate policies and corporate governance is in place.

Did u know? The Role of the SEBI in Primary Market

The SEBI plays a crucial role in the effective functioning of the primary market in the country. This it seeks to do in following ways:

1. Prescribing detailed guidelines with respect to various methods that can be adopted by a company to sell its securities;
2. Laying down comprehensive rules with respect to duties and responsibilities of various players of the primary market;
3. Prescribing exhaustive codes of conduct for different players of the primary market for protecting interests of the investors;
4. Conducting the inspection of the working of different intermediaries of the primary market so as to ensure that the relevant books of accounts, other records and documents are maintained properly as per the rules;
5. Suspending the certificate of registration granted to the intermediary in case of violation of the provisions of the SEBI Act, and rules, not observing the prescribed codes of conduct, failure to furnish information relating to his business as required by the Board, non-submission of reports as required by the Board, indulging in manipulating or price rigging or cornering activities, guilty of misconduct or improper or unbusinesslike or unprofessional conduct, failure to pay the fees and violation of the conditions subject to which the certificate of registration granted to the intermediary.

Self Assessment

Fill in the blanks:

8. ……means a process 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.
9. Merchant bankers must have a minimum net worth of ₹……
10. In ……underwriting, a number of underwriters enter into an agreement among themselves to underwrite an issue particularly the one which is quite large and/or potentially risky
11. ……represent intermediaries who are concerned with procuring the subscription to the issue from prospective investors across the country.
12. A company contemplating to issue debentures to raise ……from the market has to appoint a trustee to safeguard the interests of the debenture holders.
13. A ……..trustee must get certificate of registration from the SEBI for acting as trustee.

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14. ……..carries out the activities, such as maintaining the records of holders of securities of the company for and on behalf of the company.

15. ……..and transfer agent are the two categories of intermediaries who actively participate in the new issue activity of a company.

5.5 Summary

- Primary market of a country renders three major services: investigating and processing of proposals for new issues, underwriting of new security issues and distribution of new securities to ultimate investors. These functions are carried out by specialized agencies like financial institutions, brokers and dealers in securities.
- There are various methods of selling securities, viz., public issue through prospectus, offer for sale, private placement, right issue, over-the-counter-placement, stock option and book building.
- A host of players participate in the activities of the primary market in India. They are merchant brokers, underwriters, bankers to the issue, brokers to the issue, registrars and share transfer agencies and debenture trustees. These players can carry on their business after getting Certificate of registration from the SEBI. The SEBI has laid down comprehensive rules defining duties and responsibilities of each of these players and codes for conduct in their business. Violation of rules and failure to observe codes may lead to suspension of their business.
- The SEBI plays a vital role in the effective functioning of the primary market in India by formulating comprehensive rules regarding issue of new securities, defining duties and responsibilities of various players of the market, and conducting the inspection of the working of these players.

5.6 Keywords

Book-building means a process 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.

Brokers to an issue: Represent intermediaries who are concerned with procuring the subscription to the issue from prospective investors across the country.

Green-shoe Option: Means an option of allocation of shares in excess of the shares included in the public issue and operating a post-listing price stabilizing mechanism through a Stabilizing Agent (SA).

Merchant banker: Is any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advisor or rendering corporate advisory service in relation to such 'issue management'.

Qualified Institutional Bidders: Under this method, bidders will be free to bid at any price above the floor price and allotment would be at differential prices against the current practice of bidding within a price band.

5.7 Review Questions

1. Outline major functions of the primary market in India.
2. Discuss, in brief, about the agencies associated with activities of primary market in India.

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3. What are the various methods used in India for selling securities?
4. What is book-building?

Answers to Self Assessment

1. Distribution
2. Public issue
3. Direct selling
4. Offer for sale
5. Intermediaries
6. Sponsor
7. Unlisted/listed
8. Book-building
9. 5 crores
10. Syndicate
11. Brokers to an issue
12. long-term funds
13. debenture
14. Transfer Agent
15. Registrar

5.8 Further Readings

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Unit 6: Secondary Market

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Objectives

After studying this unit, you should be able to:

- Learn the concept of secondary market;
- Explain the objectives and functions of secondary market;
- Discuss the concept of stock exchange;
- Explain trading and settlement;
- Understand role of NSCCL.

Introduction

Secondary market is a market where the sale of previously issued securities takes place. Thus, secondary market provides a trading platform for the already issued securities of governments, semi-governments and firms. It is a two-way market in which the investors and stockbrokers are just as likely to be sellers as buyers.

The redeeming features of the secondary markets are:

1. A secondary market is a market for already existing long-term securities of governments, semi-governments and corporate enterprise. This market exists only if someone creates it.

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There are two types of market creators-dealers and brokers. Dealers stand ready to buy and sell at quoted prices. They hold on to the securities until someone else comes along wishing to buy them. In contrast, brokers do not themselves buy or sell the securities. They, instead of buying the securities, would find someone willing to buy them.

2. The secondary market can be wholesale and retail. The wholesale market is the market in which professionals, including institutional investors trade with one another. Transactions in this market are usually large. The retail market is the market in which the individual investors buy and sell securities.

3. Exchanges in the wholesale secondary market for capital securities may take place in either of the two markets, viz., Over-The Counter market (OTC) and organized exchange market. Where the organisation is more structured and communication is often face-to-face, the market is known as an organised exchange. Generally, the secondary market for government securities is an OTC market, and that the secondary market for corporate equities consists of both OTC markets and exchanges. The wholesale market for bonds in the US is principally an OTC market; fewer than 10% of all issues traded in the stock exchanges.

   Thus, an organised exchange market is characterised as auction market that uses floor traders who specialise in particular stocks. Exchange rules govern trading to ensure the efficient and legal operation of the exchange and the exchange board constantly reviews these rules to ensure that they result in competitive trading. In about 90% of trades, the specialist matches buyers with sellers. In the other 10%, the specialist may intervene by taking ownership of the stock themselves or by selling stock from inventory.

Notes Unlike organised exchanges, OTC markets have market makers. Rather than trading stocks in an auction format, they trade on an electronic network where bid and ask prices are set by market makers.

4. In the secondary market, only those securities, which are listed in the stock exchanges, are traded. Unlisted securities are not permitted to be dealt in the market.

5. Transactions in the secondary market must accord to the rules and bylaws framed by the stock exchange to regulate its day-to-day operations.

6.1 Objectives and Functions of Secondary Market

The primary objectives of a secondary market are to provide marketability to existing securities and to facilitate the acquisition of capital by corporate enterprises. In order to accomplish these objectives, the secondary market performs the following functions:

1. ***To provide for a regular market:*** The secondary market provides for a ready and continuous market where those desiring to deal in securities assemble to buy and sell securities during the business hour. This enables investors to liquidate their investments quickly and with the least possible loss. High marketability of securities enhances their value and facilitates the use of these securities as collateral for loan.

2. ***To provide stability in prices of securities:*** Through the mechanism of regular purchase and sale of securities, the secondary market ensures continuity and stability in share price which is an essential requirement of liquidity. Bulls, bears and stock brokers operating in the market deal in securities with extreme the expected changes in security prices and buy or sell securities accordingly to take price advantage. For instance, speculators expecting

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rise in share prices in future buys shares at lower prices in the present and disposes them off in future. This results in gradual rise in prices and avoids violent fluctuations in share prices. Thus, regular transactions in securities prevent sharp movement in prices unless warranted by economic and political developments in the country and abroad. Stockbrokers render useful services in equalising prices of securities of different markets. They make heavy buying in the market where share prices are ruling low and thereby increase pressure of demand of securities which would in consequence raise share prices. Where share prices are high, the stockbrokers tend to depress the rise by sale of securities substantially.

3. ***Regular valuation of securities:*** Another redeeming function of the secondary market is to provide mechanism to evaluate securities properly. For proper valuation of securities, the market provides such an economic machinery which could produce prices of securities as close as possible to investment value based on present and future income yielding prospects of various enterprises capitalised at notional rate of interest, i.e., the rate that will prevail if and when all the liquid savings are employed into productive avenues. This can be achieved by intelligent anticipation of future income yielding prospects of various enterprises and notional rate of interest. A well-developed secondary market disseminates full information about listed companies to attract a large number of informed buyers and sellers from all walks of life and to arouse keen competition among them resulting in the establishment of fairest possible price.

4. ***To provide safety in dealings:*** A well-organised and regulated secondary market ensures a greater measure of safety and fair dealings to the average investors because transactions are made publicly under well-defined rules, regulations and bylaws of the exchange. For any malpractice, or for not observing the exchange rules, the member broker is severely dealt with by the stock exchange. A listed company is required to make a continuous disclosure of all material information for the benefits of the investors.

5. ***To ensure wide ownership of securities:*** A secondary market ensures wider distribution of securities. If a company's securities are listed in different stock markets of the country, its securities will be bought and sold by persons spread across the country and ownership of securities is widely diffused. Broad ownership also safeguards the corporate sector from government interference and protects genuine security markets from dominance by large institutions and government bodies.

6.2 Importance of Secondary Market

In view of the above functions, the secondary market plays crucial role in economic and industrial development of a country through promoting capital formation and efficient allocation of capital. Secondary market promotes capital formation by assisting in the effective mobilisation of savings and their canalisation into appropriate avenue of investment. It does by providing an organized market in diverse types of securities to suit the varying notions and whims of a vast mass of savers about liquidity, profitability and risk element in their investments. The opportunity of constant evaluation of returns on one's investment compared to others, the liquidity that is imported to investment in fixed capital and price continuity that it ensures, instill confidence in the minds of savers. On the other hand, by creating conditions which reasonably ensure availability of financial resources for creating real capital, whether in private or public sector, they give impetus to development.

A secondary market increases economic efficiency. An organised exchange helps allocate capital more efficiently by establishing fair prices for securities and by minimising the costs of buying and selling them. A secondary market also helps in directing flow of savings into promising

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industries and checks the flow of capital in uneconomic and less profitable ventures. This, the secondary market seeks to achieve through keeping an eye on the exchanges. A permanent surge in share price of a particular industry suggests that more capital can be absorbed by the industry with the advantage. On the contrary, if share price in an industry registers continued fall, it suggests that the industry cannot absorb the capital profitably. Through price mechanism, the secondary market prevents gluts and scarcities of capital as between different industries and avoids misalignments between supply of capital and the demands of industry and effects economies in the use of capital.

In underdeveloped economies, not only is the volume of savings low but a large part of it is dissipated in conspicuous consumption and in hoards because of the lack of knowledge investment opportunities, high liquidity preference and other non-economic forces. The secondary market promotes conditions which take care of some of these inhibiting factors. It offers a ready market for conversion of securities into cash and thereby encourages investment and discourages hoarding. Again, its widely published operations and price quotations bring home to the savers various productive and desirable opportunities of investment.

The secondary market also facilitates an investor to shift from one type of investment to another according to his investment priorities without any significant depreciation in its real value. Accordingly, an investor does not get tied for the better or for the worse, to the particular enterprise whose shares he buys. It is this assurance that he does not have to sink or swim with it that makes him willing to venture into investment. Further, by widening the opportunities for investment, a secondary market enables investors to spread their risk by acquiring securities of different industries, and in varying proportions, which is an essential concomitant to modern investment.

A secondary market helps promote 'democratic capitalism'. By distributing the ownership of securities more widely among the public, a securities market ensures that the ownership of business is not confined to a small number of wealthy families or to big industrial-financial conglomerates.

An efficient secondary market makes access to international capital easier. Foreign investors - both direct and portfolio investors - will be encouraged to invest because of their strong preference for investment in countries where their funds are complementing, rather than replacing, domestic savings.

Thus, secondary markets serve the nation in several ways through their multifarious services. However, to many people, the secondary market is inseparately associated with speculation with a word that carries with it a cluster of anti-social implications and monstrously perverts its functions and advantages. There is no denying fact that unscrupulous and unbridled speculations breed all sorts of misfortunes. But genuine speculations, which enable the stock exchange to render the services, stated above, need not be discouraged. As such, while the significance of the secondary market need not belittled, it must always be subject to the maintenance of normally conducive conditions and effective check over unscrupulous speculation.

It is important to note that both the segments of the capital market are equally important while not being mutually exclusive. Only when a country's primary market is alive, is it possible to ensure a good deal of activity in the secondary market because it is the primary market which will ensure a continuous flow of securities to the secondary market, more so in developing economies. Looking from the other angle, if a country's secondary market is only active but not transparent and disciplined, the cult of equity and related investment in the primary market will be difficult to be continuously developed and sustained because the liquidity which the secondary markets impart to such investment in the hands of the investors will be adversely affected.

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6.3 Stock Market

Stock exchange is the term commonly used for a secondary market, which provide a place where different types of existing securities such as shares, debentures and bonds, government securities can be bought and sold on a regular basis. A stock exchange is generally organised as an association, a society or a company with a limited number of members. It is open only to these members who act as brokers for the buyers and sellers. The Securities Contracts (Regulation) Act has defined stock exchange as an "association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in securities".

The main characteristics of a stock exchange are:

1. It is an organised market.
2. It provides a place where existing and approved securities can be bought and sold easily.
3. In a stock exchange, transactions take place between its members or their authorised agents.
4. All transactions are regulated by rules and by laws of the concerned stock exchange.
5. It makes complete information available to public in regard to prices and volume of transactions taking place every day.

It may be noted that all securities are not permitted to be traded on a recognised stock exchange. It is allowed only in those securities (called listed securities) that have been duly approved for the purpose by the stock exchange authorities. The method of trading nowadays, however, is quite simple on account of the availability of on-line trading facility with the help of computers. It is also quite fast as it takes just a few minutes to strike a deal through the brokers who may be available close by. Similarly, on account of the system of scrip-less trading and rolling settlement, the delivery of securities and the payment of amount involved also take very little time, say, 2 days.

6.3.1 Functions of a Stock Exchange

The functions of stock exchange can be enumerated as follows:

1. ***Provides ready and continuous market:*** By providing a place where listed securities can be bought and sold regularly and conveniently, a stock exchange ensures a ready and continuous market for various shares, debentures, bonds and government securities. This lends a high degree of liquidity to holdings in these securities as the investor can encash their holdings as and when they want.
2. ***Provides information about prices and sales:*** A stock exchange maintains complete record of all transactions taking place in different securities every day and supplies regular information on their prices and sales volumes to press and other media. In fact, nowadays, you can get information about minute to minute movement in prices of selected shares on TV channels like CNBC, Zee News, NDTV and Headlines Today. This enables the investors in taking quick decisions on purchase and sale of securities in which they are interested. Not only that, such information helps them in ascertaining the trend in prices and the worth of their holdings. This enables them to seek bank loans, if required.
3. ***Provides safety to dealings and investment:*** Transactions on the stock exchange are conducted only amongst its members with adequate transparency and in strict conformity to its rules and regulations which include the procedure and timings of delivery and payment to be followed. This provides a high degree of safety to dealings at the stock

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exchange. There is little risk of loss on account of non-payment or nondelivery. Securities and Exchange Board of India (SEBI) also regulates the business in stock exchanges in India and the working of the stock brokers. Not only that, a stock exchange allows trading only in securities that have been listed with it; and for listing any security, it satisfies itself about the genuineness and soundness of the company and provides for disclosure of certain information on regular basis. Though this may not guarantee the soundness and profitability of the company, it does provide some assurance on their genuineness and enables them to keep track of their progress.

4. ***Helps in mobilisation of savings and capital formation:*** Efficient functioning of stock market creates a conducive climate for an active and growing primary market. Good performance and outlook for shares in the stock exchanges imparts buoyancy to the new issue market, which helps in mobilising savings for investment in industrial and commercial establishments. Not only that, the stock exchanges provide liquidity and profitability to dealings and investments in shares and debentures. It also educates people on where and how to invest their savings to get a fair return. This encourages the habit of saving, investment and risk-taking among the common people. Thus it helps mobilising surplus savings for investment in corporate and government securities and contributes to capital formation.

5. ***Barometer of economic and business conditions:*** Stock exchanges reflect the changing conditions of economic health of a country, as the shares prices are highly sensitive to changing economic, social and political conditions. It is observed that during the periods of economic prosperity, the share prices tend to rise. Conversely, prices tend to fall when there is economic stagnation and the business activities slow down as a result of depressions. Thus, the intensity of trading at stock exchanges and the corresponding rise on fall in the prices of securities reflects the investors' assessment of the economic and business conditions in a country, and acts as the barometer which indicates the general conditions of the atmosphere of business.

6. ***Better Allocation of funds:*** As a result of stock market transactions, funds flow from the less profitable to more profitable enterprises and they avail of the greater potential for growth. Financial resources of the economy are thus better allocated.

6.3.2 Advantages of Stock Exchanges

Having discussed the functions of stock exchanges, let us look at the advantages which can be outlined from the point of view of (a) Companies, (b) Investors, and (c) the Society as a whole.

1. ***To the Companies:***

   (i) The companies whose securities have been listed on a stock exchange enjoy a better goodwill and credit-standing than other companies because they are supposed to be financially sound.

   (ii) The market for their securities is enlarged as the investors all over the world become aware of such securities and have an opportunity to invest.

   (iii) As a result of enhanced goodwill and higher demand, the value of their securities increases and their bargaining power in collective ventures, mergers, etc. is enhanced.

   (iv) The companies have the convenience to decide upon the size, price and timing of the issue.

2. ***To the Investors:***

   (i) The investors enjoy the ready availability of facility and convenience of buying and selling the securities at will and at an opportune time.

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(ii) Because of the assured safety in dealings at the stock exchange the investors are free from any anxiety about the delivery and payment problems.

(iii) Availability of regular information on prices of securities traded at the stock exchanges helps them in deciding on the timing of their purchase and sale.

(iv) It becomes easier for them to raise loans from banks against their holdings in securities traded at the stock exchange because banks prefer them as collateral on account of their liquidity and convenient valuation.

3. ***To the Society:***

(i) The availability of lucrative avenues of investment and the liquidity thereof induces people to save and invest in long-term securities. This leads to increased capital formation in the country.

(ii) The facility for convenient purchase and sale of securities at the stock exchange provides support to new issue market. This helps in promotion and expansion of industrial activity, which in turn contributes, to increase in the rate of industrial growth.

(iii) The Stock exchanges facilitate realisation of financial resources to more profitable and growing industrial units where investors can easily increase their investment substantially.

(iv) The volume of activity at the stock exchanges and the movement of share prices reflect the changing economic health.

6.3.3 Speculations in Stock Exchange

The buyers and sellers at the stock exchange undertake two types of operations, one for speculation and the other for investment. Those who buy securities primarily to earn a regular income from such investment and possibly make some long-term gain on account of price rise in future are called investors. They take delivery of the securities and make full payment of the price. Such transactions are called investment transactions.

Rolling Settlement: Earlier trading in the stock exchange was held face-to-face (called pit-trading) without the use of computers and the advanced computer software as it is today. In those times, transactions were settled (i.e., actual delivery of shares, through share certificates, by the seller and payment of money by the buyer) in the stock exchange, only on a fixed day of the week, say on a Saturday, or a Wednesday irrespective of which day of the week the shares were bought and sold. This was called 'Fixed Settlement'.

Today, with the electronic / computer based system of recording and carrying out of share transactions, stock exchanges go in for 'rolling settlement'. That means, transaction are settled after a fixed number of days of the transaction rather than on a particular day of the week. For example, if a stock exchange goes in for 'T+2' days of rolling settlement, the transaction is settled within two working days of occurring of the transaction, 'T' being the day of the transaction. In T+7' days of rolling settlement, the transaction is settled on the 7th day after the transaction. This is facilitated through electronic transfer of shares, through Dematerialised Account or Demat Account i.e., the share does not have a physical form of a paper document, but is a computerised record of a person holding a share, and through transfer of money electronically or through cheques payment is settled.

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But, when the securities are bought with the sole object of selling them in future at higherprices or these are sold now with the intention of buying at a lower price in future, are called speculation transactions. The main objective of such transactions is to take advantage of price differential at different times. The stock exchange also provides for settlement of such transactions even by receiving or paying, as the case may be, just the difference in prices. For example, Rashmi bought 200 shares of Moser Baer Ltd. at ₹ 210 per share and sold them at ₹ 235 per share. He does not take and give delivery of the shares but settles the transactions by receiving the difference in prices amounting to ₹ 5,000 minus brokerage. In another case, Mohit bought 200 shares of Seshasayee Papers Ltd. at ₹ 87 per share and sold them at ₹ 69 per share. He settles these transactions by simply paying the difference amounting to ₹ 3600 plus brokerage. However, nowadays stock exchanges have a system of rolling settlement. Such facility is limited only to transactions of purchase and sale made on the same day, as no carry forward is allowed.

Though speculation and investment are different in some respects, in practice it is difficult to say who is a genuine investor and who is a pure speculator. Sometimes even a person who has purchased the shares as a long-term investment may suddenly decide to sell to reap the benefit if the price of the share goes up too high or do it to avoid heavy loss if the prices starts declining steeply. But he cannot be called a speculator because his basic intention has been to invest. It is only when a person's basic intention is to take advantage of a change in prices, and not to invest, then the transaction may be termed as speculation. In strict technical terms, however, the transaction is regarded as speculative only if it is settled by receiving or paying the difference in prices without involving the delivery of securities. It is so because, in practice, it is quite difficult to ascertain the intention. Some people regard speculation as nothing but gambling and consider it as an evil. But it is not true because while speculation is based on foresight and hard calculation, gambling is a kind of blind and reckless activity involving high degree of chance element. No only that, speculation is a legal activity duly recognised as a prerequisite for the success of stock exchange operations while gambling is regarded as an evil and a punishable activity. However, reckless speculation may take the form of gambling and should be avoided.

6.3.4 Stock Exchanges in India

The first organised stock exchange in India was started in Mumbai known as Bombay Stock Exchange (BSE). It was followed by Ahmedabad Stock Exchange in 1894 and Kolkata Stock Exchange in 1908. The number of stock exchanges in India went up to 7 by 1939 and it increased to 21 by 1945 on account of heavy speculation activity during Second World War. A number of unorganised stock exchanges also functioned in the country without any formal setup and were known as kerb market. The Securities Contracts (Regulation) Act was passed in 1956 for recognition and regulation of Stock Exchanges in India. At present we have 23 stock exchanges in the country. Of these, the most prominent stock exchange that came up is National Stock Exchange (NSE). It is also based in Mumbai and was promoted by the leading financial institutions in India. It was incorporated in 1992 and commenced operations in 1994. This stock exchange has a corporate structure, fully automated screen-based trading and nation-wide coverage.

Another stock exchange that needs special mention is Over The Counter Exchange of India (OTCEI). It was also promoted by the financial institutions like UTI, ICICI, IDBI, IFCI, LIC etc. in September 1992 specially to cater to small and medium sized companies with equity capital of more than ₹ 30 lakh and less than ₹ 25 crore. It helps entrepreneurs in raising finances for their new projects in a cost effective manner. It provides for nationwide online ringless trading with 20 plus representative offices in all major cities of the country. On this stock exchange, securities of those companies can be traded which are exclusively listed on OTCEI only. In addition, certain shares and debentures listed with other stock exchanges in India and the units of UTI and other mutual funds are also allowed to be traded on OTCEI as permitted securities. It has been noticed that, of late, the turnover at this stock exchange has considerably reduced and steps have

been afoot to revitalise it. In fact, as of now, BSE and NSE are the two Stock Exchanges, which enjoy nation-wide coverage and handle most of the business in securities in the country.

6.4 Listing of Securities

Listing of securities, on a stock exchange, allows them to be traded there under an agreement between the exchange and the issuer of the stocks. Provisions of section 73(1) of the Companies Act 1956, as amended in 1988 set the regulatory framework in India for listing at the stock exchanges. Besides this, there are the provisions of the Securities Contracts (Regulation) Act 1956, which confers powers on a stock exchange. Securities, offered to the public for subscription, have to be listed on a stock exchange. For this the stock exchange and/or the regulatory authority may require certain criteria to be satisfied, such as disclosure norms, names of the exchanges at which listings are sought, eligibility for an IPO, post-issue capital, promoters' minimum contribution and lock-in period for the same, minimum offer to public for subscription, pricing of the issue and credit rating.

Listing, a security on the stock exchange, instills a sense of confidence in the investing public, by signaling that the company has complied with certain basic requirements which govern among other things, administration of share certificates, registration of transfer of shares and new issues. These compliances are likely to create an environment conducive to wider investor participation and therefore, liquidity.

Stocks and bonds are traded on the stock exchanges. The two largest stock exchanges of the country are the Bombay Stock Exchange (BSE), Mumbai and the National Stock Exchange (NSE), New Delhi. Although it is not obligatory for stocks to be listed on a stock exchange, it becomes so, if the company declares in the prospectus, that it will seek listing.

The listing regulations are uniform for all stock exchanges in this country. Companies seeking listing of securities must meet conditions of minimum public offer, minimum issued capital, payment of interest on excess application money if not returned within 30 days from date of closure of the issue, maximum expenses permissible for an issue, restrictions on advertising, face value of shares, bonds and debentures, publication of half yearly results and its notification to the exchange. The application for listing, must be accompanied by a number of documents. The company is required to pay listing fees, which may vary from exchange to exchange.

Listing means the admission of securities of a company to trading privileges on the floor of a stock exchange. The principal objectives of listing are to:

1. Provide ready marketability and impart liquidity and free transferability to securities;
2. Ensure proper supervision and control of dealings therein; and
3. Protect the interest of shareholders and the general investing public. According to Section 73(1) of the Companies Act, every company intending to offer shares/debentures to the public for subscription by the issue of prospectus should make an application to recognized stock exchange(s) for permission to deal in them. Any allotment of shares/debentures would be void if the permission has not been granted by the stock exchange before the expiry of 10 weeks from the date of closing of the subscription list. The companies issuing securities to the public should obtain permission from the stock exchange(s) for listing within the prescribed time.

Conditional listing of companies is not permitted. The listing regulation in India in terms of (1) delisting of securities and (2) Clause 49: Corporate Governance of the listing agreements are discussed in Sections 1-2 respectively. Concluding observations are given in the last Section.

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6.5 Listing Agreement

A listing agreement is, in a sense, the code of discipline which the stock exchange(s) impose on a company as a condition precedent to listing its securities. Every listing company has certain obligations and is required to comply with the various clauses of the listing agreement. It is executed at the time of initial listing of securities of the company. Though it is signed only by the company (and not by the stock exchange), it is binding on the company. The listing agreement is amended from time to time on the directions given by SEBI to the Governing Council of the stock exchange(s). The stock exchange(s) communicate the amendments to the companies and they come into force on the specified date. The threshold limit for listing of new companies is as follows:

For Category I companies: (i) post-issue capital of ₹ 10 crore and above, (ii) post-issue net worth of ₹ 20 crore and (iii) the project/activity of the applicant must have been appraised by a financial institution/state finance corporation/bank with paid-up capital of ₹ 50 crore or Category I merchant banker with a net worth of ₹ 10 crore.

For Category II companies: (i) post-issue capital of ₹ 5 crore and above but below ₹ 10 crore, (ii) post-issue net worth of ₹ 20 crore, (iii) minimum market capitalization (i.e., issue price x post-issue subscribed number of equity shares) of ₹ 50 crore and (iv) the project/activity should have been appraised as in the case of Category I companies. All applications for listing would be scrutinized by the listing committee of the stock exchange.

The listing agreement for equity shares contains 51 clauses including Clause 49 on Corporate Governance. This Section focuses on Clause 49.

Self Assessment

Fill in the blanks:

1. A …… is, in a sense, the code of discipline which the stock exchange(s) impose on a company as a condition precedent to listing its securities.
2. ……..means the admission of securities of a company to trading privileges on the floor of a stock exchange.
3. The first ……stock exchange in India was started in Mumbai known as Bombay Stock Exchange (BSE).
4. The buyers and sellers at the stock exchange undertake two types of operations, one for …… and the other for investment.
5. The ……has defined stock exchange as an "association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in securities".

6.6 Trading System in Stock Market

Exchanges have a trading floor where the buying and selling of securities take place. Individuals or firms (brokers) are required to purchase a seat or membership of the stock exchange in order to obtain the right to trade securities there. The trading that takes place on the floor of the stock exchange resembles an auction, as members trying to sell a client's stock strive to obtain the highest price possible, while those representing the buyer-clients strive to obtain the lowest price possible. When members announce their intention to buy or sell a certain number of shares of a certain stock, they receive bids or offers as the case may be from other members.

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Sellers accept the highest bid or hold shares until an acceptable bid is offered. A member can act as buyer or seller.

Only members can transact business at the posts, where securities are traded. The 'open outcry' offers a relatively simple method of trade-matching, that has been used for centuries, in commodities markets. In this, buyers and sellers match themselves up directly by calling out bid and offer price offers in the trading 'pit'. The physical order matching system, is now emulated by the new screen based exchanges. Trading pits are rapidly losing ground to the electronic system. The new electronic media, is used mainly by market-makers and corporates, to conduct large-scale transactions.

Online trading systems are gaining popularity at the retail level as well. The more progressive stock exchanges have electronic quotation systems that provide immediate price quotations. Companies that wish to have their prices quoted must meet specific requirements on minimum assets, capital and number of shareholders. Specialists take positions in specific stocks and stand ready to buy or sell these stocks. They are expected to maintain a fair and orderly market, in the securities assigned to them. Floor brokers execute stock transactions for their clients.

Transactions are facilitated, by market-makers who stand ready to buy or sell specific stock in response to customers' orders made through telecommunications network. Liquidity of the stock market is enhanced by market-makers, because they are required to make a market at all times in an effort to stabilise prices. Whereas, brokers on the exchanges match buyers and sellers, market makers serve not only as brokers, but also as investors. Market-makers have a bid/ask spread, to charge for transactions they execute. Consequently, transaction costs become higher.

The market is created, from the flow of orders to buy or sell each stock. Investors communicate their orders to brokers by specifying name of the stock, whether to buy or sell it, number of shares to be bought or sold, and whether the order is a market order i.e. transact at the best possible price or limit order i.e. limit placed on the price at which a stock can be purchased or sold. In a limit order, investors may obtain a stock at a lower price but there is no guarantee that the price will reach that limit. Orders may be placed for a day or longer periods.

Investors can purchase stock on margin (with borrowed funds) by signing up for margin account with their broker. Investors can sell the stock short or short the stock when they anticipate that the price will decline. When they sell short, they are essentially borrowing the stock from an investor to whom they will have to provide it. Short sellers earn the difference between what they initially sold the stock for and what they pay to obtain the stock. There is also the brokerage mechanism, which is employed in thin markets for heterogeneous instruments. This is quite adequate for traders with little immediacy or liquidity requirement, who trade frequently. Brokers use their knowledge of clientele to find buyers and sellers, or are approached by brokers' clients, without taking items on to their books. In an extreme case, where the process fails, an auction may be arranged. Small company shares, are usually traded on a 'matched bargains' basis, by small regional stockbrokers. Matching methods are used, to make markets in equities and to determine opening prices for auctions. Client 'limit orders' which specify the size of the trade and an acceptable price range, are collected before the market opens. These buy and sell orders are then aggregated and the market clearing price is found at the level at which net demand is close to zero. A market-maker has the option of using this aggregate demand/supply schedule as an offer curve and can execute these limit orders against his own inventory. Liquidity in these markets, is maintained by dealers in return for privileges, which they receive from the stock exchange. There are two main mechanisms for achieving liquidity – the quote-driven and the order-driven. In the quote-driven markets, dealers announce a 'bid' price at which they stand ready to buy up to some maximum quantity and an 'ask' (or offer) price at which they are prepared to sell. They then meet orders out of their inventory, adjusting prices accordingly.

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In order-driven markets, dealers (known as intermediaries) submit limit orders on a continuous basis to the stock exchange computer. A limit order is an instruction to buy (or sell) shares up to specified maximum at a price equal or below (or above) the specified level. These orders are 'crossed' or executed against existing limit orders if possible, but otherwise added to the order book, which forms the price schedule for the market. Similarly, clients can submit limit orders. They can also submit market orders, which are unconditional as to price, and are immediately matched against the most favorable limit order price, on the computer. An individual wishing to buy or sell a security would contact salesperson at a brokerage firm and place an order. The order must specify the name of the issuer of the security, types of security, whether order is for purchase or sale, the order size, type of order, and the price and length of time the order is to be outstanding. Under type of order, market, limit, short sale, stop order are to be specified.

Order size trading on the stock markets, is usually carried out in round lots. A round lot for most common stocks, is considered to be hundred shares. An odd lot is a quantity different from hundred shares. Orders can be for both, round or odd lots. Generally, odd lots have higher transaction costs. For securities other than common stock or ordinary shares, there is no differential categorization by order size, but there may be a minimum order size.

Market orders are the most common type of orders placed by an individual investor. A market order is an order to buy (or sell) at the least (or highest) price currently available. The purchase or sale price can differ from the bid or ask. First, consider a market buy order. Other investors could simultaneously be placing market orders to sell, and the shares could be traded inside the bid-ask price. Second, the bid-ask spread could change, between the time the order is placed and the time it is executed, because of other preceding trades or because new information caused a change in the bid-ask spread. Thus, an investor using a market order is insuring execution with some uncertainty as to price.

Limit orders are orders to buy or sell at a minimum or maximum price. Limit orders control the price paid or received, but the investor has no way of knowing, when and if the order will be filled. A limit order may be utilized by an investor, who observes the price to be varying within a range and tries to sell or buy the stock at a favorable price within the range, and is willing to bear the risk of not filling the order.

Short sale investors can sell shares they do not own. This type of trade is referred to, as a short sale. When an investor short sells a security, the security is physically sold. Since the investor does not own the security, the brokerage firm borrows it from another investor or lends it to the investor. The securities borrowed normally come from the securities held, at the brokerage firm, for other investors. Securities, kept at a brokerage firm by investors, are referred to as securities registered 'in street name'. If the firm does not possess the shares they desire to sell, they would borrow the shares from someone else, often another broker. The investor, whose shares were borrowed and sold, normally would not know that the transaction had occurred and would definitely not know who had borrowed the shares. Since the shares are physically sold, the company would not pay dividend to the investor whose shares were borrowed, but instead pay the purchaser of the shares. For the investor, whose shares are borrowed, not to be hurt by the short sale, he or she must receive the dividends. The person who sold the shares short, is responsible for supplying the funds, so that the person whose shares were borrowed, can receive any dividend paid on the stock that was sold short. At a future time, the short seller repurchases the shares, and replaces the shares that were borrowed.

Stop orders are activated, only when the price of the stock reaches or passes through a predetermined limit. The price that activates the trade, is called stop price. Once a trade takes place at the stop price, the order becomes a market order. Thus, a stop loss order can be viewed as a conditional market order. A stop buys order becomes a market buy, when the trades of others equal or exceed the stop price. The investor might place a stop loss order increasing the

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stop price, if the shares continue to rise. As with all market orders, the actual price the shares will trade at, is uncertain because the trade prices might move below the stop price before the stop loss order can be executed.

A stop buy order is often used, in conjunction with a short sale. Since the share must be replaced following a short sale, any price increase harms the short seller. A stop buy order serves to limit the amount of loss, the short seller can incur.

An investor must specify the length of time an order is outstanding for orders other than market orders. A day order instructs the broker to fill the order by the end of the day. If, it is not filled by end of the day, it is automatically cancelled. If the investor does not specify the length of time, it is assumed to be, a day order. A week or month order is to be filled by the end of that period or cancelled. Good until cancelled orders, remain outstanding until the investor specifically cancels the order. Fill or kill order instructs the broker to fill the order immediately or to kill the order. Spot transactions require settlement by delivery and payment on the date of contract, or next day. A clearing house facilitates, the clearing of contracts, delivery of securities, and payments between members.

Stocks, not listed on the organised exchanges, are traded in the over-the-counter (OTC) market. Like the organised exchanges, the OTC market also facilitates secondary market transactions but does not have a trading floor. Instead, buy and sell orders are completed through a telecommunication network. Because there is no trading floor, there is no need to buy a seat to trade on this exchange, but it is necessary to register with it.

Trading on stock exchanges is done through brokers and dealers. All members can act as brokers and for this purpose they have to maintain security deposits. Brokers act as agents, buying and selling or others for which they receive brokerage commission at stipulated rates. Dealers act as principals and sell securities on their own accounts.

However, members cannot enter into contract with any person other than a member without prior permission the governing body. Given below are the key members of the stock exchanges:

1. ***Commission Broker:*** The commission broker executes buying and selling on the floor of the stock exchange.
2. ***Floor Broker:*** Floor brokers are not many. They execute orders for fellow members and receives a share brokerage commission charged by a commission broker to his/her constituent.
3. ***Tataniwala:*** He/she is a jobber or specialist in selected shares he/she 'makes the market' i.e. brings continuity to dealings. They specialize in stocks which are traded inactively.
4. ***Dealer in non-cleared securities:*** He/she deals in securities which are not on the active list.
5. ***Odd-lot Dealer:*** He/she specializes in buying and selling in amounts which are less than present trading units. They buy and sell odd lots, make them up into marketable trading units. These dealers receive commission. Their earnings come from the difference between the process at which they buy and sell. The odd-lot dealer has become an important operator since the growth of new issues. When the number of applicants for a new issue is large, shares may be allotted in lots which are smaller than prescribed lots. The odd-lot dealer makes profit on the large numbers of odd-lots by buying and selling at different prices.
6. ***Budiwalas:*** He/she specializes in buying and selling simultaneously in different markets. The difference between the buying price in another market constitutes his profit. However, he can transact such business only if a security is traded on more than one stock exchange and if exchanged telephonically or ax-linked. In India, arbitraging has become a growing

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business. Arbitraging requires prior application to the governing body "in order to avoid" the evil of "joint account" with members of other stock exchanges and consequent involvement of one exchange in the difficulties of another.

7. ***Security Dealer:*** This dealer specializes in trading in government securities. He/she mainly acts as a jobber and takes the risks inherent in ready purchase and sale of securities. The government securities are over the counter and not on the floor. They maintain daily contacts with the Reserve Bank of India and common banks and other financial institutions. As a result of their activities, government securities are quoted finely.

Margin Trading

Margin trading occur when investors who purchase stocks on margin borrow part of the purchase price of the stock from their brokers, and leave purchased stocks with the brokerage firm in street name because the securities are used as collateral for the loan. The interest rate of the margin credit charged by the broker is typically 1.5% above the rate charged by the bank making the loan. The bank rate (called the call money rate) is normally about 1% below the prime rate.

1. ***Percentage margin:*** The ratio of the net worth, or "equity value" of the account to the market value of the securities.
2. ***Maintenance margin:*** The required proportion of your equity to the total value of the stock. It protects the broker if the stock price declines.
3. ***Margin call:*** If the percentage margin falls below the maintenance margin, the broker issues a margin call requiring the investor to add new cash or securities to the margin account. If the investor fails to provide the required funds in time, the broker will sell the collateral stock to pay off the loan.

Example: Suppose an investor initially pays ₹ 6,000 towards the purchase of ₹ 10,000 worth of stock (₹ 100 shares at ₹ 100 per share), borrowing the remaining from the broker. The maintenance margin is set to be 30%. The initial percentage margin is 60%. If the price of the stock falls to ₹ 57.14, the value of his stock will be ₹ 5,714. Since the loan is ₹ 4,000, the percentage margin now is (5,714 - 4,000) / 5714 = 29.9%. The investor will get a margin call.

When investors acquire stock or other investments on margin, they are increasing the financial risk of the investment beyond the risk inherent in the security itself. They should increase their required rate of return accordingly.

Return on margin transaction = (change in investor's equity - interest - commission)/initial investor's equity

Example: Suppose an investor is bullish (optimistic) on Microsoft stock, which is currently selling at ₹ 100 per share. The investor has ₹ 10,000 to invest and expects the stock to go up in price by 30% during the next year. Ignoring any dividends and commissions, the expected rate of return would thus be 30% if the investor spent only ₹ 10,000 to buy 100 shares. If the investor borrows ₹ 10,000 from his broker and invest it in the stock (along with his own ₹ 10,000). Assume that the interest rate is 9% per year.

1. If the stock goes up to 30%, his 200 shares will be worth ₹ 26,000. After paying off ₹ 10,000 of principal and interest on the margin load leaves ₹ 15,100. The rate of return, therefore will be (₹ 15,100 - ₹ 10,000) / ₹ 10,000 = 51%. Good investment, huh?

Notes

2. Doing so, however, magnifies the downside risk. Suppose the stock actually goes down by 30%: his 200 shares of stock are worth ₹ 14,000 now. After paying off ₹ 10,900 he is left with only ₹ 3,100. The result is a disastrous rate of return of 69%.
3. If there is no change in the stock price, he will lose 9% on the cost of the loan.

Self Assessment

Fill in the blanks:

6. Percentage margin is the ratio of the…… of the account to the market value of the securities.
7. If the percentage margin falls below the maintenance margin, the broker issues a ……..
8. ……is the required proportion of your equity to the total value of the stock. It protects the broker if the stock price declines.
9. ……mainly acts as a jobber and takes the risks inherent in ready purchase and sale of securities.
10. Margin trading occur when investors who purchase stocks on margin borrow part of the ……..price of the stock from their brokers, and leave purchased stocks with the brokerage firm

6.7 Role of NSCCL

National Securities Clearing Corporation Ltd. (NSCCL) is a wholly owned subsidiary of NSE and was incorporated in August 1995. It was the first clearing corporation to be established in the country and also the first clearing corporation in the country to introduce settlement guarantee. It was set up with the following objectives:

1. to bring and sustain confidence in clearing and settlement of securities;
2. to promote and maintain, short and consistent settlement cycles;
3. to provide counter-party risk guarantee; and
4. to operate a tight risk containment system. The NSE (National Stock Exchange) is a Mumbai-based stock exchange.

NSE (National Stock Exchange) is the largest stock exchange in India and the third largest in the world in terms of volume of transactions. The NSE (National Stock Exchange) is mutually-owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries in India but its ownership and management operate as separate entities. The NSE has remained a lead player in the modernization of India's capital and financial markets. Towards this end the NSE (National Stock Exchange) set up the first clearing corporation in India - the NSCCL (National Securities Clearing Corporation Ltd). The NSCCL was a landmark in providing novation on all the spot equity market (and later, derivatives market) trades in India.

Part of the NSE Group (National Stock Exchange Group)

The National Securities Clearing Corporation Ltd. (NSCCL) is part of the NSE (National Stock Exchange) group and is a wholly-owned subsidiary of the NSE. It was incorporated in August 1995 and started clearing operations in April 1996. It was formed to build confidence in clearing

Notes

and settlement of securities, to promote and maintain short and consistent settlement cycles, to provide a counter-party risk guarantee and to operate a tight risk containment system.

Clearing and Settlement

The NSCCL (National Securities Clearing Corporation Limited) carries out the clearing and settlement of the trades executed in the CM segment of NSE (National Stock Exchange) and operates constituent SGL for settlement trades in government securities.

Inter-region Clearing

The NSCCL (National Securities Clearing Corporation Limited) facilitates inter-region clearing. It has Regional Clearing Centres at Delhi, Kolkata and Chennai and a Central Clearing Centre at Mumbai. Members have the option of delivering or receiving the securities at a clearing centre chosen by them.

Certificates Handled

To provide a level playing field to members irrespective of their location, the NSCCL (National Securities Clearing Corporation Limited) moves securities in the normal pay-in and pay-out on behalf of the Clearing Members from and to Regional Clearing Centres (RCC) and the Central Clearing Centre (CCC) at Mumbai.

Pre-delivery Verification

The NSCCL (National Securities Clearing Corporation Limited) was the first to start pre-delivery verification to detect bad papers such as fake and forged certificates or lost and stolen share certificates.

Dematerialised Settlement

The only effective solution to the problem of fake/forged and stolen shares was dematerialised trading and settlement. As SEBI made demat settlements mandatory in an ever-increasing number of securities in a phased manner, the proportion of shares delivered in the dematerialised form by the NSCCL (National Securities Clearing Corporation Limited) has increased.

Risk Management

The NSCCL has also incorporated risk containment measures. A risk group, constituted by the NSCCL (National Securities Clearing Corporation Limited) identified additional areas of perceived risk and intensified the monitoring of members' position having concentration in certain high-risk securities that attract high volumes and volatility.

Also a structured exercise of requiring unusually high pay-in liability members to make advance pay-in of funds has been put in place, in addition to offering facility of early pay-in of securities in demat mode.

Securities Lending/Borrowing

The automated lending and borrowing mechanism of the NSCCL (National Securities Clearing Corporation Limited) provides a facility to lend/borrow securities/funds at market-determined rates. This facilitates timely delivery of securities and thereby improves the efficiency of the system.

Notes

Professional Clearing Membership

The NSCCL (National Securities Clearing Corporation Limited) started the Professional Clearing Membership and the Stock Holding Clearing Corporation Ltd. has been admitted as the first professional clearing member on CM Segment.

Derivatives Settlement

The NSCCL (National Securities Clearing Corporation Limited) also provides clearing and settlement services including risk management for the derivatives market.

Multiple Depositories

The Central Depositories Securities Limited (CDSL) has been connected to the NSCCL (National Securities Clearing Corporation Limited) and clearing and settlement of securities in dematerialised form through the CDSL has also been introduced.

Did u know? The NSCCL (National Securities Clearing Corporation Limited) accepts FDRs drawn in its favour and maintains them in its custody. This has added value in services to the members as they are not any longer required to pay custodial charges but can be given instantaneous credit and benefit.

As the importance and size of the NSE grows, the importance and size of the NSCCL (National Securities Clearing Corporation Limited) is also bound to go up.

The following custodians are empanelled with NSCCL:

1. Axis Bank Ltd.
2. BNP Paribas
3. Citibank N.A.
4. DBS bank Ltd.
5. Deutsche Bank A.G.
6. Edelweiss Custodial Services Limited.
7. HDFC Bank Ltd.
8. Hong Kong Shanghai Banking Corporation Ltd.
9. ICICI Bank Ltd.
10. Infrastructure Leasing and Financial Services Ltd.
11. JP Morgan Chase Bank N.A.
12. Kotak Mahindra Bank Ltd.
13. Orbis Financial Corporation Ltd.
14. SBI Custodial Services Pvt. Ltd.
15. Standard Chartered Bank Ltd.
16. State Bank of India
17. Stock Holding Corporation of India Ltd.

Notes

Task Visit www.nseindia.com and make a note on the minimum services that the clearing banks are required to provide to all clearing members of National Securities Clearing Corporation Ltd. as also to the Clearing Corporation.

Self Assessment

Fill in the blanks:

11. The NSCCL (National Securities Clearing Corporation Limited) accepts ……. drawn in its favour and maintains them in its custody.
12. The NSCCL (National Securities Clearing Corporation Limited) also provides clearing and settlement services including …….. for the derivatives market.
13. The automated lending and borrowing mechanism of the ……..provides a facility to lend/borrow securities/funds at market-determined rates.
14. NSE (National Stock Exchange) is the largest stock exchange in India and the ……. largest in the world in terms of volume of transactions.
15. National Securities Clearing Corporation Ltd. (NSCCL) is a ……..of NSE and was incorporated in August 1995.

6.8 Summary

- Stock exchange is the secondary market, which provides a place for regular sale and purchase of different types of securities like shares, debentures, bonds and government securities. It is an organised market where all transactions are regulated by the rules and laws of the concerned stock exchanges.
- The functions of a stock exchanges are to provide ready and continuous market for securities, information about prices and sales, safety to dealings and investment, helps mobilisation of savings and capital formation. It acts as a barometer of economic and business conditions and helps in better allocation of funds.
- Stock exchanges provide many benefits to companies, investors and the society as a whole. But they also suffer from limitations like exclusive speculation and fluctuation in prices due to rumours and unpredictable events.
- Along with genuine investment, at times, stock exchange transactions may be undertaken by persons as a speculation.
- There are 23 stock exchanges in India presently, including BSE, NSE and OTCEI. Stock Exchanges are regulated by the Securities Contracts (Regulation) Act and by SEBI. SEBI has initiated a number of reforms in the primary and secondary market to regulate the stock market. Documentary and procedural requirements for listing and trading have been made stricter and foolproof to protect investors' interest.

6.9 Keywords

Budiwalas: He/she specializes in buying and selling simultaneously in different markets.

Commission Broker: The commission broker executes buying and selling on the floor of the stock exchange.

Notes

Limit orders are orders to buy or sell at a minimum or maximum price.

Listing agreement is, in a sense, the code of discipline which the stock exchange(s) impose on a company as a condition precedent to listing its securities.

Listing of securities, on a stock exchange, allows them to be traded there under an agreement between the exchange and the issuer of the stocks.

Maintenance margin: The required proportion of your equity to the total value of the stock. It protects the broker if the stock price declines.

Margin call: If the percentage margin falls below the maintenance margin, the broker issues a margin call requiring the investor to add new cash or securities to the margin account.

Margin trading occur when investors who purchase stocks on margin borrow part of the purchase price of the stock from their brokers, and leave purchased stocks with the brokerage firm in street name because the securities are used as collateral for the loan.

Odd-lot Dealer: He/she specializes in buying and selling in amounts which are less than present trading units.

Percentage margin: The ratio of the net worth, or "equity value" of the account to the market value of the securities.

Secondary market is a market for already existing long-term securities of governments, semi-governments and corporate enterprise.

Security Dealer: This dealer specializes in trading in government securities.

Short sale investors can sell shares they do not own.

Stock exchange is the term commonly used for a secondary market, which provide a place where different types of existing securities such as shares, debentures and bonds.

6.10 Review Questions

1. Define stock exchange and explain its functions.
2. Explain the importance of stock exchanges from the points of view of companies and investors.
3. Explain the role played by SEBI in protecting investors' interests and controlling the business at stock exchange.
4. Discuss the Role and objectives of NSCCL.
5. Write a brief note on the key members of the stock exchanges.
6. What do you mean by margin trading? Explain with the help of suitable examples.
7. "Every listing company has certain obligations and is required to comply with the various clauses of the listing agreement." Discuss.
8. How an efficient secondary market does make access to international capital easier?
9. Write a short note on rolling settlement.
10. As per the listing agreement what are the threshold limit for listing of new companies.

Notes

Answers to Self Assessment

1. listing agreement
2. Listing
3. organised
4. speculation
5. Securities Contracts (Regulation) Act
6. net worth
7. margin call
8. Maintenance margin
9. Security Dealer
10. purchase
11. FDRs
12. risk management
13. NSCCL
14. Third
15. wholly owned subsidiary

6.11 Further Readings

Books

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W. Arthur Lewis, The Theory of Economic Growth, George Allen & Unwin Ltd., London, 1956, p11.

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Online links

www.bis.org

www.federalreserve.gov

www.thebanker.com

Notes

Unit 7: Depositories and Custodians

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7.6 Summary

7.7 Keywords

7.8 Review Questions

7.9 Further Readings

Objectives

After studying this unit, you should be able to:

- Learn the concept of depositories and custodians;
- Explain the concept of NSDL and CDSL;
- Know importance and use of D-MAT;
- Understand role stock holding corporation of India Ltd.;
- Explain Nomination facility.

Introduction

The Phenomenal growth of both the primary and secondary equities and debentures markets and the entry of bulk traders (both domestic and foreign financial institutions in it have revealed many shortcomings and inadequacies of the market infrastructure to support the new levels volumes of securities trading in India.

The existing traditional manual methods trading, clearing settlement, transfer, registration, record keeping have been found to be cumbersome and time consuming. Moreover this resulted in slow down of system efficiency and increased the systematic risks.

Expansion of the stock trading industry has led to a tremendous increase in risk factors relating to counter party risk, credit risk, bad deliveries, long delayed deliveries, counterfeit scripts, forged certificates, wrong signatures and slow and stealing of shares.

All this ultimately led to introduce a new modern infrastructure consisting of Depositories, paperless trading and computer recording of transactions. A beginning of this was made by setting up Stock Holding Corporation of India Limited (SHCIL), jointly invested by ICICI, IDBI, IFCI, RBI, UTI, LIC.

Notes

A major development in the Indian capital market has been the setting up of depositories. The objective of a depository is to provide for the maintenance of ownership records of securities in an electronic book entry from and enable scrip less trading in stock exchanges, thereby reducing settlement risk. To strengthen further the depository and custodial services, the Finance Ministry mandated in the creation National Clearance and Depository System the Govt. introduced ordnance for Depositories in 1995.

SEBI has granted registration to two depositories, namely National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited under the Depository Act, 1996.

The overall strategic objectives of NCDS are:

1. To liberate the securities industry from the paper work gridlock,
2. To reduce paper-handling costs,
3. To eliminate transfer delays and
4. To reduce systemic risks

In specific, critical and technical objectives to achieve the overall objectives are dematerialization of new and existing issues execution of book entry transfer of ownership of securities, implementation of delivery versus payment system, provision of both operational and transactional facilities and scrip hypothecation, and implementation of beneficial owner record keeping.

The following securities are eligible for being held in dematerialized from in a depository:

1. Shares, bonds, debentures or other marketable securities of like nature of any incorporated company or other body corporate
2. Units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificates of deposit, securitised debt, money market instruments, government securities and other unlisted securities.

The depository must maintain a continuous electronic means of communication with all its participants, issuers agents, clearing houses and clearing corporations or the stock exchanges and with other depositories.

The depository has to satisfy SEBI that it has a mechanism in place to ensure that the interest of the persons buying and selling securities held in the depository are adequately protected. The depository must register the transfer of the security in the name of transferee only after the depository is satisfied that payment for such has been made.

Example: The fee for registration as a depository is given below:

Payer	Mode of Payment	Amount of fees
Sponsor or depository	A demand draft or banker's cheque payable to SEBI at Mumbai.	Application fees (sponsor) – ₹ 50,000 Registration fees (depository) – ₹ 25,00,000 Annual fees (depository) – ₹ 10,00,000

Every depository has to maintain records of securities dematerialized and rematerialised -the names of the transferor, transferee and the dates of transfer of securities. A register and an index of beneficial owners, details of the holdings of the securities of the beneficial owners as at the end of each day, records be kept. Other records of approval, notice entry and cancellation of

Notes

pledge or hypothecation, details of participants, Details of securities declared to be eligible for dematerialisation in the depository, and other documents necessary for carrying on the activities as a depository has to be kept. Every depository has to intimate SEBI of the location where the records and documents are maintained. The depository has to preserve records and documents for a minimum period of five years.

Every depository has to extend all such cooperation to the beneficial owners, issuers, and issuer's agents, custodians of securities other depositories and clearing organizations as is necessary fro the effective prompt and accurate clearance and settlement of securities transactions and conduct of business. A depository or the participant is rendering such advice, disclosure as to the interest of the dependent family members and the employer indicating their long or short position in that security has to be made.

The operations in the Depository System involve the participation of a Depository, Depository Participants, Company/Registrars and Investors. The company is also called the Issuer.

A Depository (NSDL and CDSL) is an organisation like a Central Bank, i.e. Reserve Bank where the securities of an investor are held in electronic form, through Depository participants.

A Depository Participant is the agent of the Depository and is the medium through which the shares are held in the electronic form. They are also the representatives of the investor, providing the link between the investor and the company through the Depository.

To draw analogy, the Depository system functions very much like the banking system. A bank holds funds in accounts whereas, a Depository holds securities in accounts for its clients. A bank transfers funds between accounts whereas, a Depository transfers securities between accounts.

In both systems, the transfer of funds or securities happens without the actual handling of funds or securities. Both the banks and the Depository are accountable for safe keeping of funds and securities respectively. The company has to sign an Agreement with NSDL/CDSL (the depositories) and install the necessary hardware/software for operations.

7.1 Depository Services to Investors

As a Depository Participant with the National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL). The Depository system in India links Issuers, National level Depositories, Depository Participants and Clearing Houses/Clearing Corporation of Stock Exchanges.

Our demat services business has the distinction of having all its operations ISO 9001: 2000 certified with state-of-the-art technology and operations capabilities. Our demat services has innovated over time and we provide online access to account statements and transaction alerts through SMS to its clients.

Demat services offers a secure, convenient and paperless way to keep track of investments in shares and other security instruments over time, without the hassle of handling paper based transcripts.

Dematerialisation ('Demat' in short form) signifies conversion of a share certificate from its present physical form to electronic form for the same number of holding. It is a direct application of scope provided by the tremendous progress made in the area of Information Technology whereby voluminous and cumbersome paper work involved in the scrip based system is eliminated. It offers scope for paperless trading through state-of-the-art technology, whereby share transactions and transfers are processed electronically without involving any share certificate or transfer deed after the share certificates have been converted from physical form to electronic form.

Notes

Demat attempts to avoid the time consuming and complex process of getting shares transferred in the name of buyers as well its inherent problems of bad deliveries, delay in processing/ fraudulent interception in postal transit, etc. Dematerialisation of shares is optional and an investor can still hold shares in physical form. However, he/she has to demat the shares if he/ she wishes to sell the same through the Stock Exchanges. Similarly, if an investor purchases shares, he/she will get delivery of the shares in demat form.

The Depositories Act, 1996 has been enacted to regulate the matters related and incidental to the operation of Depositories and demat operations. Two Depositories are in operation - National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL).

The operations in the Depository System involve the participation of a Depository, Depository Participants, Company/Registrars and Investors. The company is also called the Issuer.

The Depositories (NSDL/CDSL) will provide the list of demat account holders and the number of shares held by them in electronic form on the Record date to the company/registrar (known as Benpos). On the basis of Benpos, the company concerned will issue dividend warrants in favour of the demat account holders. The rights of the shareholders holding shares in demat form are at par with the holders in physical form. Hence you will be eligible to get the Annual Report and will have the right to attend the AGM as a shareholder. First, one shall have to open an account with a Depository Participant (DP) and get a unique Client ID number.

Thereafter, one has to fill up a Dematerialisation Request Form (DRF) provided by the DP and surrender the physical shares intended to be dematted to the DP. The DP upon receipt of the shares and the DRF, will send an electronic request to the Company/Registrars through the Depository for confirmation of demat. Each request will bear a unique transaction number. The DP will simultaneously surrender the DRF and the shares to the Company/Registrars with a covering letter requesting to confirm the demat. The Company/Registrars after necessary verification of the documents received from the DP and if found in order will confirm demat to the Depository. This confirmation will be passed on from the Depository to the DP, which holds the account. After receiving this confirmation from the Depository, the DP will credit the account with the shares so dematerialised. The DP will hold the shares in the dematerialised form thereafter on your behalf. And you will become beneficial owner of these dematerialised shares.

Self Assessment

Fill in the blanks:

1. The objective of a …… is to provide for the maintenance of ownership records of securities in an electronic book entry from.
2. ……. signifies conversion of a share certificate from its present physical form to electronic form for the same number of holding.
3. A ……. is the agent of the Depository and is the medium through which the shares are held in the electronic form.
4. A bank transfers funds between accounts whereas, a Depository transfers …… between accounts.
5. …… services offers a secure, convenient and paperless way to keep track of investments in shares and other security instruments over time, without the hassle of handling paper based transcripts.
6. A Depository (NSDL and CDSL) is an organisation like a Central Bank, i.e. Reserve Bank where the securities of an investor are held in electronic form, through…… .

Notes

7.2 SEBI: Guidelines with Respect to Depositories

The Securities and Exchange Board of India (SEBI) has set up the SEBI Act 1992 to:

1. To protect the interest of investors in securities.
2. Promote the development of, and regulate, the securities market.

It prevents the trading malpractices and aims at achieving a balance between self-regulation by securities industry and its statutory regulation.

Interim Functions

1. To collect information and advice the Government on the matters relating to stock and capital markets.
2. Licensing and regulation of merchant banks, mutual funds etc.
3. To prepare legal drafts for regulatory and development role of SEBI.
4. To perform any other functions as may be entrusted to it by the Government. There are certain malpractices noticed in the case of companies, merchant bankers and brokers who are all operating in the capital market. The security industry in India had to develop on the right lines.

Objectives

The SEBI has been entrusted with both the regulatory and developmental functions. The objectives of SEBI are:

1. Investor protection, so that there is steady flow of savings into the capital market.
2. Ensuring the fair practices by the issues of securities, namely, companies so that they can raise resources at least cost.
3. Promotion of efficient services by brokers, merchant bankers and other intermediaries so that they become competitive and professional.

SEBI (Issue Guidelines in respect of)

1. Information disclosure operational transparency and investor protection
2. Development of financial institutions
3. Pricing of issue
4. Preferential issues
5. Bonus issues
6. Financial instruments
7. Firm allotment and transfer of shares among promoters.

The SEBI is empowered to register any agency or intermediary who may be associated with the securities market and none of them shall buy, sell or deal in securities except under and in accordance with the conditions of a certificate of registration issued by the SEBI.

Notes

SEBI Regulations on New Issue Markets

1. ***Entry Norms:*** As per the guidelines of April 1996 only the following companies can enter the capital market for raising funds from the public, for the purpose of listing:

   (a) Companies, with a 3 year record of dividend payment out of the last 5 years.

   (b) Companies with a post equity capital of ₹ 10 crores only can be listed on the major stock exchanges like NSE, BSE, etc.

   (c) Companies with a post issue equity between ₹ 5 crores and ₹ 10 crores can be listed on regional stock exchanges.

   (d) The minimum subscription by promoters is brought down to 20% instead of 25%.

   (e) The minimum offer to be made to the public was brought down to 25% in September 1993, for the purpose of listing.

   (f) The directive of SEBI of May 1996, requires a company to be eligible for listing should have atleast 5 public shareholders for every ₹ 1 lakh of net equity capital offered for public issue and atleast 10 public shareholders for every ₹ 1 lakh of equity capital offered for sale.

2. ***Other Conditions for Listing of Companies:***

   (a) Proportional allotment for all applicants of 90% of the offer is subscribed.

   (b) Minimum application account which was raised to 500 shares (₹ 5000) in 1993 was brought down to 200 shares in 1996 to encourage greater participation from the individual investors.

   (c) The minimum offer of 25% to public was split into two components. Half of this namely 12.5 reserved for those applying for shares of a value of ₹ 10,000 or less, to promote small investors to come back to the market.

   (d) All reservations FIs, FFIs, MFs and NRIs etc. were removed and only the reservation of 25% to public 20% to promoters and 10% to employees under stock option scheme are allowed to remain at the end of December 1997.

   (e) Lock in period for all were removed except for promoters and that too reduced to 3 years.

   (f) Basic minimum floor limit of ₹ 3 crores for listing is kept on exchange with electronic trading and subject to market maker facility and sponsorship.

   (g) At least 5% of the public offer should be underwritten or subscribed by the lead merchant banker as his stake at present.

   (h) Minimum allotment per employee should be 200 shares, subject to a maximum of 10% of offer for all employees.

   (i) The company seeking listing any stock exchange has to keep a safety deposit of 1% of the issue offered to public.

   (j) Checking by SEBI representatives in issues of bigger size involving oversubscription is a safeguard against malpractices by registrars.

3. ***Appointment of Intermediaries:***

   (a) Compulsory appointment of managers to the issue.

   (b) Registrars and bankers to the issue are to be appointed compulsorily and these appointments are subject to approval by the SEBI.

Notes

(c) Underwriting is optional. But if appointed they are also to be approved by the SEBI.

(d) Allotment is to be made with in 30 days of the closure of the subscription.

(e) No provision of retention of over subscription without SEBIs permission.

(f) A code for Book building of any issue by the merchant banker or lead manager is also laid down by the SEBI.

7.3 Stock Exchange

Stock exchange means any body or 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 Stock Exchange

1. Stock exchange provides liquidity to the listed companies.
2. It gives quotations to the listed companies; they help trading and raise funds from the market.
3. By obtaining the listing and trading facilities, public investment is increased and companies were able to raise more funds.

There are twenty two stock exchanges in India. Ahmedabad, Delhi, Kolkata, Chennai and Bangalore are major ones amongst the other stock exchanges. Three thousand brokers and twenty thousand sub-brokers serve these stock exchanges.

Task Visit any near by stock trading house and watch how trading happens.

Globalization of Stock Exchanges

1. Demat form of trading
2. Electronic form of trading
3. Internet trading

The NSE, BSE and OTCEI have introduced screen based trading. All other exchanges (except Guwahati, Magadh, and Bhubaneshwar) are to introduce the computerization and screen based trading by 30th June 1996.

This will bring about greater transparency for investors, reduce spreads, allow for more effective monitoring of prices and volume and speed up settlements.

Bombay Stock Exchange (BSE)

The stock exchange in Mumbai, popularly known as "BSE" was established in 1875 as "The Native Share and Stock Brokers Association." It is the oldest one in Asia, even older than the Tokyo stock exchange, which was established in 1878. It is a voluntary non-profit making Association of Persons (AOP) and is currently in the process of converting itself into demutualised corporate entity.

It is the first stock exchange in the country to have obtained permanent recognition in 1956 from the Government of India under the Securities Contracts (Regulation) Act, 1956.

Notes

The exchange, while providing an efficient and transparent market for trading in securities, debt and derivatives upholds the interest of investors and ensures redressal of their grievances whether against the companies or its own member brokers. It also strives to educate and enlighten the investors by conducting investor education programmes and making available to them necessary information inputs.

Out of the twenty two stock exchanges in the country, Mumbai is the largest, with over six thousand stocks listed. The BSE accounts for over two-thirds of the total volume in the country. The BSE 'sensex' is a widely used market index for the BSE.

National Stock Exchange of India (NSE)

The NSE of India limited has genesis in the report of the high powered study group on establishment of new stock exchanges which recommended promotion of a National Stock Exchange by financial institutions to provide access to investors from all across the country on an equal footing. Based on the recommendations, NSE was promoted by leading financial institutions. Government of India incorporated NSE in November 1992 as a tax paying Company unlike other stock exchanges in the country.

On its recognition as stock exchange under the Securities Contract Act, 1956 in April 1993, NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994.

Currently, two hundred large companies are traded on the NSE; that list is expected to gradually expand as the exchange stabilizers. The NSE is a computerized market for debt and equity instruments.

The NSE, located in Bombay, was set up in 1993 to encourage stock exchange reform through system modernization and competition.

To improve the settlement system and minimize the risks associated these in, NSE has set up a subsidiary National Securities Clearing Corporation (NSCC).

Primary Market

Primary market is the place for issue for new securities to raise funds for investment and/or discharge some obligations.

They do so either through public issues, rights issues or offer for sale.

It is a public issue if any body and everybody can subscribe for the securities.

It is a rights issues if the offer is made only to existing shareholder.

However if the issue is made to select few people, it is called a private.

Both private and public sector companies make public issues. Every month roughly 130 issues takes place unlike many other countries, where issues are privately placed, public issues in India are directly marketed to retail investors all over the country.

Secondary Market

Secondary market enables the investor to adjust his holdings of securities in response to changes in assessment about risk and return by selling or buying the securities. It enables him to sell securities for cash to meet the liquidity needs.

It essentially comprises of the stock exchanges, which provide a platform for trading of securities. The securities are traded, cleared and settled as per a detailed well-settled regulatory framework

Notes

under the supervision of the exchanges and oversight of SEBI. The investor can access the trading platform of an exchange only through a registered brokers.

Depository System

A major reform of the Indian stock markets has been introduction of the depository system and scrip less trading mechanism, since 1996. This system of trading based on physical transfer of securities militated against the efficient functions of markets, particularly large scale entry of Foreign Institutional Investors (FII's).

Depository Participant (DP)

The DP's are service providers to the investors. A depository interfaces with its investors through them as agents/participants. To utilize the services of a depository, an investor had to open an account with a DP.

Existing Depositories in India

There are two types of depositories, they are:

NSDL

NSDL is the first depository company in the country. It has been promoted by the UTI, NSE, State Bank of India, HDFC Bank and City Bank.

Functions: NSDL performs the following functions through depository participants:

1. Enables the surrender and withdrawal of securities to and from the depository (dematerialization and rematerialisation).
2. Maintains investor holdings in the electronic form.
3. Carries out settlement to trade not done on the stock exchanges.
4. Electronic credit in public offerings of companies.
5. Transfer of securities.
6. Stock lending and borrowing.

Services Offered by the NSDL:

1. Maintenance of beneficial holdings through DP's
2. Dematerialization.
3. Trading and settlement in dematerialization securities.
4. Receipt of allotment in the dematerialized form.
5. Receipt of corporate benefits.
6. Rematerialisation.
7. Locking of an investor's account.
8. Market trade.
9. Off market trade.

Notes

CDSL

The Mumbai Stock Exchange (BSE) in association with Bank of India, Bank of Baroda, State Bank of India and HDFC Bank have promoted CDSL as the secondary depository in India for dealing in securities in electronic form.

Objectives of CDSL:

1. To accelerate the growth of scrip less trading.
2. To make a major thrust in the individual investors participation in the depository.
3. To create a competitive environment which will be responsive to the user's interest and demands.
4. To enhance liquidity.

Services offered by the CDSL to the beneficial owner are dematerialization of existing scripts, dematerialization of new issues, reliable and efficient settlement, re-materialization and corporate actions (cash and non-cash).

The depositories hold securities in demat and all securities in depository are fungible. While the investors in securities appear as beneficial owner in the records of the depository, the depositories appear as registered owners in the record of the company. All rights relating to securities, however, accrue to beneficial owners.

Holding securities in the demat form helps investors get immediate transfer of securities in case of purchases. The investor do not pay stamp duty on transfer of securities and can avoid risks associated with physical certificates such as bad delivery, false securities etc.

A depository interfaces with the investor through its agents called Depository Participants (DP). It is necessary to open an account with a DP to avail of the services offered by a depository. This is similar to opening an account with any branch of a bank in order to utilize the bank services.

SEBI Guidelines - Issue Management

Book building and Issue management include the share capital in the primary market by the way of:

Initial Public Offer

Initial Public Offer means an invitation by a company to the public to subscribe to the securities offered through a prospectus, offer for sale refers to an offer of securities by existing share holders of a company, to the public for subscription through an offer document.

Issue Procedure

Eligibility Norms: Companies issuing securities through offer document.

1. Prospectus in the case of public issue or offer for scale.
2. Letter of offer in case of a rights issue.

At the time of filing draft offer document with the SEBI and also at the time of filing the final offer document with the registrar of companies (or) designated stock exchanges.

Pricing Issues:

1. A listed company can freely price equity shares/convertible securities through a public/ rights issue.

Notes

2. Unlisted companies eligible to make a public issue and desirous of getting its securities listed on a recognized stock exchange can also freely price shares and convertible securities.
3. The free pricing of equity shares by an infrastructure company is subjected to the compliance with disclosure norms as specified by the SEBI from time to time.
4. While freely pricing their initial public issue of shares/convertibles, all banks require approval by the Reserve Bank of India (RBI).

Promoters Contribution and Lock-in-Requirements

Promoters contribution in different issues:

1. Public issue by unlisted companies' promoters should contribute at least 20% of the post-issue capital.
2. Offer for scale by unlisted companies the promoters post-issue capital should be at least 20%.
3. Public issue by listed companies' promoters should ensure to the extent of 20% of the proposed issue or 20% of the post issue capital.
4. Lock in of minimum required contribution would be locked in for a period of three years.
5. In case of public issue by an unlisted company, excess promoters' contribution would be locked-in for a period of one year.
6. Securities issued last to be locked-in-first.

Book Building

Book building is a process undertaken by which a demand for securities proposed to be issued by a body corporate is elicited and built up, the price for such securities is annexed for the determination of the quantum of such securities to be issued by means of a notice, or a circular or an advertisement.

Book building is basically a process used in Initial Public Offer (IPO) for efficient price discovery. It is a mechanism where, during the period for which the IPO is open bids are collected from investor at various prices which are above or equal to the floor price. The offer price is determined after the bid closing date.

As per SEBI guidelines, an issuer company can issue securities to the public through prospectus in the following manner:

1. 100% of the net offer to the public through book building process.
2. 75% of the net offer to the public through book building process and 25% at the price determined through book building.
3. The Fixed price position is conducted like a normal public issue after the Book Built position during the issues price is determined.
4. For the process of 100% Book building it is mandatory that time capital should be above 4.25 crores.
5. For 100% Book building process a Book runner is appointed usually a lead Merchant banker.
6. The merchant banker should draft the prospectus along with all disclosure other than price of the securities and no of securities and should file the same with SEBI.

Notes

7. The board is having a privilege for modification in the drafted prospectus and should suggest the merchant banker within 21 days of in receipt.
8. The merchant banker must invite for bid's from bidden or underwriter.

Registrar to an Issue and Share Transfer Agents

A registrar and transfer agent is a corporate body responsible for keeping a record of a company's shareholders in the physical form and carrying out the following functions:

1. Handling transactions involving share certificate.
2. Handling transactions involving actions.
3. Handling transactions relating to a transfer of shares.
4. Handling correspondences and communications with investor and the company.

Activities of Registrars and Transfer Agents

1. Transfer of shares.
2. De-materialisation of shares.
3. Re-materialization of shares.
4. Issue of duplicate share certificate.
5. Transmission of shares.
6. Transposition of shares.
7. Share splits/Replacement of shares.
8. Consolidation of shares.
9. Effecting a change of Name.
10. Effecting a change of signature.
11. Effecting a change of address.
12. Registration of mandate
13. Registration of Power of Attorney (POA).
14. Registration of nominations.
15. Registration and grievance Handling.

Underwriters

Any person, institution or a banker who is into the business of providing an assurance to the company to get minimum subscription and expecting a consideration in the form of commission.

1. Underwriter take up the securities which are not fully subscribed.
2. They give commitment to get the issues subscribed by either public or by themselves.
3. They are appointed by issuing company in consultation with lead merchant banker.
4. Underwriter must register under SEBI.

5. The capital adequacy should be not less than ₹ 20,00,000 (Net worth).
6. No underwriter should subscribe more than 20 times of their net worth at any point of time.

Banker to an Issue

The banker to an issue is engaged in activities such as acceptance of application along with application money from the investor in respect of capital and refund of application money.

1. Banker to an issue must obtain a certificate of registration from the SEBI.
2. Banker to an issue has to pay to the SEBI an annual fee at ₹ 2.5 lakhs for the first 2 years from the date of initial registration and ₹ 1 lakh for the third year to keep his registration in force. The renewal fee to be paid by him annually for the first 2 year was ₹ 1 lakh and ₹ 20,000 for the year.
3. Since 1999, schedule of fee is ₹ 5 lakh initial registration fee and ₹ 2.5 lakh renewal every year from the fourth year from the date of initial registration.

General Obligations and Responsibilities

1. Banker to an issue has to furnish to the SEBI the following information.
2. No of issues for which he was engaged as a banker to an issue.
3. The no of application or details at the application money received.
4. The dates on which application from investor were forwarded to the issuing company register to an issue.
5. The dates/amount of refund to the investor.

Brokers to the Issue

Brokers are the persons mainly concerned with procurement of subscription to the issue from the prospective investor.

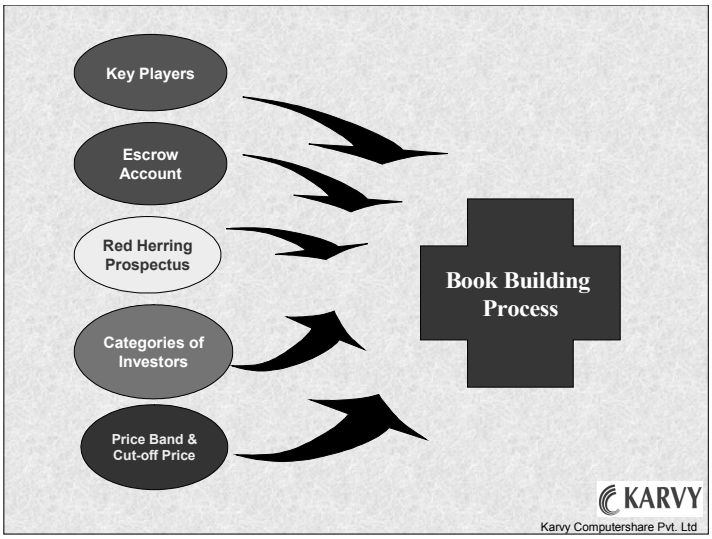
1. The appointment of brokers is not compulsory and the companies are free to appoint any no of brokers.
2. The permission granted by the stock exchange also subject to other stipulation which are set out in the letter of consent.
3. The leading merchant banker in India who act as manager to the issue have particulars of the performance of brokers in the company.
4. A copy of the consent letter should be filed along with the prospectus to the ROR.
5. The brokerage rate applicable to all types of public issue of industrial securities is fixed at 1.5 percent, whether the issue is underwritten or not.
6. The listed companies are allowed to pay a brokerage on private placement of capital at a maximum rate of 0.5%.

Brokerage is not allowed in respect of promoter quota including the amount taken up by the director, their friends and employees, and in respect of the right issue taken by or renounced by the existing shareholders.

Notes

Book Building Process

Public Issue/offer of securities through book building process is designed to ascertain demand for the security at various prices with in a price -band to facilitate discovery of the issue price.



Categories of Investors

There are three types of Investors:

1. ***Qualifies Institutional Investors:*** Public financial institutions as specified in section 4A of the companies act, FIIs, scheduled commercial banks, mutual funds, multilateral and bilateral development financial institutions, venture capital funds registered with SEBI, foreign venture capital investors registered with SEBI, state industrial development corporations, insurance companies registered with Insurance Regulatory and development Authority, provident fund with a minimum corpus of ₹ 25 crores and pension fund with a minimum corpus of ₹ 25 crores can apply for shares.

   Issue size available for allocation is 60% of the Net Issue. 5% shall be available for allocation for Mutual funds participating in 5% reservation in QIB portion will also be eligible for allocation in the remaining QIB portion. The unsubscribed portion if any, in the mutual fund reservation will be available to QIBs.

   The minimum bid amount for QIBs exceeds ₹ 1,00,000 and in multiples thereafter.

   The maximum bid size not exceeding the Issue subject to regulations as applicable to the bidder.

   The Margin amount applicable to QIB Bidden at the time of submission of Bid cum application form 10% of the Bid amount in respect of bids placed by QIB bidders on bidding.

2. ***Non-Institutional Investors:*** Non Resident Indian's, Resident Indian individuals, HUF's (in the name of karta) companies, corporate bodies, societies and can apply for shares in this category.

   Issue size available for allocation is 10% of the Net Issue.

   The unsubscribed portion in this category will be available for allocation to QIB's and Retail Individual Bidders.

Notes

There will be proportionate allocation if it is over subscribed.

Minimum bid amount for NIB's exceeds 1,00,000 and in multiple there after.

Maximum bid size not exceeding the size of the issue subject to regulators as applicable to the bidder.

Amount applicable by Non-Institutional bidder at the time of submission of Bid cum application form: Full bid amount to be paid on bidding.

3. ***Retail Individual Investors:*** Individuals (including HUFs in the name of karta) applying for equity shares such that the Bid amount per Retail individual Bidders does not exceed ₹ 1,00,000 in value.

   At least 30% of the Net issue is available for allocation.

   The unsubscribed portion in this category will available for allocations to QIB's and non-institutional Bidder.

   There will be proportionate allocation if it is oversubscribes.

   Minimum bid amount for RIB's in multiple of equity shares.

   Maximum bid should not exceed ₹ 1,00,000.

   Payment of amount applicable to Retail individual Bidder at the time of submission of Bid cum Application form depending upon the payment method.

   Additionally there can be Reservations for:

   (i) Employees/Directors of the issues/promoter companies.

   (ii) Existing shareholders of the issuer/promoter companies.

Price Band and Cut-Off Price

The investors are informed of the price band for bidding. The lower end of the price band is the floor price and the upper end of the price band is the cap price. The cap price is the price band should not be more than 20% of the floor price.

The investor can opt to bid at any price of the prices (including the floor price and ceiling price) in multiplies of ₹ 1/- within the price band. The issuer in consultation with BRLM's (Book Running Lead Manager) can revise the price band (upward or downward) during the period the bid is open subject to keeping the bidding period open for a minimum of three days after the revision.

Retail individual bidders can bid at "cut-off" price. In which case, they need not indicate the price as the specific number and yet become eligible to be considered for allotment irrespective of the issue price finally decided through the price discovery process. They must pay the margin amount calculated at the ceiling price. The other categories of investors are forbidden from applying at cut-off price.

For example: Company name is Reliance Petroleum Limited

The price band is ₹ 57/- to ₹ 62/-

Cut-off price is ₹ 16/- for partly paid case

Cut-off price is ₹ 62/- for fully paid case

Benchmarks are pre-determined for each fund based on the most appropriate indices available in the market or by constructing proxy benchmarks out of multiple indices. Performance of each fund is continuously tracked based on the benchmarks and recalibrated.

Notes

A statistical analysis is carried out to determine that the risk levels are in tune with the risk appetite of the particular fund. Statistical tools such as the standard deviation and risk-adjusted return measures such as the Sharpe ratio are calculated in order to compare the returns generated per unit of risk vis-à-vis benchmarks.

The investment policy has been designed by the Board to cover regulatory guidelines, the various product investment styles. It is ensured that the portfolio is always kept complaint with the relevant regulations. Our rigorous process and risk/compliance control are will documented.

Self Assessment

Fill in the blanks:

7. A statistical analysis is carried out to determine that the ……. levels are in tune with the risk appetite of the particular fund.
8. The …… bid amount for QIBs exceeds ₹ 1,00,000 and in multiples thereafter.
9. The …….. bid size not exceeding the Issue subject to regulations as applicable to the bidder
10. ……. are the persons mainly concerned with procurement of subscription to the issue from the prospective investor.
11. Book building is basically a process used in …… for efficient price discovery.
12. ……..Enables the surrender and withdrawal of securities to and from the depository (dematerialization and rematerialisation).
13. To improve the settlement system and minimize the risks associated these in, NSE has set up a subsidiary …… .

7.4 Nomination Facility

One has to submit a nomination form duly filled in duplicate and signed. If more than one person are holding shares along with other holders then all the holders will have to sign the nomination form. After the form is received by the company, and if found in order, a registration number will be allotted to the nomination. A duplicate copy of the nomination form received from shareholder will then be returned back with an endorsement indicating the registration number and date. Nomination can be made only in respect of shares held in physical form. In case of dematted shares, your nomination has to be recorded with your Depository Participant. Only one nomination can be made for each folio. Folios having different order or combination of names of shareholders will require separate nominations. Upon death of a shareholder, the nominee is entitled to have the shares transmitted in his favour. He/She will have to give a notice in writing to this effect along with the share certificate(s) of the deceased shareholders. Alternatively, the nominee can transfer the shares held by the deceased shareholder, to a third party. If a nominee opts for registration of shares in his name, he is required to produce proof of identity, e.g., copy of passport, driving license, voter's identity card or such other proof to the satisfaction of the company. The nominee should also submit his specimen signature duly attested along with a request for transfer. Upon scrutiny of the documents submitted by the nominee, shares will be transmitted in his favour and share certificates returned to him duly endorsed. The surviving shareholders will have to submit a request letter supported by an attested copy of the Death Certificate of the deceased shareholder and the relevant share certificates. The company on receipt of the said documents will delete the name of deceased shareholder from its records and return the share certificates to the applicant/registered holder with necessary endorsement.

Additional Information sourced from KARVY. Com (Investors services)

Notes

Factors Effecting the Success of Demat System

1. Technology Issues and Internet Providers for the growth of electronic trading. A true Internet trading system should deliver cost effective transaction fulfilment at a single point. In a net based economy it both prudent and essential for a broker/intermediary to offer total solution to the clients at a Single point. Total solutions mean offering interfaces with banks, depositories, information feeds and efficiency in trade completion. The service providers hence go beyond the stage mere order execution and emerge as information providers.
2. ***Bandwidth optimization:*** In Indian context since the availability of a sufficient bandwidth is limited, the application software optimizes the available bandwidth by deploying advance technologies.
3. ***Scalability and Robustness of the trading system:*** The fundamental difference between the internet as a transaction medium and the conventional closed user group network is that internet is universal platform providing concurrent access to infinite users at a given point of time. Hence it becomes imperative for any net-based application to have a proven capability for scalability and robustness, which ensures the ability to handle and process requests from multiple users at any given point of time.

Task

1. Visit any trading house of a depository like KARVY on a working day to understand the functioning of online trading and how depository service rendered.
2. Visit KARVY website to know more about the depository services.

7.5 Custodians

Custodians are clearing members but not trading members. They settle trades on behalf of their clients that are executed through other trading members. A trading member may assign a particular trade to a custodian for settlement. The custodian is required to confirm whether he is going to settle that trade or not. If the custodian confirms the trade, NSCCL assigns the obligation to the custodian. If the custodian rejects the trade, the obligation is assigned back to the trading member.

Custodians Clearing members are required to request Clearing Corporation for allotment of Custodian Participant (CP) code for the clients for which they wish to clear and settle. The request has to be made along-with documentation for the said purpose like SEBI registration number, PAN number etc. depending on the category of the client.

Registration

It is mandatory to register the custodians of securities with the SEBI. Before granting registration, the SEBI would consider all matters relevant to the activities of a custodian of services with particular reference to – whether the applicant:

1. Fulfils the requirement of net worth (paid-up capital plus free reserves) of ₹ 50 crore;
2. Has the necessary infrastructure including adequate office space, vaults for the safe custody of securities and computer systems capability required to effectively discharge his activities as a custodian;
3. Has the requisite approvals to provide custodial services in respect of gold/gold-related instruments of mutual funds; or title deeds of a real estate asset held by a real estate mutual fund;

Notes

4. Has in employment adequate and competent persons who have the experience capacity and ability to manage the business of a custodian;
5. Has prepared a complete manual, setting out the systems procedures to be followed by him for the effective/efficient discharge of his functions and an arms' length relationship to be maintained with his other business(es);
6. Is not a person who has been refused registration by the SEBI/whose registration has been cancelled by the SEBI;
7. His director/principal officer/any of his employees is involved in litigation connected with the securities market or has at any time been convicted of an offence involving moral turpitude/economic offence;
8. The registration is in the interest of investor; and
9. The applicant is a fit and proper person. For determining whether an applicant/custodian of securities is a fit and proper person, the SEBI would take into account the criteria specified in the SEBI Intermediaries Regulation, 2008. The applicant should be a body corporate. It has to pay registration fee of ₹ 15,00,000. The registration would require renewal after every three years.

There are certain conditions for registration of a custodian. Also, it has to abide by the provisions of the SEBI Act and Regulations in the discharge of its functions. Moreover, if any information submitted to the SEBI is found to be false/misleading in any matter or if there is any change in such information, the SEBI should be informed in writing. The SEBI may restrict the certificate of registration to provide custodial services either in respect of securities or gold/gold-related instruments of a client or title deeds of a real estate asset held by a real estate asset mutual fund.

General Obligations/Responsibilities

Included in the general obligations and responsibilities of custodians are: (1) code of conduct, (2) segregation of activities, (3) monitoring/review/evaluation/inspection of systems/controls, (4) separate custody account, (5) internal controls and (6) maintenance of records.

Code of Conduct

The custodians of securities should:

1. Maintain the highest standard of integrity, fairness and professionalism in the discharge of his duties.
2. Be prompt in distributing dividends/interest/any such accruals of income received/collected by him on behalf of his clients, on the securities held in custody.
3. Be continuously accountable for the movement of securities in/out of custody account, deposit and withdrawal of cash from the clients accounts and provide complete audit trail whenever called by the client/SEBI.
4. Establish and maintain adequate infrastructural facility to discharge custodial services to the satisfaction of clients and the operating procedures/systems should be well-documented and backed by operation manuals.
5. Maintain client confidentiality in respect of his affairs.
6. Take precautions to ensure that records are electronically maintained, continuity in record keeping is not lost/destroyed, and sufficient backup of the records is available.
7. Create and maintain records of securities in such a manner that the tracing of securities/obtaining duplicate documents is facilitated in the event of loss of original records for any reason.

Notes

8. Extend to other custodial entities/depositories/clearing organizations, all cooperation necessary for conduct of business in the areas of inter-custodial settlements and transfer of securities/funds. Ensure an arm's length relationship from other businesses, both in terms of staff and systems. Exercise due diligence in safekeeping/administration of assets of clients in custody.

9. The officers/employees engaged in custodial services should not be engaged in any other activity carried out by him.

Separate custody account and agreement with clients: A separate custody account for each client should be opened by the custodian and assets of one client should not be mixed with those of others. The custodian should enter into an agreement with each client providing for the circumstances under which he would (1) accept/release securities, assets/documents and money from the custody account, and (2) receive rights/entitlement on the securities of the client. It should also include circumstances and the manner of registration of securities in respect of each client and details of insurance to be provided for by the custodian.

Maintenance of records: The custodians should maintain records/documents on behalf of/for each client containing details of: securities, assets/documents received/released, money received/ released, rights/entitlements arising from the securities held, registration of securities ledger, instructions received from/given to clients and all reports submitted to the SEBI. These records should be maintained for at least five years and the place where they are maintained to the SEBI should be intimated.

Appointment of compliance officer: Every custodian of securities should appoint a compliance officer to monitor the compliance of the SEBI Act/regulations/notifications/ guidelines/ instruction and so on issued by the SEBI/government and for redressal of investors' grievances. He should immediately and independently report to the SEBI any non-compliance observed by him.

Information to SEBI: The SEBI can, at any time, ask for any information with respect to any matter relating to the activities of a custodian. Such information must be provided within such reasonable period as the SEBI may specify.

Monitoring and Audit of Custodians by SEBI

The SEBI is empowered to conduct inspection/investigation including inspection by an auditor of the books of accounts/records/documents/of custodians for any of the following purposes:

1. To ensure that they are being maintained in the specified manner.

2. To investigate the complaints received from the investors/clients/any other person on any matter related to the activities of Custodian.

3. To ascertain compliance with the provisions of the SEBI Act and these regulations.

On the basis of the inspection/investigation report, the SEBI can call upon the custodian to take such measures as it deems fit.

Suspension of registration: In case of default, the SEBI can suspend/cancel registration of a custodian. The registration of the custodians is liable to be suspended by the SEBI for the following reasons:

1. Contravention of the provisions of the SEBI Act, rules and regulations.

2. Failing to provide any information required by the SEBI or furnishing false/misleading information.

Notes

3. Non-submission of periodic returns reports required by the SEBI.
4. Non-cooperation in any enquiry/inspection by the SEBI.
5. Failure to update its systems/procedures as recommended by the SEBI.
6. Failure to resolve the complaints of clients or provide a satisfactory reply to the SEBI in related matters.
7. Guilty of misconduct/breach of code of conduct.
8. Failing to pay annual fees.

SEBI's Norms and Practices for Custodians

The SEBI has prescribed some uniform norms and practices for the custodians of securities in their interactions with other market participants. They must:

1. act as an integral part of the system. Therefore, no custodian should have such norms and practices as would result in their functioning in isolation, away from the clearing and settlement systems.
2. become the members of clearing houses/clearing corporations of the stock exchange(s) and participate in the clearing and settlement process, through them, for all securities.
3. comply with the applicable rules of stock exchanges where they have become members of the clearing house/clearing corporation. This would facilitate operations of clients, and also result in the reduction of cost of service for the clients.
4. advise all their clients about the facility of settling their trades through the clearing house/clearing corporation, stressing on advantages such as (i) time bound rectification of objections, (ii) no shortages, (iii) reduction of risk and (iv) cost efficiency.
5. highlight that 'DVP trades' (i.e. Delivery vs. Payment Trade) where delivery of securities is not taken or given by the custodian through the clearing house/clearing corporation would not enjoy the attendant benefits.
6. adopt the uniform good/bad delivery norms, including norms for the rectification of bad deliveries through Bad Delivery Cell, framed by the SEBI and circulated to all stock exchanges, as amended from time to time.
7. adopt, in cases of trades where the custodian does not take or give delivery from or to the clearing house/clearing corporation (DVP trades), the following norms:
   (i) Accept the partial delivery of shares arising from a trade from the buying broker, irrespective of the value of the trade.
   (ii) Accept the delivery of shares arising from a trade from the buying broker in at least two partial deliveries, with the first partial delivery accounting for at least 50 per cent of the total trade size. The delivery of shares of the second partial delivery should be completed in accordance with the bylaws of the stock exchange though which the trade was executed.
   (iii) Bring to the notice of the SEBI, exceptions in case any client has a reservation about accepting partial settlement.
   (iv) Make payment for all shares delivered up to 5.30 p.m. on day 1 by 10 a.m. on day 3, so that the high value clearing on day 3 is possible for the broker.

Notes

(v) Deliver stocks to brokers within 24 hours of availability of clear funds from the broker or 48 hours of payment through a high value cheque or pay order or demand draft by the broker, whichever is earlier.

(vi) Where collateral is taken for shares which are released to the broker for the rectification of bad delivery, the collateral should be reasonable with reference to the bad delivery portion; and for the collateral in the form of cash, interest would be paid by the custodian to the broker.

7.5.1 The Stock Holding Corporation of India Ltd.

Stock Holding Corporation of India Ltd. (SHCIL) was incorporated as a Public Limited Company in 1986. It has been jointly promoted and owned by leading Banks and Financial Institutions viz., IFCI Ltd., IDBI Bank Ltd., SU-UTI, LIC, GIC, NIA, NIC, UIC, and TOICL, all leaders in their fields of business. SHCIL began by offering custodial and post trading services, adding depository services and other services to its portfolio over a period of time. SHCIL has established itself in India as a one-stop solution provider in the Financial Services domain.

Why SHCIL?

1. Well integrated front and back office, paper and electronic systems. A focussed Client Relation Team to manage your needs & queries. A single point contact for your comfort.
2. In-house capability to address all IT needs in terms of software development, maintenance, back office processing, database administration, network maintenance, backups and disaster recovery.
3. Multilevel security is maintained in software, applications and guards to access to various data, client and internal reports.
4. Expertise in running processes utilising digital signatures.
5. Regular Audits internal and external, by SEBI, Depositories, Clients and compliance to rules and regulations.
6. Constant review and benchmarking of processes to ensure adherence to global best practices.
7. Insurance cover with international re-insurance.
8. Full Confidentiality of business operations.

Aim of the SHCIL

- to make it easy for an investor to buy/sell securities
- to keep active share and debenture certificates in safe custody
- to computerise trading among active investors of such institutions, mutual funds etc.
- to create regional SHCs as volumes grow
- to credit dividend and other payment directly to investors through central collection, and to act as a bank/custodian for shares

The SHCIL renders services like:

- Clearing and settlement services
- Registration and Transfer processing
- Depository services

Notes

- Corporate actions and benefits collection, and
- Management information system considering the pivotal services rendered by the SHCIL. NSE has considered using its services for the benefit of investors who are spread throughout the length and breadth of the country. Without its services, the functions of NSE will not be complete and perfect. SHCIL, thus, is complementary to its function as a depository.

Self Assessment

Fill in the blanks:

14. Custodians Clearing members are required to request for allotment of ..... code for the clients for which they wish to clear and settle.
15. The ……. is required to confirm whether he is going to settle that trade or not. If the custodian confirms the trade.

7.6 Summary

- The introduction of Depositories has significantly contributed for the efficient functioning of the stock marketing trading on line.
- Depositories are offering a variety of services to corporates, shareholders, banks and the Government.
- It has simplified the entire process of equity trading and settlement with in the permitted time.
- Depositories are offering other activities like company stock equity book building activity and securitisation services which have significantly contributed to the growth of stock market trading. But the depositories are adapting to false means of allocation and their binary transactions.
- SEBI should take up more stringent norms and Punish severely to prevent such frauds to retain the confidence and trust of the common investor, who is always being exploited by the market mechanism.

7.7 Keywords

Depositories (NSDL/CDSL): The Depositories (NSDL/CDSL) will provide the list of demat account holders and the number of shares held by them in electronic form on the Record date to the company/registrar (known as Benpos.

Depository (NSDL and CDSL): A Depository (NSDL and CDSL) is an organisation like a Central Bank, i.e. Reserve Bank where the securities of an investor are held in electronic form, through Depository participants.

Depository System: Depository system functions very much like the banking system. A bank holds funds in accounts whereas, a Depository holds securities in accounts for its clients. A bank transfers funds between accounts whereas, a Depository transfers securities between accounts.

7.8 Review Questions

1. Explain about the importance of depository system.
2. What are the guidelines of SEBI to regulate the depository System?

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3. What are the difficulties and capabilities required for India to attain efficient and effective functional depository system?
4. What are the SEBI Guidelines with respect to depositories?
5. What do you mean by custodians?
6. Throw light on the various activities of Registers and transfer agents.
7. What are the various factors effecting the success of demat system?
8. In the light of various categories of investors throw light on the qualified institutional Investors.
9. How is NSDL different from CDSL?
10. What are the general obligations and responsibilities of bankers to an issue?

Self Assessment

1. Depository
2. Dematerialisation
3. Depository Participant
4. Securities
5. Demat
6. Depository participants
7. Risk
8. Minimum
9. Maximum
10. Brokers
11. Initial Public Offer (IPO)
12. NSDL
13. National Securities Clearing Corporation (NSCC)
14. Custodian Participant (CP)
15. custodian

7.9 Further Readings

Books

P G Apte, International Financial Management

RBI publications: Depository Services, review, 2004

Merchant Banking, Bharath Publications

Online link

Karvy.com /investors services

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Unit 8: Financial Institutions

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Objectives

After studying this unit, you should be able to:

- Learn the concept of financial institutions;
- Explain the banking financial institutions;
- Discuss the various types of non banking financial institutions;
- Understand development banks;
- Understanding regional rural banks.

Introduction

Financial sector plays an indispensable role in the overall development of a country. The most important constituent of this sector is the financial institutions, which act as a conduit for the transfer of resources from net savers to net borrowers, that is, from those who spend less than their earnings to those who spend more than their earnings. The financial institutions have traditionally been the major source of long-term funds for the economy. These institutions provide a variety of financial products and services to fulfill the varied needs of the commercial sector. Besides, they provide assistance to new enterprises, small and medium firms as well as to the industries established in backward areas.

8.1 Banking Financial Institutions

The name bank derives from the Italian word banco or desk/bench, used during the Renaissance by Florentine bankers, who used to make their transactions above a desk covered by a green era tablecloth. However, traces of banking activity can be found even in ancient times.

In fact, the word traces its origins back to the Ancient Roman Empire, where moneylenders would set up their stalls in the middle of enclosed courtyards called "macella" on a long bench called a "bancu", from which the words "banco" and bank are derived. As a moneychanger, the merchant at the "bancu" did not so much invest money as merely convert the foreign currency into the only legal tender in Rome - that of the Imperial Mint.

8.2 Commercial Banking

8.2.1 Meaning of Commercial Banking

It has been observed that commercial banks have two popular meaning. The two popular meanings of commercial banking are given as below:

1. Commercial bank is the term used for a normal bank to distinguish it from an investment bank (a form of banking where the bank takes part in the market investment process). This is what people normally call a "bank". Since the two types of banks no longer have to be separate companies, some have used the term "commercial bank" to refer to banks that focus mainly on companies. In some English-speaking countries outside North America, the term "trading bank" was and is used to denote a commercial bank. During the Great Depression and after the stock market crash of 1929, the U.S. Congress passed the Glass-Steagall Act 1933-35, requiring that commercial banks engage only in banking activities (accepting deposits and making loans, as well as other fee-based services), whereas investment banks were limited to capital markets activities. This separation is no longer

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mandatory. It raises funds by collecting deposits from businesses and consumers via checkable deposits, savings deposits, and time (or term) deposits. It makes loans to businesses and consumers. It also buys corporate bonds and government bonds. Its primary liabilities are deposits and primary assets are loans and bonds.

2. Commercial banking can also refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses, as opposed to normal individual members of the public (retail banking).

8.2.2 The Role of Commercial Banks

Commercial banks engage in the following activities:

1. Processing of payments by way of telegraphic transfer, EFTPOs, internet banking, or other means.
2. Issuing bank drafts and bank cheques.
3. Accepting money on term deposits.
4. Lending money by overdraft, installment, loan, or other means of loans.
5. Providing documentary and standby letter of credit, guarantees, performance bonds, securities underwriting commitments and other forms of "off balance sheet" exposures.
6. Safekeeping of documents and other items in safe deposit boxes/lockers.
7. Sale, distribution or brokerage, with or without advice, of insurance, unit trusts and similar financial products as a "financial supermarket".
8. Traditionally, large commercial banks also underwrite bonds, and make markets in currency, interest rates, and credit-related securities, but today large commercial banks usually have an investment bank arm that is involved in the above mentioned activities.

8.2.3 Various Types of Loans Granted by Commercial Banks

1. ***Secured loan:*** A secured loan is a loan in which the borrower pledges some asset (e.g., a car or property) as collateral (i.e., security) for the loan.
2. ***Mortgage loan:*** A mortgage loan is a very common type of debt instrument, used to purchase real estate. Under this arrangement, the money is used to purchase the property. Commercial banks, however, are given security-a lien on the title to the house-until the mortgage is paid off in full. If the borrower defaults on the loan, the bank would have the legal right to repossess the house and sell it, to recover sums owing to it. In the past, commercial banks have not been greatly interested in real estate loans and have placed only a relatively small percentage of their assets in mortgages. As their name implies, such financial institutions secured their earning primarily from commercial and consumer loans and left the major task of home financing to others. However, due to changes in banking laws and policies, commercial banks are increasingly active in home financing. Changes in banking laws now allow commercial banks to make home mortgage loans on a more liberal basis than ever before. In acquiring mortgages on real estate, these institutions follow two main practices. First, some of the banks maintain active and well-organized departments whose primary function is to compete actively for real estate loans. In areas lacking specialized real estate financial institutions, these banks become the source for residential and farm mortgage loans. Second, the banks acquire mortgages by simply purchasing them from mortgage bankers or dealers. In addition, dealer service companies, which were originally used to obtain car loans for permanent lenders such as

commercial banks, wanted to broaden their activity beyond their local area. In recent years, however, such companies have concentrated on acquiring mobile home loans in volume for both commercial banks and savings and loan associations. Service companies obtain these loans from retail dealers, usually on a non-recourse basis. Almost all bank/ service company agreements contain a credit insurance policy that protects the lender if the consumer defaults.

3. ***Unsecured loan:*** Unsecured loans are monetary loans that are not secured against the borrowers' assets (i.e., no collateral is involved). These may be available from financial institutions under many different guises or marketing packages:

   (i) *Bank overdrafts:* Allowing the account holder to draw more than the balance held in the account, specially the current account.

   (ii) *Corporate bonds:* Debt issued by the companies as unsecured (no promise that the principal amount will be paid back).

   (iii) *Credit card:* Facility to get credit up to a certain amount on your income on purchases or cash drawn through a plastic smart card called credit card.

   (iv) Credit facilities or lines of credit.

   (v) Personal loans.

8.3 Various Types of Banks in India

In India, several types of banking are available. Brief descriptions of all the banks are given below:

1. ***Commercial bank:*** The definition and class of commercial bank has been discussed in the previous part of this unit.

2. ***Investment bank or merchant banks:*** These are banks which takes part in long and mid term fixed loan to the business organization. They take part in the development of new business, besides helping them to raise money from the financial market.

3. ***Exchange banks:*** These are banks which provide foreign exchange to the business house for settlement of transaction of overseas business.

4. ***Cooperative banks:*** These banks are formed under the cooperative system and are largely operative in rural and agrarian sector.

5. ***Land development banks:*** These banks are essentially formed to finance the short-term and long-term fund requirements of the agriculture sector. They are popularly called as Regional Rural Banks.

6. ***Saving banks:*** These mobilize fund through savings in domestic sector. In India, Government arranges to run saving banks through post offices.

7. ***Central banks:*** These are controlling banks for the financial and fiscal system of various countries. They act as the lender of last resort to the banks and act as the custodian of money. The Reserve Bank of India (RBI) is the central bank of India.

Various Kinds of Banking Prevalent in India

1. ***Branch banking:*** Under this method a single bank does the banking through a network of branches in various parts of the country. Most of the scheduled commercial banks operate in India through branch banking mode.

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2. ***Unit banking:*** Under this method, the banking is carried out through a single office confirmed to a particular area.

3. ***Correspondent banking:*** This is a system under which banks make arrangement for banking with other banks in the country or with overseas banks.

8.4 Nationalization of Banks in India

By the 1960s, the Indian banking industry had become an important tool to facilitate the development of the Indian economy. At the same time, it had emerged as a large employer, and a debate had ensued about the possibility to nationalize the banking industry. Indira Gandhi, the then Prime Minister of India expressed the intention of the GOI in the annual conference of the All India Congress Meeting in a paper entitled "Stray thoughts on Bank Nationalisation." The paper was received with positive enthusiasm. Thereafter, her move was swift and sudden, and the GOI issued an ordinance and nationalized the 14 largest commercial banks with effect from the midnight of July 19, 1969. Jayaprakash Narayan, a national leader of India, described the step as a "masterstroke of political sagacity." Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August 1969.

A second dose of nationalization of six more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second dose of nationalization, the GOI controlled around 91% of the banking business of India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. After this, until the 1990s, the nationalized banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy.

Self Assessment

Fill in the blanks:

1. …….. act as a conduit for the transfer of resources from net savers to net borrowers.

2. ……. can also refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses.

3. Commercial banks engage in …….. by overdraft, installment, loan, or other means of loans.

4. A …….. is a loan in which the borrower pledges some asset collateral for the loan.

5. A mortgage loan is a very common type of ……. instrument, used to purchase real estate.

6. Unsecured loans are monetary loans that are …….. against the borrowers' assets.

7. …….. are formed under the cooperative system and are largely operative in rural and agrarian sector.

8. Under …….. method a single bank does the banking through a network of branches in various parts of the country.

9. …… is a system under which banks make arrangement for banking with other banks in the country or with overseas banks.

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8.5 Non Banking Financial Institutions / Companies

8.5.1 Introduction

The study of Non-banking Financial Companies (NBFCs) is a difficult proposition in India. This is because the number of companies working under the roof of NBFC is very large and their functions are very diverse. Very small portion actually report to the RBI. The blurring of the definition has been due to large number of multi service companies coming into being. The RBI (Amendment) Act 1997 defines NBFC as an institution or company whose principle business is to accept deposit under any scheme or arrangement or in any manner, and to lend in any manner. Due to this definition many loan and investment companies have been reported as NBFCs.

The numbers of companies whose activities are listed under NBFC are as follows:

1. Equipment Leasing Companies (ELC) are those whose principle activity is to arrange leasing of assets.
2. Hire Purchase Finance Companies (HPFC) which finance and does hire purchase of assets as main activity.
3. Housing Finance Companies (HFC) whose function is to acquire fund and creates housing for individual or corporate. This includes acquiring of land as well.
4. Investment companies (IC) whose principle activity is to acquire securities.
5. Loan Companies (LC) thrives by providing loan and finances as main business.
6. Mutual Benefit Financial Companies (MBFC) are the companies which are notified by the Central Government under section 620A of the Companies Act, 1956 (1 of 1956) and are popularly known as Nidhis.
7. Miscellaneous Non-banking Companies (MNBC) are the ones which carry out any one of the activity listed below:
   (i) Managing, conducting or supervising as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specific number of subsidiaries that every one of them shall subscribe a certain sum in installment over a definite period of time and that every one of such subscribers shall provide for in the agreement be entitled to the prize sum/amount.
   (ii) Conducting any other form of chit or kuri which is different from the type of business referred to above.
   (iii) Undertaking any business or engaging in or executing in any or one of the business similar to the ones mentioned above.
8. Residuary Non-banking companies (RNBC) means a company which receives any deposit under any scheme or arrangement, by whatever name called, on a lump sum or installments, by way of contributions or subscriptions or by sale of units or certificates or any other instruments, or in any other manner and which according to the definitions contained in the Non-banking Companies (Reserve Bank) Direction, 1977 or as the case may be, the Miscellaneous Non-banking Companies (Reserve Bank) Direction, 1977 is not an insurance company or a company belonging to 1 to 7 above.

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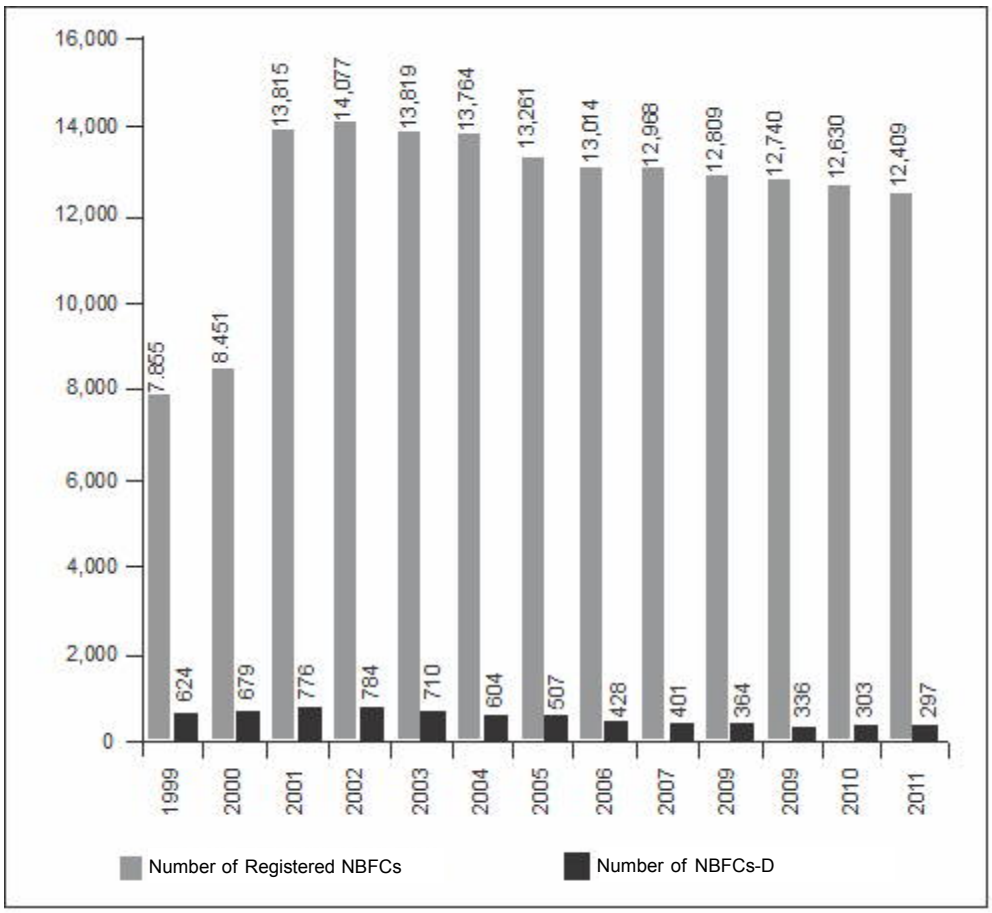
The NBFCs have helped in bridging the credit gaps in several sectors which traditional institutions, such as banks, could not fulfill. They have been playing a positive role in accessing certain depositor segments and catering to specified credit requirements of certain classes of borrowers. A thriving and growing NBFC is a requirement for the healthy financial growth of a nation.

As said earlier, there are thousands of NBFC players, many of which are not reported. Figure 8.1 below gives a picture of the reported NBFCs as noted by the RBI Bulletin, in March 2011.

Figure 8.1: Number of NBFCs Registered with the RBI in India in 1999-2009



Source: RBI Bulletin

Note: NBFCs-D pertains to deposit taking NBFCs

8.5.2 Current Scenario of the NBFCs Business

In recent years, the number of NBFCs once again has begun to decline on account of high cost of funds, intense competition with the banking sector and increase in consolidation activity. The number of deposit taking NBFCs (NBFCs-D) fell sharply from 710 as at end-March 2003 to 336 as at end-March 2009 to 297 as end-March 2011, primarily due to the exit of many NBFCs from deposit taking activities.

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Table 8.1: Current Scenario of the NBFCs Business

(Number of Companies)

Ownership (1)	NBFCs ND (2)	Deposit taking NBFCs (3)
A. Government Companies	**9**	**9**
	(2.8)	(3.0)
B. Non-Government Companies	**310**	**288**
	(97.2)	(97.0)
1. Public Ltd Companies	181	279
	(56.7)	(93.9)
2. Private Ltd Companies	129	9
	(40.4)	(3.0)
Total No. of Companies (A)+(B)	**319**	**297**

Note: 1) Figure in parentheses is percentage share in total number of NBFCs.
2) NBFCs-ND pertains to non-deposit taking NBFCs

The ownership pattern of NBFCs-ND as well as deposit taking NBFCs suggests that these companies were predominantly non-government companies (Public Limited Companies in nature). The percentage of non-government companies were 97.2 per cent and 97.0 per cent, respectively, in NBFCs-ND and deposit taking NBFCs as against government companies having a share of 2.8 per cent and 3.0 per cent, respectively at end- March 2011.

8.5.3 Regulation of NBFCs

While the NBFCs have provided a lot of good service to the country, there had been gross irregularities, adverse lending practices and overall unhealthy financial scams which became a part of the nation's history now. With the RBI (Amendment) Act, 1997, the NBFCs except for the HFC have been brought under the regulation of the RBI. The HFCs have been brought under the regulation of NHB (National Housing Board).

The major regulatory provisions currently in force for the NBFCs are as follows:

1. The minimum net owned funds of ` 25 lakh and RBI registration are the entry point norms now. The RBI has powers to cancel registration of NBFCs.
2. NBFCs have to maintain only 5 per cent of their deposits in liquid assets effective from 1st January 2000.
3. They have to create reserves fund and transfer not less than 20 per cent of their net deposits to it every year.
4. The RBI can now direct them on issues of disclosures, prudential norms, credit, investment, etc.
5. Nomination facility is now made available to depositors of these companies.
6. Unincorporated bodies engaged in financial activity cannot accept deposits from the public from 1st April, 1997.

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7. They have to achieve a minimum credit rating from any one of the three existing credit rating agencies.
8. A ceiling of 15 per cent interest as also the ceiling on the quantum of deposits for NBFCs (other than nidhis) have been removed, subjected to compliance with the RBI directives and guidelines.

8.5.4 Major NBFCs in India

Having talked about the regulation it is important to discuss some of the major NBFCs in India that operate across the length and breadth of the country in various forms.

Loan Companies (LCs)

The LCs constitute the major part of the NBFC sector, accounting for about 50 per cent of the total deposits of this sector till now. They are mostly partnership concerns, and their operators are generally confined to a few places in India like Gujarat and Karnataka. They accept manly fixed deposits but sometimes, accept call deposits too. Most of these deposits are not insured and are unsecured, which make it uninteresting for the common depositors. To attract deposits they sometime offer attractive prizes and provide a higher interest rate which can be as high as 7 to 8 per cent higher than the bank deposits. Since their lending practices are not governed by scientific principles they bear disproportionate risk to the capital employed. These institutions also provide other services such as discounting facilities and purchasing of "hundis".

Investment Companies (ICs)

Investment companies are numerically the largest and the most important of the NBFCs. Their function covers narrow and specialized areas like giving commercial loans, personal loans, etc. They provide mostly domestic loans and the share of industrial loans is negligible. Most of these companies have close links and puts them in better position for the task of decentralization of the financial structure of the country. They charge higher rate of interest than the commercial banks for the borrowing and also provide higher interest rate for borrowing. They attract customers due to simple and non-cumbersome procedure as against the banking industry. These institutions get business because they create liabilities and assets which satisfy in a great measure non-financial preferences of the lenders and borrowers. As these institutions do not accept demand deposits they do not compete with the banks in that field.

Hire Purchase Finance Companies (HPFCs)

Hire purchase credit is defined as a system under which term loans for purchase of goods and services are advanced to be fractionally liquidated through a contractual obligation. The goods whose purchases are thus financed may be consumer goods or producer goods or they may be simply services such as air travel, etc. Hire purchase finance in India is provided by large segment of the market, which includes the seller of the goods and services from their capital, the banks and specialized institutions. The terms of credit purchase vary from product to product and on geographical location too. However, the banks follow a common method and they get these hire purchases secured by covering it with insurance all the time. The volumes of HPFCs has declined as is recorded in the table 8.2 below:

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Table 8.2: Public Deposits held by NBFC-D

Classification	As at end March				Percentage y-o-y Change in Public Deposits (%)
	Number of NBFCs		Public Deposits (Rs mn)		
	FY08	FY09P	FY08	FY09P	
Asset Finance	185	147	11,610 (56.9)	13.640 (70.3)	17.5
Equipment Leasing	15	11	100 (0.5)	30 (02)	–70.6
Hire Purchase	76	74	1,690 (8.3)	1,860 (9.6)	10.1
Investment	1	1	190 (0.9)	- -	-
Loan	70	42	6,830 (33.4)	3,880 (19.9)	–43.3
MNBC	3	-	10 -	- -	-
Total	350	275	20,420	19,410	–4.9

-: Nil/Negligible. P. Provisional

Notes: Figures in parentheses are percentages to respective totals

Source: RBI

Lease Finance (LF) Companies

A lease is a financial device which has developed rapidly during 1960s and 1970s in the U.S. and in India just before the mid-1980s. It is a form of financing employed to acquire the use of assets. Through lease, firms can acquire the economic use of assets for a stated period of time without owning it. Every lease involves two parties: the user of the asset known as the lessee and the owner of the asset know as the lessor. Leases are of two kinds: (1) Operating lease and (2) Financial lease or capital lease. The operating lease is a short-term lease which can be cancelled by giving notice to the counterparty. Financial lease is a non-cancellable contractual commitment on the part of the lessee to make a series of payments to the lessor for the use of an asset. It can be cancelled only if the lessor is reimbursed for any loss. The leasing industry experienced a short boom during 1983-87 when the number of ELCs had increased from less than 5 to about 400. There was a spat of public issues of equity capital by many such companies during this period. There was a burst in the number of leasing companies thereafter, but the volume of say 126 leasing companies grew to ₹ 19,500 crore thereafter.

Housing Finance Companies (HFC)

Housing is one of the basic necessities of man and the capital required per dwelling is so large that few individuals can raise it from their own savings. There is therefore, a greater need and scope for the development of arrangements for the supply of loans or finances for the purpose of house construction. However, for some reason or the other, the shelter sector of the Indian financial system remained utterly underdeveloped till end of the 1980s. Thereafter, impetus given by the government to borrow housing loans by providing tax incentives have worked wonders in the Indian economy. Per capita housing infrastructure has gone up by 40 per cent during the last decade. Organizations which have been doing well in these sectors include HUDCO, a government sponsored company, which is both in individual home finance and town and mega infrastructure finance; State Housing Finance (SHFSs) which work in the residual mortgage market and are involved in both individual retail loans and corporate loans. HDFC, a private public set up, which has a high visibility to the extent of 70 per cent of the urban retail

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loans are with these organization. Commercial banks, UTI, LIC and several other government organizations have come forward to establish the housing finance companies. All these HFCs are governed by National Housing Bank (NHB). There are reportedly 74 HFCs with 9.6 per cent deposit mobilization of the total NBFC and a total resource of ₹ 1,860 million as of 2009.

Mutual Benefit Financial Companies (MBFCs)

Mutual benefit companies or nidhis, as they are known in India are public limited joint stock companies operating mainly in the southern India. They are old institutions and the history of some of them dates back to 100 years. Out of 123 nidhis in 1995, 97 were in Tamil Nadu alone; and that too in Chennai city, there were 70 nidhis. They source their capital from the members, depositors and public at large besides the promoters. The deposits they accept are fixed and recurring deposits. Unlike NBFIs, they also take demand deposits. The main function of the nidhis is to advance loans to their members for the house construction or repairs, marriage and other personal works. These loans are generally secured loans, given against the security of tangible assets such as house property, gold, jewellery or stocks of companies and insurance policies. The notable term of these organizations is that (1) they offer saving schemes to those which are linked with the assurance to make credit available when required, (2) they make credit available to those whom commercial banks may hesitate to give loans, (3) they are local people friendly, and (4) the interest rates of these organizations are comparable to the banks. They are incorporated bodies governed by the RBI.

Residuary Non-banking Companies (RNBCs)

Residuary non-banking companies generally tap the public saving by operating deposit schemes akin to recurring deposit schemes of the banks. Mobilization of deposits is effected from a large number of small and uniform depositors by expressly promising them that their money would be invested in banks and government securities. The collection of deposits at the doorsteps of depositors through field staff is what makes these organizations successful. These companies acquire the funds at low cost for longer terms and deploy them at relatively higher yields. Many of these organizations work with meagre capital.

Merchant Banks (MBs)

The activities in which the MBs are involved are quite large. They are often called "acceptance and issue houses" in the UK and "investment banks" in the US. They offer a whole lot of financial services and finance which include management, marketing and underwriting of new issues, project promotions and project finance, syndication of credit and other facilities, leasing including project leasing, corporate advisory services and investment advisory services, to name a few. The kind of organizations which are involved in these sectors include commercial banks, all-India financial institutions such as the IDBI, private consultancy firms such as J. M. Financial services, technical consultancy organizations such as PWC and Ernst Young. SEBI has made categories of MBs as I, II, II and IV on the basis of different eligibility criteria which were set by keeping in view the different activities taken up by these MBs. The minimum net worth required by these categories are: I= ₹ 5 crore, II = ₹ 50 lakhs, III = ₹ 25 lakhs and IV = nil. Despite huge numbers available there are handful of which are doing well in the industry.

Venture Capital Funds (VCFs)

These institutions supply risk capital to new businesses. However, their activity largely remains vague. The VCFs play an important role in developing upcoming and new industries such as software, biotechnology firms, etc. Although venture capital provides common equity capital, their common vehicle of finance is convertible preference shares. They do not generally provide

debt capital. They target 48 to 50 per cent return in the business. Several institutional investors are involved in venture capital such as IDBI, UTI, etc.

Factors

A factor is a financial institution which manages the collection of accounts receivables of the companies on their behalf and bears the credit risk associated with those accounts. In general, factoring means selling, with or without recourse, the receivables by the firm to a factor. By factoring, the company relieves itself of the organization, procedures and internal expenses of collecting its receivables. Banks and other financial organizations are largely involved in factoring in India. The common type of factoring in India is 'full recourse factoring' where, the factor gets the full right to collect the accounts receivables of the client (the seller) from their customers.

Credit Rating

Credit rating agencies are properly individual organizations which are given assignment to find the credibility of debt and equity issues in terms of the risk involved in them. Their services are used by various parties including the investors, the regulators, the market intermediaries, the merchant banks, etc. In India, there are three main credit raters which include CRISIL, ICRA and CARE. Besides that, there is ONIDA individual credit rating agency ltd (ONICRA).

Depository and Custodial Services

The change in trading of securities market to electronic form, and the huge growth in the electronic trading has resulted in creating the depository and custodial function in India. They largely hold the stock in electronic forms (dematerialized account or demat account) of the physical stocks. They facilitate the stock market in a paperless manner and help in the bookkeeping of the stock and security market (including the debt market). NSDL is the first depository company which came up in 1996 as a joint effort of NSE, IDBI and UTI. However, a beginning had been made in 1988 with the establishment of Stock Holding Corporation of India Ltd. (SHCIL).

Concluding the whole issue, the NBFCs are important links in the financial segments of the business and they form and serve the missing links which the banks and major financial services can not promote in India.

8.5.5 Liberalization of Non-banking Financial Companies

The four categories of non-banking financial companies, that is, equipment leasing companies (ELCs), Hire Purchase Companies (HPs) Investment Companies (ICs) and Leasing Companies (LCs) submit statutory annual reports to the RBI along with the schedule of expense and income.

The RBI has issued a separate set of directions for financial, miscellaneous and residuary non-banking and non-banking deposit accepting companies.

The activities of the NBFC are regulated by the Government of India, under the (Acceptance of Deposit) Rules 1975, framed under section 58A of the Companies Act 1956.

In order to moderate the deposit mobilization of NBFCs and protect investors' funds, the quantum of deposits have been linked to the Net Owned Funds (NOF) which is the aggregate of the paid up capital and free reserve reduced by balance of loss, deferred revenue expenditure and other intangible assets. As of now, all NBFCs are not allowed to raise any fund from the public if the NOF is less than ₹ 25 lakh. It has been made mandatory for all NBFCs to receive credit rating on public deposit that they float. The NBFCs have been subjected to 16 per cent per annum interest

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rate ceiling. Besides, brokerage and commission payable by NBFC to its agents have been fixed at 2 per cent on 1 year to 5 years of deposit.

The group on financial companies constituted under the Chairmanship of Dr. A. C. Shah, suggested category-wise classification of the NBFCs. It further suggested that regulation should be asset-based. It allowed the NBFC to accept deposit between 12 to 84 months. The group further suggested for adaptation of prudential norms as far as income recognition, transparency of accounts and provisions for bad debts are concerned.

Some of the suggestions of the group were taken up by the Government of India and liberalization measures were undertaken in 1996. The liberalization enabled a classification of registered financial companies in the equipment leasing and loan companies besides giving them the benefit to enjoy the reduction of SLR from 15 per cent to 12.5 per cent.

Caselet

RBI to Plug Regulatory Gaps in NBFC Biz

The Reserve Bank of India plans to strengthen the regulatory framework for non-deposit taking systemically important non-banking finance companies as tightening of the regulation for the banking sector has increased the incentives for regulatory arbitrage by moving business to NBFCs.

Pointing out that setting up an NBFC is a more attractive option as entry point norm for them (at present net owned funds of ₹ 2 crore) is low as compared to that for banks (₹ 300 crore) and that they are subject to relatively lighter touch regulation, the RBI, in its second financial stability report said "some concerns remain especially in the context of the rapidly expanding NBFC sector."

Among the reasons why regulatory gaps need to be plugged include NBFCs not being subject to any restrictions regarding investment in the capital market thereby leading to enhanced market risk; nor do they have any restrictions on setting up of subsidiaries, thereby allowing setting up of possibly opaque structures with concomitant transparency issues. Further, quality of corporate governance and management can give rise to serious concerns, the report said.

Another concern that arises is in the context of definition of an NBFC in terms of its "principal business" which makes it possible for an NBFC to conduct some other non-financial activity by deploying funds in non-financial assets, leading to a lack of level playing field vis-à-vis banks.

Multiple regulators for non-banking financial entities in the country and an entity-based approach to regulation gives rise to possible regulatory gaps - functional activities remaining unregulated, gaps in regulation permitting surrogate raising of public funds, leveraged activities by entities like merchant banks, portfolio managers and brokerages not being subject to prudential regulation. These, according to the report, will need to be urgently addressed.

Referring to the fact that certain NBFCs, coming under the purview of other regulators, have been exempted from the regulatory purview of the RBI subject to certain conditions, the central bank said this has given rise to instances of certain functional activities of some exempted NBFCs (for example merchant banks) remaining unregulated.

Source: http://www.thehindubusinessline.in

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Task Enumerate the various controls which have been imposed on the NBFCs in India.

8.6 Introduction to Development Banks

Development banking is the financing of projects assessed on the basis of their viability to generate cash flows to meet the interest and repayment obligation. They have an in-built promotional aspect, because projects have to fall within the overall national industrial priorities, located preferably in backward areas and promoted by entrepreneurs.

8.6.1 Nature of Development Banking

In the late forties, right after the Second World War there was a paradigm shift in the approach to lending for industrial projects from security for the loan to income or cash flow from the project. This required a new set of institutions providing finance on a medium and long-term basis from 5 to 7 or even 10 years. Their approach to appraisal had to take into account the time value of money, which involved the use of discounted cash flow techniques. The projects represented income streams and their viability was assessed on that basis and not on the basis of any security provided for the loan. Until the emergence of a vibrant capital market in the 90s, development banks for almost four decades played a vital role in promoting an industrial structure conforming to national priorities, located in backward areas and encouraging entrepreneurs.

8.6.2 Development Banks in India

Asian Development Bank India Resident Mission (ADBINRM) - Provides information about ADB and India partners in development, INRM's newsletter, project activities in India, business opportunities, and more.

Development Credit Bank Limited

1. Economic Development Corporation of Goa, Daman, and Diu Ltd (EDC) – Development bank set up by the government of Goa whose objective is to promote industrial investment in the state.
2. Industrial Financial Corporation of India – A development finance institute.
3. Small Industries Development Bank of India – Provides financing and development of industry in the small scale sector.

An Overview of Development Banking in India

The concept of development banking rose only after Second World War, successive of the Great Depression in 1930s. The demand for reconstruction funds for the affected nations compelled in setting up a worldwide institution for reconstructions. As a result the IBRD was set up in 1945 as a worldwide institution for development and reconstruction. This concept has been widened all over the world and resulted in setting up of large number of banks around the world which coordinating the developmental activities of different nations with different objectives among the world. The Narashimam committee had recommended to give up its direct financing functions and to perform only the promotional and refinancing role. However it is the S. H. Khan committee appointed by RBI that has recommended to transform the Development Bank (development finance institution) into universal banking institutions.

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The course of development of financial institutions and markets during the post-Independence period was largely guided by the process of planned development pursued in India with emphasis on mobilisation of savings and channelising investment to meet Plan priorities. At the time of Independence in 1947, India had a fairly well-developed banking system. The adoption of bank dominated financial development strategy was aimed at meeting the sectoral credit needs, particularly of agriculture and industry. Towards this end, the Reserve Bank concentrated on regulating and developing mechanisms for institution building. The commercial banking network was expanded to cater to the requirements of general banking and for meeting the short-term working capital requirements of industry and agriculture. Specialised development financial institutions (Development banks) such as the IDBI, NABARD, NHB and SIDBI, etc., with majority ownership of the Reserve Bank were set up to meet the long-term financing requirements of industry and agriculture. To facilitate the growth of these institutions, a mechanism to provide concessional finance to these institutions was also put in place by the Reserve Bank.

The first development bank In India incorporated immediately after independence in 1948 under the Industrial Finance Corporation Act as a statutory corporation to pioneer institutional credit to medium and large-scale. Then after in regular intervals the government started new and different development financial institutions to attain the different objectives and helpful to five-year plans.

The early history of Indian banking and finance was marked by strong governmental regulation and control. The roots of the national system were in the State Bank of India Act of 1955, which nationalized the former Imperial Bank of India and its seven associate banks. In the early days, this national system operated alongside of a large private banking system. Banks were limited in their operational flexibility by the government's desire to maintain employment in the banking system and were often drawn into troublesome loans in order to further the government's social goals.

The financial institutions in India were set up under the strong control of both central and state Governments, and the Government utilized these institutions for the achievements in planning and development of the nation as a whole. The all India financial institutions can be classified under four heads according to their economic importance that are:

1. All-India Development Banks
2. Specialized Financial Institutions
3. Investment Institutions
4. State-level institutions
5. Other Institutions

Industrial Development Bank of India (IDBI)

The Industrial Development Bank of India (IDBI) was established on July 1, 1964 under an Act of Parliament as a wholly owned subsidiary of the Reserve Bank of India. In February 1976, the ownership of IDBI was transferred to the Government of India and it was made the principal financial institution for coordinating the activities of institutions engaged in financing, promoting and developing industry in the country. Although Government shareholding in the Bank came down below 100% following IDBI's public issue in July 1995, the former continues to be the major shareholder (current shareholding: 52.3%). During the four decades of its existence, IDBI has been instrumental not only in establishing a well-developed, diversified and efficient industrial and institutional structure but also adding a qualitative dimension to the process of industrial development in the country. IDBI has played a pioneering role in fulfilling its mission

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of promoting industrial growth through financing of medium and long-term projects, in consonance with national plans and priorities. Over the years, IDBI has enlarged its basket of products and services, covering almost the entire spectrum of industrial activities, including manufacturing and services. IDBI provides financial assistance, both in rupee and foreign currencies, for green-field projects as also for expansion, modernisation and diversification purposes. In the wake of financial sector reforms unveiled by the government since 1992, IDBI evolved an array of fund and fee-based services with a view to providing an integrated solution to meet the entire demand of financial and corporate advisory requirements of its clients. IDBI also provides indirect financial assistance by way of refinancing of loans extended by State-level financial institutions and banks and by way of rediscounting of bills of exchange arising out of sale of indigenous machinery on deferred payment terms.

IDBI has played a pioneering role, particularly in the pre-reform era (1964-91), in catalyzing broad based industrial development in the country in keeping with its Government-ordained 'development banking' charter. In pursuance of this mandate, IDBI's activities transcended the confines of pure long-term lending to industry and encompassed, among others, balanced industrial growth through development of backward areas, modernisation of specific industries, employment generation, entrepreneurship development along with support services for creating a deep and vibrant domestic capital market, including development of apposite institutional framework.

Narasimham committee recommends that IDBI should give up its direct financing functions and concentrate only in promotional and refinancing role. But this recommendation was rejected by the government. Latter RBI constituted a committee under the chairmanship of S. H. Khan to examine the concept of development financing in the changed global challenges. This committee is the first to recommend the concept of universal banking. The committee wanted to the development financial institution to diversify its activity. It recommended to harmonise the role of development financing and banking activities by getting away from the conventional distinction between commercial banking and developmental banking.

In September 2003, IDBI diversified its business domain further by acquiring the entire shareholding of Tata Finance Limited in Tata Home finance Ltd., signaling IDBI's foray into the retail finance sector. The fully-owned housing finance subsidiary has since been renamed 'IDBI Home finance Limited'. In view of the signal changes in the operating environment, following initiation of reforms since the early nineties, Government of India has decided to transform IDBI into a commercial bank without eschewing its secular development finance obligations. The migration to the new business model of commercial banking, with its gateway to low-cost current, savings bank deposits, would help overcome most of the limitations of the current business model of development finance while simultaneously enabling it to diversify its client/ asset base. Towards this end, the IDB (Transfer of Undertaking and Repeal) Act 2003 was passed by Parliament in December 2003. The Act provides for repeal of IDBI Act, corporatisation of IDBI (with majority Government holding; current share: 58.47%) and transformation into a commercial bank. The provisions of the Act have come into force from July 2, 2004 in terms of a Government Notification to this effect. The Notification facilitated formation, incorporation and registration of Industrial Development Bank of India Ltd. as a company under the Companies Act, 1956 and a deemed Banking Company under the Banking Regulation Act 1949 and helped in obtaining requisite regulatory and statutory clearances, including those from RBI. IDBI would commence banking business in accordance with the provisions of the new Act in addition to the business being transacted under IDBI Act, 1964 from October 1, 2004, the 'Appointed Date' notified by the Central Government. IDBI has firmed up the infrastructure, technology platform and reorientation of its human capital to achieve a smooth transition.

On July 29, 2004, the Board of Directors of IDBI and IDBI Bank accorded in principle approval to the merger of IDBI Bank with the Industrial Development Bank of India Ltd. to be formed incorporated under the Companies Act, 1956 pursuant to the IDB (Transfer of Undertaking and

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Repeal) Act, 2003 (53 of 2003), subject to the approval of shareholders and other regulatory and statutory approvals. A mutually gainful proposition with positive implications for all stakeholders and clients, the merger process is expected to be completed during the current financial year ending March 31, 2005.

IDBI would continue to provide the extant products and services as part of its development finance role even after its conversion into a banking company. In addition, the new entity would also provide an array of wholesale and retail banking products, designed to suit the specific needs cash flow requirements of corporates and individuals. In particular, IDBI would leverage the strong corporate relationships built up over the years to offer customised and total financial solutions for all corporate business needs, single-window appraisal for term loans and working capital finance, strategic advisory and "hand-holding" support at the implementation phase of projects, among others.

IDBI's transformation into a commercial bank would provide a gateway to low-cost deposits like Current and Savings Bank Deposits. This would have a positive impact on the Bank's overall cost of funds and facilitate lending at more competitive rates to its clients. The new entity would offer various retail products, leveraging upon its existing relationship with retail investors under its existing Suvidha Flexi-bond schemes. In the emerging scenario, the new IDBI hopes to realize its mission of positioning itself as a one stop super-shop and most preferred brand for providing total financial and banking solutions to corporates and individuals, capitalising on its intimate knowledge of the Indian industry and client requirements and large retail base on the liability side.

IDBI upholds the highest standards of corporate governance in its operations. The responsibility for maintaining these high standards of governance lies with its Board of Directors. Two Committees of the Board viz. the Executive Committee and the Audit Committee are adequately empowered to monitor implementation of good corporate governance practices and making necessary disclosures within the framework of legal provisions and banking conventions.

Industrial Investment Bank of India Ltd.

The industrial investment bank of India is one of oldest banks in India. The Industrial Reconstruction Corporation of India Ltd., set up in 1971 for rehabilitation of sick industrial companies, was reconstituted as Industrial Reconstruction Bank of India in 1985 under the IRBI Act, 1984. With a view to converting the institution into a full-fledged development financial institution, IRBI was incorporated under the Companies Act, 1956, as Industrial Investment Bank of India Ltd. (IIBI) in March 1997. IIBI offers a wide range of products and services, including term loan assistance for project finance, short duration non-project asset-backed financing, working capital/ other short-term loans to companies, equity subscription, asset credit, equipment finance as also investments in capital market and money market instruments.

In view of certain structural and financial problems adversely impacting its long-term viability, IIBI submitted a financial restructuring proposal to the Government of India on July 25, 2003. IIBI has since received certain directives from the Government of India, which, inter alias, include restricting fresh lending to existing clients approved cases rated corporates, restrictions on fresh borrowings, an action plan to reduce the overhead expenditure, disposal of fixed assets and a time-bound plan for asset recovery/reconstruction. The Government of India has also given its approval for the merger of IIBI with IDBI and the latter has already started the due diligence process.

8.6.3 Types of Development Banks in India

The banks in India are classified under the Indian Banking Act, 1949. Banks are classified in it, and banking functions are also classified in it.

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The apex banking body is Reserve bank of India which governs all banking and monetary functions in India. Apart from this, there are two types of banks:

(1) Commercial Banks (2) Development Banks

Now under the Commercial Banks there are two sub-types (1) Scheduled Banks, it has four sub types: (i) Public Sector Banks (State Bank of India and other government Banks), (ii) Foreign Banks, (iii) Private Sector Banks (like HDFC, ICICI), (iv) Co-operative Banks and (2) Non-scheduled Banks.

Under the Development Banks, there are three sub types: (1) IFCI (Industrial Finance Corporation of India), (2) IRBI (Industrial Reconstruction Bank of India), (3) SIDBI (Small Industries Development Bank of India).

There are three apex bodies: (1) NHB (National Housing Bank), (2) EXIM (Export Import Bank of India), (3) NABARD (National Bank for Agriculture and Rural Development).

Apart from above, there are credit guarantees Institutions in India that are involved with banking: Deposit Insurance & Credit Guarantee Corporation secondly, Export Credit Guarantee Corporation of India Limited.

The development banks in India can be further classified according to their functions and activities:

1. ***All India Development Banks:*** Industrial Finance Corporation of India Ltd (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI), and Industrial Investment Bank of India (IIBI), Industrial Credit and Investment Corporation of India Ltd. (ICICI Ltd.) has ceased to be a bank after its merger with ICICI Bank with effect from March 30, 2002. IDBI was converted into a bank on October 11, 2004.
2. ***Specialised Development Banks:*** Export-Import Bank (EXIM Bank), IFCI Venture Capital Fund (IVCF, formerly RCTC) Ltd., ICICI Venture Ltd. (formerly TDICI Ltd.), Tourism Finance Corporation of India Ltd., and Infrastructure Development Finance Company Ltd. (IDFC) Ltd.
3. ***Refinance Development Banks:*** National Housing Bank (NHB), and National Bank for Agriculture and Rural Development (NABARD).
4. ***State Level Development Banks:*** These include, State Financial Corporations (SFCs), and State Industrial Development Corporations (SIDCs).
5. ***Other Development Banks:*** Some other banking institutions are: Export Credit and Guarantee Corporation of India Ltd. (ECGC) and Deposit Insurance and Credit Guarantee Corporation (DICGC).

Of all the above nine institutions only nine (IDBI, IFCI, EXIM Bank, NABARD, SIDBI, IDFC, IFCI, IIBI and NHB) fall within the regulatory and supervisory domain of the Reserve Bank of India.

Functions of Development Banks in India

In India, development banks have been established and funded by the Government to develop and promote certain strategic sectors of the economy, and to achieve social goals. The important sectors of the economy currently supported by the development banks are to promote industrialization, particularly the high-technology industries, export-oriented industries, infrastructure development and highly capital-intensive investments and the agriculture sector.

The Development banks also play a crucial role in the development of industries and housing sectors.

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Development banks are expected primarily to fill in the gaps in the supply of financial services that are not normally provided by the banking institutions. Such development institutions are generally specialised in provision of medium and long-term financing of projects, which require specialised skills and focus, and may carry higher credit risks or market risks due to the longer investment tenures. In some cases, the mandated roles of the development banks include the promotion and achievement of Government's specific social and economic objectives.

The Development banks have in varying degrees contributed to the development and growth of the targeted industries and strategic sectors of the economy.

The Development banks are expected to provide support to these sectors without resulting in losses or incurring a direct cost to the Government. To enable them to perform these functions, such development banks have generally been accorded special benefits in the form of funding at lower rates, implicit Government guarantee to the institutions' debts, special status for their debt instruments and favourable tax treatment.

8.6.4 Growth of Development Banks in India

In many countries, development banks have been major conduits for channeling funds to particular firms, industries and sectors during the latter's process of development. In India, development banks have been a more important source of long-term funds (mainly debt) for industry than bank loans or other sources of debt. Using data from the Indian corporate sector, we evaluate the role of development banks in India for the period 1989-97 by examining how firms' investment decisions are affected by their ability to access development banks. We find that firms that had prior access to development banks continue to receive funds from these sources only if they can be classified as a priori more financially constrained. Access to development banks for funds spurs investment. These results suggest that development bank lending is not governed by considerations of lobbying, precedence or even to sponsor particular types of projects that might be socially desirable but not privately profitable. Rather, the primary role of development banks has been to reduce financial constraints faced by firms. We also find that the drastic contraction of long-term bank lending to industry in India in the early nineties had adverse consequences for firms that were particularly bank-dependent, but only if these firms could be classified as a priori more financially constrained. Together, these results support the view that in contrast to firms in well-developed capital markets, in emerging markets, firms with growth potential are likely to rely significantly on debt financing, especially debt that is channelled through financial intermediaries.

Structure and Working of Development Banks

Not only developed countries, but several underdeveloped countries in Asia, Africa, and Latin America established special financial institutions to hasten the pace of industrialisation and growth.

The International Bank for Reconstruction and Development (IBRD) known as the World Bank and the International Monetary Fund (IMF) are examples of development banks at the international level. The major objective of the World Bank is to promote world development and perform the task of transfer of enormous financial and technical resources from the developed to developing nations. The IMF performs a special function of providing financial assistance to private sector projects in developing countries.

Development Financial Institutions in India: The need for development financial institutions was felt very strongly immediately after India attained independence. The country needed a strong capital goods sector to support and accelerate the pace of industrialisation. The existing industries required long-term funds for their reconstruction, modernisation, expansion and

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diversification programmes while the new industries required enormous investment for setting up gigantic projects in the capital goods sector. However, there were gaps in the banking system and capital markets which needed to be filled to meet this enormous requirement of funds.

1. Commercial banks had traditionally confined themselves to financing working capital requirements of trade and industry and abstained from supplying long-term finance.
2. The managing agency houses, which had served as important adjuncts to the capital market, showed their apathy to investment in risky ventures.
3. Several malpractices, such as misuse of funds, excess speculation, and manipulations were unearthed. Owing to this, the investors were not interested in investing in the capital market.
4. There were a limited number of issue houses and underwriting firms that sponsored security issues.

Hence, to fill these gaps, a new institutional machinery was devised-the setting up of special financial institutions, which would provide the necessary financial resources and know-how so as to foster the industrial growth of the country.

The first step towards building up a structure of development financial institutions was taken in 1948 by establishing the Industrial Finance Corporation of India Limited (IFCI). This institution was set up by an Act I of Parliament with a view to providing medium- and long-term credit to units in the corporate sector and industrial concerns.

In view of the immensity of the task and vast size of the country, it was not possible for a single institution to cater to the financial needs of small industries spread in different states.

Hence, the necessity for setting up I regional development banks to cater to the needs of small and medium enterprises was recognized. Accordingly, the State Financial Corporations Act was passed in 1951 for setting up state financial corporations (SFCs) in different states. By 1955-56, 12 SFCs were set up and by 1967-68, all the 18 SFCs now in operation came I into existence. SFCs extend financial assistance to small enterprises.

Even as the SFCs were being set up, a new corporation was established in 1955 at the all-India level known as the National Small Industries Corporation (NSIC) to extend support to small industries. The NSlC is a fully government owned corporation and is not primarily a financing institution. It helps small scale I industries (SSls) through various promotional activities, such as assistance in securing orders, marketing the products of SSls, arranging for the supply of machinery, and training of industrial workers.

The above institutions had kept themselves away from the underwriting and investment business as these were considered to be risky. Due to the absence of underwriting facilities, new entrepreneurs and small units could not raise equity capital nor could they get loan assistance owing to this weak financial position. To fill this gap, the Industrial Credit and Investment Corporation of India Limited (ICICI) was set up in January 1955 as a joint stock company with support from the Government of India, the World Bank, the Commonwealth Development Finance Corporation, and other foreign institutions. The ICICI was organised as a wholly privately owned institution; it started its operation as an issuing-cum-lending institution. It provides term loans and takes an active part in the underwriting of and direct investments in the shares of industrial units.

In 1958, another institution, known as the Refinance Corporation for Industry (RCI) was set up by the Reserve Bank of India (RBI), the Life Insurance Corporation of India (LIC), and commercial banks with a view to providing refinance to commercial banks and subsequently to SFCs against term loans granted by hem to industrial concerns in the private sector. When the Industrial Development Bank of India (IDBI) was Jet up in 1964 as the central coordinating agency in the field of industrial finance, the RCI was merged with it.

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At the state level, another type of institution, namely, the State Industrial Development Corporation (SIDC) was established in the sixties to promote medium and large scale industrial units in the respective states. The SIDCs promoted a number of projects in the joint sector and assisted in setting up industrial units. In recognition of the crucial role played by them in the promotion of industries in different states, the SIDCs were made eligible for IDBI refinance facilities in 1976. Thus, they became an integral part of the development banking system of the country.

The State Small Industries Development Corporations (SSIDCs) were also established to cater to the requirements of the industry at the state level. They helped in setting up and managing industrial estates, supplying of raw materials, running common service facilities, and supplying machinery on hire-purchase basis.

By the early sixties, a plethora of financial corporations catering to the financial needs of a variety of industries had come into existence. However, the need for an effective mechanism to coordinate and integrate the activities of the different financial institutions was increasingly felt. Furthermore, many gigantic projects of national importance were held up as these financial institutions were not able to supply the necessary capital in view of their own limited resources. Hence, the establishment of a financial institution with a substantially large amount of capital resource and capable of functioning independently, unhindered by statutory rigidities, became inevitable.

The Industrial Development Bank of India (IDBI) was set up in 1964 as an apex institution to establish an appropriate working relationship among financial institutions, coordinate their activities, and build a pattern of inter-institutional cooperation to effectively meet the changing needs of the industrial structure. IDBI was set up as a wholly owned subsidiary of the Reserve Bank of India. The IFCI became a subsidiary of the IDBI so that it might play an enlarged role. In February 1976, the IDBI was restructured and separated from the control of the RBI.

An important feature of industrial finance in the country is the participation of major investment institutions in consortium with other all India financial institutions. The Unit Trust of India (UTI), established in 1964, the Life Insurance Corporation of India (LIC), established in 1956, and the General Insurance Corporation of India (GIC), established in 1973, work closely with other all India financial institutions to meet the financial requirements of the industrial sector.

Specialized institutions were also created to cater to the needs of the rehabilitation of sick industrial units, export finance, and agriculture and rural development. In 1971, the Industrial Reconstruction Corporation of India Limited (IRCI) was' set up for the rehabilitation of sick units. In January 1982, the Export-Import Bank of India (EXIM Bank) was set up. The export finance operations of the IDBI were transferred to the EXIM Bank with effect from March 1, 1982. With a view to strengthening the institutional network catering to the credit needs of the agricultural and rural sectors, the National Bank for Agriculture and Rural Development (NABARD) was set up in July 1982.

The country is being served by 57 financial institutions, comprising 11 institutions at the national level and 46 institutions at the state level. These financial institutions have a wide network of branches and are supported by technical consultancy organisations with IDBI acting as the apex institution for coordinating their diverse financing and promotional activities. Their strategies, policies, and industrial promotional efforts sub-serve the national objectives of rapid industrial growth, balanced regional development, creation of a new class of entrepreneurs, and providing self employment opportunities.

The national level institutions, known as All India Financial Institutions (AIFIs), comprise six All India Development Banks (AIDBs), two specialised financial institutions (SFIs) and three investment institutions. The AIDBs are IDBI, IFCI, ICICI, Industrial Investment Bank of India Limited (IIBI), Infrastructure Development Finance Company Limited (IDFC) and SIDBI.

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At the state level; there are 18 State Financial Corporations (SFCs) and 28 State Industrial Development Corporations (SIDCs).

The Specialised Financial Institutions (SFIs) comprise Export-Import Bank of India (EXIM Bank) and National Bank for Agriculture and Rural Development (NABARD). Hitherto, SFIs included three institutions, namely, IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Company Limited, and Tourism Finance Corporation of India Limited. However, due to the tiny nature of their operations, these institutions have been excluded from the category of SFIs.

The investment in situations are Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC), and Unit Trust of India (UTI).

The financial institutions were functioning in a highly regulated regime up to 1991. The DFIs were mostly engaged in consortium lending and they offered similar services at uniform prices. In the administered interest rate regime, the cost of borrowings of DFIs was substantially lower than the return on financing (lending). Long-term lending involves uncertainties and to handle this, the DFIs used to get concessional funds up to the nineties. The Reserve Bank and the Central Government used to finance these institutions by subscribing to the share capital, allowing them to issue government guaranteed bonds and extending long-term loans at concessional rates. However, this concession all ending was phased out in the 'nineties' with the initiation of financial sector reforms. Interest rates were deregulated and the facility of issuing bonds eligible for SLR investments was withdrawn. Now, these financial institutions have to rely on equity and debt markets for financing their needs. These DFIs have resorted to market-based financing by floating a number of innovative debt and equity issues. They also raise resources by way of term deposits, certificates of deposits and borrowings from the term money market within the umbrella limit fixed by the Reserve Bank in terms of net owned funds. Wore stringent provisioning norms have come into operation. Many of the DFIs including IDBI have lost heir tax-exempt status.

Moreover, with deregulation, the distinction between different segments of financial intermediaries has blurred. The commercial banks are now financing the medium- and long-term capital needs of the corporate sector and the DFIs have started extending short-term/ working capital finance. This has led to a stiff competition between banks and DFIs. As a result, the focus of DFIs has shifted from the purpose for which they were set up.

With globalisation and liberalisation, the financing requirements of the corporate sector has undergone a tremendous change. Many foreign players entered into strategic alliances with Indian firms. There was an increase in research and development activities as well as the diversification plans of firms. Investment in technology and infrastructure became crucial. With a view to taking advantage of the new opportunities, the financial institutions started offering a wide range of new products and services. These DFIs set up several subsidiaries/associate institutions which offer various services such as commercial banking. Consumer finance-, investor and custodial services, broking, venture capital finance. Infrastructure financing, registrar and transfer services, and e-commerce.

DFIs are in the process of converting themselves into universal banks. ICICI has become a universal bank by a reverse merger with its subsidiary ICICI Bank. IDBI is in the process of transforming itself into a universal bank. The Reserve Bank of India has issued guidelines for DFIs to become commercial Banks. These guidelines are the same as for commercial banks under the Banking Regulation Act. It is envisaged that will be only two types of financial intermediaries in future, that is, commercial banks and non-banking ace companies (NBFCs).

Universal banking is a one-stop shop of financial products and services. Universal banks provide a complete range of corporate financial solutions under one roof -everything from term finance, working capital, project advisory services, and treasury consultancy. Universal banking

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encompasses commercial banking and Investment banking, including investment in equities and project finance. It refers to a bank undertaking all types of business-retail, wholesale, merchant, private, and others under one organisational roof. It means a complete breakdown of barriers between different categories of financial intermediaries such as commercial banks, FIs and NBFCs. Universal banking helps the service provider to build up long-term relationships with the client by catering his different needs. The client also benefits as he gets a whole range of services at low cost under one roof. Globally, banks such as Deutsche Bank, Citibank, and ING Bank, are universal banks.

In India, the trend towards universal banking began when financial institutions were allowed to finance working capital requirements and banks started term financing. This trend got a momentum with the report of Narasimham Committee II, suggesting that development finance institutions should convert ultimately into commercial banks or non-bank finance companies (NBFCs). The Khan Committee, which was set up by RBI to examine the harmonisation of business of banks and development financial institutions, endorsed this conversion.

It was of the view that DFIs should be allowed to become banks at the earliest. The committee recommended a gradual move towards universal banking and an enabling framework for this purpose should be evolved. In January 1999, the Reserve Bank of India (RBI) released a "Discussion Paper" for wider public debate on universal banking. The feedback indicated the desirability of universal banking from the point of view of efficiency of resource use. In the mid-term review of monetary and credit policy (1999-2000), the RBI acknowledged that the principle of universal banking "is a desirable goal". In April 2001 it set out the operational and regulatory aspects of conversion of DFIs into universal banks.

ICICI was the first financial institution to convert itself into a truly universal bank. The concept of universal banking provides the financial institutions an access to the retail market wherein high margins are involved. This concept is slowly gaining popularity among banks as the interest spread has squeezed in the past few years and non-performing assets (NPAs) have increased in banking activity. A foray into universal banking would help the banks to diversify beyond the traditional portfolio of loans and investment and extend to treasury, capital market operations, infrastructure finance, retail lending, and advisory services.

The policy measures and change in the role of DFIs, the South-East Asian crisis and the general economic slowdown necessitated introduction of policy measures and regulation. In November 1994, the Board for Financial Supervision (BFS) was constituted under the aegis of the Reserve Bank for comprehensive and integrated regulation and supervision over commercial banks. Financial Institutions (FIs) and Non-Banking Finance companies have been brought under the purview of the Board. The scope and coverage of the FIs inspection are very limited, unlike that of NBFCs, and are not as rigorous as that of banks. Select FIs such as IDBI, ICICI Ltd., IFCI Ltd., IIBI Ltd., NABARD, NHB, EXIM Bank, TFCI, SIDBI and IDFC have been brought under the supervisory purview of the Reserve Bank to enhance the transparency in their performance and maintain systemic stability.

1. Financial institutions were permitted to include the "general provision on standard assets" in their supplementary (tier II) capital with a stipulation that the provisions on standard assets along with other "general provisions and loss reserves" should not exceed 1.25% of the total risk weighted assets.
2. An asset would be treated as non-performing, if interest and/or installment of principal remain overdue for more than 180 days with effect from the year ending March 31, 2002. A non-performing asset is that part of a financial institution's asset that is currently yielding no return and on which none is expected.
3. FIs have to assign a 100 percent risk weight only on those state government guaranteed securities which were issued by the defaulting entities.

Notes

4. FIs are required to assign a risk weight of 2.5% for market risk in respect of investments in all securities from March 31,2001. This risk weight would be in addition to 20%/100% risk weight already assigned for credit risk in non-government/non-approved securities.

5. In order to bring about uniformity in the disclosure practices adopted by the FIs and with a view to improving the transparency in their affairs, FIs were advised to disclose certain important financial ratios/data with effect from the financial year 2000-01. These disclosures pertain to capital-to- risk weighted assets ratio (CRAR), Core CRAR, supplementary CRAR, amount of subordinated debt raised/outstanding as tier II capital, risk weighted assets, shareholding pattern, asset quality and credit concentration, maturity pattern of rupee and foreign currency assets and liabilities, and details on operating results. Besides, separate details on loan assets arid substandard assets which have been subject to restructuring, and so on, would also need to be disclosed.

6. Capital to risk-weighted Asset Ratio (CRAR) should be 9% of risk weighted assets (RWA) on an ongoing basis. CRAR represents the amount of capital maintained in consonance with the risk-adjusted aggregate of funded and non-funded assets of an FI. The risk-adjusted asset is arrived at by multiplying each asset with its corresponding risk weight in the case of funded assets. Conversion factors are assigned in case of non-funded assets apart from weights. CRAR includes core capital (tier I) and supplementary capital (tier II). Tier I capital includes paid up capital, statutory reserves, and other disclosed free reserves, if any. Certain Government of India grants and reserves held under section 36(1)(viii) of the Income Tax Act, 1961 are treated as capital. Besides capital reserves, equity investment in subsidiaries, intangible assets, gaps in provisioning, and losses in the current period and those brought forward from the previous period will be deducted from tier I capital. The core CRAR should not be less than 50% of CRAR at any point of time. Supplementary CRAR, or tier II capital, includes undisclosed reserves and cumulative preference shares, revaluation reserves, general provisions and reserves, hybrid debt capital instruments, and subordinated debt. The supplementary capital is limited to a maximum of 100% of tier I capital.

7. Since June 2000, FIs need not seek the Reserve Bank's issue wise prior approval/registration for raising resources through either public issue or private placement if (a) the minimum maturity period is 3 years, (b) where bonds have call/put or both options, the same is not exercisable before expiry of one year from date of issue, (c) yield to maturity (YTM) offered at the time of issue of bonds, including instruments having call/put options, does not exceed 200 basis points over that on government securities of equal residual maturities, and (d) 'exit' option is not offered prior to expiry of one year, from date of issue. The outstanding total resources mobilised at any point of time by an individual FI including funds mobilised under the 'umbrella limit' as prescribed by the Reserve Bank should not exceed 10 times its net owned funds as per the latest audited balance sheet.

8. The rating for the term deposits accepted by FIs was made mandatory effective November 1, 2000.

9. FIs are required to classify entire investment portfolio from March 31, 2001, under three categories, viz., (a) held to maturity, (b) available for sale, and (c) held for trading. Investments under (b) and (c) are to be marked-to-market as prescribed or at more frequent intervals, while those under (a) need not be marked-to-market and should not exceed 25% of total investments.

10. Looking to the deteriorating financial position of FIs, it was decided that the inspection of all the FII would be undertaken by the Reserve Bank on an annual basis.

11. The Reserve Bank introduced a CAMELS based supervisory rating model for the FIs effective March 31, 2002.

Notes

The above mentioned policy initiatives were undertaken by the RBI for strengthening the regulation and supervision of select all India financial institutions in the context of their financial performance, the market conditions for resource mobilization and increasing competition from banks.

Term Loans from Development Banks

Development Finance Institutions (DFIs) or development banks starting with the Industrial Finance Corporation of India and the State Finance Corporation to assist the promotion and financing of fixed assets of industrial units have been in existence since 1948. Now, at the all India level, there are the Industrial Development Bank of India, Industrial Investment Bank of India Ltd. (IIBI), Industrial Development Finance Company Ltd. and Small Industries Development Bank of India. There are specialized institutions, IVCT, ICICI Venture and TFCT. At the state level, there are State Financial Corporations (SFCs) and State Industrial Development Corporations. Apart from DFIs, there are All-India-Investment Institutions, like the Unit Trust of India, Life Insurance Corporations of India and General Insurance Corporation of India and its subsidiaries. All these institutions, DFIs (excluding SFCs) and investment institutions together sanctioned ₹ 42,485 crores and dispersed ₹ 25.942 crores in 2004-05 to industrial units. In the case of underwriting and direct subscription of shares and debentures, sanctions amounted to ₹ 8,192 crores and disbursements ₹ 5,637 crores in 2004-05. Loans sanctioned amounted ₹ 33,280 crore and disbursements ₹ 19,448 crores. The resource flows of five all India financial institutions in 2004-05 were sanctions ₹ 32,094 and disbursements ₹ 16,907 crores. Outstanding borrowings of all five All-India Financial Institutions amounted to ₹ 30,574 crore. The CRAR of all the AIFIs, except IFCI and IIBI remained above regulatory minimum in 2003-04. The resources raised by IDFC and SIDBI among the five all-India Financial Institutions amounted ₹ 6,617 crores in 2004-05.

8.7 Development Financial Institutions

8.7.1 Industrial Development Bank of India (IDBI)

The Industrial Development Bank of India (IDBI) which was established in 1964 under an Act of Parliament is the principal financial institution for providing credit and other facilities for development of industry coordinating working of institutions engaged in financing, promoting or developing industrial units and assisting development of such institutions. IDBI has been providing direct financial assistance to large and medium industrial units and also helping small and medium industrial concerns, (the small industries sector has been transferred to Small Industries Development Bank) through banks and state level financial institutions. On July 29, 2004 IBDI was transformed into IDBI Ltd., a company under the Companies Act and a scheduled bank.

Notes The purpose of setting up IDBI was to propel the wheels of industrial sector to achieve maximum growth by eliminating the gaps in the capital market and supplying the sinews of development to all the financial agencies engaged in this work. Keeping this purpose in mind the Bank set the objectives of providing financial as well as non-financial support at reasonable cost to all the deserving projects belonging to industries of national importance and spread over different regions of the country.

Notes

Functions of IDBI

1. ***Coordinating Function:*** The IDBI coordinates the functions and operations of all the financial institutions, including the IFCI, the ICICI, the LIC, GIC and the UTI into a single integrated financial structure so that each may contribute to the total effect - the growth of the economy.

2. ***Financing Function:*** As an industrial financier, the IDBI would assist all the deserving projects (regardless of their size), which experience enormous problems in assembling funds from normal channels. Its endeavour in this regard is to ensure that no worthwhile project, however, small, is allowed to languish for want of, or insufficiency of, institutional support. The bank can assist a project, directly and indirectly. As direct financier, it may assist industrial concerns in following ways:

   (i) Grant term loans and advances;

   (ii) Subscribe to, purchase or underwrite, the issue of stocks, shares or debentures;

   (iii) Guarantee the deferred payments due from industrial concerns to third parties and the loans raised by them in the open market or from financial institutions; and

   (iv) Providing working capital to projects assisted by the bank.

   Direct assistance is usually granted for the acquisition of fixed assets for new units as well as for expansion, modernization or renovation of existing units. It is usually provided to large-scale and medium sized projects which have not been able to obtain their full requirements from other term-financing institutions, it normally prefers not to assist projects whose needs can be met by other institutions.

3. ***Promotional Function:*** The IDBI is authorized to perform promotional activities with a view to bringing about a viable industrial development, especially in the less developed areas. These promotional activities are oriented towards meeting the dual objectives of balanced regional development and acceleration in industrial growth. The activities directed towards the first objective include the identification and follow-up of projects located in backward areas. These directed towards fulfilling the second objective include efforts at building up an appropriate frame work for industrial development.

Corporate Strategy of IDBI

Within the overall framework of its purpose and objectives the IDBI during the first decade of its existence adopted the strategy of supporting all deserving projects of national importance directly through lendings and direct investment and indirectly through dispensation of resource support to other term financing institutions. It adopted consortium approach for assisting gigantic projects. While playing the role of a promoter IDBI adopted penetration strategy to identify growth potential areas of the country, identify project ideas, provide help to potential entrepreneurs to appraise these ideas and to help them to materialize these ideas into projects.

As an apex institution, the IDBI adopted the strategy of coordinating the operations of the term lending institutions through inter-institutional periodic meetings.

During the second decade of its operations the IDBI adopted consolidation strategy so as to carry forward its mission of fostering industrial growth in the country and diving a qualitative thrust to the process of industrialization. Thus, the bank focused its efforts on the promotion of small and medium scale industries, development of industrially backward areas, widening of the entrepreneurial base in the country and modernization and up gradation of technology.

Notes

To meet the specific financial requirements of entrepreneurs in the small, tiny, village and cottage industries the IDBI took various steps such as launching refinancing packages, strengthening the structure of state-level institutions and introduction of tailored products such as automatic refinance facility, composite loans and specific refinance facilities.

The bank also endeavoured to create and widen entrepreneurial base and the related infrastructure, services, etc, so as to give fill up to sustaining industrial growth of the country. It set up along with other institutions the Entrepreneurial Development Institute of India (EDII) in 1983 and a number of institutes for Entrepreneurship Development to focus on entrepreneurial development requirements, particularly in the industrially less developed regions.

The third decade of the Bank's operations witnessed continuance of its consolidation strategy during the first few years of operations followed by diversification strategy to respond to the emerging changes in the financial sector and economic environments.

Thus, the two-pronged strategy during the latter part of the third decade was, therefore, on diversification of products and services offered and on the ability to tap the market for raising resources at competitive rates.

In addition to project specific financing, the IDBI devised a host of new products to meet the needs of industrial enterprises including financial products for technology up gradation, venture capital to provide finance to technocrats for introduction of innovative products/services, equipment finance for energy conservation and pollution control, asset credit, focus on its non-fund based activities and financial services making an entry in the areas of Merchant Banking, Debenture Trust-ship and forex services.

Diversification strategy was also adopted with respect to foreign exchange services. From 1993 it has offered a range of foreign exchange related products in the form of forward cover to borrowers in respect of their debt services obligations to the Bank or payments against letters of credit which are backed by rupee loans from the Bank.

The Bank is also planning to offer other liability management products such as interest and currency swaps, FRAs, etc., to its borrowers.

In addition to non-fund based business, the IDBI has diversified into related areas finance such as credit rating, investor's services and corporate advisory services.

The Bank also responded to the situation of competing for funds from the market by introducing new instruments that were tailored to meet the needs of diverse investor groups. The IDBI's initial foray into the capital market through its unsecured public bond issues proved highly attractive and received tremendous investor response.

Fee-Based Services

In recent few years the IDBI has embraced fee-based services such as:

1. ***Merchant Banking:*** The IDBI has been providing a wide range of merchant banking services which include pre-project counseling, projects appraisal, placement, of equity with banks, foreign institutional investors, high net worth investors, mutual funds, institutional investors and private equity funds, placement of preference shares and debentures with domestic investors, structuring and syndication of bought-out-deals, loan syndication, syndication of structured debt instrument, coordinating the financial participation of multilateral agencies and international banks, issue management offering advice on the management of tender offer.

   The stress of the bank is on managing only select large-sized equity issues, which would attract investor's interest.

Notes

Despite subdued stock market condition in the country the IDBI managed successfully 40 public and right issues involving mobilization of ₹ 5,136 crores during the period 1996-2000. During 1999-2000, the bank also executed two assignments for private placement of equity and bonds aggregating ₹ 120 crores. The bank also carried out appraisal of a number of large capital investments planned by 'Navaratna' PSUs.

Corporate Advisory Services: Corporate advisory services rendered by the bank include equity and business valuation, advice in merges, acquisition and diversities advice on business and financial restructuring, privatisation advice and restructuring/ rehabilitation advice for weak units.

Among non-fund business, the IDBI in view of its strengths has focused core on provision of advisory services to the corporate sector. The Bank has been mandated for several advisory and syndication assignments in large projects, mainly in power, petroleum, telecommunications and steel sectors.

The bank has acted as a consultant to the Government of India for its programme relating to disinvestments of its shareholding in two public sector enterprises. The Bank also advised on financial restructuring of one of India's largest corporate in the public sector. Assignments, including those for several reputed public sector undertakings. It also completed three advisory and during 1999-2000, the IDBI completed 24 project and corporate advisory syndication assignments involving mobilization of ₹ 6,085 crores. The Bank has at present 19 advisory and credit syndication assignments, involving mobilization of over ₹ 13,300 crores.

2. ***Trusteeship Services:*** The IDBI has been rendering trusteeship services since 1992-93. As a trustee, it seeks to represent and protect the interest of debenture/bond holders. It also acts as security agent and mortgage trustee in respect of loans granted by domestic and foreign lenders to companies.

   The Bank accepts trusteeship of those companies which have complied with SEBI guidelines for issue of debentures/bonds and have fixed assets cover of 1.25:1, debt-equity ratio not exceeding 2:1, current ratio of 1.33:1 and have obtained satisfactory credit rating in case of public issue. The trusteeship assignments with the Bank up to end-March 2000 aggregated 404 in number and ₹ 18,510 crore in value terms.

3. ***Forex Services:*** The IDBI opens letters of credit (LCs) and effects foreign currency (FC) remittances on behalf of its assisted companies for import of goods and services. The Bank also disburses FC loans for project-related Rupee expenditure, in line with the prevailing guidelines for External Commercial Borrowings (ECBs). So as to improve the forex services, the IDBI implemented a forex trader software in 1999-2000 which enables speedier generation and transmission of LCs and amendments through Society for World-Wide Inter bank Financial Telecommunications (SWIFT).

4. ***Treasury Operations:*** The IDBI has recently set up a separate treasury department with an Integrated Dealing Room (Comprising Rupee and FC) for exclusively monitoring the overall liquidity position, investment of surplus funds with the objective of enhancing fields and to take an integrated view of the developments in both money and forex markets.

   The Bank has been trying to optimize returns on its short-term surplus funds through efficient treasury operations. Risk management has been a focused area in treasury operations. The Bank is taking steps for speedy processing of information through state-of-the-art software package to facilitate quick decision-making.

5. ***Insurance Business:*** The IDBI has, of late, decided to enter into insurance business. For this purpose, it has tied up with the Dutch financial services giant, ING group for insurance.

Notes

The tie up is one of the biggest in insurance sector. The IDBI is the largest financial institution in INDIA and ING group is one of the largest financial groups in the world.

The IDBI-ING alliance will stretch to both life and general insurance areas. The IDBI will give foreign equity in the venture to ING as per the prevalent insurance guidelines.

Achievements of IDBI

With a view to performing their channelising function effectively, the IDBI formulated suitable strategies and operational policies in regard to sanction of assistance and its utilization, forms of assistance and its purpose as also with respect to sectoral, regional and industrial distribution of the assistance. The Bank has been found adhering to the norms and sanctioned assistance only to those fulfilling these norms.

Following its assistance policies the IDBI pumped in burgeoning amount of funds to meet growing industry demand. It is interesting to observe that the Bank has introduced a slew of innovative products and services to cater to the varied needs of up and coming enterprises of plan priority. However, loans constitute the predominant form of assistance of the IDBI. This can be explained, inter alia, by minimum risk, high core competence and scope for better earnings.

It is intriguing to note that quite a large proportion of the sanctioned assistance has remained unutilised for various reasons including time consuming and complex lending procedures. It is, therefore, suggested that disbursement procedures should be re-examined thoroughly and as far as possible the same be simplified.

What is most striking to note that the Bank has yet not accorded serious attention to underwriting business and has failed to develop equity culture in its operations primarily because of its obsession with avoidance of risk.

Nevertheless the IDBI has devoted its resources for financing up and coming industrial projects, the thrust of the Bank in recent years has been on infrastructural and core sectors.

Further, a few industrially advanced states of the country continue to receive greater attention of the IDBI. One of the major factors responsible for this tendency has been the absence of any explicit policy guidelines being provided by the Government regarding assistance to relatively underdeveloped states. As a result, the IDBI has followed the line of least assistance and extended assistance where it could do that most conveniently. In its endeavour to meet the competitive challenges and to provide wide variety of products and services to customers under one umbrella and to economise on cost of operations the IDBI is presently seized with the task of transforming itself to an Universal Bank and for that matter, it has already started holding discussions with the RBI on the possible regulatory regime once it converts itself into a full-fledged bank. The Bank is also negotiating with foreign management consultants to hire one of them who could help it in formulating the universal banking strategy.

However, to be highly competitive and more useful existing role of the Bank will have to be rationalized. It will have to focus on lending business with market orientation, hone its risk identification and project management skills and strengthen its infrastructural network.

The IDBI should undertake the underwriting business on a large scale with a view to nursing new and nascent industrial units. This will certainly solve the financing problems of industrial enterprises and also bolster up the new issue activity which has been sagging in recent years.

8.7.2 ICICI

Unlike the IDBI, the IFCI and the SFCs, which were set-up as government-owned institutions, the ICICI was organized as a wholly-owned private institution. In fact, it was one of the

development banks which the World Bank had sponsored in a number of under developed countries. The ownership of the corporation was entirely in private hands; but interested groups built some safeguards into the structure of the corporation against acquisition of its control. The corporation commenced its operations as an issuing-cum-lending institution.

Corporate Vision, Mission and Objectives of ICICI

With integration of Indian economy with the global economy, increasing disintermediation in financial sector and growing competition from both domestic and global players fuelled by proliferation and convergence of informational and computation technologies and rapid deregulation and liberalization, the ICICI has metamorphosed its vision to become a globally competitive player through constant innovation and adoption of cutting edge technology to provide superior customer solutions.

The ICICI moved from being a wholesale lender to becoming a universal bank and now, the repositioning moves on to a different platform-that of becoming an e-commerce power house and emerge as a click and brick banker.

The corporation, thus, aims to become the pre-eminent provider of a complete spectrum of financial products and services in India and abroad to its clients combining emerging technology with new strategies-with the ultimate objective of increasing its market presence and ensure a greater share of the customer's wallet and thereby enhancing value creation for its shareholders.

Tasks of ICICI

In order to achieve the above objectives the ICICI performs the following functions:

1. To provide medium and long-term project finance and infrastructure finance to private industry in India.
2. To provide asset credit.
3. To make funds available for investments by revolving investment as rapidly as possible.
4. To provide supplier's line of credit.
5. To provide treasury and custodial services to private sector industrial enterprises.
6. To provide lease financing facility.
7. To perform the activities of a banker with view to providing corporate banking services, working capital finance and cash management services.
8. To act as investment banker for the enterprises and thereby performing the functions of investment banking, primary dealership, playing active role in equity and debt-capital markets, providing private equity and rendering project finance advisory services.
9. To provide brokerage facilities.
10. To supply venture capital.
11. To raise funds from the market through floatation of bonds, loans and through acceptance of deposits.
12. To render retail banking and Internet banking services.
13. To distribute and service retail loan products.
14. To provide mutual fund and asset management facilities.

Notes

The ICICI has come to be recognized as the most resilient and vibrant financial institution which provides wide variety of financial products and services for the creation, expansion and modernization of industrial enterprises, encouraging and promoting participation of private capital, both internal and external, in such enterprises, encouraging and promoting industrial investment and helping development of capital markets.

The Corporation has served as an important handmaid of the private sector enterprises. Furthermore, it has endeavoured to foster growth in relatively backward regions by functioning as a catalytic agent.

While recognizing the need for substantial expansion in the capacity and production of consumer goods industries and the need for assisting them, the ICICI has helped set up capacity in non-traditional fields such as fertilizers, petrochemicals, refineries, energy, castings apart from capital goods and ancillary industries.

In all these, the focus of the Corporation has been on accomplishing a sound and balanced industrial growth. Thus, the ICICI may take legitimate pride in helping to build a financial superstructure. In the impressive edifice that has come up, the Corporation may well claim to have played a significant and seminal role in India's industrial development.

So as to achieve competitive edge over the new players in the liberalized milieu, the ICICI has diversified in non-fund-based activities with a view to providing excellent need based products and services to its clients and to improving their operational performance.

Even it is planning to enter into conglomerate business of commodities and courier. However, the management should avoid going too far for sake of diversification into new business and enhancing its earnings without ensuring core competencies in these fields.

Very recently, the ICICI has decided to go ahead with merger between ICICI and ICICI Bank and has already communicated about this to the RBI. In its communication the ICICI informed the RBI that it would take seven years to fully comply with the present requirements applicable to a bank.

In a consolidation drive, the ICICI has decided to merge three of its subsidiaries-ICICI Capital Services, ICICI Web Trade and ICICI Personnel Finance-into a single company.

In sum, the ICICI with its track record of fund-based services is poised to become a globally competitive player through constant innovation and adoption of cutting edge technology to provide superior customer solutions.

It is always on the look out of usurping opportunities and prepared to meet the challenges ahead without, in any way, losing sight of the development objectives for which it was set up.

8.7.3 Industrial Reconstruction Corporation of India

Another addition to the institutional structure of the Indian capital market is the Industrial Reconstruction Corporation of India (IRCI), which was set-up in April 1971 as a public limited company under the Companies Act of 1956 to fortify the institutional structure for the provision of reconstruction and rehabilitation assistance to units which close down, or face the risk of closure, but have an economic justification for reconstruction, and can be made viable with suitable assistance.

The need for establishing IRCI, despite the fact that a variety of financial corporations were already in existence, arose from the depressed industrial climate following the recession, combined with various adverse factors-mismanagement, misutilisation of financial resources, unsatisfactory labour-management relations and critical raw material position which led to the closure or sickness of many industrial units particularly in West Bengal.

Notes

It was of vital importance to have them operative again in view of their significance to the economy of the country and the need for the employment of a large workforce. However, the task was too big for the means of any one of the existing financial institutions. Besides, the financing of reconstruction and rehabilitation activities would have diverted the limited resources of the existing financial corporations from their main developmental activities. The setting up of an additional institution, which specialized in reviving and revitalizing the ailing and closed units, became inevitable.

Accordingly, the Reserve Bank of India, at the instance of the Government of India, took the initiative, and IRCI was constituted. In course of operations, the IRCI had to face several impediments handicapping its major task of changing the ineffective management of assisted units and implementing reconstruction schemes.

The Corporation could not acquire majority of the shares in the assisted companies nor it could put on the Board of the defaulting companies competent professionals as Directors and executives because they did not enjoy statutory immunities and were available to the nominees of IDBI, IFCI and SFCs.

IRCI could implement any scheme of reconstruction, amalgamation and merger within the provisions of Companies Act and the process being long drawn acted as a deterrent to the speedy revival of the sick industrial concerns.

In order to overcome the above constraints, the Government constituted Industrial Reconstruction Bank of India (IRBI) in March, 1985 to act as the principal credit and reconstruction agency for reconstruction and rehabilitation of sick industrial units through assistance for their modernization, diversifications expansion or rationalization and for coordinating similar work of the other institutions enjoyed therein.

With the setting up of Board for Industrial and Financial Reconstruction (BIFR), the role of IRBI became irrelevant and as a sequel to that Government of India decided to convert IRBI into a full-fledged all-purpose development finance institution.

Accordingly, Industrial Investment Bank of India Ltd. (IIBI) was incorporated as a government company under the Companies Act, 1956 in March, 1997 thereby providing it with adequate operational flexibility and financial autonomy.

Objectives and Tasks of IIBI: The transformation of IRBI into IIBI has led to a paradigm shift in its objectives and tasks from rehabilitation to development banking.

Accordingly, the primary objective of the IIBI is to provide customized financial assistance to industrial enterprises so as to cater to their financial needs. The thrust of the institution is on setting new standards in the industry as the most innovative financial institution.

As a development bank, the IIBI renders assistance in the form of term loans, underwriting, direct subscription, deferred payment guarantees and also under asset credit/equipment finance scheme and equipment leasing/hire purchase scheme.

Besides, the IIBI has also been assigned with the task of undertaking merchant banking activities.

Further, the IIBI provides short-term non-product asset-backed financing in the form of working capital and other short-term loans to companies to meet their fund requirements.

8.7.4 Summary of SIDBI Performance

Small Industries Development Bank of India (SIDBI), set up as a wholly - owned subsidiary of IDBI by an Act of Parliament in 1989, commenced its operations from April 2, 1990 by taking over the outstanding portfolio and activities of IDBI pertaining to the small sector.

Notes

The basic idea underlying the formation of the SIDBI was to foster the growth of small-scale sector which occupies a pivotal position in Indian economy. Thus, the Bank has been assigned the role of the principal financial institution for promotion, financing and development of industry in the small, tiny and cottage sectors and to coordinate the functioning of institutions engaged in similar activities.

It has to pay concentrated attention to the multi-dimensional village, cottage, and tiny sectors.

Initially, the SIDBI's business comprised refinancing to term loans granted by SFCs, SIDCs, banks and other eligible financial institutions; direct discounting and rediscounting of bills arising out of sale of machinery/capital equipment by manufactures in the small scale sector on deferred credit and rediscounting of short-term trade bills arising out of sale of products of the small scale sector.

At present, the SIDBI renders equity type of assistance to special target groups like new promoters, women and ex-servicemen under National Equity Fund, and voluntary agencies working for development/to the up liftment of underprivileged women.

It also provides resource support to NSIC and SSIDCs for their material supply and marketing of SSI products as well as their hire purchase and leasing activities. For promotion, development and growth of small-scale sector, SIDBI extends technical and related support services.

The SIDBI, in tandem with the overall policy measures of the Government of India and keeping in view the expectations of the sector, has been refining its strategies and putting in place new policies and programmes for the development of small scale sector.

As an apex institution, the Bank has been expected to play a more proactive role in reaching out financial and support services to SSIs with the help of existing credit delivery structure and support service agencies.

Besides co-promoting new intermediaries and strengthening the existing network of institutions engaged in development of small scale sector, the SIDBI has developed tailor-made schemes catering to specific requirements of SSIs, thus supplementing the efforts of PL's.

A major challenge confronting the SIDBI is to devise strategies for development of all three distinct segments with in small scale sector, viz., micro, tiny and modern SSI, the first two predominantly covering traditional industries.

Promotional and Development Role of SIDBI

The SIDBI has been playing the role of catalytic agent to foster growth of small-scale enterprises. The focus of the Bank's promotional and developmental activities has been on the following:

1. ***Enterprise Promotion:*** Enterprise promotion is being accomplished through four programmes/schemes, viz., Micro Credit Scheme (MCS), Rural Industries Programme (RIP), Mahila Vikas Nidhi (MVN) and Entrepreneurship Development Programmes (EDPs).

2. ***Micro Credit Scheme:*** Under the enterprise promotion initiatives of the Bank, Micro credit programme was accorded greater importance in terms of policy changes and quantum of finance, which are critical for growth of micro finance sector. In view of the acute need for provision of financial services to the poor and huge growth potential of the micro finance sector, the SIDBI played a proactive role as an apex Bank to promote the process of establishing an appropriate and responsive credit delivery system for the poor, especially women in rural areas.

   Under the scheme, soft loan assistance is provided to well managed NGOs for on-lending to SHGs/individuals for pursuing non-farm income generating activities coupled with grant assistance to help them in institutional capacity building. The pilot phase was a

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useful learning experience under which assistance of ₹ 30. 71 crore was sanctioned to 142 intermediary NGOs till March 31, 1999.

With the pilot programmes attaining the take off stage, a demand for up scaling SIDBI's micro credit programme emerged. Further, the lessons learnt during the pilot phase necessitated certain changes in MCS.

The Bank took up itself the task of setting up of SIDBI Foundation for Micro Credit (SFMC). The SFMC, launched in November 1998 on an all India basis, is presently functioning as a new department within SIDBI at Lucknow.

The mission of SFMC is to create a national network of strong, viable and sustainable Micro Finance Institutions (MFIs) to provide wide ranging micro finance services to the poor. The Bank renders a customized package of assistance to these MFIs consisting of a mix of loan, equity and need-based assistance for capacity building.

It endeavors to promote and develop these agencies into strong financial intermediaries, which would act at major players in the micro credit segments, especially for reaching out to smaller NGOs and MFs, and for building their capabilities through in credit delivery and usage. Besides, the programme also aims at promoting best practices and introduction of innovative features that would contribute to financial viability of micro credit programmes, which would, in turn, ensure appropriate financial services to the poor.

SFMC provided so far assistance aggregating ₹ 21.90 crore to 31 MFIs. The assistance is likely to benefit about 105700 poor persons.

The cumulative sanctions by the SIDBI since its inception amounted ₹ 52.61 crore to 160 MFIs, covering over 313,700 poor.

Keeping in view its intent and purpose, SFMC is now focusing on a limited clientele consisting of large MFIs having considerable growth potential. The selected MFIs are proposed to be developed and nurtured as long term partners who would act as major financial intermediaries for delivering efficient, convenient and timely micro products and services to the poor.

The SIDBI has so far sanctioned assistance of the order of ₹ 7.86 crore under this scheme to as many as 151 NGOs for the benefit of about 19250 women. This assistance is dispensed to provide training and employment opportunities to women in rural areas by facilitating creation of suitable infrastructural facilities.

It has been the policy of the SIDBI to institutionalize the Entrepreneurship Development Programme (EDP). Accordingly, the Bank provides support to NGOs and specialised agencies for conducting specially designed programmes covering various target groups, which would result in promotion of enterprises.

Sensing the importance of human resource management in small-scale sector, the SIDBI has decided to address the human resources development needs of the SSI sector by acting as a conduit between reputed management/technology institutions and the SSI sector.

The Bank supports these institutions to offer tailor-made management development programmes, viz., Small Industries Management Programme (SIMAP) and Skill-Cum-Technology Up gradation Programme (STUP).

The SIDBI launched Technology up gradation programme in 1994 with the sole objective of encouraging adoption of improved technology in homogenous clusters. The reach of the programmes was extended in 1998-99 to include issues like marketing, export promotion, and finance which are relevance to SSI units and assume more significance in the traditional clusters.

Notes

3. ***Quality and Environment Management:*** The SIDBI provides support to reputed agencies for conducting ISO-9000 awareness programmes for the SSI sector and for guiding and helping SSI units for acquiring ISO-9000 certification. Thirty-five SSI units have so far acquired the ISO-9000 certification on account of the Bank's support. Another 45 units are undergoing the process for acquiring the same.

4. ***Market Promotion:*** In order to boost up marketing efforts of the SSI sector the SIDBI has since its inception accorded special focus to market related development initiatives. It has set up Marketing Finance and Development Department (MFDD) as the nodal department.

5. ***Information Dissemination:*** For dissemination of entrepreneurship related information through the electronic media the SIDBI provides support to 'Udyog Sadhana' series programme.

In the year 1998-99 'Udyog Sadhana' programme in Orissa picked up with repeat broadcast of 47 episodes on All India Radio and follow up services provided by a drop-in center supported by the state nodal agency, viz., Centre for Development Research and Training, Xavier Institute of Management Bhubaneshwar.

Thus, the SIDBI has emerged as a principal financial institution to render yeoman services to the small scale sector and with its present financial strength is all set to fulfill the mission of fostering growth of India's small industries sector.

However, the Bank has to take various proactive measures to counter the challenges, which it is going to face in the ensuing years. The greatest challenge before the SIDBI is to strengthen financially, managerially and technically the SSI units so that it can counteract the threats stemming out of the Government policy of globalisation.

The fast changing market scenario would further deepen the problems of the SSI sector particularly when the provisions of WTO came into play in full swing. Besides for exports in the global market, challenges await in the domestic market as well. Consequently, the SSI sector has to focus on technology up gradation, quality control economies of scale, production and delivery schedule in order to achieve competitive edge in this era of globalisation. In this mammoth task, the SIDBI has to play still more crucial role.

Another future challenge before the SIDBI emanates from the upsurge of universal banking concept. The existing all India development financial institutions prefer to connect themselves into Universal banks. The SIDBI finds itself at the crossroads at this juncture when it has to perform the apex role conferred on it by the provisions of SIDBI Act. The SIDBI will have to strike a delicate balance between its developmental role for the SSI sector, on the hand and the role of viable financial institution to improve its profitability, adhere to prudential norms, contain NPAs and achieve higher net worth by adopting competitive banking practices on the other.

In future the SIDBI is destined to emerge as a big conglomerate financial institution meeting new innovative demands of SSI sector, having set up subsidiaries, viz., SIDBI Venture capital Ltd., and SIDBI foundation for Micro Credit and Credit Guarantee Fund Trust. Further, separate specialized outfits for technology development and finance, marketing, capital market and for capturing international markets are on the anvil. Once these outfits come into full play, the SIDBI is expected to become five to six times bigger than its present size.

8.7.5 Small Industrial Development Corporation

The objective of establishing the SIDCs has been growth in the state by undertaking developmental promotional and financing functions.

Notes

The SIDC act as catalysts for industrial development and provide impetus to investment in their respective states. The assistance impetus by SIDCs is in the form of term loans, underwriting/ direct subscription to shares/debentures and guarantees inter-corporate deposits. They also open letters of credit on behalf of their borrowers. They underwrite a range of promotional activities such as preparation of feasibility reports, conducting industrial potential surveys, entrepreneurship development programmes and developing industrial aerial estates. These institutions are also involved in setting up of medium and large industrial projects in the joint Sector/assisted sector in collaboration with private entrepreneurs or as wholly owned subsidiaries. The SIDCs also act agent of providing tax benefits under the state Government's package scheme of incentives. Since SIDCs also offer a package of development services which include technical guidance, assistance in plant location and coordination with other agencies. In line with the changing. Environment, many of the SIDC are making efforts to diversity their activities to enter the field of equipment leasing, merchant banking and mutual funds.

Did u know? SIDCs have made it a policy to promote the industrial projects in medium scale sectors and projects costing up to ₹ 10 crore. Projects where cost exceeds ₹ 10 crore are required to approach all India Institutions for financial assistance.

SIDCs insist on debt-equity ratio in the ratio of 2:1. However, in certain cases they reserve the right to relax it but not exceeding 2.5: 1. The SIDC have prescribed a maximum promoter's contribution ranging from 12.5% to 22.5% depending upon the location of the project and category of entrepreneur.

In consequence with the Government policy of sponsoring industrial development in back regions, the SIDCs/SIICs have provided financial assistance on liberal terms and conditions to such units as are located in back ward area.

Some SIDCs assumed the role of initiating arrangements for the promotion of new industries such as securing industrial licenses for projects in their own names, feasibility studies and negotiating collaborations and other arrangements.

The SIDCs analysis of the operations of the SIDCs reveals that these institutions have played an important role in the development of small and medium industries. Besides giving loans, they have offered venture capital to a large extent, which is really praiseworthy.

They are competing with the state financial corporations in different states. SFCs concentrate on lending funds to small and medium concerns; the SFCs may assume the role of provincial development banks to provide venture capital to companies and managerial and technical assistance to entrepreneurs in the identification of new project ideas, carrying out feasibility studies and implementing the project ideas.

8.7.6 Regional Rural Banks (RRBs)

Regional Rural Banks (RRBs) were introduced to meet the need for extending credit to the weaker section of the society. They were to supplant the activities of the nationalized commercial banks in order to create a better distribution channel of the rural credit.

The RRBs were expected to provide credit to the weaker sections and extend the habit of thrift amongst the poor. They were also designed to mobilize deposits from the rural household in the country. RRBs were supposed to be an integral part of rural finance in the country.

The RBI provides refinance assistance at 3 per cent to the RRBs in order to facilitate their operations. They have also been allowed to maintain a lower SLR than the commercial banks. Besides, the RRBs are allowed to pay half per cent more interest then the commercial banks on deposits so that more people are interested in saving with them.

Notes

Besides IDBI, NABARD and SIDBI are supposed to provide marginal and financial assistance to the RRBs in order to promote them. This is being provided under the RRB Act in order to promote these institutions.

The RRBs have grown by leaps and bounds and from a mere six in 1975, there are 86 RRBs as of 2008-09.

Performance Evaluation of RRBs

The committee constituted by the RRBs in June 1977 to evaluate the performance of RRBs concluded that the RRBs were important and useful tools in providing rural credit with minor modification.

The Working Group on Multi Agency Approach in Agriculture Finance appointed by the RBI in 1978 upheld the RRBs and suggested that the RRBs should not play a supplementary role in providing credit for agriculture to the commercial banks.

The study found that RRBs can break even at ₹ 8 crore businesses through a network of 70 branches in about 6 years, provided they enjoy a margin of 5 per cent between borrowing and lending.

The Committee to review Arrangements for Institutional Credit for Agriculture and Rural Development which inter alia examined the role of RRBs in the rural development work suggested the following:

1. RRBs should be promoted to provide rural development by opening more branches in rural area.
2. Eligible business of commercial banks in rural branches may be transferred to the RRBs.
3. The losses in initial year to be covered by the equity and shareholders fund.
4. The sponsor banks should continue to provide support until 10 years.
5. Concessionary refinance by the RBI should be continued.
6. Control and regulation should be given to NABARD.

Regulatory Control of RRBs

The following regulatory controls are imposed on RRBs:

1. Cash reserve ratio of 3 per cent of their demand and time liabilities.
2. Quarterly/half yearly review of RRBs, especially weak ones by the sponsor banks.
3. Merger of RRBs coming under sponsor banks and operating in contiguous areas.
4. Off site surveillance.
5. Framing of appointment and promotion rules, 1998 for the staff of RRBs.
6. Introduction of Kisan Credit Cards for provision of credit to farmers.

Credit Delivery System of RRBs

Two ideas have influenced RRBs: (1) Grant of cheap credit, and (2) Lending to individuals belonging to poor class. In terms of monitory issues, the RRBs have been a success. However, they have failed in terms of purpose, since most of the lending has been done without any meaningful activity being identified. Political motives of creating equality have overridden the

economic need of lending. RRBs had tried to build in equity without giving enough emphasis on asset build-ups. As a result, the NPA of RRBs have risen from 56% in 1996 to 86% in 2009.

RRBs and Microcredit

RRBs were influenced to get into the mode of microcredit in the line and length of the Bank Rakyat Indonesia, the Grameen Bank-Bangladesh and Banco Solidario, S.A. (BancoSol). This was largely due to the working paper published by Mr. Y.S.P. Thorat of the Rural Planning and Credit Department in the RBI monograph, "A comprehensive study of micro enterprise finance institutions".

Role of RRBs in Poverty Alleviation

Poverty alleviation has been the centre of discussion since independence. The question of equitable growth and distribution of wealth in the nation has been the priority of all the plans since then.

One way which the Government of India has thought of eliminating poverty was to create a structure which would generate income for the poor. Instead of providing employment to the poor, it was thought to empower them to become entrepreneurs and make then a part of the production and output generation system. Livelihood programmes were adopted in order to move in this direction. Skill-based training was imparted in order to generate even distribution of labour, which in turn, would give scope for a entrepreneurial move for the poor.

It is essential to note that certain Western models of employment generation and stereotyped work hours do not hold well in India. India is not wealthy enough to sustain a burden of salary to be paid to 100 million people. Hence, the focus of the burden has to shift from the employment generation to employment generator. Small and medium scale projects had been promoted in this respect.

Notes Inclusiveness has become the keyword of the economy today. The country has understood that unless the growth involves the smallest of the small in the country, the growth which we seek cannot be achieved.

In order to lend a cohesive alignment to these objectives, the RRBs have played a very significant role.

They have helped the country in making the reach of the employment and livelihood programmes to the poor of the country. Besides, they have at least been able to create a capital buffer for the poor entrepreneurs so that inclusive growth becomes a reality. The All India Debt and Investment Survey of the RBI puts that the total investment achieved by RRBs have been about 30 per cent of the total in the country. The Government has tried to integrate the RRBs with such schemes as Jawaharlal Nehru Rojgar Yojana and Rural Renewal Mission. In sum, it could be said that RRBs have helped in a limited way to lesson the gap between the saving and investment.

Self Assessment

Fill in the blanks:

10. The RBI (Amendment) Act 1997 defines ……as an institution or company whose principle business is to accept deposit under any scheme or arrangement or in any manner, and to lend in any manner.

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11. ……..are those whose principle activity is to arrange leasing of assets.
12. ……..credit is defined as a system under which term loans for purchase of goods and services are advanced to be fractionally liquidated through a contractual obligation.
13. ……agencies are properly individual organizations which are given assignment to find the credibility of debt and equity issues in terms of the risk involved in them.
14. Development banking is the financing of projects assessed on the basis of their viability to generate cash flows to meet the interest and ……..obligation.
15. …….were introduced to meet the need for extending credit to the weaker section of the society.

8.8 Summary

- Banking, per se, commercial banking, has a long history. Starting its journey from the traders of Rome, it traces its way to the modern day prime intermediation.
- The history of banking is by far the history of the State Bank of India, being the oldest bank in the country.
- The post-independence economic scenario forced the Government of India to nationalize the banks. These banks acted as a major source of institutional support for the Indian financial system.
- NBFCs occupy a large segment of Indian financial system. They have evolved over age. Starting from small mutual benefit organizations, today they are there in almost all walks of life, touching millions of people of the country.
- The most common of them are equipment leasing, hire purchase and housing finance companies. These companies offer public deposit as well as provide loans to business houses.
- It has been observed that there were hardly any regulations on these organizations.
- In order to regulate them and protect investors' interests, several committees and groups were established by the Government of India. Based on the recommendation of these committees, there have been several liberalization and control steps to make these organizations more accountable and vibrant.
- The role played by all these leading development banks in the promotion of large scale, medium, small scale and micro and cotton industries is commendable. The establishment of these banks has facilitated and supported the promotion of industry.
- By providing the entrepreneurs by means of project assistance, planning, capital requirements, training, marketing and special assistance to promote exports and imports finance etc.
- These banks have taken up a variety of new activities as desired by the Govt. of India from time to time to establish business in production and service sectors.
- The SIDCs are primarily conceived as development institutions they have not built up a well-developed organizational framework to undertake challenging tasks to develop small and medium industries as desired by the Central Government.
- To improve their functioning they have to equip with technological competencies to project guidance and to undertake economic potential surveys to identify new sectors of development, which can provide more employment. Gaining of such expertise is important

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for SIDCs to help the business units to assist them in providing marketing and production management and warehousing, exporting kind of areas.

- The SIDCs in Andhra Pradesh, Maharashtra, Gujarat, Tamil Nadu, Karnataka have shown promising performance.
- RRBs have had a definitive role to play in the development of rural India. Directly under the supervision of the RBI, it has been a major channeliser of livelihood and other rural employment schemes of the Government of India. Despite the fact that effort has been put to create wealth for the poor through RRBs, the gap between the objectives and the achievements for RRBs have been large.

8.9 Keywords

Bank risk: Banks in the process of providing financial services assume various kinds of risks, credit, interest rate, currency, liquidity and operational risks.

Credit risk is the risk of loosing money when loans default. Credit risk or default risk gives rise to problems of bank management.

Development banking is the financing of projects assessed on the basis of their viability to generate cash flows to meet the interest and repayment obligation. They have an in-built promotional aspect, because projects have to fall within the overall national industrial priorities, located preferably in backward areas and promoted by entrepreneurs.

Liquidity risk refers to the bank's ability to meet its cash obligations to depositors and borrowers. A liability-sensitive position than to assets of interest rates reduces the liquidity position of a bank.

Unit banking consists of provision of banking services by a single institution. The size as well as the area of operation is small and far more limited than branch banking. However, the unit bank may have branches within a strictly limited area.

Venture capital is long-term risk capital to finance high technology projects, which involve risk, but at the same time has strong potential for growth.

Venture capitalist pools their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium.

8.10 Review Questions

1. Describe the meaning of the word 'banking' tracing its roots in history. How have modern banks evolved from the traditional banks?
2. Enumerate the banking history of India and explain its role in the modern-day economy.
3. How has nationalization of commercial banks in India helped in supporting the Indian economy?
4. Detail the economic liberalization and its role in the Indian economy.
5. Describe the various kinds of banking prevalent in India.
6. What are NBFCs and how are they different from RNBCs?
7. Explain the various needs for regulating the NBFCs in India.
8. What are the liberalization drives that have been undertaken to make NBFCs perform better?
9. Explain the role of IDBI in promoting industry India.

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10. Write about the development of IDBI since its establishment to date.
11. What are the functions and types of assistance offered by IDBI?
12. Explain the role of IFCI in promoting industry India.
13. What are the functions and types of assistance offered by SIDBI to promote small-scale sector industry in India?
14. How the functioning of ICICI is different from the existing development banks in India?
15. What is the strategic approach of development banks in promoting their business expansion and achievement of goals?

Answers to Self Assessment

1. Financial institutions
2. Commercial banking
3. Lending money
4. secured loan
5. debt
6. not secured
7. Cooperative banks
8. Branch banking
9. Correspondent banking
10. NBFC
11. Equipment Leasing Companies
12. Hire purchase
13. Credit rating
14. Repayment
15. Regional Rural Banks (RRBs)

8.11 Further Readings

Books

Micro Financing for SMSE, SIDBI publication.

Credit Risk Management in Terms Loans, NABARD publication.

Asset and Liability Management, RBI publications

Online links

www.sebi.gov.in

www.sebi.com

investor.sebi.gov.in

sebiedifar.nic.in

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Case Study

Infrastructure Financing: NBFCs for Enlarging Global Lenders' Pool

Elimination of the restrictive condition, whereby overseas lenders are required to have a direct exposure to infrastructure projects amounting to three times of what is being lent to NBFCs, has been sought.

Mumbai, April 7 Non-banking finance companies, dedicated to financing infrastructure projects, have moved the Reserve Bank of India to enlarge the pool of global lenders from whom they can borrow. They have also sought elimination of the restrictive condition whereby overseas lenders are required to have a direct exposure to infrastructure projects amounting to three times of what is being lent to NBFCs.

NBFCs in the infrastructure financing space want the pool of overseas lenders, from whom they can borrow, expanded to include reputed banks and bilateral financial institutions so that they can source loans on favourable terms and conditions.

The big NBFC players in the infrastructure space include Infrastructure Development Finance Company, SREI Infrastructure Finance, Power Finance Corporation and Rural Electrification Corporation, among others.

ECB Restrictions

As per RBI's external commercial borrowings (ECBs) policy, sourcing of funds has been restricted to multilateral/ regional financial institutions and government-owned financial institutions.

Under the ECB policy, NBFCs can avail themselves of ECB up to $500 million per financial year under the 'approval route' to finance import of equipments for leasing to infrastructure projects in India. The average maturity of the borrowing should be five years. The requirement of all-in-cost ceilings on ECB has been dispensed with until June 30, 2009.

Analysts say that the ECB policy encourages import of capital equipment by infrastructure developers/financiers to the detriment of domestic capital goods manufacturers.

"As it is, very few lending agencies are willing to invest in the infrastructure sector in emerging economies. Even if they do, they have their unique set of problems such as lengthy appraisal process, pre-condition like sourcing of inputs from lending countries, etc. This reduces the number of viable sourcing options for NBFCs," said a senior official with a leading NBFC.

NBFCs want the twin conditions whereby overseas lenders, at all times, are required to maintain the ratio of their direct lending to the infrastructure sector in India to their total ECB lending to NBFCs at 3:1 and that Authorised Dealer Category - I banks should obtain a certificate lenders to this effect, completely eliminated.

Smaller Players

"There are smaller regional/ bilateral financial institutions which do not have the wherewithal to lend directly to infrastructure projects. They depend on domestic financial intermediaries (FIs) who have the expertise in financing such projects. Hence, they prefer to route their funds through local FIs for on-lending to small and medium infrastructure

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projects. Such overseas lenders will not be able to comply with the 3:1 ratio," the official explained.

The non-banking financiers want a level playing field vis-a-vis infrastructure companies when it comes to tapping ECB under the 'automatic route' so that the credit needs of the smaller infrastructure developers can be met without much ado.

While larger infrastructure players are able to source ECBs on their own, the smaller players are not in a position to tap the overseas market. Hence, the smaller project developers' bank on NBFCs for financing and the approval route causes unnecessary delays.

Question

Discuss the role of NBFCs in infrastructure development in India.

Source: http://www.thehindubusinessline.in

Unit 9: Commercial Banking Services

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Objectives

After studying this unit, you should be able to:

- Learn the concept of commercial banking;
- Explain the factors effecting the growth of the banking sector;
- Discuss the functions of commercial banking;
- Understanding risk management by commercial banks;
- Understand management of loans in commercial banks.

Introduction

Banks are financial firms and depend on economies of size and gains arising from internalizing certain activities rather than relying on market transactions. Banks provide packages of financial services which individuals find too costly to search out, produce and monitor by them. Commercial banking offers a wide variety of services to small, medium and large scale business units. The role of banking is more prominent in the open economy.

9.1 Evolution of Commercial Banking

The evolution of banking which lasted for centuries until two types of modern banking developed in the industrially advanced economies in the late nineteenth century was an integral part of the expansion of capitalism. The techniques of banking developed in the 17th century facilitated the industrial and territorial expansion that began about the same time. Banking systems evolved to meet the demands of the constituents, vested interests are regulations governing their establishment. The British system evolved around the central banking system with a central bank and clearing banks with a large network of offices regulated by the central bank while the German one evolved out of an identification of interests of finance, industry and government to provide multiple services to the constituents. The US system however was set apart by the dominance of the unit banks, the role played by an active interbank market in deposits and reserves and the cooperative lending practices. It also features wholesale banking, which was the source of several innovative practices such as rollover credit or flexi rate lending.

9.1.1 Factors affecting Banking Systems Growth

While provision of payment services involving the transfer of ownership of bank deposits from one account to another, provision of deposit facilities and advance credit by means of overdrafts and loans, by the discounting of bills and by trade finance constitutes the ordinary business of banking, there has been a sea change in the business of banking in the lasts forty years as exemplified by the rise of wholesale banking, liability management, international banking, multiple currency loans, rollover credits, securities lending collaterised mortgages note issuance facilities, interest rate and currency options and financial futures.

Example:

Credit cards

Debit cards

Automated teller machines

E-cash and on-line banking

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Banks globally have undergone fundamental changes because of the ongoing revolution in information technology and communications.

The winds of change are reshaping the nature of banking and financial markets. The demand for new types of services as well as the need to step up earnings through fee income is the major factors. On the other hand, technological advances by reducing costs give individuals and business firms direct access to markets reducing the need for banks to offer certain services. Technological advances and subsequent innovations have also led to the creation of new markets in terms of future options, secondary mortgage markets expanding the range of portfolio strategies open to financial intermediaries.

The changes in competitive conditions since 1990s with banks as a leading partner of financial services industry have transformed banks (especially large international ones) into new financial firms. Among the important factors behind changes in competitive conditions are the internationalization of banking and financial markets.

The opening up of financial markets, the supply of cross-border financial services and the impact of the entry of foreign commercial and investment banks are the important features of the process. Other factors are the continuous process of deregulation, partly as a consequence of the globalization of the markets and partly as a muddle through process. The sources of change of banking industry, mergers and amalgamations of banks, integration of markets by exchanges, growth of financial information business and internet.

9.1.2 Desegmentation of Financial Services Industry

Global financial services industry in the 1990s has become desegmented on account of the transformation of traditional business lines such as securities trading, insurance and asset management and assuming concomitant risk. Banks had to diversify by taking on related activities in different markets since their lending business suffered on account of competition from securities market and institutional asset managers. Banks had to seek new ways of intermediating funds.

The degree of disinter mediation, however, varies between banks and countries. Banks in turn, face competition from non-bank financial institutions such as mutual funds, investment banks, pension funds and insurance. During 1990s, the business of banks with international focus experienced displacement, especially of lending by other activities, larger growth in off balance sheet items relative to total assets and larger increase in other operating income as compared to traditional deposit loan spread. Derivatives and fee based income became important sources of income.

Restructuring of the banking industry is reflected in banks expanding into other segments of financial industry and by consolidation within the banking industry. In domestic insurance, business banks distribute insurance products such as annuities and variable life policies that mirror other long-term investment products to retail customers. In Europe, banks distribute standardized savings type policies referred to as bank assurance, and some have acquired insurance companies. With the passage of time, recent legislation banks in USA can now enter insurance business. Banks were earlier fastest growing distributors of annuities and life insurance policies. They have also set up or acquired asset management units to earn fee income from providing investment management to their traditional customers. Universal banks in Europe which have been providing asset management services have to meet competition now from asset managers.

9.1.3 Mergers and Acquisitions

Finally, there is a wave of mergers and acquisition activities among domestic banks in North America, Japan and Europe since size is considered an advantage in competing both domestically

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and internationally. Further, international competition is a reality since restrictions on the entry of foreign financial institutions are being removed. Global banks can maintain extensive distribution channels, develop new products and transfer risks around the globe. The trend in disaggregation at national and international levels is likely to lead banks and other financial institutions to become more specialized, niche players. The institutions will specialize only in few areas and meet particular customer demands. Liberalisation of domestic capital markets and of international capital flows since the early 1970s coupled with rapid gain in information technology has been the catalyst for financial innovation and the growth in cross border capital movements. These national financial markets have become increasingly integrated into a single financial system.

9.2 Role of Exchanges

Global markets are integrated by the exchanges which link up across borders. This results in reduction of costs, lower trading fee and longer trading hours. SIMEX and Chicago Mercantile Exchanges are also relaxing membership criteria to expand participation by including off site members. The switch from floor trading to screen based trading has also opened the door to remote membership and broader participation. Broader membership means access to more capital and less risk for clearing house and larger volume. Some exchanges (MATIF) are combining floor trading with electronic trading by allowing some of each.

9.3 Financial Information Business

Facilitating globalisation-Reuters Holding, Bloomberg, Dow Jones Markets and Bridge Information services are the four large firms. The line between information provision and trading is becoming blurred in the race to provide globally accessible financial services.

9.3.1 Internet

Internet is breeding a host of niche players with connection to financial institutions and investors.

9.3.2 Market Oriented vs. Bank Oriented Financial Systems

The two systems of banking are the market-oriented financial system (Anglo Saxon) characterized by a division of functions and the bank-oriented financial system (Central European) characterized by universal banking. In a market-oriented financial system, specialized financial institutions including banks, financial markets and market intermediaries cater to the different financial needs. In a bank-oriented financial system, savings are largely transferred directly from those who generate them to those wishing to use them by the intermediation of banks. Britain with its functional specialisation represents a market-oriented financial system while Germany with her tradition of universal banking as a bank-oriented financial system.

9.3.3 Branch vs. Unit Banking Systems

The unit and branch banking systems evolved around the central banking system which consists of the central bank, commercial banks and other financial institutions. Unit banking consists of provision of banking services by a single institution. The size as well as the area of operation is small and far more limited than branch banking. However, the unit bank may have branches within a strictly limited area. A third of banking offices in the United States are unit banks. Their presence in USA is a result of law vested interests and the ability of this type of organization to meet the demands of banking customers. It was also a practical method earlier because of

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inadequate transportation and communication facilities. Unit banking gave way to branch banking in many parts of USA with the economic interdependence of large areas, the development of transportation and communication, the growth of big business firms, a more mobile population and increasing emphasis placed on location and convenience.

The banking systems operating in different countries may be classified into branch banking and unit banking system. Unit banking exists when banking services are provided by single offices. Some of these banks are often allowed to have some branches within a limited area. These unit banks are linked together by the correspondent bank system. The correspondent bank system acts as a medium for remittances between one bank and another and provides facilities for consultation for lending risks and sharing loan business.

Did u know? Approximately a third of American banking offices are unit banks. The presence of unit banks in American banking system is partly a be termed as local banking system emphasizing the limited areas served by result of law, vested interests and the ability of the unit type of bank organization to meet the demands of banking customers. In the absence of transportation and communication facilities in the nineteenth century, the most practical banking organization was unit banking. The unit banking system in USA would perhaps most banks rather than a form of bank organization. Unit banking is largely concentrated between the Mississippi and the Rockies.

9.4 Functions of Commercial Bank

The functions of a commercial bank are:

1. To change cash for bank deposits and bank deposits for cash.
2. To transfer bank deposits between individuals and\or companies.
3. To exchange deposits for bills of exchange, government bonds, the secured and unsecured promises of trade and industrial units.
4. To underwrite capital issues, they are also allowed to invest 5% of their incremental deposit liabilities in shares and debentures in the primary and secondary markets. The commercial banks have set up subsidiaries to provide advice on portfolio management or investment counseling. They also offer their constituents services to pay insurance advice on-tax problems and undertake executive and trustee services.

9.5 Transformation Services

Banks combine various types of transformation services with financial intermediation. They provide three transformation services when they undertake intermediation process.

Firstly, liability, asset and size transformation consist of mobilization funds and their allocation (provision of large loans on the basis of numerous small deposits).

Secondly, maturity transformation by offering the savers, the relatively short-term claim on liquid deposits they prefer and providing borrowers long-term loans which are better matched to the cash flows generated by their investment.

Finally, risk transformation by transforming and reducing the risk involved in direct lending by acquiring more diversified portfolios than individual savers can. Commercial banks by effectively appraising credit requests can channel funds into productive uses.

Notes

9.5.1 Transformation Services and Risks

Banks incur risks while undertaking transformation services. In the past three decades, banks abroad assumed new roles and accepted new forms of financial intermediation by undertaking currency and interest rate swaps and of dealing in financial futures, options and forward agreements. These new instruments reflect considerable flexibility in responding to market situations and adjusting continually assets and liabilities both on and off balance sheet, while enhancing profitability.

9.6 Risk Management

Risk is inherent in banking and is unavoidable. The basic function of bank management is risk management. In the words of Alan Greenspan, former Chairman of the Federal Reserve Board of US (Conference at Federal Reserve Bank of Chicago, May 12, 1994), "traditional banking can be viewed at an elemental level as simply the measurement, management and acceptance of risk" and banking involves understanding, processing and using massive amounts of information regarding the credit risks, market risks and other risks inherent in a vast array of products and services, many of which do not involve traditional lending, deposit taking and payment services.

Banks in the process of providing financial services assume various kinds of risks, credit, interest rate, currency, liquidity and operational risks. To some extent, these risks could be managed through sound business practices and the others through a combination of product design and pricing. In the past banks concentrated on asset management with liquidity and profitability being regarded as two opposing considerations. As a result, banks ended up distributing assets in such a way that for given liquidity level, the return was the maximum.

9.6.1 Overall Risk of a Bank

A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the standard deviation of the value.

9.6.2 Types of Risk

Banks have to manage four types of risk to earn profits for maximizing shareholder wealth. These are credit risk, interest rate risk, liquidity risk and operational risk. In addition there is a systematic risk arising due to various disruptions in the working of a major bank, which in no time could spread to other banks or the whole financial system. Credit risk arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise. The solvency of the bank would be threatened when the bank cannot fulfill its promise to pay a fixed amount to depositors because of the decline in the value of the assets caused by an increase in interest rate. Liquidity risk arises when the bank is unable to meet the demands of depositors and needs of the borrowers by turning assets into cash or borrow funds when needed with minimal loss. Finally, operational risk arises out of an inability to control operating expenses, especially non-interest expenses such as salaries and wages. In a competitive environment, high operational expenses would jeopardize the banks prospects to survive. Empirical analysis reveals that banks risk exposure depends upon volatility of interest rates and asset prices in the financial market, the banks maturity gaps, the duration and interest elasticity of its assets and liabilities and the ability of the management to measure and control the exposure.

Notes

Internet Sensitive Assets

These risks are a part of either assets or liabilities or both of a bank them. Assets are managed through money market instruments such as interbank lending, treasury bills and repos. Shortening the maturity of these assets makes them interest sensitive. Shifting liabilities such as interbank borrowing, issue of CDs while shortening the maturity of the liability side of the balance sheet makes liabilities more interest-sensitive and increases the risk of the bank's portfolio.

Credit Risk

The assets of a bank whether a loan or investment carries credit risk. Credit risk is the risk of loosing money when loans default. Credit risk or default risk gives rise to problems of bank management. The principal reason for bank failures is bad loans. Banks can raise their credit standards to avoid high risk loans. Guarantees and collaterals can reduce risk. After the loan is made, compliance can be ensured by monitoring the behaviour of the borrower which reduces risk. Credit risk can be transferred by selling standardized loans. Loans portfolio can be diversified by making loans to a variety of firms whose returns are not perfectly and positively correlated.

RBI Guidelines

RBI guidelines envisage that banks should put in place the loan policy covering the methodology for measurement, monitoring and control of credit risk. Banks are also expected to evolve comprehensive credit rating system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions.

Interest Rate Risk

Interest rate risk management may be approached either by on-balance sheet adjustment or off-balance sheet adjustment or a combination of both. On-balance sheet adjustment involves changes in banks portfolio of assets and liabilities, as interest rates change. When medium or long-term loans are funded by short-term deposits, a rise in the rate of interest will increase the cost of funds but the earnings on the assets will not, thereby reducing the margin or spread on the assets. The problem could be resolved by adopting adjustable interest rate on loans on the assets side of the balance sheet and increasing the maturity pattern of deposits on the liability side of balance sheet. These decisions relating to banks portfolio of assets and liabilities represent balance sheet adjustments.

The interest rate risk position can also be adjusted by the bank by making off-balance sheet adjustments which involve the use of various non-traditional financial instruments referred to as derivatives such as futures, options, swaps or creation of synthetic loans through use of futures.

Liquidity Risk

Liquidity risk refers to the bank's ability to meet its cash obligations to depositors and borrowers. A liability-sensitive position than to assets of interest rates reduces the liquidity position of a bank. The mismatch between short-term liabilities and long-term assets creates a severe funding problem as the liabilities mature. Again, if the duration of assets exceeds the duration of liabilities, the ability to realize liquidity from the assets of the bank is reduced. Liquidity needs are increasingly met by deposit and non-deposit sources of funds paying market rates of interest. Banks have decreased the quantity of liquid assets they hold for the purpose of deposits withdrawal

Notes

and loan demand. Liability management has replaced asset management as a method to fund liquidity needs. The effect of replacement of asset management by liability management would be enhancement of credit risk since liquid asset have been replaced by loans. The replacement of short-term assets by long-term assets would also require an increase in gross rates of return, since upward sloping yield curves require higher rate of return on long-term assets than on short-term assets.

Notes Asset liquidity is a reserve that a bank can fall back upon when bank's access to funds is reduced. Liquid assets can also be used to fund loans when interest rates are relatively high. Short-term assets are a less expensive source of funds than relatively high interest rate deposits.

Foreign Exchange Risk

Foreign exchange risk arises out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur. An open foreign exchange position implies a foreign exchange risk. When a bank owns an uncovered claim in foreign currency, it is said to be long and when it has uncovered liability in foreign currency, it is said to be short. There are several techniques available to hedge or cover exposure to foreign exchange risk. These techniques help in minimize the impact of unfavourable potential outcomes. Forward contracts, money market alternative, foreign currency futures, currency swaps and foreign currency options are used to cover exposure to foreign exchange risk.

Treasury Functions

To take advantage of the opportunities provided by development of new financial markets and the internationalization of banking while managing risk has led to the growth of treasury function within bank. The role of new treasury department is to manage a wide range of short-term assets and liabilities. The dealers employed in treasury department are constantly trading in wholesale deposits, interbank deposits, certificates of deposit, foreign exchange, repurchase agreements, securities, financial futures and options. Apart from trading in short-term assets and liabilities, the treasury department monitors the banks position with respect to earnings and risks due to maturity gaps and interest rate or foreign currency exposures. The treasury department usually reports to a high level treasury or asset and liability management committee. The committee after taking into account the entire balance sheet of the bank as well as off-balance sheet liabilities decides the treasury policy.

Monitoring Risks

To monitor risks, various techniques such as maturity profile, rate of interest ladder and concept of duration have been developed. A maturity profile shows all assets and all liabilities by maturities to enable the calculation of mismatches within each period. Rate-of-interest ladder classifies all asset and liabilities by repricing dates and allows the calculation of rate of interest risk for each period. Duration presents the interest exposure.

9.7 Asset and Liability Management

Asset and liability management is not a static technique but a dynamic approach to deal with the problem banks face and changes in bank's goals. Frozen lending was offset by increasing flexibility by making new loans against the provision of tradable assets which could be sold

Notes

before expiry, in case of need. Against a background of rapid growth in the banking business, integrated approach to managing all assets and all liabilities evolved as balance sheets became more complex and as the volatility of interest rates and exchange rates increased. In the eighties, the rescheduling of debt of developing countries on account of their serious payments difficulties involved conversion of short-term and medium term assets into long-term and became frozen. Banks abroad met the problem by raising long-term funds including capital liabilities. In the process, banks could meet the rise in capital adequacy norms stipulated by bank supervisors. Banks shifted their focus from growth to profitability and asset quality. Banks also started lending against negotiable assets and to the packaging for resale of conventional bank loans. Borrowers were encouraged to raise funds directly through issue of negotiable short-term paper by providing guarantees, standbys and backup facilities. Banks benefited from fee income without expanding balance sheet which would worsen capital ratios. Of course, off-balance sheet contingent liabilities went up.

There was a deliberate attempt to extend asset liability management beyond the range of on - balance sheet assets and liabilities which arises from the bank acting as principal in direct transactions with borrowers and lenders of money. Asset and liability management has helped to bring about securitisation of banking blurring the distinction between commercial banking and investment banking.

Self Assessment

Fill in the blanks:

1. In a market-oriented financial system, specialized ……..including banks, financial markets and market intermediaries cater to the different financial needs.
2. In a …….financial system, savings are largely transferred directly from those who generate them to those wishing to use them by the intermediation of banks.
3. ……..consists of provision of banking services by a single institution.
4. A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the ……of the value.
5. ……..arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise.
6. Liquidity risk refers to the bank's ability to meet its …….obligations to depositors and borrowers.
7. ……..risk arises out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur.

9.8 RBI Guidelines for Risk Management

Consequent to the liberalization of domestic market in India, the volatility in interest/exchange rates would be transmitted to the financial sector as a whole. To address these risks, banks have to undertake a comprehensive Asset Liability Management (ALM) strategy. The objectives of ALM are to control volatility of net interest income and net economic value of a bank.

RBI issued guidelines on 21.10.1999 for risk management in banks which broadly cover credit, market and operational risks. Earlier, guidelines were issued on 10.2.1999 on asset-liability management system which covered management of liquidity and interest rate risks. Together they are purported to serve as benchmark to banks.

Notes

Credit Risk

Banks should put in place the loan policy covering the methodologies for measurement, monitoring and control of credit risk. Banks should also evolve comprehensive credit ration system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions.

Proposals for investment should be subjected to the same degree of credit risk analysis as loan proposals. Portfolio quality should be evaluated on an ongoing basis rather than near about balance sheet date. Risk evaluation should be on the basis of total exposure, credit and investment decisions combined.

As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. A suitable framework to provide a centralized overview of the aggregate exposure on other banks is to be evolved. The banks should also develop an internal matrix that reckons the counter party and country risk.

Liquidity Risk

Banks should put in place prudential limits on interbank borrowings, especially call fundings, purchased funds, core deposits to core assets, off-balance sheet commitments and swapped funds. Liquidity profile should be evaluated under bank specific and market crisis scenarios. Contingency plans should be prepared to measure the ability to withstand sudden adverse swings in liquidity conditions.

Interest Rate Risk

A time-frame should be fixed for moving over to value at risk (VAR) and duration approaches for measurement of interest rate risk.

Market Risk

Explicit capital cushion based on international standards should be provided for the market risks to which banks are exposed.

Operational Risk

In view of the phenomenal increase in the volume of financial transactions, proper systems for measurement, monitoring and control of operational risk should be set up. Suitable methodologies for estimating and maintaining economic capital should be developed.

The design of the risk management should be oriented towards the banks own requirement dictated by the size and complexity of business risk philosophy, market perception and the existing level of capital. Banks can evolve their own systems compatible with the type and size of operations as well as risk perception. It is neither possible nor necessary to adopt uniform risk management system in all banks on account of the diversity and varying size of balance sheet items.

The success of ALM depends on the effective existence of (1) information and policies, and (2) risk management system. There should be asset-liability managers and an asset-liability committee (ALCO) that manages the bank's balance sheet in such a manner so as to minimize the volatility in its earnings, liquidity and equity to changes in market conditions. The successful pursuit of the objective would manifest in stable net interest margins, optimal earnings, adequate liquidity and effective control of financial risk. For this purpose the strong. ALCO must be

aware of policies which would address asset liability management goals and risk limits and by information that relates directly to its asset liability position.

9.9 Risk Management Systems

Measurement, control and monitoring of risk will help banks to attain the objective. Techniques such as gap, duration and value at risk are suggested to analyse risk. Strengthening of information technology in commercial banks is a prerequisite to implement effectively A.I.M system. The role of a broad-based ALCO in advising boards of banks is of significance.

9.9.1 Financial Services

Commercial banks provide securities related services. Commercial banks in Indian have set up subsidiaries to provide capital market related services, advice on portfolio management or investment counseling. In US, the Glass-Stegall Act of 1933 restricts the nature of services provided by commercial banks. In US, they may offer discount brokerage services but not general purpose brokerage services. US banks facilitate mergers and acquisitions and in trading in currencies and US Government securities.

The Glass-Stegall Banking Act prohibits commercial banks from owning a firm dealing in securities. The Act has been challenged by banks offering money market mutual funds and other investment services. US Federal Reserve Board in January, 1997 issued a proposal that would allow bank holding companies and their securities industry affiliates to offer one stop shopping for their customers. Commercial banks in US in 1990s have become very active in the management and distribution of mutual funds, managing more than 10 per cent of the assets of all mutual funds. In India, several commercial banks such as Bank of India, Canara Bank, Indian Bank and State Bank of India have set up subsidiaries under the guidelines issued by the Reserve bank in 1987, followed by guidelines laid down by the Ministry of Finance in 1991.

9.9.2 Fiduciary Services

In US, banks manage employee pension and profit-sharing programs that do not show up on banks balance sheet. In US, banks operate separate trust departments which manage the funds of others for a fee under the guidance of a trust agreement. The assets held in trust do not show up on banks balance sheet because they do not own the assets held in trust.

9.10 Functions of Bank Capital

Bank capital is the link between financial markets and bank's profitability. By relating bank's operations to financial markets, it indicates how well banks are performing. A capital shortage of a bank indicates that it should change, among others, its operating policies.

Bank capital is a source of funds. It helps meet start-up costs of investment in land, plant and equipment. Established banks also require capital to finance growth.

Return on bank capital indicates how well a bank's programmes can be sustained and the capital sum serves as a cushion against temporary losses and as a protection to uninsured depositors and other holders of liabilities in the event of liquidation. Financial markets continuously evaluate the relationship between earnings, assets and capital. The return on assets is measured by the return on capital divided by leverage. Profitability is the cornerstone of the capital policy of banks. Banks with low profitability are regarded as inefficient and may find it difficult to raise capital.

Notes

Bank capital provides a cushion against temporary losses and signals that the bank has a basis of continuity and that its constituents have reason to look at banks difficulties in a long-term perspective.

Bank capital is generally less than 10% of assets whereas non-financial firms have capital assets ratios in the range of 40-60%.

Relatively small unanticipated losses can significantly affect bank capital and threaten bank solvency. In 1990-91, before the advent of banking sector reforms, the ratio of paid-up capital and reserves to deposits, the capital base of public sector banks at 2.85% was quite low by international standards. Ownership of banks by government resulted in complacency about capital ratio. Lack of proper disclosure norms led many banks to keep the problems under cover.

Capital is the contrepiece of regulatory policies. Bank regulators stipulate minimum requirements to promote safety and soundness in the banking system. Shareholders are not the concern of regulators. With the progressive privatisation of public sector banks, shareholders with significant stakes in the bank will act to control risk-taking to protect their investment. The shareholding of the Government of India and the Reserve Bank constituted 1.8% and 59.7% in the case of State Bank of India, respectively. Other banks which are not fully owned by Government of India are Bank of Baroda (66.6%), Bank of India (76.6%), Corporation Bank (68.3%), Dena Bank (71.0%) and Oriental Bank of Commerce (66.5%). Existing norms permit dilution up to 51% through the issue of fresh capital by public sector banks. There are 14 banks in the public sector which are fully owned by Government of India. The private sector banks can raise capital in the form of equity issues without the approval of the RBI.

Capital Adequacy

Financial risk increases the probability of banks insolvency. Bank regulators are concerned about the downside risk of banks and they focus on lower end of the distribution of bank earnings. The variability of earnings from the regulators viewpoint should not lead to elimination of capital and insolvency of bank. Shareholders on the other hand are concerned with the expected return and require higher earnings per share as bank profitability becomes more variable. They have to be compensated for the bank risk.

The problem of financial risk is not solved by stipulating high capital requirement. High requirement may inhibit the efficiency and competitiveness of the banking system and may act as a constraint on the lending operations of the bank. Banks may not allocate funds in the most efficient manner. Relatively high capital requirement for banks as compared to other providers of financial services may also constrain the rate at which bank assets may be expanded, impairing their competitive strength.

9.11 Risk Adjusted Capital Requirements

The Basic Committee on Banking Regulations and Supervisory Practices appointed by the Bank for International Settlements (BIS) has prescribed certain capital standards to be followed by commercial banks. The proposal for risk based capital rules was adopted in 1988 by the Committee. The rationale for the proposal was that empirical evidence did not disclose any obvious relationship between bank capital and failure risk. The proposed norms apart from being closely related to failure risk, would also promote convergence of supervisory policies on the adequacy of capital among countries with major international banking centers. The Basel Agreement was signed in June, 1988 by 12 industrialised nations. US banks had to comply with the norms by close of 1992.

Notes

The RBI accepted for implementation, the standard of measuring capital as a ratio of risk weighed assets. The Committee on the Financial System (1991) suggested the adoption of capital adequacy norms, prudential norms for income recognition and provisions for bad debts. The risk weighed assets ratio approach to capital adequacy is considered to be more equitable as an institution with a higher risk assets profile so as to maintain a higher level of capital. Further, the integration of on-balance sheet and off-balance sheet exposures into the capital ratio would provide risk sensitivity and skills to manage risk and structure balance sheet in a prudent manner.

9.12 Classification of Capital of Banks

Capital funds of scheduled commercial banks in India include Tier I or Core capital and Tier II or Supplemental capital. Tier I capital includes paid-up capital, statutory reserves and other disclosed free reserves and capital reserves representing the surplus arising out of the sale proceeds of assets. In computing Tier I capital, equity investment in subsidiaries, intangible assets and losses are deducted. Tier I capital consists of permanent and readily available support to a bank against expected losses. Tier I capital should not be less than 50 per cent of total capital. In the US capital, reserves are excluded from equity since loan loss reserves reflect anticipated actual losses.

Tier II capital comprises of less permanent and less readily available elements such as undisclosed reserves and cumulative perpetual preference shares, revaluation reserves, general provisions and loss reserve, hybrid debt, capital instruments and subordinated debt. The total of Tier II elements should be limited to a maximum of 100 per cent of total Tier I elements.

Capital to Risk Assets Ratio (CRAR)

In April, 1992, the RBI introduced a risk assets ratio system for banks (including foreign banks) in India, as a capital adequacy measure. Under the system, the balance sheet assets, non-funded items and other off-balance sheet exposures were assigned risk weights, according to the prescribed percentages.

Risk Adjusted Assets

They are the weighted aggregate of the degree of credit risk expressed as percentage of the funded and non-funded items. The aggregate is used to determine the minimum capital ratio.

Funded Risk Assets

The percentage weights allotted to the funded risk assets are:

1. Cash, balances with RBI, balances with other banks, money at call and short notice, investment in government and other approved securities — 0%
2. Claims on commercial banks such as certificate of deposit — 0%
3. Other investments — 100%
4. Loans and advances:
   - (a) Loans guaranteed by Government of India — 0%
   - (b) Loans guaranteed by the State Governments — 0%
   - (c) Loans granted to public sector undertakings of Government of India and the State Governments — 100%

Notes

(d)	Premises, furniture and fixtures	100%
(e)	Bills purchased and discounted and other credit facilities	100%

Norms for Capital Adequacy

Banks are required to maintain unimpaired minimum capital funds equivalent to the prescribed level of the aggregate of the risk-weighted assets and other exposures on an ongoing basis. All banks with international presence had to achieve the norm of 8% as early as possible, and in any case, by March 31, 1994. Foreign banks operating in India had to achieve this norm by March 31, 1993. Other banks had to achieve a capital adequacy norm of 4% by March 31, 1993 (Tier I or Core capital having been set at not less than 50% of total capital) and the 8% norm by March 31, 1996. The total of Tier II elements will be limited to a maximum 100% of total Tier I elements for the purpose of compliance with the norms. Banks were advised to review the existing level and plan to increase the capital funds vis-à-vis the prescribed level and plan to increase the capital funds in a phased manner to achieve the prescribed ratio by the end of the period stipulated.

In conformity with the recommendations of the Committee on Banking Sector Reforms 1998 (CBSR), RBI announced a package of reform measures in October, 1998 in the areas relating to the prudential norms. These measures aim at increasing the minimum capital adequacy ratio from 8% to 9% by March 31, 2000; recognizing the market risks and prescribing a risk-weight of 2.5% in Government approved securities by March 31, 1999; providing 100% risk weight for foreign exchange and gold open posting limits from the year ended March 31, 1999; moving towards tighter asset classification, income recognition and provisioning norms; putting in place a formal asset liability management system with effect from April 1, 1999; and further enhancing the transparency in accounting and disclosure practices.

In February, 1999 banks were given autonomy to raise rupee denominated subordinated debt as Tier II capital. To restrict cross-holdings, an individual bank's investment is restricted at 10%. CBSR would also be eligible for SLR investment by banks and approved instruments for LIC, GIC and provident funds.

In USA, the capital of banks includes long-term debt of seven years. In the context of regulatory capital, long-term debt only serves to absorb operating losses in the event of bank failure.

New Capital Adequacy Framework, 1999

The Basic Committee on Banking Supervision (BCBS) has issued in June, 1999 a new capital adequacy framework to replace the Capital Accord of 1988. The New Capital Adequacy Framework consists of minimum capital adequacy requirement, supervisory review of an institution's capital adequacy and internal assessment process; and effective use of market discipline as a lever to strengthen disclosure and encourage safe and sound banking.

While the Capital Accord of 1988 has helped strengthen the soundness and stability of the international banking system and enhance competitive equality among internationally active banks, it has become a less accurate indicator of a bank's financial condition, in view of the developments in the financial market place. The new framework is designed to better align regulatory capital requirements with underlying risks and to recognize the improvements in risk measurement and control.

Minimum Regulatory Capital Requirements

The objective of minimum regulatory capital requirement is to provide a comprehensive and risk sensitive treatment of credit risk. The coverage of the Accord is expanded to incorporate

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other major categories of risk such as market risk, interest rate risk in the banking books and operating risk and develop explicit capital charge.

Supervisory Review Process

The supervisory review of capital adequacy will seek to ensure that a bank's capital position is consistent with its overall risk profile and with its overall strategy and encourage supervisory intervention, if the capital does not provide sufficient buffer against risk. Bank managements can develop an internal capital assessment process and set targets for capital that are commensurate with the bank's specific risk profile and control environment. The internal process would then be subjected to supervisory review and intervention where appropriate.

Market Discipline

Market discipline according to BCBS is a lever to strengthen the safety and soundness of the banking system.

A close correspondence between the inherent riskiness of assets and the associated capital charge will lead to changes in the assessment of the risk and return characteristics of financial assets. A more precise allocation of banks risk capital could reduce the pricing differential between loans and debt securities.

The proposals are likely to reduce regulatory capital arbitrage. Banks for example have been economizing on the relatively high capital cost of corporate loans by securitising their highest quality assets. Existing capital charges have encouraged them to hold a greater proportion of lower quality assets. The existing rules may have created a bias in favour of short-term lending to banks in emerging countries. Lastly, the proposals might have an impact on OTC derivatives market since the 50% maximum risk weight that has been applied to off-balance sheet credit risk exposures is likely to be replaced by a graduated scale based on credit ratings.

CRR and SLR on Interbank Deposits

The Sodhani Group (1995) identified the reserve requirement as the major impediment for the development of the term interbank money market and recommended that it should be lifted. The Group has also suggested that commercial banks should be permitted to deposit/borrow short-term dollars abroad, up to the limits specified by the RBI.

The Reserve Bank of India, through its slack season credit policy announced on April 15, 1997 has removed CRR and SLR on interbank liabilities. A term money market among banks, besides engendering a rupee yield curve, is likely to emerge. Banks will no longer be forced to square off their borrowing from other banks within the same fortnight. The interbank market which was restricted to call and 14 day deposits/borrowing can now extend to 1-6 months term money which will have beneficial impact on the availability and cost and volatility would be reduced. Further, the freedom given to banks to borrow and invest funds in overseas money market instruments up to $10 million through the credit policy announced on April 15, 1997 will not only link the money and exchange markets but will augment the supply and demand for funds and relate interest to the forward margin.

9.13 Nature of Primary Reserve in Commercial Banks

The term primary reserve is an analytical term used commonly in banking to refer to absolutely non-earning liquid assets held by a commercial bank. The aggregate of cash holdings by bank with itself and with the central bank and other commercial banks is designated as the primary reserve. It consists of cash in hand, the balance with RBI and demand deposits with other banks.

Notes

A major function of primary reserve is to maintain liquidity in the bank with a view to protecting it against illiquidity crises. It enables the bank to satisfy the depositors claims immediately to perform its expected crisis. The primary reserve plays the role of first day-to-day business needs but to comply with the obligation imposed on it by law. The primary reserve may be divided into:

1. Legal Reserve
2. Working Reserve

The legal reserve represents that portion of the primary reserve, which the law requires a bank to maintain. The reserves are computed on the basis of the average deposits outstanding on the bank's books over a short period (one or two weeks). Since the bank is a dealer in public money and attracts public deposits on the premise that the deposits on the premises that the depositors will get back their money on demand, the government has the responsibility to ensure sufficient liquidity in the banking system so that the depositors claims are met in full as promised. The law prescribes the minimum percentage of deposits, which a commercial bank has to carry with the central bank. By changing the reserve requirements, the central bank can regulate the magnitude of credit. In order to curb inflationary trends, banks may raise the reserve requirements and restrict the lending and investment activities of banks. Similarly the legal reserve weapon may be used along with other control techniques to take out economy from the possibility of depression, which is another undesired situation to keep the nation on growth track.

The regulatory function of legal reserve involves three steps by the government of the central banking authority:

1. Defines those particular types of assets which can be counted towards the legal reserve requirements. According to RBI the two types of assets- Cash in hand and balance with RBI are considered eligible for legal reserve purpose.
2. Regulates the rupee volume of the legal reserve maintainable by banks. In India, this is the main function of the RBI.
3. Requires banks to hold legal reserves equal to at least some stated fraction of their deposit liabilities.

Statutory Provisions Regarding Cash Holdings

The RBI Act, 1984 empowered RBI to require scheduled banks to keep with it not less than 5 percent of their demand liabilities and 2 percent of their time liabilities. RBI announces its CRR policy for the year such that the banks can coop up with the maintaining of adequate Cash Reserve Ratios to prevent illiquidity.

Working Reserve – Nature and Functions

Commercial Banks have to carry cash reserves in excess of the legal minimum reserve to meet the depositors claims, satisfy the credit needs of the community and provide protection against unforeseen withdrawals. This excess cash reserves held by the commercial banks to fulfill day to day business requirements is designated as working reserve.

This consists of:

1. Cash in their own vaults.
2. Demand deposits with other banks
3. Excess reserve with the central bank.

Notes

The principal function of the working reserve is to take of both regular and exceptional requirements.

Since they have to meet the obligatory demands of human, predicting about their requirements is very difficult and that's why determining working reserve determining is complicate. How much of total deposit liabilities should be held in the form of working reserves is a basic problem which confronts a commercial bank, A commercial bank has to trade off between liquidity and profit. In order to determine the proper size of the working reserve a banker should consider all those variables, which affect the quantum and nature of money inflows, and cheques are collected.

The various factors, which generally affect are:

1. Banking habit of the people
2. Nature of Business conditions
3. Seasonal factors
4. Existence of clearing house arrangements
5. Cash reserves held by other Banks
6. Structure of Deposits
7. Size of Deposit Accounts
8. Ownership of deposit accounts
9. Size of secondary Reserve
10. Location of Bank
11. availability and cost of borrowings
12. Ownership of deposit account
13. Banks inclination and ability to adjust working reserve position.

9.14 Cash Management in a Commercial Bank

An efficient utilization of cash is essential for the successful survival of a bank. A bank receives money from customers in various deposit accounts and pays cash to depositors and demand cheques or demand drafts or bank orders etc. The basic issues involved in cash management in a bank are:

1. The management has to keep the cash balance at the lowest possible level in order to avoid the loss of opportunity income.
2. A low cash level will mean a greater risk of running out of cash and higher cost of replenishment.

Prudence in the management of cash lies in striking a balance between the two factors. The banks have to compile data weekly about:

1. Cash receipts from the customers
2. Cash receipts by way of remittances
3. Routine cash payments to customers.
4. Payments in the form of remittances to the head office
5. The amount of cash receipts utilized for the purpose of making everyday.

Notes

Cash Management system should be effective to increase profitability and liquidity of any bank. The bank managers should compile periodically information relating to cash receipts, cash payments and similar other information (weekly) and submit to the head office.

The head office should analyze the data and determine the optima cash levels for huge withdrawals and determine cash Inventory levels by scientific inventory management techniques. They can be applied to determine optimal cash levels for each bank and if followed that would improve the profitability of a bank.

Nature of Secondary Reserve in Commercial Banks

A commercial bank generally relies on highly liquid earning assets to meet its expected and unexpected financial needs because it can't afford to hold a larger proportion of funds in the vault for the reasons stated earlier. The aggregate of highly liquid earning assets is designated as the secondary reserve in banking circles. The principal objective of holding the secondary reserve is to impart adequate liquidity to funds without adversely affecting the profitability of a bank. The bank must have such assets which are highly liquid and at the same time generate some yield on them. Call loans to brokers or bankers which may be terminated at any time at a very short notice may be regarded as highly liquid assets.

Keeping above requirements of high liquidity, yield and shiftability, the following types of assets may be grouped in the category of secondary reserve:

1. Call loans to stock brokers and commercial banks.
2. Short term loans to commercial banks.
3. Short term loans secured against self liquidating assets or blue chips.
4. Investment in treasury bills.
5. Promissory notes of short period maturity.
6. Discounting of usance bills eligible for rediscounting from the RBI.
7. Short period debentures of companies.

9.15 Functions of Secondary Reserve in Commercial Banks

The principal function of the secondary reserve is to replenish the primary reserve, while its subsidiary function is to earn a moderate income. Since it is very difficult of estimate correctly the working reserve requirements because the bank deals with human beings who are motivated by a variety of factors, a banker would like to keep a little more cash in the vault than is absolutely necessary to avoid an illiquid crisis. Secondary reserve helps a banker to trade off successfully between liquidity and profitability. Where a bank has a surplus in the primary reserve because of heavy cash inflows, it is invested in secondary reserve assets so that it may be drawn conveniently. Moreover the bank can earn some yield rather than earning nothing or far less yield.

Factors Influencing the Level of Secondary Reserve in Commercial Banks

The factors can be classified into External factors and Local factors:

External Factors

1. ***General state of Economy:*** If the level of business activity is expected to increase, which means more demand for business loans the banker can keep large proportion of loans in secondary reserve to meet the requirements.

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2. ***Political conditions:*** When there are uncertain political conditions in the country, banks generally lose public confidence and consequently and there is a run on the banks. In such conditions to meet the heavy customers banks have to invest in secondary reserves more and release conveniently.
3. Taxation policy of the government may affect the size and composition of the secondary reserve. A bank may be tempted to invest more in government securities if the government decides to exempt them from the levy of tax because this investment will not only strengthen the liquidity position of the bank and also profitability.
4. ***Monetary policy:*** A banker has to understand the monetary policies announced by the central bank and expected to be followed at the same time liquidity and profitability are also balanced.

Local Factors

Character of the local economy- A banker must be familiar with the characteristics of the economy in which in which he is operating because the character and magnitude of deposits and loans is affected by them. Indian economy is dominated by agriculture and its requirements are highly vulnerable therefore because banks receive large deposits after the harvest season, while withdrawals take place throughout the year. Similarly the banks in industrial locality must familiarize with the industrial requirements pattern and accordingly invest the surplus in secondary reserves.

A large number of internal factors such as deposit structures, ownership of deposit accounts, average size of bank accounts, access to money market, nature of bank loan, maturities and diversification of investment portfolio are such other factors influence regarding the size of secondary reserves of a bank.

Banks can apply statistical methods to analyse the various demand supply requirements of money and accordingly determine the structure its secondary reserve portfolio to maintain liquidity and profitability.

9.16 Management of Loans in a Commercial Bank

Lending is the most important function commercial banks. At they aim at lending results in maximum return and their survival depends on high they can do it with in the frame work of central bank regulations and guidelines along with the social responsibility for the economy development as expected by the society. The important characteristics of commercial bank loans are:

1. The bulk of the loans in India are provided to trade and industries.
2. As the banks look at liquidity they give maximum proportion of loans of less than year type which are short term nature.
3. Commercial banks in India demand sound security like goods, financial assets, gold, and hypothecation. Unsecured credit loans are given to firms with a sound financial position and stable earning records.

Lending is the most profitable business of a commercial bank but at the same time it is highly risky. A banker is supposed to do the lending business on the sound principles of safety, liquidity and profitability. Banks should diversify their risk of lending by evolving to a right portfolio. It should not be merely defensive but provide for earning for increasing average rate of return on fund. The principle of maturity diversification allows the loan portfolio is staggered over different maturity periods so that a certain amount of loans mature at regular intervals of time

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periods so that the realizations can be utilized to meet the investors obligations. The funds can be invested in securities of diversified nature to earn reasonable returns.

Banks should check well into the purpose of loan an applicant seeks and track whether the loan is applied. This is important for productive purpose and the banks social obligations are also satisfied. An advance made to for non productive and speculative purposes is subject to high risk of recovery. A banker should avoid making loans against wasteful expenditure on social functions. The banker should examine whether the credit granted is not for a purpose other than that is sought.

A bank has the social obligation of meeting the diverse credit needs of the society ranging from personal needs to small businesses to large industrial business needs. It can not afford to lend the funds of its depositors indiscriminately and incur losses. The loan policy should be carefully structured to maintain uniformity and standardization of lending policies. There is always a risk of misunderstanding and misinterpretation of the policy. In general the loan policy in a bank largely influenced by the following factors:

1. ***Capital position:*** A bank having strong capital base can follow a liberal lending policy.
2. ***Earning Requirements:*** Profit making and required rate of return becomes the basis while structuring lending policy.
3. ***Deposit variability:*** Large variation is found between the urban banks and rural banks regarding demand and of supply of money. Banks expecting a rising tendency can go for liberal credit policy.
4. ***State of local economy and National economy:*** Banks have to understand the local needs and national needs due to variation in seasonality, commercial activity or agricultural needs.
5. ***Monetary policy of the Central bank:*** RBI announces the lending policy of term loans and interest rates range focusing on sectoral growth for prosperity and to put a check on inflationary movements affecting the common man and welfare of the economy. Fiscal disciplinary measures are to be followed by the banks and need to follow the directives of the central banks.
6. Term lending policy of a commercial bank is usually based on industrial activity and sectoral growth needs. Banks have to commit large funds to long term loans to industry. Commercial banks generally seek the assistance of banks like NABARD, IDBI etc. while granting collaborative lending to commercial purposes with respect to term loans.

The commercial banks thus play an important role in the growth of an economy by mobilizing funds from small investors to business and play a critical role in the transformation of the nation to a greater and powerful economy.

Task Prepare a project feasibility proposal as per the guidelines of a merchant Banker by selecting an entrepreneurial activity.

Self Assessment

Fill in the blanks:

8. …….is the link between financial markets and bank's profitability.
9. A capital shortage of a bank indicatos that it should change, among others, it's ……policies.

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10. ……indicates how well a bank's programmes can be sustained and the capital sum serves as a cushion against temporary losses.
11. Market discipline according to ……is a lever to strengthen the safety and soundness of the banking system.
12. ……is the most profitable business of a commercial bank but at the same time it is highly risky.
13. Term lending policy of a commercial bank is usually based on industrial activity and ……..needs.
14. A bank has the social obligation of meeting the diverse …… needs of the society ranging from personal needs to small businesses to large industrial business needs.
15. ……..reserve helps a banker to trade off successfully between liquidity and profitability.

9.17 Summary

- The importance of Commercial banks and their contribution are discussed. An attempt is made is to provide the effect of RBI banking regulations, demand supply theory of money, interest and profitability of banks are explained.
- The risk management practices observed by banks are discussed. The management of primary and secondary reserves, loan policy formulation and issues involved are discussed.
- There is also discussion on the financial institutions, which offer a variety of specialized to traditional services to the business and act as mediators and agents of transfer of funds to create wealth to the society at some charge for the service, which would be their source of revenue. They have the obligation of creating a qualitative Financial System and should cooperate with the regulatory bodies engaged with various measures to discipline the economic system.

9.18 Keywords

Credit or loan: Credit or loan refers to sum of money along with interest payable.

Finance: Finance is monetary resources comprising debt and ownership funds of the state, company or person.

Financial Institutions: Financial Institutions are business organizations that act as mobilizes and depositories of savings and as purveyors of credit or finance. They also provide various financial services to the society.

Financial System: Financial System is concerned about money, credit and finance.

Money: Money refers to the current medium of exchange or means of payment.

9.19 Review Questions

1. What is the role of commercial banking in developing the economy?
2. Explain about the functions of commercial banks.
3. Write about the regulating policies RBI with respect to commercial banks.
4. What are the various factors influencing the level of secondary reserve in commercial banks?

Notes

5. Discuss the factors hindering the growth of financial services in India.
6. Narrate about lending and interest rate policy and the effect of it on the operational risk of a bank.
7. Discuss the RBI guidelines regarding the management of risk.
8. Write about primary reserve and secondary reserves of a commercial bank.
9. Write a short notes on the Management of loans by commercial banks.
10. Explain about the general guide lines while designing the loan policy of a bank.

Answers to Self Assessment

1. financial institutions
2. bank-oriented
3. Unit banking
4. standard deviation
5. Credit risk
6. cash
7. Foreign exchange
8. Bank capital
9. Operating
10. Return on bank capital
11. BCBS
12. Lending
13. sectoral growth
14. credit
15. Secondary

9.20 Further Readings

Books

G. M. Meier and R. E. Baldwin, Economic Development, Theory, History, Policy, John Wiley & Sons, INC, New York, 1957, p.2.

Merchant Banking by Bharath Publications

SLR and CRR updations and policies from RBI Publications

Srivastava Management of Indian Financial Institutions

Online links

www.nseindia.com/content/ncfm/ncfm_CBBM_workbook.pdf

www.ingcommercialbanking.com › ... › International Network › Asia

www.preservearticles.com/.../essay-on-the-growth-of-commercial-ba..

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Unit 10: Credit Rating and Consumer Finance

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Objectives

After studying this unit, you should be able to:

- Understand regulatory framework;
- Understand credit rating process;
- Understand credit rating agencies;

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- Understand consumer Finance Concept and Purpose;
- Know Retail Consumer Finance.

Introduction

According to SEBI, "rating" means an opinion regarding securities, expressed in the form of standard symbols or in any other standardized manner, assigned by a credit rating agency and used by the issuer of such securities, to comply with a requirement specified by these regulations.

A credit rating estimates the credit worthiness of an individual, corporation, or even a country. It is an evaluation made by credit bureaus of a borrower's overall credit history.

10.1 Regulatory Framework

The regulatory framework for the credit rating agencies is determined under Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. The following are the main highlights:

10.1.1 Conditions of Certificate and Validity Period

1. The certificate granted to certify a company as a credit rating agency is, subject to the following conditions, namely:
   (i) the credit rating agency shall comply with the provisions of the Act, the regulations made under and the guidelines, directives, circulars and instructions issued by the Board from time to time on the subject of credit rating.
   (ii) where any information or particulars furnished to the Board by a credit rating agency:
      (a) is found to be false or misleading in any material particular ; or
      (b) has undergone change subsequently to its furnishing at the time of the application for a certificate.
   (iii) the credit rating agency shall forthwith inform the Board in writing.
2. The period of validity of certificate of registration shall be three years.

10.1.2 Renewal of Certificate

A credit rating agency, if it desires a renewal of the certificate granted to it, has to make to the Board, an application for the renewal of the certificate of registration. Such application for renewal of certificate of registration made under sub-regulation has to be accompanied by a non refundable application fee as specified in the Second Schedule of SEBI.

A renewal application has to be made not less than three months before expiry of the period of the validity of the certificate.

The application for renewal made under sub-regulation is to be accompanied by a renewal fee as specified in the second schedule. As far as possible a renewal application is dealt with in the same manner as if it were an application for the grant of a fresh certificate.

Notes

Did u know? What are the conditions where certificate is not granted?

If, after considering an application, the Board is of the opinion that a certificate should not be granted or renewed, as the case may be, it may, after giving the applicant a reasonable opportunity of being heard, reject the application.

10.1.3 Effect of Refusal to Grant Certificate

An applicant whose application for the grant of a certificate has been rejected, shall not undertake any rating activity.

If the Board is satisfied that it is in the interest of the investors, it may permit the credit rating agency to complete the rating assignments already entered into by it, during the pendency of the application or period of validity of the certificate.

The Board may, in order to protect the interests of investors, issue directions with regard to the transfer of records, documents or reports relating to the activities of a credit rating agency, whose application for the grant or renewal of a certificate has been rejected.

The Board may also appoint a person to take charge of the records, documents or reports relating to the rating activities of a credit rating agency and for this purpose also determine the terms and conditions of such appointment.

10.1.4 Code of Conduct

Every credit rating agency has to abide by the Code of Conduct contained in the Third Schedule.

Every credit rating agency has to enter into a written agreement with each client whose securities it proposes to rate, and every such agreement shall include the following provisions, namely:

1. the rights and liabilities of each party in respect of the rating of securities shall be defined;
2. the fee to be charged by the credit rating agency shall be specified;
3. the client shall agree to a periodic review of the rating by the credit rating agency during the tenure of the rated instrument;
4. the client shall agree to cooperate with the credit rating agency in order to enable the latter to arrive at, and maintain, a true and accurate rating of the clients securities and shall in particular provide to the latter, true, adequate and timely information for the purpose;
5. the credit rating agency shall disclose to the client the rating assigned to the securities of the latter through regular methods of dissemination, irrespective of whether the rating is or is not accepted by the client;
6. the client shall agree to disclose, in the offer document:
   (i) the rating assigned to the client's listed securities by any credit rating agency during the last three years; and
   (ii) any rating given in respect of the client's securities by any other credit rating agency, which has not been accepted by the client;
7. the client shall agree to obtain a rating from at least two different rating agencies for any issue of debt securities whose size is equal to or exceeds, rupees one hundred crores.

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10.1.5 Monitoring of Ratings

Every credit rating agency has to, during the lifetime of securities rated by it continuously monitor the rating of such securities.

Every credit rating agency has to shall disseminate information regarding newly assigned ratings, and changes in earlier rating promptly through press releases and websites, and, in the case of securities issued by listed companies, such information shall also be provided simultaneously to the concerned regional stock exchange and to all the stock exchanges where the said securities are listed.

10.1.6 Procedure for Review of Rating

Every credit rating agency has to carry out periodic reviews of all published ratings during the lifetime of the securities. If the client does not cooperate with the credit rating agency so as to enable the credit rating agency to comply with its obligations, the credit rating agency shall carry out the review on the basis of the best available information.

Provided that if owing to such lack of cooperation, a rating has been based on the best available information, the credit rating agency shall disclose to the investors the fact that the rating is so based.

A credit rating agency cannot withdraw a rating so long as the obligations under the security rated by it are outstanding, except where the company whose security is rated is wound up or merged or amalgamated with another company.

10.1.7 Internal procedures to be framed

Every credit rating agency has to frame appropriate procedures and systems for monitoring the trading of securities by its employees in the securities of its clients, in order to prevent contravention of:

1. the Securities and Exchange Board of India (Insider Trading) Regulations, 1992;
2. the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to the Securities Market) Regulations, 1995; and
3. other laws relevant to trading of securities.

10.1.8 Disclosure of Rating Definitions and Rationale

Every credit rating agency:

1. has to make public the definitions of the concerned rating, along with the symbol and,
2. has to also state that the ratings do not constitute recommendations to buy, hold or sell any securities.

Every credit rating agency has to make available to the general public information relating to the rationale of the ratings, which shall cover an analysis of the various factors justifying a favourable assessment, as well as factors constituting a risk.

Where any information is called for by the Board from a credit rating agency for the purposes of these regulations, including any report relating to its activities, the credit rating agency has to furnish such information to the Board:

1. within a period specified by the Board or
2. if no such period is specified, then within a reasonable time.

Notes

Every credit rating agency has to, at the close of each accounting period, furnish to the Board copies of its balance sheet and profit and loss account.

All the credit rating agencies have to comply with such guidelines, directives, circulars and instructions as may be issued by the Board from time to time, on the subject of credit rating.

10.1.9 Appointment of Compliance Officer

Every credit rating agency has to appoint a compliance officer who is responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc. issued by the Board or the Central Government.

The compliance officer immediately and independently reports to the SEBI any non-compliance observed by him.

10.1.10 Maintenance of Books of Accounts, Records, etc.

Every credit rating agency has to keep and maintain, for a minimum period of five years, the following books of accounts, records and documents, namely:

1. copy of its balance sheet, as on the end of each accounting period;
2. a copy of its profit and loss account for each accounting period;
3. a copy of the auditor's report on its accounts for each accounting period;
4. a copy of the agreement entered into, with each client;
5. information supplied by each of the clients;
6. correspondence with each client;
7. ratings assigned to various securities including upgradation and down gradation (if any) of the ratings so assigned;
8. rating notes considered by the rating committee;
9. record of decisions of the rating committee;
10. letter assigning rating;
11. Particulars of fees charged for rating and such other records as the Board may specify from time to time.

Every credit rating agency has to intimate to the Board the place where the books of account, records and documents required to be maintained under these regulations are being maintained.

Every credit rating agency has to, within two month's from the date of the auditor's report, take steps to rectify the deficiencies if any, made out in the auditor's report, insofar as they relate to the activity of rating of securities.

Caution Every credit rating agency has to treat, as confidential, information supplied to it by the client and no credit rating agency can disclose the same to any other person, except where such disclosure is required or permitted by under or any law for the time being in force.

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10.1.11 Rating Process

1. Every credit rating agency has to:
   (i) specify the rating process;
   (ii) file a copy of the same with the Board for record; and file with the Board any modifications or additions made therein from time to time.
2. Every credit rating agency shall, in all cases, follow a proper rating process.
3. Every credit rating agency shall have professional rating committees, comprising members who are adequately qualified and knowledgeable to assign a rating.
4. All rating decisions, including the decisions regarding changes in rating, are taken by the rating committee.
5. Every credit rating agency has to be staffed by analysts qualified to carry out a rating assignment.
6. Every credit rating agency has to inform the Board about new rating instruments or symbols introduced by it.
7. Every credit rating agency, has to, while rating a security, exercise due diligence in order to ensure that the rating given by the credit rating agency is fair and appropriate.
8. A credit rating agency cannot rate securities issued by it.
9. Rating definition, as well as the structure for a particular rating product, cannot be changed by a credit rating agency, without prior information to the Board.
10. A credit rating agency has to disclose to the concerned stock exchange through press release and websites for general investors, the rating assigned to the securities of a client, after periodic review, including changes in rating, if any.

10.1.12 Restriction on Rating of Securities Issued by Promoters or by Certain Other Persons

Definitions

In this unit, unless the context otherwise requires:

1. "associate" , in relation to a promoter, includes a body corporate in which the promoter holds ten percent or more, of the share capital;
2. "promoter" means a person who holds ten percent or more, of the shares of the credit rating agency.

Securities Issued by Promoter

1. No credit rating agency can rate a security issued by its promoter.
2. In case promoter is a lending institution, its Chairman, director or employee cannot be a Chairman, director or employee of credit rating agency or its rating committee.
3. Securities issued by certain entities, connected with a promoter, or rating agency not to be rated:
   (a) No credit rating agency can, rate a security issued by an entity, which is:

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(i) a borrower of its promoter; or

(ii) a subsidiary of its promoter; or

(iii) an associate of its promoter, if

(iv) there are common Chairman, Directors between credit rating agency and these entities;

(v) there are common employees;

(vi) there are common Chairman, Directors, Employees on the rating committee.

(b) No credit rating agency can rate a security issued by its associate or subsidiary, if the credit rating agency or its rating committee has a Chairman, director or employee who is also a Chairman, director or employee of any such entity.

Provided that the Credit Rating Agency may, subject to the provisions of sub-regulation rate a security issued by its associate having a common independent director with it or rating committee if:

1. such an independent director does not participate in the discussion on rating decisions, and

2. the Credit Rating Agency makes a disclosure in the rating announcement of such associate (about the existence of common independent director) on its Board or of its rating committee, and that the common independent director did not participate in the rating process or in the meeting of its Board of Directors or in the meeting of the rating committee, when the securities rating of such associate was discussed.

Notes For the purposes of this sub-regulation the expression 'independent director' means a director who, apart from receiving remuneration as a director, does not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board of the company, may affect the independence of the judgment of such director.

Securities Already Rated

Nothing applies to securities whose rating has been already done by a credit rating agency before the commencement of these regulations, and such securities may, subject to the provisions of the other Chapters of these regulations, continue to be rated, without the need to comply with the restrictions imposed by the regulations contained in this chapter.

10.1.13 Procedure for Inspection and Investigation

The Board may appoint one or more persons as inspecting officers, to undertake inspection or investigation of the books of account, records and documents of the credit rating agencies.

The purposes referred to in sub-regulation may be the following, namely:

1. to ascertain whether the books of account, records and documents are being maintained properly;

2. to ascertain whether the provisions of the Act and these regulations are being complied with;

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3. to investigate into complaints received from investors, clients or any other person on any matter having a bearing on activities of the credit rating agency;
4. in the interest of the securities market or in the interest of investors.

The inspections ordered by the Board do not ordinarily go into an examination of the appropriateness of the assigned ratings on the merits. Inspections to judge the appropriateness of the ratings may be ordered by the Board, only in case of complaints which are serious in nature. Inspections are carried out either by the officers of the Board or independent experts, with relevant experience or combination of both.

Notice before Inspection or Investigation

Before ordering an inspection or investigation, the Board gives no less than ten days written notice to the credit rating agency for that purpose. Nevertheless, where the Board is satisfied that in the interest of the investors, no such notice is given, it, by an order in writing, directs that the inspection or investigation of the affairs of the credit rating agency be taken up without such notice.

During the course of an inspection or investigation, the credit rating agency against whom the inspection or is being carried out is bound to discharge all its obligations.

Task Find out what are the obligations of credit rating agency on inspection or investigation by the Board and list them.

Submission of Report to the Board

The inspecting officer, as soon as possible, on completion of the inspection or investigation, submits a report to the Board. If directed to do so by the Board, he may submit an interim report.

Action on Inspection or Investigation Report

The Board or the Chairman, after consideration of inspection or investigation report take such action as the Board or Chairman deems fit and appropriate including action under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002.

10.1.14 Procedure for Action in Case of Default

Liability for action in case of default Substituted by SEBI (Procedure For Holding Enquiry by Enquiry officer and Imposing Penalty) Regulation, 2002, w.e.f. 27-9-2002. Prior to its substitution it read as follows:

Communication of Findings etc. to the Credit Rating Agency

The Board shall, after consideration of the inspection report or the interim report referred to in regulation 32, communicate the findings of the inspecting officer to the credit rating agency and give it a reasonable opportunity of being heard in the matter.

On receipt of the explanation, if any, from the credit rating agency, the Board may call upon the credit rating agency to take such measures as the Board may deem fit in the interest of the securities market and for due compliance with the provisions of the Act and these regulations.

Notes

Substituted by the SEBI (Procedure for Holding Enquiry by Enquiry Officer and Imposing penalty) Regulations, 2002.w.e.f.27-9-2002. Prior to its substitution it read as follows:

Liability for Action in Case of Default

1. A credit rating agency which:
   (a) fails to comply with any condition subject to which a certificate has been granted; or
   (b) contravenes any of the provisions of the Act or these regulations or any other regulations made under the Act; shall be dealt with in the manner provided under the Securities and Exchange Board of India (Procedure for holding Enquiry by Enquiry officer and Imposing penalty) Regulations, 2002 and shall be liable to either of the penalties specified as under.
2. The penalties referred to in the above sub-regulation are:
   (a) suspension of registration; or
   (b) cancellation of registration.

Manner of Making Order of Suspension and Cancellation

No order of suspension or of cancellation of the certificate of registration, is passed by the Board, except after holding an enquiry in accordance with the procedure specified.

The holding of such an enquiry shall not be necessary in cases where:

1. the credit rating agency is declared insolvent or is wound up;
2. the credit rating agency fails to pay to the Board registration fees or renewal fee as per these regulations; or
3. an opportunity of hearing shall be given before any action against the credit rating agency is taken.

Manner of Holding Enquiry before Suspension or Cancellation

1. For the purpose of holding an enquiry, the Board may appoint one or more enquiry officers.
2. The enquiry officer issues to the credit rating agency a notice at the registered office or the principal place of business of the credit rating agency, setting out the grounds on which action is proposed to be taken against it and calling upon it to show cause against such action within a period of fourteen days from the date of receipt of such notice.
3. The credit rating agency, may, within fourteen days from the date of receipt of such notice, furnish to the enquiry officer a written reply, together with copies of documentary or other evidence relied on by it or sought by the Board from the credit rating agency.
4. The enquiry officer has to give a reasonable opportunity of hearing to the credit rating agency, to enable it to make its submission in support of its reply.
5. Before the enquiry officer, the credit rating agency may either appear in person or through any person duly authorised on this behalf.

No lawyer or advocate is permitted to represent the credit rating agency at the enquiry. However, where a lawyer or an advocate has been appointed by the board as a presenting officer, it is lawful for the credit rating agency to present his case through a lawyer or advocate.

Notes

If it is considered necessary, the enquiry officer may request the Board to appoint a presenting officer to present its case. The enquiry officer, after taking into account all relevant facts and submissions made by the credit rating agency, submits a report to the Board and recommend the penalty, if any to be imposed upon the credit rating agency as also the grounds on the basis of which the proposed penalty is justified.

Show-cause Notice and Order

On receipt of the report from the enquiry officer, the Board shall consider the same and issue a show-cause notice to the credit rating agency, as to why the penalty as proposed by the enquiry officer should not be imposed.

The credit rating agency has to, within fourteen days of the date of receipt of the show-cause notice, send a reply to the Board. And the Board, after considering the reply of the credit rating agency to the show-cause notice, shall as soon as possible passes such order as it deems fit.

Every order passed by the Board is self-contained and has to give reasons for the conclusions stated therein, including justification of the penalty if any imposed by that order. The Board also sends to the credit rating agency, a copy of the order passed.

10.1.15 Effect of Suspension and Cancellation of Registration of Credit Rating Agency

On and from the date of suspension of the certificate of registration, the credit rating agency ceases to carry on any rating activity during the period of suspension and shall be subject to such directions of the Board with regard to any records, documents securities or reports that may be connected with in its rating activities, as the Board may specify.

On and from the date of cancellation of the certificate of registration, the credit rating agency:

1. ceases to carry in any rating activity; and
2. is subject to such directions of the Board with regard to the transfer of records, documents, securities or reports connected with its rating activities which may be in its custody or control as the Board may specify.

Notwithstanding the suspension or cancellation of certificate of a credit rating agency, if the Board is satisfied that it is in the interest of the investors to grant such permission, the Board grants to the credit rating agency permission to carry on such activities relating its assignments undertaken prior to such suspension or cancellation, as the Board may specify.

Publication of Order of Suspension or Cancellation

The order of suspension or cancellation of certificate of registration is published by the Board in at least two daily newspapers.

Appeal to the Securities Appellate Tribunal

Any person aggrieved by an order of the Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, (i.e., after 16th December 1999), under these regulations may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter.

Notes

10.2 Credit Rating Process

Credit ratings are calculated from financial history and current assets and liabilities. Typically, a credit rating tells a lender or investor the probability of the subject being able to pay back a loan. However, in recent years, credit ratings have also been used to adjust insurance premiums, determine employment eligibility, and establish the amount of a utility or leasing deposit.

A poor credit rating indicates a high risk of defaulting on a loan, and thus leads to high interest rates, or the refusal of a loan by the creditor. The credit rating process can be categorized in four steps namely:

1. ***Receiving the completed application form:*** This is the first step in the rating process. The company that wants it to achieve a credit rating approaches the appropriate credit rating agency and submits the completed application form. As soon as the agency receives the completed form, the movement towards the next step starts.
2. ***Representatives visiting the company:*** Thereafter, the representatives of the credit rating agency visit the company that requested for the rating.
3. ***Analysts having a short discussion with the management of the company:*** This step ensures the agencies about the vision and operational nitty gritties of the company and helps the credit rating agency in the preparation of the credit report.
4. ***Preparation of a rating report, assigning a rating and sending the copy of the report to the company and NSIC:*** As the last step of the rating process, the rating report is prepared. Under this report, the rating is assigned and copy of the same is sent to the company as well as the NSIC for further use of the prospective investors.

Rating Scale

Your rating will reflect two components, Financial Strength and Performance Capability. Ratings will be assigned on the following rating scale:

Example: Financial Strength

High Performance	Moderate	Low Capability	
Highest	SE 1A	SE 1B	SE 1C
High	SE 2A	SE 2B	SE 2C
Moderate	SE 3A	SE 3B	SE 3C
Weak	SE 4A	SE 4B	SE 4C
Poor	SE 5A	SE 5B	SE 5C

A company with high Performance Capability and high Financial Strength will be rated 'SE2A', while one with weak Performance Capability and low Financial Strength will be rated 'SE4C'.

Notes

Caselet

RBI to Review, Monitor Credit Rating Agencies

Mumbai, April 23 Reserve Bank of India has decided to review and monitor the performance of credit rating agencies, for continuation of their accreditation. The move is aimed at ensuring greater accountability in the quality of the rating process and methodologies.

According to the G-20 Working Group recommendations, all credit rating agencies whose ratings are used for regulatory purposes will be subject to regulatory oversight regime, which includes registration and compliance with the International Organisation of Securities Commissions (IOSCO) Code of Conduct Fundamentals. "The Reserve Bank of India will liaise with SEBI, on the issue of rating agencies' adherence to the IOSCO Code of Conduct Fundamentals," the recommendation said.

RBI has accorded accreditation to four rating agencies registered with market regulator SEBI.

This will allow them to use their rating for assigning risk weights within the framework of the Basel II Accord, which has been implemented with effect from March.

Prior to this, RBI had undertaken a review of the rating agencies' practices and procedures to ensure that they comply with the criteria prescribed for accreditation in the Basel II Framework. Regulations for credit-rating agencies had been framed by SEBI many years ago. However, with ratings now spanning many products such as bank loans, commercial paper and security receipts issued by asset reconstruction companies, the RBI wanted oversight on rating agencies to be strengthened.

Source: http://www.thehindubusinessline.in

10.3 Credit Rating Agencies

As we all know, credit rating agencies are registered and regulated by the Securities and Exchange Board of India. The following is the eligibility criteria for an individual to be registered as a credit rating agency:

1. the applicant is set up and registered as a company under the Companies Act, 1956;
2. the applicant has, in its Memorandum of Association, specified rating activity as one of its main objects;
3. the applicant has a minimum net worth of rupees five crores. Provided that a credit rating agency existing at the commencement of these regulations, with a net worth of less than rupees five crores, shall be deemed to have satisfied this condition, if it increases its net worth to the said minimum within a period of three years of such commencement;
4. the applicant has adequate infrastructure, to enable it to provide rating services in accordance with the provisions of the Act and these regulations;
5. the applicant and the promoters of the applicant, referred to in regulation 4 have professional competence, financial soundness and general reputation of fairness and integrity in business transactions, to the satisfaction of the Board;
6. neither the applicant, nor its promoter, nor any director of the applicant or its promoter, is involved in any legal proceeding connected with the securities market, which may have an adverse impact on the interests of the investors;

Notes

7. neither the applicant, nor its promoters, nor any director, of its promoter has at any time in the past been convicted of any offence involving moral turpitude or any economic offence;
8. the applicant has, in its employment, persons having adequate professional and other relevant experience to the satisfaction of the Board;
9. neither the applicant, nor any person directly or indirectly connected with the applicant has in the past been:
   (a) refused by the Board a certificate under these regulations; or
   (b) subjected to any proceedings for a contravention of the Act or of any rules or regulations made under the Act;

Notes For the purpose of this clause, the expression "directly or indirectly connected person" means any person who is an associate, subsidiary, inter-connected or group/ company of the applicant or a company under the same management as the applicant.

10. the applicant, in all other respects, is a fit and proper person for the grant of a certificate;
11. grant of certificate to the applicant is in the interest of investors and the securities market.

Caution

The Securities and Exchange Board however, does not consider an application unless the applicant is promoted by a person belonging to any of the following categories, namely:

1. a public financial institution, as defined in section 4 A of the Companies Act, 1956 (1 of 1956);
2. a scheduled commercial bank included for the time being in the second schedule to the Reserve Bank of India Act, 1934 (2 of 1934);
3. a foreign bank operating in India with the approval of the Reserve Bank of India;
4. a foreign credit rating agency recognised by or under any law for the time being in force in the country of its incorporation, having at least five years experience in rating securities;
5. any company or a body corporate, having continuous net worth of minimum rupees one hundred crores as per its audited annual accounts for the previous five years prior to filing of the application with the Board for the grant of certificate under these regulations.

The main credit rating agencies in India are:

1. Credit Rating Information Services of India Limited (CRISIL)
2. Investment Information and Credit Rating Agency of India (ICRA)
3. Credit Analysis & Research Limited (CARE)
4. Duff & Phelps Credit Rating India Private Ltd. (DCR India)
5. ONICRA Credit Rating Agency of India Ltd.

Notes

Let us know a brief about each of them

1. ***Credit Rating Information Services of India Limited (CRISIL):*** Established in 1987, CRISIL is India's leading Ratings, Research, Risk and Policy Advisory company. CRISIL delivers opinions and solutions that:

   (a) Make markets function better,

   (b) Help clients mitigate and manage their business & financial risks, and

   (c) Help shape public policy.

   CRISIL offers domestic and international customers a unique combination of local insights and global perspectives, delivering independent information, opinions and solutions that help them make better informed business and investment decisions, improve the efficiency of markets and market participants, and help shape infrastructure policy and projects. Its integrated range of capabilities includes credit ratings; research on India's economy, industries and companies; investment research outsourcing; fund services; risk management and infrastructure advisory services.

2. ***Investment Information and Credit Rating Agency of India (ICRA):*** ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional Investment Information and Credit Rating Agency. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The participation of Moody's is supported by a Technical Services Agreement, which entails Moody's providing certain high-value technical services to ICRA. Specifically, the agreement is aimed at benefiting ICRA's in-house research capabilities, and providing it with access to Moody's global research base. Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

   ICRA information products, Ratings, and solutions reflect independent, professional and impartial opinions, which assist businesses enhance the quality of their decisions and help issuers access a broader investor base and even lesser known business entities approach the money and capital markets.

   As an early entrant in the Credit Rating business, ICRA Limited is one of the most experienced Credit Rating Agencies in the country today. ICRA Rates rupee denominated debt instruments issued by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and municipalities, among others. ICRA also Rates structured obligations and sector-specific debt obligations such as instruments issued by Power, Telecom and Infrastructure companies. The other services offered include Corporate Governance Rating, Stakeholder Value and Governance Rating, Corporate Governance Assessment, Credit Risk Rating of Debt Mutual Funds, Rating of Claims Paying Ability of Insurance Companies, Project Finance Rating, and Line of Credit Rating. ICRA, along with National Small Industries Corporation Limited (NSIC), has launched a Performance and Credit Rating Scheme for Small Scale Enterprises in India. The service is aimed at enabling Small and Medium Enterprises (SMEs) improve their access to institutional credit, increase their competitiveness, and raise their market standing.

3. ***Credit Analysis & Research Limited (CARE):*** Credit Analysis & Research Ltd. (CARE Ratings) is a full service rating company that offers a wide range of rating and grading services across sectors. CARE Ratings methodologies are in line with the best international practices.

Notes

CARE Ratings has completed over 5846 rating assignments having aggregate value of about ₹ 16,594 bn (as at March 31, 2009), since its inception in April 1993. CARE is recognised by Securities and Exchange Board of India (Sebi), Government of India (GoI) and Reserve Bank of India (RBI) etc.

CARE has seven offices in India located at - Mumbai, Delhi, Kolkata, Chennai, Hyderabad, Bangalore and Ahmedabad.

The ratings division of CARE has over a decade long experience in rating debt instruments/ Enterprise ratings covering the full spectrum of Universe comprising:

(a) Industrial Companies

(b) Service companies

(c) Infrastructure companies

(d) Banks

(e) Financial Institutions (FIs)

(f) Non-Bank Finance companies (NBFCs)

(g) Public Sector Undertakings (PSUs)

(h) State Government Undertakings

(i) Municipal Corporations

(j) Structured Finance Transactions

(k) Securitisation Transactions

(l) SMEs

(m) SSI

(n) Micro Finance Institutions

In addition to debt ratings CARE Ratings has experience in providing the following specialized grading/rating services:

(a) Corporate Governance ratings

(b) IPO grading

(c) Mutual Fund Credit quality Ratings

(d) Insurance Claims Paying Ability Ratings

(e) Issuer Ratings

(f) Grading of Construction entities

(g) Grading of Maritime training institutes

(h) LPG/SKO Ratings

CARE Ratings is well equipped to rate all types of debt instruments like Commercial Paper, Fixed Deposit, Bonds, Debentures, Hybrid instruments, Structured Obligations, Preference Shares, Loans, Asset Backed Securities (ABS), Residential Mortgage Backed securities (RMBS) etc.

CARE Ratings has been recognized by statutory authorities and other agencies in India for rating services. The authorities/agencies include: Securities and Exchange Board of India (Sebi), Reserve Bank of India (RBI), Director General, Shipping and Ministry of Petroleum

Notes

and Natural Gas (MoPNG), Government of India (GoI), National Housing Bank (NHB), National Bank for Agriculture and Rural development (NABARD), National Small Scale Industries Commission (NSIC). CARE Ratings has also been recognized by RBI as an Eligible Credit Rating Agency (ECRA) for Basel II implementation in India.

CARE Ratings has significant presence in all sectors including Banks / FIs, Corporate, Public finance. Coverage of CARE Ratings has extended to more than 1075 entities over the past decade and is widely accepted by investors, issuers and other market participants. CARE Ratings have evolved into a valuable tool for credit risk assessment for institutional and other investors, and over the years CARE has increasingly become a preferred rating agency.

CARE's Credit Rating is an opinion on the relative ability and willingness of an issuer to make timely payments on specific debt or related obligations over the life of the instrument. CARE rates rupee denominated debt of Indian companies and Indian subsidiaries of multinational companies. CARE ratings are not recommendations to buy/sell or hold any security.

4. ***Duff & Phelps Credit Rating India Private Ltd. (DCR India):*** CR India or Duff & Phelps Credit Rating India Private Ltd. is one of the top credit rating agencies in India. Over the years, DCR India has been providing excellent services to its clients.

   Duff & Phelps Credit Rating India Private Ltd. (DCR India) has played an important role in rating India's forex debt obligations. The services provided by Duff & Phelps Credit Rating India Private Ltd. (DCR India) are considered to be at par with other leading providers of credit rating services in India like Credit Rating Information Services of India Limited (CRISIL), ONICRA Credit Rating Agency of India Ltd., Investment Information and Credit Rating Agency of India (ICRA), Operation Research Group & Marketing & Research Group and Credit Analysis & Research Limited (CARE).

5. ***ONICRA Credit Rating Agency of India Ltd.:*** ONICRA, a path breaking innovative organization analysis data and provides individual credit rating solutions that enable the lender or service provider to take a valued judgment on financial and other transactions . ONICRA facilitates over 100,000 transactions per day through a single window clearance on a national basis in the TELECOM, BANKING, INSURANCE, HEALTH AND EDUCATION SECTOR.

   Over the years, ONICRA has developed a long list of esteemed clients. The client list of ONICRA includes some of India's top 500 companies like Airtel, Mahindra & Mahindra, Reliance, Volkswagen, HDFC and Genpact, etc.

   ONICRA has been acknowledged as pioneers in this field by the Ministry of Finance in the Economic Survey (1993-1994) .It is also recognized and empanelled by the likes of NSIC (National Small Industries Corporation) for SSI (Small Scale Industry) assessment. Their ratings have also been accepted by the Indian Banks Association.

Self Assessment

Fill in the blanks:

1. A credit rating for an issuer takes into consideration the issuer's …… .
2. CARE's Credit Rating is an opinion on the relative …… and …… of an issuer to make timely payments on specific debt or related obligations over the life of the instrument.
3. Credit rating agencies are registered and regulated by the …… .
4. The Board may appoint one or more persons as inspecting officers, to undertake inspection of the books of account, …… and …… of the credit rating agencies.

Notes

5. The order of suspension or cancellation of certificate of registration is published by the Board in at least …… daily newspapers.
6. The period of validity of certificate of registration shall be …… years.
7. ……, a path breaking innovative organization analysis data and provides individual credit rating solutions that enable the lender or service provider to take a valued judgment on financial and other transactions.
8. The services provided by …… (DCR India) are considered to be at par with other leading providers of credit rating services in India.
9. Duff & Phelps Credit Rating India Private Ltd (DCR India) has played an important role in rating India's …… .
10. …… means a person who holds ten percent or more, of the shares of the credit rating agency.

10.4 Consumer Finance

Consumer finance has to do with the lending process that occurs between the consumer and a lender. In some instances, the lender may be a bank or financial institution. At other times, the lender may be a business that offers in house credit in exchange for the business of the consumer. Consumer finance can include just about any type of lending activity those results in the extension of credit to a consumer.

Most people have received financial assistance in obtaining desirable products through the use of consumer finance methods. In retail banking, the lender extends secured and unsecured loans to consumers who wish to purchase automobiles, homes, or engage in other activities that require substantial financing, such as remodeling a home. Generally, consumer lending of this type caries some degree of competition, since the consumer with a solid credit rating can often shop around and secure superior interest rates and terms for the loan agreement.

At the same time, not all forms of consumer finance are in the best interests of the consumer. In many parts of the world, institutions are in the business of lending money even to consumers with poor credit ratings, or who lack a reasonable ability to repay the borrowed funds. This can take the form of credit card offers, loans with extremely high rates of interest included in the finance structure of the loan, and other terms that will be difficult if not impossible for the consumer to meet.

As with any type of financial arrangement, it is important for the consumer to understand the exact nature of the commitment that is made as part of any consumer finance strategy. By understanding and accepting the terms and conditions associated with any lending situation, the consumer is pledging that the ability to repay within terms is present, and that the consumer has every intention of complying with each component or section of the loan agreement. To this end, it is in the best interests of the individual consumer to seek out the most desirable arrangements for any type of consumer finance, taking care to avoid any situation that will place an undue amount of stress on the resources in the possession of the consumer.

10.5 Retail Consumer Finance

Most people have received financial assistance in obtaining desirable products through the use of consumer finance methods. In retail banking, the lender extends secured and unsecured loans to consumers who wish to purchase automobiles, homes, or engage in other activities that require substantial financing, such as remodeling a home.

Notes

Example: An automaker may operate a subsidiary that offers financing for the purchase of a new vehicle, similar to the loan plans offered by a local bank or credit union. This arrangement would be considered consumer financing, since the purchased automobile is not intended for use in a business operation, but as a pleasure vehicle for an individual owner.

Self Assessment

Fill in the blanks:

11. The lending process occurs between the …….. and a lender.
12. …….. can include just about any type of lending activity those results in the extension of credit to a consumer.
13. In …….. the lender extends secured and unsecured loans to consumers who wish to purchase automobiles, homes, or engage in other activities.
14. Consumer finance has to do with the …….. process.
15. In consumer finance the lender may be a bank or …….. .

10.6 Summary

- A credit rating estimates the credit worthiness of an individual, corporation, or even a country.
- It is an evaluation made by credit bureaus of a borrower's overall credit history.
- Credit ratings are calculated from financial history and current assets and liabilities.
- A credit rating agency (CRA) is a company that assigns credit ratings for issuers of certain types of debt obligations as well as the debt instruments themselves.
- In some cases, the service providers of the underlying debt are also given ratings.
- In most cases, the issuers of securities are companies, special purpose entities, state and local governments, non-profit organizations, or national governments issuing debt-like securities (i.e., bonds) that can be traded on a secondary market.
- A credit rating for an issuer takes into consideration the issuer's credit worthiness (i.e., its ability to pay back a loan), and affects the interest rate applied to the particular security being issued.
- The credit rating agencies are regulated by the Securities and Exchange Board of India. The main credit rating organizations in India are CRISIL, CARE, DCR India and ONICRA.
- Consumer finance has to do with the lending process that occurs between the consumer and a lender. In some instances, the lender may be a bank or financial institution.
- In retail banking, the lender extends secured and unsecured loans to consumers who wish to purchase automobiles, homes, or engage in other activities that require substantial financing, such as remodeling a home.

10.7 Keywords

Rating: An opinion regarding securities, expressed in the form of standard symbols or in any other standardised manner, assigned by a credit rating agency and used by the issuer of such securities, to comply with a requirement specified by these regulations.

Notes

Securitisation: Securitisation involves pooling assets together and turning them into a tradable security. In the case of loans it is pooling the receivables from a loan and then selling them to a third party.

10.8 Review Questions

1. What do you think is the advantage for an economy to have multiple credit rating agencies?
2. What are the limitations of multiple credit rating agencies?
3. Do you think that SEBI itself is unable to handle the rating issue of the credit companies and that is why it registers credit rating agencies under it?
4. Evaluate the working of:
   (a) CRISIL
   (b) CARE
   (c) DCR India
   (d) ONICRA as credit rating agencies in India.
5. Critically evaluate the contribution of credit rating system in Indian economy.
6. What are the suggestions that you would give to various credit rating agencies operating in India for further improvement and why?
7. What do you mean by Consumer finance?
8. "Consumer finance has to do with the lending process that occurs between the consumer and a lender. In some instances, the lender may be a bank or financial institution." Explain.
9. Discuss the concept of Retail consumer finance.
10. Discuss the restrictions on the listing of securities by the promoters.

Answers to Self Assessment

1. credit worthiness
2. ability, willingness
3. Securities and Exchange Board of India
4. records, documents
5. two
6. three
7. ONICRA
8. Duff & Phelps Credit Rating India Private Ltd
9. forex debt obligations
10. promoter
11. consumer
12. Consumer finance
13. retail banking

Notes

14. lending
15. financial institution

10.9 Further Reading

Book

Michael K. Ong, Credit Ratings: Methodologies, Rationale and Default Risk, Risk Books

Online links

www.onicra.com

www.sebi.com

www.indianembassy.org

Case Study

Indian Insurers' Credit Ratings seen Stable

'Ownership change likely if foreign partners can't provide more capital'.

Mumbai, Sept. 24 The credit ratings of Indian insurance companies – both life and non-life – are unlikely to be affected in the near future despite the global financial crisis affecting the foreign stakeholders of these companies.

But if the foreign partners are unable to bring in additional capital in the long term due to the global slowdown, it could mean a change of ownership for Indian insurance companies, said analysts.

In the wake of the financial crisis, a number of companies in the banking and insurance sector across the world have faced downgrades, either due to their exposure to Lehman Brothers and AIG or to reflect heightened industry risk following the turmoil in the global financial markets.

Foreign companies such as Allianz, Prudential Financial Inc, AXA, AEGON, Sun Life Financial, Aviva, BNP Paribas, Fortis and ING have all reported some kind of exposure to either Lehman Brothers or AIG or both.

So far, the ratings of AIG and its subsidiaries and Fortis' Asian subsidiary have been downgraded.

All these companies are stake holders in Indian insurance companies and hold about 26 per cent stake each.

But, according to analysts, this is unlikely to affect the credit ratings of these insurance companies at least in the short term.

Strong Parentage

"Most of these companies have strong parents and their ratings are unlikely to be revised in the near term," said Mr. Subroto Ray, Head Corporate Sector Ratings, ICRA.

Contd...

Notes

"In the short-term, these relatively new insurance companies are well capitalised, well managed and have good solvency margins, much more than the requirements specified by the IRDA. All the foreign partners have already brought in capital commensurate with their equity stake," said Mr. Rajesh Mokashi, Executive Director, Care Ratings.

But this situation could change in the long term if the foreign partners are unable to bring in more capital for fuelling the expansion plans of companies.

"In the long term, if the foreign partner is unable to bring in the required capital, the Indian partner always has the option to buy him out or look for another partner. Besides, the insurance companies even have the option of listing themselves on the bourses to raise funds," Mr. Mokashi added.

The global financial crisis could lead to a change in the foreign ownership of many domestic insurance companies, said Mr. Ashu Dutt, MD, Asia Financial Services Practice, Northbridge Capital.

As India and China are considered among the fastest growing markets in the world, other companies would be keen on entering the sector and would look for tie-ups with companies here.

"Even if the Government raises the cap on foreign direct investment to 49 per cent from the existing 26 per cent, the foreign partners might decide not to raise their stake due to their inability to bring in the requisite amount of capital. It could even lead to the foreign partners selling off their stakes to other European entities that have escaped unscathed in the current crisis," said Mr. Dutt.

Question

Why companies go for credit rating? Discuss.

Source: http://www.thehindubusinessline.in

Notes

Unit 11: Leasing and Factoring

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Objectives

Introduction

11.1 Meaning and Types of Leasing

11.2 Financial Aspect

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11.6 Tax Aspect

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11.10.1 Rediscounting of Bills

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11.13 Review Questions

11.14 Further Readings

Objectives

After studying this unit, you should be able to:

- Understand meaning of leasing;
- Discuss the types and financial aspect of leasing;
- Know legal aspect of leasing;
- Know concept of factoring;
- Define bill discounting and rediscounting.

Introduction

A lease is a contract conferring a right on one person (called a tenant or lessee) to possess property belonging to another person (called a landlord or lessor) to the exclusion of the owner landlord. It is a rental agreement between landlord and tenant. The relationship between the tenant and the landlord is called a tenancy, and the right to possession by the tenant is sometimes called a leasehold interest. A lease can be for a fixed period of time (called the term of the lease) but may be terminated sooner. The consideration for the lease is called rent or the rental.

Notes

11.1 Meaning and Types of Leasing

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Under normal circumstances, an owner of property is at liberty to do what they want with their property, including destroy it or hand over possession of the property to a tenant. However, if the owner has surrendered possession to another (i.e. the tenant) then any interference with the quiet enjoyment of the property by the tenant in lawful possession is unlawful.

A lease contract can be classified on various characteristics in following categories:

1. Finance Lease and Operating Lease
2. Sales & Lease back and Direct Lease
3. Single investor and Leveraged lease
4. Domestic and International lease

Let us understand them one by one.

1. ***Finance Lease:*** A Finance lease is mainly an agreement for just financing the equipment/ asset, through a lease agreement. The owner lessor transfers to lessee substantially all the risks and rewards incidental to the ownership of the assets (except for the title of the asset). In such leases, the lessor is only a financier and is usually not interested in the assets. These leases are also called "Full Payout Lease" as they enable a lessor to recover his investment in the lease and derive a profit. Finance lease are mainly done for such equipment/assets where its full useful/economic life is normally utilized by one user - i.e. Ships, aircrafts, wagons etc.

   Generally a finance lease agreement comes with an option to transfer of ownership to lessee at the end of the lease period.

   Normally lease period is the major part of economic life of the asset.

2. ***Operating Lease:*** An operating lease is one in which the lessor does not transfer all risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period. The operating lease is normally for such assets which can be used by different users without major modification to it. The lessor provides all the services associated with the assets, and the rental includes charges for these services. The lessor is interested in ownership of asset/equipment as it can be lent to various users, during its economic life.

Example:

- Earth moving equipments,
- mobile cranes,
- computers,
- automobiles, etc.

3. ***Sale and Lease Back:*** In this type of lease, the owner of an equipment/asset sells it to a leasing company (lessor) which leases it back to the owner (lessee).

Notes

4. ***Direct Lease:*** In direct lease, the lessee and the owner of the equipment are two different entities. A direct lease can be of two types: Bipartite and Tripartite lease.

   (a) *Bipartite lease:* There are only two parties in this lease transaction, namely

      (i) Equipment supplier-cum-financier (lessor) and

      (ii) Lessee: The lessor maintains the assets and if necessary, replace it with a similar equipment in working condition.

   (b) Tripartite lease: In such lease there are three different parties

      (i) Equipment supplier

      (ii) Lessor (financier) and

      (iii) Lessee

   In such leases sometimes the supplier ties up with financiers to provide financing to lessee, as he himself is not in position to do so.

5. ***Single investor lease:*** This is a bipartite lease in which the lessor is solely responsible for financing part. The funds arranged by the lessor (financier) have no recourse to the lessee.

6. ***Leveraged lease:*** This is a different kind of tripartite lease in which the lessor arranges funds from another party linking the lease rentals with the arrangement of funds. In such lease, the equipment is part financed by a third party (normally through debt) and a part of lease rental is directly transferred to such lender towards the payment of interest and installment of principal.

7. ***Domestic Lease:*** A lease transaction is classified as domestic if all the parties to such agreement are domiciled in the same country.

8. ***International Lease:*** If the parties to a lease agreement domiciled in different countries, it is known as international lease. This lease can be further classified as:

   (i) ***Import lease:*** In an import lease, the lessor and the lessee are domiciled in the same country, but the equipment supplier is located in a different country. The lessor imports the assets and leases it to the lessee.

   (ii) ***Cross border lease:*** When the lessor and lessee are domiciled in different countries, it is known as cross border lease. The domicile of asset supplier is immaterial.

Notes The term of the lease may be fixed, periodic or of indefinite duration. If it is for a specified period of time, the term ends automatically when the period expires, and no notice needs to be given, in the absence of legal requirements.

The term's duration may be conditional, in which case it lasts until some specified event occurs, such as the death of a specified individual. A periodic tenancy is one which is renewed automatically, usually on a monthly or weekly basis. A tenancy at will lasts only as long as the parties wish it to, and be terminated without penalty by either party.

It is common for a lease to be extended on a "holding over" basis, which normally converts the tenancy to a periodic tenancy on a month by month basis.

11.2 Financial Aspect

Lease financing enables the lessee to have finance for huge investments in land, building, plant and machinery etc., up to 100%, without requiring any immediate down payment.

Notes

Additional Sources of Funds: Leasing facilitates the acquisition of equipments/ assets without necessary capital outlay and thus has a competitive advantage of mobilizing the scarce financial resources of the business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

Less costly: Leasing as a method of financing is a less costly method than other alternatives available.

Ownership preserved: Leasing provides finance without diluting the ownership or control of the promoters. As against it, other modes of long-term finance, e.g. equity or debentures, normally dilute the ownership of the promoters.

Avoids conditionality: Lease finance is considered preferable to institutional finance, as in the former case, there are no strings attached. Lease financing is beneficial since it is free from restrictive covenants and conditionality, such as representation on board etc.

Flexibility in structuring rental: The lease rentals can be structured to accommodate the cash flow situation of the lessee, making the payment of rentals convenient to him. The lease rentals are so tailor made that the lessee is bale to pays the rentals from the funds generated from operations.

Simplicity: A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation.

Tax Benefit: By suitable structuring of lease rentals a lot of tax advantages can be derived. If the lessee is in tax paying position, the rental may be increased to lower his taxable income. The cost of asset is thus amortized faster to than in a case where it owned by the lessee, since depreciation is allowable at the prescribed rates.

Obsolescence risk is averted: In a lease arrangement the lessor being the owner bears the risk of obsolescence and the lessee is always free to replace the asset with latest technology.

A lease agreement offers various advantages to lessor as well. Let us discuss those advantages one by one.

Full security: The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset in case of default by the lessee.

Tax benefit: The greatest advantage to the lessor is the tax relief by way of depreciation.

High profitability: The leasing business is highly profitable, since the rate of return is more than what the lessor pays on his borrowings. Also the rate of return is more than in case of lending finance directly.

Trading on equity: The lessor usually carry out their business with high financial leverage, depending more on debt fund rather equity.

High growth potential: The leasing industry has a high growth potential. Lease financing enables the lessee to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital.

11.3 Legal Aspect

As such there is no separate law regulating lease agreements, but it being a contract, the provisions of The Indian Contract Act, 1872 are applicable to all lease contracts. There are certain provisions of law of contract, which are specifically applicable to leasing transactions. Since lease also involves motor vehicles, provisions of the Motor Vehicles Act are also applicable to specific lease agreements. Lease agreements are also subject to:

Indian Stamp Act: Let us discuss in short, the Indian Contract Act, 1872 related to leasing.

Notes

Contract: A contract is an agreement enforceable by law. The essential elements of a valid contract are – Legal obligation, lawful consideration, competent parties, free consent and not expressly declared void.

Discharge of Contracts: A contract me by discharged in following ways - By performance, by frustration (impossibility of performance), by mutual agreement, by operation of law and by remission.

Remedies for Breach of Contract: Non-performance of a contract constitutes a breach of contract. When a party to a contract has refused to perform or is disabled from performing his promise, the other party may put an end to the contract on account of breach by the other party. The remedies available to the aggrieved party are - Damages or compensations, specific performance, suit for injunction (restrain from doing an act), suit for Quantum Meruit (claim for value of the material used).

Provisions Related to Indemnity and Guarantee: The provisions contained in the Indian Contract Act, 1872 related to indemnity and guarantee are related to lease agreements. Main provisions are as under:

Indemnity: A contract of indemnity is one whereby a person promises to make good the loss caused to him by the conduct of the promisor himself or any third person.

Example: A person executes an indemnity bond favoring the lessor thereby agreeing to indemnify him of the loss of rentals, cost and expenses that the lessor may be called upon to incur on account of lease of an asset to the lessee.

The person who gives the indemnity is called the 'indemnifier' and the person for whose protection it is given is called the 'indemnity-holder' or 'indemnified'.

In case of lease agreements, there is an implied contact of indemnity, where lessee will have to make good any loss caused to the asset by his conduct or by the act of any other person, during the lease term.

Guarantee: A contract of guarantee is a contract, whether oral or written, to perform the promise or discharge the liability third person in case of his default. A contract of guarantee involves three persons - 'surety' who gives guarantee, principal debtor and creditor. A contract of guarantee is a conditional promise by the surety that if the debtor defaults, he shall be liable to the creditor.

Bailment: The provisions of the law of contract relating to bailment are specifically applicable to leasing contracts.

Lease agreements are essentially a type of bailment.

11.4 Main Provisions Related to Lease

Liabilities of Lessee: A lessee is responsible to take reasonable of the leased assets. He should not make unauthorized use the assets. He should return the goods after purpose is accomplished. He should pay the lease rental when due and must insure and repair the goods.

Liabilities of Lessor: A lessor is responsible for delivery of goods to lessee. He should take back the possession of goods when due. He must disclose all defects in the assets before leasing. He must ensure the fitness of goods for proper use.

Remedies to the lessor: The lessor can forfeit the assets and claim damages in case of breach by lessee. The lessor can repossession of the assets in case of any breach by the lessee.

Remedies to the lessee: Where the contract is repudiated for lessor's breach of any obligation, the lessee may claim damages less resulting from termination. The measure of damages is increased

lease rentals (if any) the lessee has to pay on lease other asset, plus the damages for depriving him from the of the leased asset from the date of termination of the date expiry of lease term.

Lease of a Leased Asset: The lessee must not do any act, which is not consistent with the terms of the lease agreement. Lease agreements, generally, expressly exclude the right to sublease the leased asset. Thus, one should not sub-lease the leased assets, unless the lease agreement expressly provides.

Effect of sub-lease: The effect of a valid sub-lease is that the sub-lease becomes a lease of the original lessor as well. The sublease and the original lessor have the same right and obligations against each other as between any lessee and lessor.

Effect of termination of Main lease: A right to sub-lease restricted to the operation of the main lease agreement. Thus, termination of the main lease will automatically terminate the sub-lease. This may create complications for sub-lessee.

So far we have discussed the main provisions related to The Indian Contract Act, 1872. Now let us discuss the other laws related to leasing.

Motor Vehicles Act

Under this act, the lessor is regarded as dealer and although the legal ownership vests in the lessor, the lessee is regarded owner as the owner for purposes or registration of the vehicle under the Act and so on. In case of vehicle financed under lease/hire purchase/hypothecation agreement, the lessor is treated as financier.

Indian Stamp Act

The Act requires payment of stamp duty on all instruments/ documents creating a right/ liability in monetary terms. The contracts for equipment leasing are subject to stamp duty, which varies from state to state.

11.5 Lease Documentation and Agreement

A lease transaction involves a lot of formalities and various documents. The lease agreements have to be properly documented to formalize the deal between the parties and to bind them. Documentation is necessary to overcome any sort of confusion in future. It is also legally required, since it involves payment of stamp duty. Without proper documentation, it will be very difficult to prove your claim in competent court, in case of any dispute.

The essential requirements of documentation of lease agreements are that the person(s) executing the document should have the legal capacity to do so; the documents should be in prescribed format; should be properly stamped, witnessed and the duly executed and stamped documents should be registered, where necessary with appropriate authority.

Clauses in Lease Agreement: There is no standard lease agreement, the contents differ from case to case. Yet a typical lease agreement shall contain following clauses:

- ***Nature of lease:*** This clause specifies whether the lease is an operating lease, a financial lease or a leveraged lease. It also specifies that the lessor agrees to lease the equipment to the lessee and the lessee agrees to take on lease from the lessor subject to terms of the lease agreement, the leased asset.
- ***Description:*** The clause specifies the detailed description of equipment, its actual condition, size, components, estimated useful life, and so on.
- ***Delivery and Re-Delivery:*** The clause specifies when and how the equipment would be delivered to the lessee and re-delivered to the lessor R or expiry of the lease contract.

Notes

- ***Rentals:*** This clause specifies the procedure for paying lease. Lease rentals by the lessee to the lessor at the rates specified in the schedule to the agreement. Use lawful usage.
- ***Repairs and Maintenance:*** This clause specifies the responsibility for repairs and maintenance, insurance and so on.
- ***Alteration:*** It specifies that no alteration to the leased equipment may be made without the written consent of the lessor.
- ***Taxes and Charges:*** This clause specifies clearly which party to the agreement would bear the delivery, re-delivery, customs, income tax, sales tax and clearance charges.
- ***Inspection by Lessor:*** It gives the lessor or his representative a right to enter the lessees premises for the purpose of confirming the existence, condition and proper maintenance of the equipment.
- ***Prohibition of Sub-leasing:*** This clause prohibits the lessee from the D sub-leasing or selling the equipment to third parties.

Apart from the main/master lease agreement the attachments consists of:

1. Guarantee agreement
2. Promissory note
3. Receipt of goods
4. Power of attorney
5. Collateral security and Hypothecation agreement.

11.6 Tax Aspect

Unfortunately, the tax benefits which leasing companies enjoy in the developed countries are not available to the Indian leasing companies. Tax benefits arising out of depreciation, investment allowance of deposit scheme, etc., are not conducive to the growth and promotion of leasing companies. Investment allowance (u/s 32A) was abolished from 1 April 1987, and in its place an investment deposit scheme (u/s 32AB) has been introduced. Under this scheme, the amount of deduction is limited to 20 per cent of the profit of eligible business or profession as per the audited accounts. However, this scheme excludes certain categories of leasing. The latest position is that even this has been abolished as announced in the budget of 1990-91.

In addition to the above, the Finance Act 1987, had introduced Section 115J of Income Tax Act, 1961 which provided for a minimum tax of 30 per cent on the book profits of a company. The leasing companies brought within the orbit of this new tax provision faced uneasiness; now this has been abolished, as announced in the budget 1990-91.

Sales Tax Problems

Leasing companies are also facing the problems of sales tax. The 46th Amendment to the Indian Constitution, which came into force from February 1983, has empowered the State governments to levy sales tax on the transfer of rights or to the use of any goods for valuable consideration. As a result, the legal position of finance lease is a "deemed sale" under the State Sales Tax Act. The governments of Andhra Pradesh, Bihar, Gujarat, Haryana, Karnataka, Kerala, Maharashtra, Madhya Pradesh, Orissa, Tamil Nadu, and West Bengal have already amended their sales tax Acts in accordance with the 46th amendment to the Constitution. Hence, leasing companies are required to pay sales tax at higher rates on a lease transaction as they are not being allowed to use 'G' forms. This makes leasing more expensive, as the cost of the asset acquired under lease

finance gets enhanced to the extent of sales tax paid by the leasing companies. This is bound to cripple the leasing industry, which is still in the nascent stage. In view of the burden created by sales tax, the Central Government should take immediate steps and formulate guidelines, ensuring uniform legislation among various States. It should ensure uniformity in the scope and contents of the sales tax. The facility of using 'G' should also be extended to leasing companies.

Prabhu, Chairman, Canara Bank in his chairman's speech in June 1989 remarked that there were certain avoidable constraints restraining the lease finance from becoming a major source of corporate finance. The levy of sales tax on rentals by many State governments makes leasing unattractive. The benefits of lease finance, in terms of accelerated modernisation and industrial growth, are to that extent adversely affected. Yet another problem is in obtaining approval for issue of 'C' Forms by lessors under the Central Sales Tax.

It is noticed from the analysis of the questionnaire responses that 100 per cent of the respondents suggested that Section 115J of the Income-Tax Act, 1961, and sales tax on lease rentals should be abolished with immediate effect. About three fourths of the respondents expressed that the investment allowance and investment deposit scheme should be extended to the leasing companies. The leasing companies would feel relieved since Section 115 has been scrapped.

Rigid Procedure for Import Leasing

In India, Leasing industry has high potential in areas like import leasing or international leasing. Recently, a few leasing companies entered the arena of import leasing. The import and Export Policy for 1985-88 has laid down the following eligibility criteria for leasing companies to do import leasing.

The memorandum and articles of association of the leasing company must specifically provide for leasing as one of the objectives. The leasing company must have a minimum paid-up share capital and reserves of ₹ 1 crore. The share of leasing company must be listed in a recognized stock exchange. Thus, leasing of imported equipment has been restricted a meagre part of the industry. A number of respondents indicated the problems of import leasing and made the following suggestions:

1. Import of OGL items to be permitted without approval the Joint Chief Controller of Imports and Exports (JCCI & E).
2. The Chief Controller of Imports and Exports (CCI&E) has to reduce the period for giving permission for import leasing.

Self Assessment

Fill in the blanks:

1. The 46th Amendment to the Indian Constitution, has empowered the State governments to levy sales tax on the ..... of rights.
2. The tax benefits which leasing companies enjoy in the developed countries are ..... to the Indian leasing companies.
3. To, take a decision whether to finance a lease or lease an asset, the lessor/ financier requires a lot of commercial document of the ..... .
4. The provisions of the ..... relating to bailment are specifically applicable to leasing contracts.
5. In an import lease, the lessor and the lessee are domiciled in the ..... country.

Notes

6. A contract of guarantee is a contract, whether oral or written, to perform the promise or discharge the liability third person in case of his ..... .

11.7 Factoring

Receivables constitute a significant portion of current assets of firm. But, for investment in receivables, a firm has to incur certain costs such as costs of financing receivables and costs of collection from receivables. Further, there is a risk of bad debts also. It is, therefore, very essential to have a proper control and management of receivables. In fact, maintaining of receivables poses two types of problems:

1. The problem of raising funds to finance the receivables, and
2. The problems relating to collection, delays and defaults of the receivables.

A small firm may handle the problem of receivables management of its own, but it may not be possible for a large firm to do so efficiently as it may be exposed to the risk of more and more bad debts. In such a case, a firm may avail the services of specialised institutions engaged in receivables management, called factoring firms.

At the instance of RBI a Committee headed by Shri C. S. Kalyan Sundaram went into the aspects of factoring services in India in 1988, which formed the basis for introduction of factoring services in India. SBI established, in 1991, a subsidiary-SBI Factors Limited with an authorized capital of ₹ 25 crores to undertake factoring services covering the western zone.

11.8 Meaning

Factoring may broadly be defined as the relationship, created an agreement, between the seller of goods/services and a financial institution called .the factor, whereby the later purchases the receivables of the former and also controls and administers the receivables of the former.

Factoring may also be defined as a continuous relationship between financial institution (the factor) and a business concern selling goods and/or providing service (the client) to a trade customer on an open account basis, whereby the factor purchases the client's book debts (account receivables) with or without recourse to the client - thereby controlling the credit extended to the customer and also undertaking to administer the sales ledgers relevant to the transaction.

The term "factoring" has been defined in various countries in different ways due to non-availability of any uniform codified law. The study group appointed by International Institute for the Unification of Private Law (UNIDROIT), Rome during 1988 recommended, in simple words, the definition of factoring as under:

"Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor:

1. Finance
2. Maintenance of accounts
3. Collection of debts
4. Protection against credit risks".

The above definition, however, applies only to factoring in relation to supply of goods and services in respect of the following:

1. To trade or professional debtors

2. Across national boundaries
3. When notice of assignment has been given to the debtors.

The development of factoring concept in various developed countries of the world has led to some consensus towards defining the term. Factoring can broadly be defined as an arrangement in which receivables arising out of sale of goods/services are sold to the "factor" as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Hence the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer(s).

The forfeiting owes its origin to a French term 'a forfait' which means to forfeit (or surrender) ones' rights on something to some one else. Forfeiting is a mechanism of financing exports:

1. By discounting export receivables
2. Evidenced by bills of exchanges or promissory notes
3. Without recourse to the seller (viz; exporter)
4. Carrying medium to long-term maturities
5. On a fixed rate basis up to 100% of the contract value.

In other words, it is trade finance extended by a forfeiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount.

Forfaiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms. Recourse to forfaiting usually takes place where the credit is for long date maturities and there is prohibition for extending the facility where the credits are maturing in periods less than one year.

11.9 Mechanics

Factoring business is generated by credit sales in the normal course business. The main function of factor is realisation of sales. Once the transaction takes place, the role of factor step in to realise the sales/collect receivables. Thus, factor act as a intermediary between the seller and till and sometimes along with the seller's bank together.

The mechanism of factoring is summed up as below:

1. An agreement is entered into between the selling firm and the firm. The agreement provides the basis and the scope understanding reached between the two for rendering factor service.
2. The sales documents should contain the instructions to make payment directly to the factor who is assigned the job of collection of receivables.
3. When the payment is received by the factor, the account of the firm is credited by the factor after deducting its fees, charges, interest etc. as agreed.
4. The factor may provide advance finance to the selling firm conditions of the agreement so require.

11.10 Discounting of Bills

In addition to the rendering of factoring services, banks financial institutions also provide bills discounting facilities provide finance to the client. Bill discounting, as a fund-based activity, emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial scene in India.

Notes

According to the Indian Negotiable Instruments Act, 1881:

"The 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 that instrument."

The bill of exchange (B/E) is used for financing a transaction in goods which means that it is essentially a trade-related instrument.

11.10.1 Rediscounting of Bills

Presently banks purchase/discount/negotiate bills under Letter of Credit (LC) only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks. Banks could not, therefore, extend fund-based credit facilities (including bills financing) to a non-constituent borrower or a non-constituent member of a consortium/multiple banking arrangement.

Further, the practice of drawing bills of exchange clause 'without recourse' and issuing letters of credit bearing the legend 'without recourse' is discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the Negotiable Instruments Act. Banks therefore, do not open LCs and purchase/discount/negotiate bills bearing the 'without recourse' clause.

Did u know? Reserve Bank of India (RBI) in notification to banks dated 3rd August 2007 has advised that:

1. In cases where negotiation of bills drawn under LC is restricted to a particular bank, and the beneficiary of the LC is not a constituent of that bank, the bank concerned may negotiate such an LC, subject to the condition that the proceeds will be remitted to the regular banker of the beneficiary. However, the prohibition regarding negotiation of unrestricted LCs of non-constituents will continue to be in force.
2. The banks may negotiate bills drawn under LCs, on 'with recourse' or 'without recourse' basis, as per their discretion and based on their perception about the credit worthiness of the LC issuing bank. However, the restriction on purchase/discount of other bills (the bills drawn otherwise than under LC) on 'without recourse' basis will continue to be in force.

Self Assessment

Fill in the blanks:

7. Banks do not open LCs and purchase/discount/negotiate bills bearing the ..... clause.
8. The bill of exchange is an instrument in writing containing an ..... order.
9. Factoring services like 'undisclosed factoring' are ..... in nature.
10. Factoring undertakes to ..... the bills of the client.
11. The forfeiting owes its origin to a French term ..... .
12. ..... may broadly be defined as the relationship, created an agreement, between the seller of goods/services and a financial institution.

Notes

Task Find out the situations under which the banks cannot rediscount the bills.

Caselet

Bill on 'Factoring' Coming in Budget Session: Minister

The Centre will, in the upcoming Budget session of Parliament, introduce a Bill on 'factoring' so as to provide a comprehensive legal and regulatory framework for such services, Mr Namo Narain Meena, Minister of State for Finance, has said.

The proposed legislation would provide adequate protection for major players to further develop the factoring business in India, Mr Meena said here on Wednesday. Factoring covers a range of services including receivable financing, sales ledger administration, accounts receivable collection and management, and credit protection.

What's Factoring

Factoring business had not made much progress in India due to the absence of a consolidated legal framework for such business. Although the concept of factoring services was not very new for India, there are only few players in the market, Mr Meena pointed out. Mr Meena highlighted that the Department of Financial Services has already prepared a draft factoring Bill in consultation with various stakeholders including the Ministry of Micro, Small and Medium Enterprises. The proposed legislation will be conducive to increasing lending to SMEs, he said. Among the various risks faced by SMEs, which are largely unorganised, a major one is delay or default of payment by counterparty.

Source: http://www.thehindubusinessline.in

11.11 Summary

- Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. Under normal circumstances, an owner of property is at liberty to do what they want with their property.
- However, if the owner has surrendered possession to another (i.e. the tenant) then any interference with the quiet enjoyment of the property by the tenant in lawful possession is unlawful. A lease contract can be classified on various characteristics in many categories like Finance Lease and Operating Lease; Sales & Lease back and Direct Lease; Single investor and Leveraged lease and Domestic and International lease.
- There are many financial, legal and tax related aspects of leasing. Financially, leasing is more advantageous than harmful.
- But in India, the tax benefits given to the leasing companies are not substantially as good as their counterparts in developed economies.
- Factoring may be defined as the relationship, created an agreement, between the seller of goods/services and a financial institution. Forfeiting is trade finance extended by a forfeiter to an exporter seller for an export/sale transaction involving deferred payment terms over a long period at a firm rate of discount.
- In addition to the rendering of factoring services, banks financial institutions also provide bills discounting facilities provide finance to the client.

Notes

- The 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 that instrument.

11.12 Keywords

Account receivables: Any trade debt arising from the sale of goods/ services by the client to the customer on credit.

Client: He is also known as supplier. It may be a business institution supplying the goods/ services on credit and availing of the factoring arrangements.

Contract: A contract is an agreement enforceable by law.

Contract of indemnity: A contract whereby a person promises to make good the loss caused to him by the conduct of the promisor himself or any third person.

Customer: A person or business organisation to whom the goods/ services have been supplied on credit. He may also be called as debtor.

Eligible debt: Debts, which are approved by the factor for making prepayment.

Lease: Lease is a contract conferring a right on one person (called a tenant or lessee) to possess property belonging to another person (called a landlord or lessor) to the exclusion of the owner landlord.

Open account sales: Where in an arrangement goods/ services are sold/supplied by the client to the customer on credit without raising any bill of exchange or promissory note.

Prepayment: An advance payment made by the factor to the client up to a certain percent of the eligible debts.

Retention: Margin maintained by the factor.

11.13 Review Questions

1. Analyse the regulatory authority that the RBI has been able to exercise over the leasing companies operating in India for last 5 years.
2. Why do you think has the govt. of India fixed a rigid procedure for import leasing?
3. Present a comparative analysis of the tax benefits that the leasing companies have in developed countries and their counterparts have here in India.
4. Is there any flaw in the provisions related to Indemnity and Guarantee? Support your argument with reasons.
5. Which is the most common type of lease that you generally witness across and which is the rarest? What do you think to be the reasons behind them?
6. How is bills discounting and factoring different from each other?
7. What is more important factoring or forfeiting and why?
8. Discuss the mechanisms of factoring and forfeiting.
9. How do you see the provisions for rediscounting of bills?
10. What makes discounting of bills, a profitable activity?

Notes

Answers to Self Assessment

1. Transfer
2. Unavailable
3. Lessee
4. law of contract
5. same
6. default
7. without recourse
8. unconditional
9. confidential
10. collect
11. forfeit'
12. Factoring

11.14 Further Readings

Books

Charles W.L. Hill, International Business, Tata McGraw Hill Co. Ltd., New Delhi

Thakur, Burton & Srivastava, International Management, Tata McGraw Hill Co. Ltd., New Delhi

Sharan V., International Financial Management, Prentice Hall of India, New Delhi

Online links

www.forfeiting.com

www.forfeiting.com

www.languages.ind.in

Case Study

PNB Enters Factoring Business

Picks up 30% stake in IFFSL; to focus on SMEs initially.

Punjab National Bank (PNB) has forayed into factoring business through the joint venture route. The joint venture company, India Factoring & Finance Solutions Pvt Ltd (IFFSL), on Wednesday commenced commercial operations simultaneously in New Delhi, Mumbai and Chennai.

To begin with, IFFSL will focus on domestic factoring and provide this financing solution primarily to small and medium enterprises (SMEs) and small-scale industries, PNB Chairman and Managing Director, Mr K. R. Kamath, said.

Contd...

Notes

Factoring is a financial transaction where a business sells its accounts receivable to a third party called 'factor', which undertakes the activity of financing the receivables, administration of debt and collection of debt.

PNB has a 30 per cent stake in IFFSL and has already pumped in ₹ 30 crore into the venture. IFFSL has commenced operations with an initial paid-up capital of ₹ 100 crore, according to Mr Mohan Tanksale, Chairman of IFFSL, and an Executive Director of PNB.

Malta-based FIMBank Plc has 49 per cent stake in IFFSL. The remaining stake is with other joint venture partners - Italy-based Banca IFIS and Blend Financial Services of Mumbai.

Mr Kamath also said that regulatory approvals have been sought for IFFSL to provide international factoring/forfeiting. "Once the regulatory approval is received, IIFSL will provide both domestic and international factoring," he said.

Legal Framework

He also highlighted that factoring business in India has not made much progress due to lack of consolidated legal framework for the business. However, there has been growing realisation that factoring can be a solution for receivable management of the SME sector, Mr Kamath noted. In India, SMEs employ about 60 million people and account for about 45 per cent of total exports (in value terms) from the country.

Question

Discuss the impact of factoring on bank's business.

Source: http://www.thehindubusinessline.in

Unit 12: Merchant Banking and Venture Capital

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Objectives

After studying this unit, you should be able to:

- Understand meaning and role of merchant banking;
- Understand functions of merchant banking;
- Understand SEBI guidelines regarding merchant banking;
- Understand role and importance of venture capital;
- Understand functions and techniques of venture capital.

Introduction

In banking, a merchant bank is a financial institution primarily engaged in offering financial services and advice to corporations and to wealthy individuals. The term can also be used to describe the private equity activities of banking. The chief distinction between an investment bank and a merchant bank is that a merchant bank invests the banks own capital in a client company whereas an investment bank purely distributes (and trades) the securities of that company in its capital raising role. Both merchant banks and investment banks provide fee based corporate advisory services including in relation to mergers and acquisitions.

12.1 Meaning and Role

A merchant bank can be defined as a bank that deals mostly in (but is not limited to) international finance, long-term loans for companies and underwriting. Merchant banks do not provide regular banking services to the general public.

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Their knowledge in international finances make merchant banks specialists in dealing with multinational corporations.

In the past the role of the merchant banker was to arrange the necessary capital and ensure that the transaction would be implemented i.e. a financial intermediary facilitating the flow of capital among the concerned parties. But today, a merchant banker plays multiple roles which include those of an entrepreneur, a management advisor, an investment banker, and a transaction broker.

This shows that the breadth and depth of a merchant bankers activity has changed over the years.

A merchant bank deals with the commercial banking needs of international finance, long term company loans, and stock underwriting. A merchant bank does not have retail offices where one can go and open a savings or checking account. A merchant bank is sometimes said to be a wholesale bank, or in the business of wholesale banking. This is because merchant banks tend to deal primarily with other merchant banks and other large financial institutions.

The most familiar role of the merchant bank is stock underwriting. A large company that wishes to raise money from investors through the stock market can hire a merchant bank to implement and underwrite the process. The merchant bank determines the number of stocks to be issued, the price at which the stock will be issued, and the timing of the release of this new stock. The merchant bank files all the paperwork required with the various market authorities, and is also frequently responsible for marketing the new stock, though this may be a joint effort with the company and managed by the merchant bank. For really large stock offerings, several merchant banks may work together, with one being the lead underwriter.

Merchant bankers offer customised solutions to solve the financial problems of their clients. Advice is sought in areas of financial structuring. Merchant bankers study the working capital practices that exist within the company and suggest alternative policies. They also advise the company on rehabilitation and turnaround strategies, which would help companies to recover from their current position. They also provide advice on appropriate risk management strategies like hedging strategies.

These financial intermediaries arrange loans, for their clients, by analysing their cash flow pattern, so that the terms of borrowing meet the clients cash requirements. They also offer assistance in loan documentation procedures.

Merchant bankers assist the management of the client company to successfully restructure various activities, which include mergers and accquisitions, divestitures, management buyouts, joint venture among others. They also play a lead role to help companies achieve the objectives of these restructuring strategies, the merchant banker participates in different activities at various stages which include understanding the objectives behind the strategy (objectives could be either to obtain financial, marketing, or production benefits), and help in searching for the right partner in the strategic decision and financial valuation of the proposal.

12.2 Functions

Merchant Banks are popularly known as "issuing and accepting houses". They offer a package of financial services. Unlike in the past, their activities are now primarily non-fund based. One of the basic requirements of merchant banks is highly professional staff with skills and worldwide contacts. The basic function of merchant banks is marketing corporate and other securities, that is guaranteeing sales and distribution of securities.

All the aspects- origination, underwriting and distribution of the sale of industrial securities are handled by them. They are experts and good judges of the type, timing and terms of issues and

Notes

make them acceptable to investors under prevailing preferences and market conditions, and at the same time afford the borrowing company, flexibility and freedom that it needs to meet possible future contingencies. They guarantee the success of issues by underwriting them. They also provide all the services related to receiving applications, allotment, collecting money, sending share certificates and so on.

The merchant banker normally does not assume all the risk himself while underwriting the issue. Merchant banks offer services also to investors. The range of activities offered by merchant banks is much wider than sponsoring public issues of industrial securities. They offer project finance, syndication of credit, corporate advisory services, mutual fund investments, investment management etc. Let us go through the most important services of Merchant Banks.

1. ***Project Counselling:*** Project counselling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising the project report with the financial institutions or banks. It also includes filling up of application forms with relevant information for obtaining funds from financial institutions and obtaining government approval.

2. ***Issue Management:*** Management of issue involves marketing of corporate securities viz. equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as an intermediary whose main job is to transfer capital from those who own it to those who need it. After taking action as per SEBI guidelines, the merchant banker arranges a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing date of board meeting to approve and sign prospectus and pass the necessary resolutions. Pricing of issues is done by the companies in consultant with the merchant bankers.

3. ***Underwriting of Public Issue:*** Underwriting is a guarantee given by the underwriter that in the event of under subscription, the amount underwritten would be subscribed by him. Banks/Merchant banking subsidiaries cannot underwrite more than 15% of any issue.

4. ***Managers, Consultants or Advisers to the Issue:*** The managers to the issue assist in the drafting of prospectus, application forms and completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies can appoint one or more agencies as managers to the issue.

5. ***Portfolio Management:*** Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and government securities. Portfolio management refers to maintaining proper combinations of securities in a manner that they give maximum return with minimum risk.

6. ***Advisory Service Relating to Mergers and Takeovers:*** A merger is a combination of two companies into a single company where one survives and other loses its corporate existence. A takeover is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the two companies.

7. ***Off Shore Finance:*** The merchant bankers help their clients in the following areas involving foreign currency:

   (a) Long term foreign currency loans

   (b) Joint Ventures abroad

   (c) Financing exports and imports

   (d) Foreign collaboration arrangements

Notes

8. ***Non-resident Investment:*** The services of merchant banker includes investment advisory services to NRI in terms of identification of investment opportunities, selection of securities, investment management, and operational services like purchase and sale of securities.

9. ***Loan Syndication:*** Loan syndication refers to assistance rendered by merchant bankers to get mainly term loans for projects. Such loans may be obtained from a single development finance institution or a syndicate or consortium. Merchant bankers help corporate clients to raise syndicated loans from banks or financial institutions.

10. ***Corporate Counselling:*** Corporate counselling covers the entire field of merchant banking activities viz. project counselling, capital restructuring, public issue management, loan syndication, working capital, fixed deposit, lease financing acceptance credit, etc.

Task Compare the working of merchant banks in India with those of European Union and discuss where we need to move ahead to match the pace.

12.3 SEBI Guidelines Regarding Merchant Banking

Without holding a certificate of registration granted by the Securities and Exchange Board of India, no person can act as a merchant banker.

Only a body corporate other than a non-banking financial company shall be eligible to get registration as merchant banker.

The categories for which registration may be granted are given below:

1. Category I – to carry on the activity of issue management and to act as adviser, consultant, manager, underwriter, portfolio manager.
2. Category II – to act as adviser, consultant, co-manager, underwriter, portfolio manager.
3. Category III – to act as underwriter, adviser or consultant to an issue.
4. Category IV – to act only as adviser or consultant to an issue.

Did u know? The capital requirement depends upon the category. The minimum net worth requirement for acting as merchant banker is given below:

1. Category I – ₹ 5 crores
2. Category II – ₹ 50 lakhs
3. Category III – ₹ 20 lakhs
4. Category IV – Nil

5. An application should be submitted to SEBI in Form A of the SEBI (Merchant Bankers) Regulations, 1992. SEBI shall consider the application and on being satisfied issue a certificate of registration in Form B of the SEBI (Merchant Bankers) Regulations, 1992.
6. ₹ 5 lakhs which should be paid within 15 days of date of receipt of intimation regarding grant of certificate.
7. The validity period of certificate of registration is three years from the date of issue.
8. For renewal, three months before the expiry period, an application should be submitted to SEBI in Form A of the SEBI (Merchant Bankers) Regulations, 1992. SEBI shall consider

the application and on being satisfied renew certificate of registration for a further period of 3 years.

9. ₹ 2.5 lakhs which should be paid within 15 days of date of receipt of intimation regarding renewal of certificate.

10. The person whose registration is not current shall not carry on the activity as merchant banker from the date of expiry of validity period.

12.4 Underwriting Services in India

The word "underwriter" is said to have come from the practice of having each risk-taker write his or her name under the total amount of risk that he or she was willing to accept at a specified premium. In a way, this is still true today, as new issues are usually brought to market by an underwriting syndicate in which each firm takes the responsibility (and risk) of selling its specific allotment.

Thus underwriting can be understood as the process by which investment bankers raise investment capital from investors on behalf of corporations and governments that are issuing securities (both equity and debt). It is also the process of issuing insurance policies.

Underwriting of capital issues has become very popular due to the development of the capital market and special financial institutions. The lead taken by public financial institutions has encouraged banks, insurance companies and stock brokers to underwrite on a regular basis. The various types of underwriters differ in their approach and attitude towards underwriting:

1. *Development banks like IFCI, ICICI and IDBI:-* they follow an entirely objective approach. They stress upon the long-term viability of the enterprise rather than immediate profitability of the capital issue. They attempt to encourage public response to new issues of securities.

2. *Institutional investors like LIC and AXIS:-* their underwriting policy is governed by their investment policy.

3. *Financial and development corporations:-* they also follow an objective policy while underwriting capital issues.

4. *Investment and insurance companies and stock-brokers:-* they put primary emphasis on the short term prospects of the issuing company as they cannot afford to block large amount of money for long periods of time.

To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI). The certificate is granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters. Under it, an underwriter is required to enter into a valid agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity. These regulations have been further amended by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2006.

Self Assessment

Fill in the blanks:

1. Underwriting of ..... has become very popular due to the development of the capital market and special financial institutions.

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2. Corporate ..... covers the entire field of merchant banking activities.
3. The validity period of certificate of registration is ..... years from the date of issue.
4. Development banks stress upon the ..... of the enterprise.
5. A ..... is a combination of two companies into a single company where one survives and other loses its corporate existence.
6. The person whose registration is not current shall not carry on the activity as merchant banker from the date of ..... of validity period.
7. Without holding a certificate of registration granted by the ....., no person can act as a merchant banker.

Caselet

Merchant Bankers Willing to Take Less for PSU Offerings

Seek to Generate more Business

Merchant bankers continue to quote a nominal fee for book-running and lead managing the public sector offering even after recent selection norm changes substantially lowered the weight for bid price.

According to sources in the Government, one merchant banker had bid for the Coal India IPO assignment at a fee as low as 0.000001 per cent. Public sector issuer sources said the changed rules last month, which put greater weight (70 per cent) on quality - technical expertise and experience - over that on quoted fees (30 per cent) has not influenced the bidding pattern.

"The pool of registered merchant bankers sports almost similar qualitative standards. Therefore, the quoted fee determines short-listing. Competitive pressure for public sector offerings forces the merchant bankers to keep the fees low, often highly loss making or stay out," said a top official of public sector enterprise.

Market sources say while the going rate for merchant banking fees for a private issuer of a comparable size is around 3 per cent, the rate for PSU offerings remains close to zero.

"This is not a charitable exercise. Merchant bankers extract marketing mileage and seek more future business from the Government-run organisations to serve their commercial interest indirectly. But they also to make up for the huge cost, which runs into crores of rupees, through other means, which are strictly not clean," said the managing director of a listed private company.

Mr Prithvi Haldea, primary market expert and the Chairman of Prime Database, told Business Line that the environment was not conducive to a fair and transparent method of selecting quality services.

"The Government needs to pay a reasonable fee to merchant bankers for the best services so that the issues do not suffer. In the context of the Government's plan to raise huge sum (₹ 40,000 crore) in 2010-11 through several offloading of shares or fresh issues, the technical qualification should be the primary criterion for selection of merchant bankers. Fixing of

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an upfront payment to the selected book-runners and lead managers for each issue considering the cost involved can ensure better response and quality rendering of services."

This fiscal, the lead managers for the SJVN Ltd issue were JM Financial, IDFC Capital, IDBI Capital and SBI Capital Markets. Citibank, Deutsche Bank, DSP Merrill Lynch, Morgan Stanley, Enam Securities and Kotak Securities have been appointed to act as book running lead managers for the Coal India Limited IPO.

For EIL, the government has short-listed HSBC Holdings Plc, ICICI Securities, SBI Capital Markets and IDFC Capital to manage the public offering. UBS AG, Kotak Mahindra Capital, Enam Securities and IDBI Capital Market Services, Avendus Capital, Edelweiss Capital and Centrum Broking also competed for EIL issue. Hindustan Copper Ltd, which would view the bids after June 24, has obtained several bids, according to sources.

Source: http://www.thehindubusinessline.in

12.5 Venture Capital

Venture capital is a post-war phenomenon in the business world mainly developed as a sideline activity of the rich in USA. The concept, thus, originated in USA in 1950s when the capital magnets like Rockfeller Group financed the new technology companies. The concept became popular during 1960's and 1970's when several private enterprises started financing highly risky and highly rewarding projects. To denote the risk and adventure and some element of investment, the generic term "Venture Capital" was developed. The American Research and Development was formed as the first venture organization which financed over 100 companies and made profit over 35 times its investment. Since then venture capital has grown' vastly in USA, UK, Europe and Japan and has been an important contribution in the economic development of these countries.

Of late, a new class of professional investors called venture capitalists has emerged whose specialty is to combine risk capital with entrepreneurs management and to use advanced technology to launch new products and companies in the market place.

Undoubtedly, it is the venture capitalists extraordinary skill and ability to assess and manage enormous risks and extort from them tremendous returns that has attracted more entrants.

Innovative, hi-tech ideas are necessarily risky. Venture capital provides long-term start-up costs to high risk and return projects. Typically, these projects have high mortality rates and therefore are unattractive to risk averse bankers and private sector companies.

Venture capitalist finances innovation and ideas, which have potential for high growth but are unproven. This makes it a high risk, high return investment. In addition to finance, venture capitalists also provide value-added services and business and managerial support for realizing the venture's net potential.

12.6 Meaning

Venture Capital has emerged as a new financial method of financing during the 20th century. Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects.

There is a common perception that venture capital is a means of financing high technology projects. However, venture capital is investment of long term finance made in:

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1. Ventures promoted by technically or professionally qualified but unproven entrepreneurs, or
2. Ventures seeking to harness commercially unproven technology, or
3. High risk ventures.

The term 'venture capital' represents financial investment in highly risky project with the objective of earning a high rate return. While the concept of venture capital is very old the recent liberalisation policy of the government appears to have given fillip to the venture capital movement in India. In the real sense, venture capital financing is one of the most recent entrants the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked.

These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. In addition to providing capital, these VCFs (venture capital firms) take an active interest in guiding the assisted firms.

A young, high tech company that is in the early stage of financing and is not yet ready to make a public offer of securities may seek venture capital. Such a high risk capital is provided venture capital funds in the form of long-term equity finance with the hope of earning a high rate of return primarily in form of capital gain. In fact, the venture capitalist acts as a partner with the entrepreneur.

Thus, a venture capitalist (VC) may provide the seed capital unproven ideas, products, technology oriented or start up firms. The venture capitalists may also invest in a firm that unable to raise finance through the conventional means.

Features

"Venture capital combines the qualities of a banker, stock market investor and entrepreneur in one."

The main features of venture capital can be summarised as follows:

1. ***High Degrees of Risk:*** Venture capital represents financial investment in a highly risky project with the objective of earning a high rate of return.
2. ***Equity Participation:*** Venture capital financing is, invariably, an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable. .
3. ***Long Term Investment:*** Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.
4. ***Participation in Management:*** In addition to providing capital, venture capital funds take an active interest in the management of the assisted firms. Thus, the approach of venture capital firms is different from that of a traditional lender or banker. It is also different from that of a ordinary stock market investor who merely trades in the shares of a company without participating in their management. It has been rightly said, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one".
5. ***Achieve Social Objectives:*** It is different from the development capital provided by several central and state level government bodies in that the profit objective is the motive behind the financing. But venture capital projects generate employment, and balanced regional growth indirectly due to setting up of successful new business.

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6. ***Investment is liquid:*** A venture capital is not subject to repayment on demand as with an overdraft or following a loan repayment schedule. The investment is realised only when the company is sold or achieves a stock market listing.

   It is lost when the company goes into liquidation.

Task List some of the venture capitalists operating under your territory and analyse if their services miss any of the features discussed above.

12.7 Techniques

Venture capital firms usually recognise the following two main stages when the investment could be made in a venture namely:

Early Stage Financing

1. ***Seed Capital & Research and Development Projects:*** Venture capitalists are more often interested in providing seed finance i. e. making provision of very small amounts for finance needed to turn into a business.

   Research and development activities are required to be undertaken before a product is to be launched. External finance is often required by the entrepreneur during the development of the product. The financial risk increases progressively as the research phase moves into the development phase, where a sample of the product is tested before it is finally commercialised "venture capitalists/firms/ funds are always ready to undertake risks and make investments in such R & D projects promising higher returns in future.

2. ***Start Ups:*** The most risky aspect of venture capital is the launch of a new business after the Research and development activities are over. At this stage, the entrepreneur and his products or services are as yet untried.

   The finance required usually falls short of his own resources. Start-ups may include new industries/businesses set up by the experienced persons in the area in which they have knowledge. Others may result from the research bodies or large corporations, where a venture capitalist joins with an industrially experienced or corporate partner. Still other start-ups occur when a new company with inadequate financial resources to commercialise new technology is promoted by an existing company.

3. ***Second Round Finance:*** It refers to the stage when product has already been launched in the market but has not earned enough profits to attract new investors. Additional funds are needed at this stage to meet the growing needs of business. Venture Capital Institutions (VCIs) provide larger funds at this stage than at other early stage financing in the form of debt. The time scale of investment is usually three to seven years.

Later Stage Financing

Those established businesses which require additional financial support but cannot raise capital through public issue approach venture capital funds for financing expansion, buyouts and turnarounds or for development capital.

1. ***Development Capital:*** It refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public, thus needs financial support. Funds are needed for the purchase of new equipment/plant, expansion of

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marketing and distributing facilities, launching of product into new regions and so on. The time scale of investment is usually one to three years and falls in medium risk category.

2. ***Expansion Finance:*** Venture capitalists perceive low risk in ventures requiring finance for expansion purposes either by growth implying bigger factory, large warehouse, new factories, new products or new markets or through purchase of exiting businesses. The time frame of investment is usually from one to three years. It represents the last round of financing before a planned exit.

3. ***Replacement Capital:*** Another aspect of financing is to provide funds for the purchase of existing shares of owners. This may be due to a variety of reasons including personal need of finance, conflict in the family, or need for association of a well known name. The time scale of investment is one to three years and involve low risk.

4. ***Turn Arounds:*** Such form of venture capital financing involves medium to high risk and a time scale of three to five years. It involves buying the control of a sick company which requires very specialised skills. It may require rescheduling of all the company's borrowings, change in management or even a change in ownership. A very active "hands on" approach is required in the initial crisis period where the venture capitalists may appoint its own chairman or nominate its directors on the board.

5. ***Buy Outs:*** It refers to the transfer of management control by creating a separate business by separating it from their existing owners. It may be of two types:

   (a) *Management Buyouts (MBOs):* In Management Buyouts (MBOs) venture capital institutions provide funds to enable the current operating management/ investors to acquire an existing product line/business. They represent an important part of the activity of VCIs.

   (b) *Management Buyins (MBIs):* Management Buy-ins are funds provided to enable an outside group of manager(s) to buy an existing company. It involves three parties: a management team, a target company and an investor (i.e. Venture capital institution). MBIs are more risky than MBOs and hence are less popular because it is difficult for new management to assess the actual potential of the target company. Usually, MBIs are able to target the weaker or under-performing companies.

In nutshell, venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability. Venture capitalists evaluate technology and study potential markets besides considering the capability of the promoter to implement the project while undertaking early stage investments. In later stage investments, new markets and record of the business/entrepreneur is closely examined.

12.8 Indian Venture Capital Scenario

In India the Venture Capital plays a vital role in the development and growth of innovative entrepreneurships. Venture Capital activity in the past was possibly done by the developmental financial institutions like IDBI, ICICI and State Financial Corporations. These institutions promoted entities in the private sector with debt as an instrument of funding. For a long time funds raised from public were used as a source of Venture Capital. This source however depended a lot on the market vagaries. And with the minimum paid up capital requirements being raised for listing at the stock exchanges, it became difficult for smaller firms with viable projects to raise funds from public. In India, the need for Venture Capital was recognised in the 7th five year plan and long term fiscal policy of GOI. In 1973 a committee on Development of small and medium enterprises highlighted the need to faster VC as a source of funding new entrepreneurs and technology. VC financing really started in India in 1988 with the formation of Technology

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Development and Information Company of India Ltd. (TDICI) - promoted by ICICI and UTI. The first private VC fund was sponsored by Credit Capital Finance Corporation (CFC) and promoted by Bank of India, Asian Development Bank and the Commonwealth Development Corporation viz. Credit Capital Venture Fund. At the same time Gujarat Venture Finance Ltd. and APIDC Venture Capital Ltd. were started by state level financial institutions. Sources of these funds were the financial institutions, foreign institutional investors or pension funds and high net-worth individuals.

The Indian venture capital (VC) market has been getting more active by the day. During the last year or so, almost all the major global VC firms have either established an on-ground presence in India or raised significant India-dedicated funds. In 2006, VC investment levels increased by more than 300% to almost $7.5 billion from $2.2 billion in 2005. This quantum leap was not the result of a low base-as 2005 was a record year in itself.

What is driving this VC investment boom? The most important fact is Indian GDP growth coming within striking range of double-digits. Annual growth rates of 7-9% are unheard of in mature western economies, and global investors want high returns. Furthermore, several key sectors of the Indian economy (IT/BPO, telecom, pharma/healthcare, financial services, retail and automotive components) that are investment targets are experiencing even higher growth than the said levels (of 7-9%). Other key attractions include: an economy well positioned to mine the opportunities of globalisation, an increased appetite for innovation and entrepreneurship, well-regulated and fully functional capital markets and a spurt in consumerism powered by the young demographic profile. Clearly, the liberalisation of the economy has also had a significant impact, laying the foundation for a relatively stable macroeconomic environment in combination with high growth.

However, on the regulatory side, many investors would like to see the government use the current momentum to push forward with further deregulation. Some recent regulations, they fear, have not been well thought through. Examples of these include the introduction of FBT on stock options and the recent news on preference share capital requiring compliance with ECB guidelines on interest/dividend coupon caps and end-use restrictions (that is, compliance with external debt norms, unless the shares are fully-convertible). For the VC industry, the new end-use restrictions are particularly harmful as funds raised via preference shares cannot be used for general corporate purposes, funding of working capital, repayment of existing loans and acquisition of shares and/or real-estate. At present, it is estimated that about 30% of the Indian VC/PE investments are structured as preference share capital. Unless this gets revised, the percentage might well come down. This is in sharp contrast with many western markets, where an even higher and ever-increasing percentage of VC investments are structured with a layer of preference share capital-also referred to as 'hybrid capital.

Caselet

Govt Plans ₹ 3,000-cr Venture Capital Fund for Drug Discovery

Government is willing to look at the industry's demand for a single regulatory authority to do away with multiple regulatory bodies.

The Government is planning to set up a ₹ 3,000-crore venture capital fund to give a fillip to drug discovery and strengthen the pharma infrastructure in the country. The National Institute of Public Finance & Policy (NIPFP) is set to finalise the bid document and the expression of interest for setting up the find will be issued this month.

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Speaking at the National Convention on Biopharma, organised by the Department of Pharmaceuticals and FICCI, Mr Ashok Kumar, Secretary, Department of Pharmaceuticals, said that the Government had issued an expression of interest for technical and financial bids for the selection of a global level consultant (GLC) for preparation of a detailed project report (DPR) for developing India as a drug discovery and pharma innovation hub by 2020.

The selection of a consultant would be made this month and the report is expected to be ready by year end.

Mr Kumar also said that the Government was willing to look at the industry's demand for a single regulatory authority to do away with multiple regulatory bodies.

The biopharma market in India is growing at 15 per cent annually. By 2020, the market is projected to be worth over $200 billion, driven by a shift in usage from conventional drugs to biopharma products.

Mr. Kumar released the 'Vision 2020' paper on a bio pharma strategy for India, prepared by PricewaterhouseCoopers and Association of Biotechnology Led Enterprises (ABLE).

The document spells out the challenges before the biopharma industry and suggests key action areas. For the medium term, it suggests that in the area of research and development, India would need to build protein characterisation laboratories and GLP-certified animal study facilities; create a national animal breeding facility, expand viral testing facilities; provide financial assistance for ensuring compliance with global standards; promote the development of pro-clinical providers; provide practical support for clinical trials and simplify the procedures for importing and exporting biologics.

As for the regulatory framework, the report states that it is imperative to simplify the procedure for approving biologics; create an independent inspection facility and modify the regulations on process validation.

The report states that if India was to become the world leading provider of affordable biopharmaceutical products by 2020, it cannot simply count on biosimilars and vaccines; it must also become a source of innovation.

More specifically, it should aim to have at least 10 original biologics on the local market and at least two on the global market by 2020.

Source: http://www.thehindubusinessline.in

Self Assessment

Fill in the blanks:

8. TDICI was incorporated in January 1988 with the support of the ..... and the ..... .
9. Venture capital firms finance both early and later stage investments to maintain a balance between ..... and ..... .
10. For the VC industry, the new end-use restrictions are particularly harmful as funds raised via ..... shares cannot be used for general corporate purposes.
11. One aspect of financing is to provide funds for the purchase of ..... shares of owners.
12. Venture Capital Institutions (VCIs) provide larger funds during ..... financing.
13. ..... refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public.

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Case Study

Technology Development & Information Company of India Ltd.

TDICI was incorporated in January 1988 with the support of the ICICI and the UTI. The country's first venture fund managed by the TDICI called VECAUS (Venture Capital Units Scheme) was started with an initial corpus of ₹ 20 crore and was completely committed to 37 small and medium enterprises. The first project of the TDICI was loan and equity to a computer software company called Kale Consultants.

Present Status: At present the TDICI is administering two UTI -mobilised funds under VECAUS-I and II, totaling ₹ 120 crore. the ₹ 20 crore invested under the first fund, VECAUS-I, has already yielded returns totaling ₹ 16 crore to its investors.

Some of the projects financed by the TDICI are discussed below:

MASTEK , a Mumbai based software firm, in which the TDICI invested ₹ 42 lakh in equity in 1989, went public just three years later, in November 1992. It showed an annual growth of 70-80 percent in the turnover.

TEMPTATION FOODS, located in PUNE, which exports frozen vegetables and fruits, went public in November 1992. The TDICI invested ₹ 50 lakh in its equity.

RISHABH INSTRUMENTS of Nasik got ₹ 40 lakh from the TDICI. It manufactures a range of meters used in power stations in collaboration with the ABB Metra Watt of Germany. After making cash losses totaling ₹ 25 lakh in two bad years, it turned around in 1989 and showed an increase of over 70 percent in the turnover.

SYNERGY ART FOUNDATION, which runs art galleries in Mumbai and Chennai and plans to set up in Pune and Delhi too, had received ₹ 25 lakh from the TDICI as convertible loans which were converted into equity on march 31, 1994. Most of this money has been used for the company's innovative art library scheme at least paintings to corporate clients.

Questions

1. How has TDICI gained through its venture funds?
2. How do you think can TDICI gain further?

Source: www.indiape.com

12.9 Summary

- Merchant Banking is an important service provided by a number of financial institutions that helps in the growth of the corporate sector which ultimately reflects into the overall economic development of the country.
- The activities of the merchant banking in India is very vast in nature of which includes the management of the customers securities, management of the portfolio, the management of projects and counseling as well as appraisal, the management of underwriting of shares and debentures, the circumvention of the syndication of loans and management of the interest and dividend, etc.
- Merchant banks were expected to perform several functions like issue management, underwriting, portfolio management, loan syndication, consultant, advisor and host of other activities.
- SEBI was also made all powerful to regulate the activities of merchant banks in the best interest of investors and economy.

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- Apart, merchant banking was the necessity of banks themselves which were in need of non-fund based income so as to improve their profitability margins by all means in the changed economic scenario.
- Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects.
- A venture capitalist (VC) may provide the seed capital unproven ideas, products, technology oriented or start up firms.
- The venture capital involves high degrees of risk. Venture capital financing is an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable.
- Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.
- Venture capital funds take an active interest in the management of the assisted firms. Venture capital projects generate employment, and balanced regional growth indirectly due to setting up of successful new business.
- Venture capital firms usually recognise the following two main stages when the investment could be made in a venture namely Early Stage Financing and Later Stage Financing.
- In India the Venture Capital plays a vital role in the development and growth of innovative entrepreneurships.

12.10 Keywords

Management Buyins (MBIs): Management Buy-ins are funds provided to enable an outside group of manager(s) to buy an existing company.

Management Buyouts (MBOs): In Management Buyouts (MBOs) venture capital institutions provide funds to enable the current operating management/ investors to acquire an existing product line/business.

Merchant Banker: A bank that deals mostly in (but is not limited to) international finance, long-term loans for companies and underwriting.

Turnarounds: Such form of venture capital financing involves medium to high risk and a time scale of three to five years.

Underwriting: Underwriting is an agreement, entered into by a company with a financial agency, in order to ensure that the public will subscribe for the entire issue of shares or debentures made by the company.

Answers to Self Assessment

1. Capital issues
2. Counseling
3. Three
4. long-term viability
5. merger
6. expiry
7. SEBI
8. ICICI, UTI

Notes

9. risk, profitability
10. preference
11. existing
12. second round
13. Development Capital

12.11 Review Questions

1. What is the significance of merchant banking in Indian context?
2. What are the SEBI guidelines regarding merchant banking?
3. Write a critical evaluation of the underwriting services in India.
4. Do you think merchant banks in India have been playing the role as needed for them?
5. What is the basis of lending venture capital? Are internet/technology companies given first priority for funding these days?
6. Is it true that most investors are ready and willing to invest and fund quickly? If not, explain with reasons.
7. In the past year, what has been the most interesting IPO or acquisition in the industry you want to enter?
8. Where do venture capitalists get their money from? Do you think venture capitalists in India have been investing it in the right places?
9. After making a detailed analysis of this unit, what do you think are the main types of companies and industries that venture capitalists invest in?
10. How do venture capitalists realize a return on their investment?
11. What's the difference between venture capital and private equity? What impact does corporate venture investing have on the venture industry?

12.12 Further Readings

Books

Machiraju, H.R., Merchant Banking: Principles and Practice, New Age International Pvt. Ltd.

Gurusamy, Merchant Banking And Financial Services, Thomson Learning

Online links

www.onemine.org

www.pnbindia.in

www.indbankonline.com

www.canarabank.com

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Unit 13: Mutual Funds and Insurance Services

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Objectives

After studying this unit, you should be able to:

- Know introduction to unit trust of India;
- Know types and significance of mutual funds;
- Knowperformance evaluation;
- Know concept of insurance;
- Know types of insurance.

Introduction

Mutual fund concept, which has been in vogue in the Western world since long, is gaining popularity in developing countries including India as an institutional device to bridge the gap between supply and demand of capital in the market.

Mutual fund is an American concept and the terms 'Investment Trust', 'Investment Company', 'Mutual fund' etc., are used interchangeably in American literature. Mutual funds are corporations which accept dollars to buy stock, long-term bonds, short-term debt instruments issued by business or government units. These corporations pool funds and thus, reduce risk by diversification. The term 'mutual' signifies that all gains or losses resulting from the investment accrue to all the investors in proportion to their subscription. Mutual fund is, thus, a concept of

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mutual help of the subscribers for portfolio investment and management of these investments by experts in the field.

According to Hirch, a mutual fund is a professionally managed investment company that combines the money of many people whose goals are similar and invest this money in a wide variety of securities. As per the UK Investment Trust and Companies, a mutual fund is a vehicle that enables a number of investors to pool their money and have it jointly managed by professional money managers. Investment Company Institute, USA defines the term mutual fund as a type of Investment Company that gathers assets from investors and collectively invests those assets in stock, bonds or money market instruments.

Securities and Exchange Board of India (Mutual Fund) Regulations, 1996 defines mutual fund as a fund established in the form of a trust to raise monies 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.

Mutual fund generally refers to open-end investment trusts whose distinctive feature is regular sale and purchase of securities. Further, mutual funds must redeem their shares at the funds current net asset value at the time the shareholders request redemption.

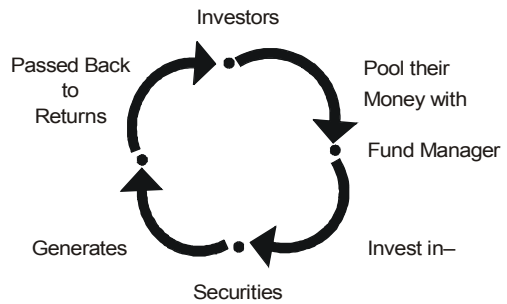
Caution A closed-end fund is often incorrectly referred to as a mutual fund, but is actually an investment trust.

There are many types of mutual funds, including aggressive growth fund, asset allocation fund, balanced fund, blend fund, bond fund, capital appreciation fund, clone fund, closed fund, crossover fund, equity fund, fund of funds, global fund, growth fund, growth and income fund, hedge fund, income fund, index fund, international fund, money

13.1 Mutual Fund

In sum, mutual fund is a form of collective investment bought in by a large group of investors for the mutual benefit of savers as well as investors. Each fund is divided into equal portions or units. Anyone investing in the fund is allocated units in proportion to the size of one's investment. The price of these units is governed principally by value of the underlying investment held by the fund. The flow chart, as brought out in Figure 13.1 presents the working of mutual funds.

Figure 13.1: Structure of Mutual Fund



The chart above throws lucid light on rationale of mutual funds. They receive money savings from many investors, pool them and then purchase securities. The individual investors receive the benefits of professional management and diversified portfolio at relatively low cost with much convenience and flexibility.

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13.2 Types of Mutual Funds

In order to cater to the varying needs and preferences of large number of savers across the country and abroad, many types of mutual funds have come into existence. Choice of a fund by a saver would depend on what he desires his money to earn for him and how much risk he is willing to assume. Thus, mutual funds can be classified into the following three major groups:

Functional Classification

Functional classification, based on basic characteristic of the mutual fund schemes opened for public subscription, can be grouped into:

1. Open-ended funds continuously offer new shares for sale and always stand ready to buy securities at any time. The capitalization of the funds is constantly changing as investors buy and sell their shares directly with the fund. US-64 and Franklin Blue Chip are examples of such funds.
2. Closed-ended mutual funds are open for subscription only once and can be redeemed only after a fixed investment period. These funds have a fixed number of shares that can be owned by the investing public. Morgan Stanley Growth fund, Canpep 95, UTI Master Equity 98, Pru ICICI premier, UTI/UGS 2,000 and UTI/UGS 5,000 are some examples of such funds.
3. Interval funds are the variations of the above stated two concepts. Thus, some funds are close-ended for the first couple of years and become open-ended after sometime. Some funds allow fresh subscriptions and redemptions at fixed intervals every year in order to reduce the hassles of daily entry and exit, yet providing reasonable liquidity.

Portfolio Classification

Mutual funds can be categorized according to the type of instruments in which the funds have been invested. As such, different funds are designed to meet the diverse notions of savers and generally designated as stock funds, bond funds, balanced funds, money market/liquid funds and other funds.

1. ***Stock Funds:*** These funds invest primarily in common stocks. There is a broad range of common stock funds - from those that invest solely in the new, unestablished companies. There may be several subdivisions of stock funds. Thus, Growth and Income Funds place relatively equal weight on capital growth and dividend income and accordingly invest in equity stock and preference shares. Growth funds invest their funds in common stock primarily for capital growth purpose. They meet the investors' need for appreciation, high risk-bearing capacity and ability to defer liquidity. As such, the investments by growth-oriented funds are predominantly made in equities. Income funds aim at ensuring to their investors high current income; growth in the value of the portfolio is of small importance. Such funds employ their funds in high yielding common stock. There are two basic groups within the income funds; those that focus on constant income possible even with the use of leverage. Naturally, the greater the anticipated return of any investment, the higher the potential risk of the investment.
2. ***Bond Funds:*** Bond funds obviously employ their funds in bonds so as to ensure regular and fixed income to their investors. In the US, it is common to have two types of bond funds, one emphasizing high-yielding but risky bonds and the other low-yielding but high grade bonds.

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3. ***Balanced Funds:*** Balanced funds combine bonds and/or preferred stocks with the ownership of common stock, usually at some predetermined percentage relationship. Several balanced funds keep one-half of the portfolio in common stocks and one-half in bonds and preferred stocks. Balanced portfolios are more conservative than common stock funds and they generally do not have significant price movement either up or down. The main purpose of balanced funds is to earn an adequate return in the form of interest and dividends from the fixed portion of the portfolio, while at the same time gaining a modest growth in the common stock portion. Balanced funds are most suited for the investors who have an appetite for some risk, but are wary of taking to 100 percent equity route through an equity fund.

4. ***Money Market/Liquid Funds:*** These funds invest in highly liquid money market instruments such as Treasury Bills (issued by the government), certificate of deposits (issued by banks) and commercial papers (issued by companies). Hallmarks of such funds are safety and high liquidity. Pru ICICI liquid funds, Birla Cash plus and Templeton India Liquid fund are some examples of liquid funds.

5. ***Other Schemes:*** Within each of the above categories, there can be further variants of the funds. For instance, debt funds may be diversified debt funds, focused debt funds and high yield debt funds. Likewise, equity funds may be diversified funds, sector funds, index funds and equity linked savings schemes.

   (a) Diversified funds have investment portfolios spread across industries and companies. Choice of stock is the discretion of the fund managers. Can equity diversified funds of Canara Bank is an example of such funds. HDFC Top 200 fund is another diversified equity funds.

   (b) Sector funds deploy funds in stocks of a particular business sector or industry, like Information Technology (IT), Fast Moving Consumer Goods (FMCG) or pharma. The degree of diversification of risk is very limited in this type of fund, making it extremely risky. Of course, the potential earnings can be high if the sector does very well. Franklin Pharma, Franklin FMCG, Franklin Infotech, Kotak Tech, Tata Life Science and Tech, UTI Petro and UTI Pharma and Health Care are some examples of this type of fund.

   (c) Index funds track key market indices like BSE SENSEX or NSE Nifty. Thus, an index fund is directly related to the performance of the index, except the tracking error, which is due to the management fees and transaction costs, charged to its unitholders. Nifty EeEs and Bank BeEs of Bench mark mutual fund, Magnum Index of SBI mutual fund and Index Adv BSE-Sensex of UTI mutual fund are important examples of Index funds.

   (d) Taxation funds are designed to provide tax exemption benefits to the investors, whether in the domestic or foreign capital markets. Birla Tax Plan 98, FT Tax Shield 99, SBI Magnum ELSS 96 and Sundaram Tax Saver 98 are some examples of these funds.

Geographical Classification

Mutual funds can also be grouped according to geographical boundaries of their operations, as domestic mutual funds, offshore funds and overseas funds.

1. Domestic funds are open for mobilizing savings of the nationals within the country. These funds may be of various kinds, as outlined above under the portfolio and functional groups.

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2. Offshore funds represent mutual funds with investments source abroad. Thus, subscription to these funds is mobilized from international financial markets for its investment in the economies and capital market instruments of specific country (ies). These funds are cross border instruments facilitating capital movement of investible surpluses from cash rich countries to high growth or potentially high growth economies of the world. Kotak Global India Fund, SBI's Magnum Global and Global opportunity fund are few examples of overseas funds.

   Indian mutual funds have been permitted to invest in foreign debt securities in countries with fully convertible currencies. In the recent past, mutual funds have also been permitted to invest in equity shares of listed overseas companies having shareholding of at least 10 percent in an Indian company listed on a recognized stock exchange in India.

   Thus, a host of mutual funds have come into existence to garner savings from the savers for investment outside the country. Such kind of mutual funds are called 'Overseas' funds. There are three types of overseas funds, viz., global funds, international funds and country funds. While global funds invest in the domestic funds as well as foreign stocks and bonds, international funds invest strictly in foreign countries. Country funds invest in the stocks and bonds of a particular country or region.

   The basic idea underlying formation of overseas mutual funds is to exploit the bright investment opportunities abroad and thereby augment the fund's overall rate of return.

Did u know? Role of the mutual funds is not limited to domestic sphere only. In addition to attracting domestic savings, these funds can offer their units abroad and attract foreign capital just as UTI has recently done by offering India Fund, India Growth Fund schemes. Similarly, they may serve as useful institutions for securing profitable investment avenues abroad for domestic savings. Investment in foreign industrial securities requires fairly detailed knowledge of the state of the foreign economy in general and of industries in particular as also of fiscal position of industrial enterprises and their future prospects. As a result, despite attractive investment of prospects abroad for surplus domestic savings, individual investors would find it an extremely difficult task to make foreign investment on their own. Mutual funds have, as in the case of domestic investment, stepped in to solve these problems for the savers.

13.3 Significance of Mutual Funds

Mutual funds are financial intermediaries concerned with mobilizing savings of those who have surplus income and channelisation of these savings in those avenues where there is demand of funds. These institutions employ their resources in such a manner as to afford for their investors the combined benefits of low risk, steady return, high liquidity and capital appreciation through diversification and expert management.

Savers of moderate means in underdeveloped regions are generally reluctant to invest in corporate securities because of their lack of adequate knowledge about complicated investment affairs. Moreover, their resources being small, they can at best hold securities of one or two or just a few industrial concerns only and as such, the fate of their savings and prospects of earnings therefrom are tied to the fate of such unit or units. Investment in securities of mutual funds takes care of both these problems, for such investment, in effect, represents a part of the funds' entire portfolio diversified in terms of securities, units, industries and geographical regions. These institutions employ expert investment analysts and thus professional knowledge and expertise go into the selection and supervision of their investment portfolio. Diversification and expert investment knowledge ensure steady and regular earnings to the fund and a share in the general prosperity.

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Accordingly, investors in the shares of mutual funds are assured of low risk, steady return, liquidity and capital appreciation. By taking upon themselves the problems which confront the small savers in investing their savings and dealing with them effectively, mutual funds help mobilize savings of the people and promote thrift.

Mutual funds also provide benefits of flexibility in as much as investors can systematically invest or withdraw funds, or switch to other schemes according to their needs, through features provided under their different schemes, such as regular investment, withdrawal plans and dividend reinvestment options.

Tax benefits to investors in certain schemes constitute any added attraction for mutual funds. Dividends paid by mutual funds to unitholders are taxed only at the time of distribution of dividends. These dividends after this deduction are tax-free in the hands of investors. On the contrary, investment in bonds or other deposits that earns interest (over and above ₹ 12,000 that is eligible for exemption under Section 80L) is taxed at 30 percent.

Savings pooled by mutual funds are invested largely in industrial securities. They usually finance long-term business requirements largely by way of direct subscription to share capital of industrial enterprise. Mutual funds, while themselves raising resources from a large number of small savers, make funds available to industrial concerns in relatively bigger lots and thus reduce their burden and botheration involved in raising finance directly from individual savers.

Thus, by playing the role of financial intermediation, mutual funds provide a convenient and effective link between savings and investment. Well-managed mutual funds would be mutually beneficial arrangement. While, on the one hand, they help the investing community by offering share of corporate growth, on the other, they have a salutary impact on the stock markets. By blending caution with aggression and analysis with intuition, the funds can successfully convert market opportunities into lucrative of the investors.

Task Discuss the main limitations as you analyse in the functioning of the companies involving mutual funds.

13.4 Performance Evaluation

Let us start the discussion of the performance of mutual funds in India from the day the concept of mutual fund took birth in India. The year was 1963. Unit Trust of India invited investors or rather to those who believed in savings, to park their money in UTI Mutual Fund. For 30 years it goaled without a single second player. Though the 1988 year saw some new mutual fund companies, but UTI remained in a monopoly position. The performance of mutual funds in India in the initial phase was not even closer to satisfactory level. People rarely understood, and of course investing was out of question. But yes, some 24 million shareholders were accustomed with guaranteed high returns by the beginning of liberalization of the industry in 1992. This good record of UTI became marketing tool for new entrants. The expectations of investors touched the sky in profitability factor. However, people were miles away from the preparedness of risks factor after the liberalization.

The Assets Under Management of UTI was ₹ 67bn. by the end of 1987. Let me concentrate about the performance of mutual funds in India through figures. From ₹ 67bn. the Assets Under Management rose to ₹ 470 bn. in March 1993 and the figure had a three times higher performance by April 2004. It rose as high as ₹ 1,540bn.

The net asset value (NAV) of mutual funds in India declined when stock prices started falling in the year 1992. Those days, the market regulations did not allow portfolio shifts into alternative

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investments. There were rather no choices apart from holding the cash or to further continue investing in shares. One more thing to be noted, since only closed-end funds were floated in the market, the investors disinvested by selling at a loss in the secondary market.

The performance of mutual funds in India suffered qualitatively. The 1992 stock market scandals, the losses by disinvestments and of course the lack of transparent rules in the where about rocked confidence among the investors. Partly owing to a relatively weak stock market performance, mutual funds have not yet recovered, with funds trading at an average discount of 1020 percent of their net asset value.

The supervisory authority adopted a set of measures to create a transparent and competitive environment in mutual funds. Some of them were like relaxing investment restrictions into the market, introduction of open-ended funds, and paving the gateway for mutual funds to launch pension schemes.

The measure was taken to make mutual funds the key instrument for long-term saving. The more the variety offered, the quantitative will be investors. At last to mention, as long as mutual fund companies are performing with lower risks and higher profitability within a short span of time, more and more people will be inclined to invest until and unless they are fully educated with the dos and don'ts of mutual funds.

Mutual Fund performance can be analysed through performance measurement ratios that are used in portfolio analysis. In case of a well-diversified portfolio the standard deviation could be used as a measure of risk, but in case of individual assets and not-so-well diversified portfolios the relevant measure of risk could be the systematic risk.

There are three popular measures to estimate the return per unit of risk from a portfolio. They are

(a) Sharpe's Ratio

(b) Treynor's Measure

(c) Jensen's Differential Returns

Sharpe's Ratio

A ratio developed by Nobel laureate William F. Sharpe to measure risk-adjusted performance. It is calculated by subtracting the risk-free rate - such as that of the 10-year US Treasury bond - from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns.

Sharpe's measure is called the "Reward-to-Variability" Ratio. The returns from a portfolio are initially adjusted for risk-free returns. These excess returns attributable as reward for investing in risky assets are validated in terms of return per unit of risk. Sharpe's ratio is as follows:

Or $$S = \frac{E[R] - R_f}{\sigma}$$

$$= \frac{\bar{r}_p - r_f}{\sigma_p}$$

Where:

$\bar{r}_p$ = Expected portfolio return

r_f = Risk free rate

sp = Portfolio standard deviation

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The Sharpe ratio tells us whether the returns of a portfolio are due to smart investment decisions or a result of excess risk. This measurement is very useful because although one portfolio or fund can reap higher returns than its peers, it is only a good investment if those higher returns do not come with too much additional risk. The greater a portfolio's Sharpe ratio, the better its risk-adjusted performance will be.

A variation of the Sharpe ratio is the Sortino ratio, which removes the effects of upward price movements on standard deviation to instead measure only the return against downward price volatility.

Example: Consider two portfolios A and B. On the basis of information given below, compare the performance of portfolios A and B.

Portfolio	Return	Risk-free	Excess	Portfolio risk
	I (R_M)	rate (R_F)	return ($R_F - R_M$)	(SD)
A	21	8	13	10
B	17	8	9	8

Solution:

A = 13/10 = 1.3 B = 9/8 = 1.125

Reward per unit of risk in case of Portfolio A is relatively higher. Hence its performance is said to be good.

Treynor Portfolio Performance Measure (aka: reward to volatility ratio)

This measure was developed by Jack Treynor in 1965. Treynor (helped developed CAPM) argues that, using the characteristic line, one can determine the relationship between a security and the market. Deviations from the characteristic line (unique returns) should cancel out if you have a fully diversified portfolio.

Treynor's Composite Performance Measure: He was interested in a performance measure that would apply to all investors regardless of their risk preferences. He argued that investors would prefer a CML with a higher slope (as it would place them on a higher utility curve). The slope of this portfolio possibility line is:

$$Ti = \frac{R_M - R_F}{\beta_1}$$

Where: R = Market Return, RFR = Risk Free return, and β_m = SD

A larger Ti value indicates a larger slope and a better portfolio for all investors regardless of their risk preferences. The numerator represents the risk premium and the denominator represents the risk of the portfolio; thus the value, T, represents the portfolio's return per unit of systematic risk. All risk-averse investors would want to maximize this value.

The Treynor measure only measures systematic risk – it automatically assumes an adequately diversified portfolio.

You can compare the T measures for different portfolios. The higher the T value, the better the portfolio performance. For instance, the T value for the market is:

$$Tm = \frac{R_m \cdot RFR}{\beta_m}$$

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In this expression, β_m = 1.

Example: Assume that you are an administrator of a large pension fund (i.e. Terry Teague of Boeing) and you are decide whether to renew your contracts with your three money managers. You must measure how they have performed. Assume you have the following results for each individual's performance: Market return 14%, Risk-free 8% and Beta 1.

Solution:

We can calculate the T values for each investment manager:

Tm (0.14-0.08)/1.00 = 0.06

TZ (0.12-0.08)/0.90 = 0.044

TB (0.16-0.08)/1.05 = 0.076

TY (0.18-0.08)/1.20 = 0.083

These results show that Z did not even "beat-the-market." Y had the best performance, and both B and Y beat the market. [To find required return, the line is: 0.08 + 0.06(Beta)].

You can achieve a negative T value if you achieve very poor performance or very good performance with low risk. For instance, if you had a positive beta portfolio but your return was less than that of the risk-free rate (which implies you weren't adequately diversified or that the market performed poorly) then you would have a (–) T value. If you have a negative beta portfolio and you earn a return higher than the risk-free rate, then you would have a high T-value. Negative T values can be confusing, thus you may be better off plotting the values on the SML or using the CAPM [in this case, 0.08 + 0.06(Beta)] to calculate the required return and compare it with the actual return. i.e. realised portfolio return (R_p) in excess of risk-free rate (R_f) divided by the beta of the portfolio. Both these measures provide a way of ranking the relative performance of various portfolios on a risk-adjusted basis. For investors whose portfolio is a predominant representation in a particular asset class, the total variability of return as measured by standard deviation is the relevant risk measure.

Example:

Fund	Return	Risk-free Rate	Excess Return	SD	Beta
1	20	10	10	8	0.80
2	30	10	20	15	1.10

Calculate of Sharpe and Treynor ratios for two hypothetical funds.

Solution:

Sharpe Ratio Fund 1 = (20 – 10)/8 = 1.23

Sharpe Ratio Fund 2 = (30 – 10)/1.5 = 1.33

Treynor Ratio Fund1 = (20 – 10)/0.80 = 12.50

Treynor Ratio Fund 2 = (30 – 10)/1.10 = 18.18

The ranking on both these measures will be identical when both the funds are well diversified. A poorly diversified fund will rank lower according to the Sharpe measure than the Treynor ratio. The less diversified fund will show greater risk when using standard deviation.

Treynor Measure vs. Sharpe Measure: The Sharpe measure evaluates the portfolio manager on the basis of both rate of return and diversification (as it considers total portfolio risk in the

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denominator). If we had a fully diversified portfolio, then both the Sharpe and Treynor measures will give us the same ranking. A poorly diversified portfolio could have a higher ranking under the Treynor measure than for the Sharpe measure.

Differential Return (Jensen Measure)

Jensen's measure is an absolute measure of performance, adjusted for risk. This measure assesses the portfolio manager's predictive ability. The objective is to calculate the return that should be expected for the fund given the risk level and comparing it with the actual return realized over the period.

Jensen Measure of differential return with risk measured by Beta.

The model used is; $R_{jt} + R_{ft} + \alpha_1 + \beta_j + (R_{mt} - R_{ft}) + e \rightarrow 1$

The Jensen measure of differential return for portfolio p_1 and p_2 is

$$\overline{R}_{p_1} - \overline{R}_{p_2} = \left[R_F + \left(\overline{R}_M - R_F\right)\beta_{p_1}\right] - \left[R_F + \left(\overline{R}_M - R_F\right)\beta_{p_{21}}\right],$$

which simplifies to

$$\overline{R}_{p_1} - \overline{R}_{p_2} = \left(\overline{R}_M - R_F\right)\left(\beta_{p_1} - \beta_{p_2}\right).$$

Or, (RARB) = [RA - R (βA) I + [R (βA) - RF]

The variables are expressed in terms of realized return and risk.

R_{jt} – Average return on portfolio for period t

R_{ft} – Risk-free rate of interest for period t

α_1 – Intercept that measures the forecasting ability of the portfolio manager

β_j – A measure of systematic risk

R_{mt} – Average return on the market portfolio

e – Error term.

In both Sharpe and Treynor models, it is assumed that the intercept is at the origin. In the Jensen model, the intercept can be at any point, including the origin.

If the intercept has a positive value, it indicates that the superior return has been earned due to superior management skills.

$a_j = 0$ indicates neutral performance.

The manager has done as well as an unmanaged randomly selected portfolio with a buy-and-hold strategy. If intercept has negative value it indicates that the managed portfolio did not do as well as an unmanaged portfolio of equal systematic risk.

Applying the Jenson Measure

This requires that you use a different risk-free rate for each time interval during the sample period. You must subtract the risk-free rate from the returns during each observation period rather than calculating the average return and average risk-free rate as in the Sharpe and Treynor measures. Also, the Jensen measure does not evaluate the ability of the portfolio manager to diversify, as it calculates risk premiums in terms of systematic risk (beta). For evaluating diversified portfolios (such as most mutual funds) this is probably adequate. Jensen finds that mutual fund returns are typically correlated with the market at rates above 0.90.

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Example: Actual Return and Risk

Funds	R_{ft}	R_{jt}	R_{mt}	Beta
Fund A	5	12	15	0.5
Fund B	5	20	15	1.0
Fund C	5	14	15	1.10

Solution:

From equation 1 return on the portfolio is:

$$R_{jt} + R_{ft} + \alpha_1 + \beta_j + (R_{mt} - R_{ft})$$

$$\alpha = r_p - r_{jt}$$

Fund A

$$R_{jt} = 5 + 0.5\ (15 - 5) = 10$$

$$\alpha = 12 - 10 = 2\% \text{ (Excess Positive Return)}$$

Fund B

$$R_{jt} = 5 + 1.0(15 - 5) = 15$$

$$\alpha = 20 - 15 = 5\% \text{ (Excess Positive Return)}$$

Fund C

$$R_{jt} = 5 + 1.10(15 - 5) = 16$$

$$\alpha = 14 - 16 = -20\% \text{ (Negative Return)}$$

The Jensen measure not only calculates the differential between actual and expected earnings, but also enables an analyst to determine whether the differential return could have occurred by chance or whether it is significantly different from zero in a statistical sense. The (alpha value) value in Equation 1 can be tested to see if it is significantly different from zero by using a 't statistic'.

13.4.1 Mutual Fund Companies in India

The concept of mutual funds in India dates back to the year 1963. The era between 1963 and 1987 marked the existence of only one mutual fund company in India with ₹ 67bn assets under management (AUM), by the end of its monopoly era, the Unit Trust of India (UTI). By the end of the 80s decade, few other mutual fund companies in India took their position in mutual fund market. The new entries of mutual fund companies in India were SBI Mutual Fund, Canbank Mutual Fund, Punjab National Bank Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund.

The succeeding decade showed a new horizon in Indian mutual fund industry. By the end of 1993, the total AUM of the industry was ₹ 470.04 bn. The private sector funds started penetrating the fund families. In the same year the first Mutual Fund Regulations came into existence with re-registering all mutual funds except UTI. The regulations were further given a revised shape in 1996.

Kothari Pioneer was the first private sector mutual fund company in India which has now merged with Franklin Templeton. Just after ten years with private sector player's penetration, the total assets rose up to ₹ 1218.05 bn. Today there are 33 mutual fund companies in India.

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13.4.2 Major Mutual Fund Companies in India

ABN AMRO Mutual Fund

ABN AMRO Mutual Fund was setup on April 15, 2004 with ABN AMRO Trustee (India) Pvt. Ltd. as the Trustee Company. The AMC, ABN AMRO Asset Management (India) Ltd. was incorporated on November 4, 2003. Deutsche Bank A G is the custodian of ABN AMRO Mutual Fund.

Birla Sun Life Mutual Fund

Birla Sun Life Mutual Fund is the joint venture of Aditya Birla Group and Sun Life Financial. Sun Life Financial is a global organization evolved in 1871 and is being represented in Canada, the US, the Philippines, Japan, Indonesia and Bermuda apart from India. Birla Sun Life Mutual Fund follows a conservative long-term approach to investment. Recently it crossed AUM of ₹10,000 crores.

Bank of Baroda Mutual Fund (BOB Mutual Fund)

Bank of Baroda Mutual Fund or BOB Mutual Fund was setup on October 30, 1992 under the sponsorship of Bank of Baroda. BOB Asset Management Company Limited is the AMC of BOB Mutual Fund and was incorporated on November 5, 1992. Deutsche Bank AG is the custodian.

HDFC Mutual Fund

HDFC Mutual Fund was setup on June 30, 2000 with two sponsors namely Housing Development Finance Corporation Limited and Standard Life Investments Limited.

HSBC Mutual Fund

HSBC Mutual Fund was setup on May 27, 2002 with HSBC Securities and Capital Markets (India) Private Limited as the sponsor. Board of Trustees, HSBC Mutual Fund acts as the Trustee Company of HSBC Mutual Fund.

ING Vysya Mutual Fund

ING Vysya Mutual Fund was setup on February 11, 1999 with the same named Trustee Company. It is a joint venture of Vysya and ING. The AMC, ING Investment Management (India) Pvt. Ltd. was incorporated on April 6, 1998.

Prudential ICICI Mutual Fund

The mutual fund of ICICI is a joint venture with Prudential Plc. of America, one of the largest life insurance companies in the US of A. Prudential ICICI Mutual Fund was setup on 13th of October, 1993 with two sponsorers, Prudential Plc. and ICICI Ltd. The Trustee Company formed is Prudential ICICI Trust Ltd. and the AMC is Prudential ICICI Asset Management Company Limited incorporated on 22nd of June, 1993.

Sahara Mutual Fund

Sahara Mutual Fund was set up on July 18, 1996 with Sahara India Financial Corporation Ltd. as the sponsor. Sahara Asset Management Company Private Limited incorporated on August 31, 1995 works as the AMC of Sahara Mutual Fund. The paid-up capital of the AMC stands at ₹ 25.8 crore.

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State Bank of India Mutual Fund

State Bank of India Mutual Fund is the first Bank sponsored Mutual Fund to launch offshore fund, the India Magnum Fund with a corpus of ₹ 225 cr. approximately. Today it is the largest Bank sponsored Mutual Fund in India. They have already launched 35 Schemes out of which 15 have already yielded handsome returns to investors. State Bank of India Mutual Fund has more than ₹ 5,500 crores as AUM. Now it has an investor base of over 8 lakhs spread over 18 schemes.

Tata Mutual Fund

Tata Mutual Fund (TMF) is a Trust under the Indian Trust Act, 1882. The sponsorers for Tata Mutual Fund are Tata Sons Ltd., and Tata Investment Corporation Ltd. The investment manager is Tata Asset Management Limited and its Tata Trustee Company Pvt. Limited. Tata Asset Management Limited is one of the fastest in the country with more than ₹ 7,703 crores (as on April 30, 2005) of AUM.

Kotak Mahindra Mutual Fund

Kotak Mahindra Asset Management Company (KMAMC) is a subsidiary of KMBL. It is presently having more than 1,99,818 investors in its various schemes. KMAMC started its operations in December 1998. Kotak Mahindra Mutual Fund offers schemes catering to investors with varying risk-return profiles. It was the first company to launch dedicated gilt scheme investing only in government securities.

Unit Trust of India Mutual Fund

UTI Asset Management Company Private Limited, established in Jan 14, 2003, manages the UTI Mutual Fund with the support of UTI Trustee Company Private Limited. UTI Asset Management Company presently manages a corpus of over ₹ 20000 crore. The sponsorers of UTI Mutual Fund are Bank of Baroda (BOB), Punjab National Bank (PNB), State Bank of India (SBI), and Life Insurance Corporation of India (LIC). The schemes of UTI Mutual Fund are Liquid Funds, Income Funds, Asset Management Funds, Index Funds, Equity Funds and Balance Funds.

Reliance Mutual Fund

Reliance Mutual Fund (RMF) was established as trust under Indian Trusts Act, 1882. The sponsor of RMF is Reliance Capital Limited and Reliance Capital Trustee Co. Limited is the Trustee. It was registered on June 30, 1995 as Reliance Capital Mutual Fund which was changed on March 11, 2004. Reliance Mutual Fund was formed for launching of various schemes under which units are issued to the Public with a view to contribute to the capital market and to provide investors the opportunities to make investments in diversified securities.

Standard Chartered Mutual Fund

Standard Chartered Mutual Fund was set up on March 13, 2000 sponsored by Standard Chartered Bank. The Trustee is Standard Chartered Trustee Company Pvt. Ltd. Standard Chartered Asset Management Company Pvt. Ltd. is the AMC which was incorporated with SEBI on December 20,1999.

Franklin Templeton India Mutual Fund

The group, Franklin Templeton Investments is a California (USA) based company with a global AUM of US$ 409.2 bn. (as of April 30, 2005). It is one of the largest financial services groups in the

world. Investors can buy or sell the Mutual Fund through their financial advisor or through mail or through their website. They have Open end Diversified Equity schemes, Open end Sector Equity schemes, Open end Hybrid schemes, Open end Tax Saving schemes, Open end Income and Liquid schemes, Closed end Income schemes and Open end Fund of Funds schemes to offer.

Morgan Stanley Mutual Fund India

Morgan Stanley is a worldwide financial services company and it's leading in the market in securities, investment management and credit services. Morgan Stanley Investment Management (MISM) was established in the year 1975. It provides customized asset management services and products to governments, corporations, pension funds and non-profit organizations. Its services are also extended to high net worth individuals and retail investors. In India it is known as Morgan Stanley Investment Management Private Limited (MSIM India) and its AMC is Morgan Stanley Mutual Fund (MSMF). This is the first close end diversified equity scheme serving the needs of Indian retail investors focusing on a long-term capital appreciation.

Escorts Mutual Fund

Escorts Mutual Fund was setup on April 15, 1996 with Escorts Finance Limited as its sponsor. The Trustee Company is Escorts Investment Trust Limited. Its AMC was incorporated on December 1, 1995 with the name Escorts Asset Management Limited.

Alliance Capital Mutual Fund

Alliance Capital Mutual Fund was setup on December 30, 1994 with Alliance Capital Management Corp. of Delaware (USA) as sponsorer. The Trustee is ACAM Trust Company Pvt. Ltd. and AMC, the Alliance Capital Asset Management India (Pvt) Ltd. with the corporate office in Mumbai.

Benchmark Mutual Fund

Benchmark Mutual Fund was setup on June 12, 2001 with Niche Financial Services Pvt. Ltd. as the sponsorer and Benchmark Trustee Company Pvt. Ltd. as the Trustee Company. Incorporated on October 16, 2000 and headquartered in Mumbai, Benchmark Asset Management Company Pvt. Ltd. is the AMC.

Canbank Mutual Fund

Canbank Mutual Fund was setup on December 19, 1987 with Canara Bank acting as the sponsor. Canbank Investment Management Services Ltd. incorporated on March 2, 1993 is the AMC. The Corporate Office of the AMC is in Mumbai.

Chola Mutual Fund

Chola Mutual Fund under the sponsorship of Cholamandalam Investment & Finance Company Ltd. was setup on January 3, 1997. Cholamandalam Trustee Co. Ltd. is the Trustee Company and AMC is Cholamandalam AMC Limited.

Self Assessment

Fill in the blanks:

1. Most funds have a particular ..... they focus on when investing.

Notes

2. Tax efficient mutual fund aims to ..... tax bills, such as keeping turnover levels low or shying away from companies that provide dividends.
3. UTI Mutual Fund was created as a ..... registered fund.
4. Unit Trust of India was created by the UTI Act passed by the Parliament in ..... .
5. ..... are the stocks from firms with relative low Price to Earning (P/E) Ratio, usually pay good dividends.
6. Morgan Stanley is a worldwide financial services company and it's leading in the market in ....., ... and credit services.

Caselet

SEBI Favours Self-regulation for Mutual Funds

The Securities and Exchange Board of India (SEBI) on Wednesday mooted the idea of self-regulatory organisation (SRO) for the mutual fund industry.

Under the proposed plan, the Association of Mutual Funds in India (AMFI) would act as the SRO with parts of the powers with SEBI being delegated to the apex body of the mutual fund industry.

"Idea of SRO would help and support SEBI better in regulating the mutual funds," the SEBI Chairman, Mr G.N. Bajpai, said at a function organised to release the Hindi edition of the AMFI workbook and also the launch of the certification course on the e-learning portal of NSE.IT.

He said this would help the mutual funds to regulate themselves in a better way.

Currently the proposal was still in the conceptual stage and details would be known after consulting with AMFI and mutual funds, he said adding that the delegation of powers would be in phases.

The SEBI Chairman also said the market regulator was also looking at the replacement of external auditors of asset management companies of mutual funds in the wake of international accounting scandals.

Mr Bajpai suggested that mutual funds should expand the distribution network to small towns and for this they should groom their distributors. He also said that mutual funds should bring professionalism through the AMFI certification programme.

On the suggestion from the industry to allow them to manage pension funds, Mr Bajpai said he would discuss the matter with the Government.

Source: http://www.thehindubusinessline.in

Case Study

Mutual Funds Turning to Capital Protection Funds

Equity market's volatility pushes investors to other schemes.

While the equity market is rather unpredictable at this time, debt and money markets have become a more attractive proposition for investors.

Contd...

Notes

Mutual funds, capitalising on the same, are turning to capital protection funds, which provide both the security of being invested in fixed income instruments along with the higher-returns-potential of the equity side of investment.

UTI, SBI, Sundaram, IDFC, Franklin Templeton are some of the fund houses that have launched capital protection funds.

"These are for investors who are conservative and prefer their investments to be in the form of bank deposits. There is potential upside and virtually no downside to these funds. But there is no guarantee of capital protection here," said Mr Dhirendra Kumar, Chief Executive Officer, Value Research.

A capital protection fund is a close-ended fund which invests 80 per cent of its corpus in fixed income securities such as corporate bond papers, government securities and other money market instruments. The rest of its corpus - 20 per cent - will be in equities.

At the end of the fund's tenure, the capital invested is protected through returns from fixed income securities while the returns on the investment itself would be from the equity investments of the fund.

Capital Guarantee

"The capital guarantee is done via investments in high quality debt papers," said Mr Dwijendra Srivastava, Head-Fixed Income, Sundaram Mutual, whose fund house plans to launch 12 more capital protection funds in the next 16-18 months.

"Also, these funds are structured in such a manner that investors cannot exit before the end of the tenure."

After 2008, fixed income as an asset class has become more popular with investors.

"The capital protection fund is an investor need. These funds are not meant for super HNIs or informed investors. The fund is for those who are averse to losing capital and want to stay invested for the long haul," said Mr Srivastava.

With redemption pressures continuing to affect the industry, it seems that fund houses are turning to products like capital protection funds to lure investors and to ensure that they stay invested for a longer period.

Question

Make a analysis on mutual funds investment vs stock market investment.

Source: http://www.thehindubusinessline.in

13.5 Insurance Services

Insurance may be described as a social device to reduce or eliminate risk of life and property. Under the plan of insurance, a large number of people associate themselves by sharing risk, attached to individual. The risk, which can be insured against include fire, the peril of sea, death, incident, and burglary. Any risk contingent upon these may be insured against at a premium commensurate with the risk involved.

Insurance is actually a contract between 2 parties whereby one party called insurer undertakes in exchange for a fixed sum called premium to pay the other party happening of a certain event. Insurance is a contract whereby, in return for the payment of premium by the insured, the insurers pay the financial losses suffered by the insured as a result of the occurrence of unforeseen events. With the help of Insurance, large number of people exposed to a similar risk make

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contributions to a common fund out of which the losses suffered by the unfortunate few, due to accidental events, are made good.

Indian insurance companies play a key role in India's financial sector. With India's population becoming more affluent and globalized, insurance is growing rapidly. This increasing market is creating considerable competition among Indian insurance companies in an industry that 20 years ago was relatively small.

13.6 Public and Private Sector Insurance

The concept of insurance is intimately related to security. Insurance acts as a protective shield against risk and future uncertainties. Traditionally, a risk-averse behavior has been a characteristic feature of Indians who preferred a "low & certain" disposable income to a "high & uncertain" one.

Hence insurance has become a close associate of Indians since 1818, when Oriental Life Insurance Company was started by Europeans in Kolkata to cater to the needs of their own community. The age was characterized by intense racial discrimination as Indian insurance policy holders were charged higher premiums than their foreign counterparts. The first Indian Insurance Company to cover Indian lives at normal rates was Bombay Mutual Life Assurance Society which was established in the year 1870.

By the dawn of the 20th century, new insurance companies started mushrooming up. In order to regulate the insurance business in India and to certify the premium rate tables and periodic valuations of the insurance companies, the Life Insurance Companies Act and the Provident Fund Act were passed to regulate the Insurance Business in India in 1912. Such statistical estimates made by actuaries revealed the disparity that existed between Indian and foreign companies.

The Indian Insurance Sector went through a full circle of phases from being unregulated to completely regulated and then being partly deregulated which is the present situation. A brief on how the events folded up is discussed as follows:

The Insurance Act of 1938 was the first legislation governing all forms of insurance to provide strict state controls over insurance business.

In 19th January, 1956, the life insurance in India was completely nationalized through the Life Insurance Corporation Act of 1956. At that time, there were 245 insurance companies of both Indian and foreign origin. Government accomplished its policy of nationalization by acquiring the management of the companies. Bearing this objective in mind, the Life Insurance Corporation (LIC) of India was created on 1st September, 1956 which has grown in leaps and bounds henceforth, to become the largest insurance company in India.

The General Insurance Business (Nationalization) Act of 1972 was formulated with the objective of nationalizing nearly 100 general insurance companies and subsequently amalgamating them into four basic companies namely National Insurance, New India Assurance, Oriental Insurance and United India Insurance which have their headquarters in four metropolitan cities.

The Insurance Regulatory and Development Authority (IRDA) Act of 1999 deregulated the insurance sector in India and allowed the entry of private companies into the insurance sector. Moreover, the flow of Foreign Direct Investment (FDI) was also restricted to 26 % of the total capital held by the Indian Insurance Companies.

While LIC is the sole operator in the public sector, the following are a few examples of private companies in India are as under:

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Example:

- ICICI Prudential Life Insurance
- HDFC Standard Life
- SBI Life Insurance
- Birla Sunlife
- Bajaj Allianz
- Aviva
- Kotak Mahindra Insurance
- Tata AIG Life
- Reliance Life Insurance Company Limited
- ING Vysya Insurance
- Metlife India
- Max New York Life Insurance
- Shriram Life Insurance
- Bharti AXA Life Insurance Company Limited

Caselet

IRDA's Guidelines on Outsourcing Get Mixed Response from BPOs

Norms to make insurer responsible for outsourcing arrangement.

'Core' problems

Only 'non-core' functions like house keeping, data entry, etc., can be outsourced.

Most 'core' functions that cannot be outsourced in India are outsourced in the West.

One way out for insurers could be forming joint ventures with back office companies.

The Insurance Regulatory and Development Authority's (IRDA) recent norms on outsourcing may prompt insurers to increase the quantum of back office work they give out to third party vendors in the medium term.

However, it will deter Indian back office companies from moving up the value chain as they remain stuck with low-end processing-related work, say industry watchers.

In its draft guidelines on outsourcing, IRDA had defined the processes that could be outsourced and those that should be done in-house. Core functions such as product design, claims, IT support and policy servicing were functions that could not be outsourced. Non-core functions include house keeping, Web site management, internal audit, payroll management, HR services, data entry, medical check-ups, tele-marketing and call centre for outbound calling among others.

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"Lot of insurance companies are waiting for norms on outsourcing to come through…now it is good for them to know what they can outsource and what they can't. I expect the new guidelines to open up the market in the medium term," said Mr Sanjay Venkataraman - Executive Vice-President and Head-Asia Business Unit, Firstsource Solutions.

End-to-end Responsibility

Firstsource Solutions works with one of the largest private insurance players in India. Mr Aparup Sengupta, Managing Director and CEO of Essar Group-promoted Aegis BPO, believes the new norms are designed to formally place end-to-end responsibility of the outsourcing arrangement on the insurer. "Insurance companies can no longer pass on the contingent risks to the outsourcing agents alone since their skin will also be in the game," said Mr Sengupta.

As mentioned earlier, many of the non-core functions are already getting outsourced to third party players.

On the flip side, core activities such as claims processing, IT support and policy servicing are generally outsourced to back office companies by firms in the US and UK. In India, a small sub-section within claims processing - namely, data entry work related to procurement and lodging of insurance claims - is outsourced. Settlement of insurance claims is still very much done in-house by the insurer. "Majority of the functions prescribed by the IRDA as core are generally outsourced in the Western World. Since these cannot be outsourced by Indian insurers, it is a dampener in terms of the future revenue outlook for back office firms," a senior industry watcher said.

Forming Joint Venture

Some companies, like the Mumbai-based Datamatics, feel that clients who still want to outsource some of the core functions could do so by forming a joint venture with a back office company. "This ensures that the core functions are still dealt with by the insurer...We are having some conversations on similar lines with prospective customers," said Mr Rahul Kanodia, Vice-Chairman and Chief Executive, Datamatics.

Source: http://www.thehindubusinessline.in

13.7 Life Insurance

Basic Terminology of Life Insurance

- ***Life insurance:*** Insurance plan providing for payment of a specified amount on the insured's death, either to his or her estate or to a designated beneficiary or to the policy holder (if survives) at a specified date.
- ***Assured:*** The person or party protected by a policy of the insurance. It is another word for insured.
- ***Attained age:*** An age which a person or insured has attained in relation to a given date. For life insurance purposes, the age is based either on the nearest birthday or the last birthday, depending on the practices of the insurance company involved.
- ***Actuary:*** A social mathematician who uses mathematical skills to define, analyze and solve complex business and social problems involving insurance and employee benefit programmes.
- ***Age limits:*** Every life insurance company stipulates minimum and maximum ages below and above which the company will not accept applications or will not renew policies.

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- ***Agent:*** A person who has the authority to act for another i.e. the principal. In insurance terminology, an agent is the person who sells insurance by contacting the policyholder.
- ***Beneficiary:*** An individual designated in a will to receive an inheritance, or to receive the proceeds of an insurance policy, retirement account, trust, or other asset..
- ***Life of another-policy:*** An insurance policy taken on the life of another.
- ***Mode of payment:*** The manner in which payment is made i.e. monthly, quarterly, half yearly or annually.
- ***Nomination:*** An act by which the policy holder authorises another person to receive the policy money. The person so authorised is called Nominee.
- ***Medical examination:*** The examination conducted by a qualified physician to determine the insurability of an applicant.
- ***Maturity:*** The date upon which the face amount of a life insurance policy, if not previously invoked due to the contingency covered (death), is paid to the policyholder.
- ***Maturity claim:*** The payment to the policyholder at the end of the stipulated term of the policy is called maturity claim.
- ***Premium finance:*** A finance option, which allows the insured to pay part of the premium when insurance coverage takes effect, and pay the rest during the policy period.
- ***Waiver of premium:*** Provision to relieve the insured of premium payments due to total disability or certain other reasons.
- ***Burglar and theft insurance:*** Risk coverage against property losses due to burglary or robbery.
- ***Compulsory insurance:*** Any form of insurance, which is required by law, e.g. Motor, third party insurance.
- ***Fire Insurance:*** A policy that covers the movable and immovable assets against fire and allied perils.
- ***Fidelity:*** Fidelity guarantee, covers the risk of the employers in the event of fraud by an employee. This risk arises due to the dishonesty of employees who hold a position of trust.
- ***Human life value:*** For purpose of life insurance, the present value of family's share of deceased breadwinner's future earnings is considered as human life value.
- ***Marine Insurance:*** A policy that covers cargo, hull and freight, both in ocean and inland transits.
- ***Liability insurance:*** Insurance covering the policy holder's legal liability resulting from injuries to other persons or damage to their property.
- ***Liability limits:*** The stipulated sum beyond which an insurance company is not liable to protect an insured.
- ***Personal insurance:*** The risk of individuals and families are covered under personal insurance. Examples are life insurance, pensions, accidents, sickness, old age coverage etc. Personal insurance protects against two distinct risks-premature deaths and living too long.
- ***Product liability insurance:*** Protection against loss arising out of the legal liability incurred by a manufacturer, merchant, or distributor because of injury or damage caused to a consumer resulting from the use of its product.

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- ***Property insurance:*** Insurance providing financial protection against the loss of, or damage to, real and personal property caused by perils like theft, windstorm, hail, explosion, riot, aircraft, motor vehicles, vandalism, etc.
- ***Senior citizen policies:*** Insurance policies for individuals of age 65 years or more.
- ***Total disability:*** An illness or injury which prevents an insured person from continuing to perform his own duties pertaining to his/her occupation or engaging in any other type of work.
- ***Third party:*** The claimant under a liability policy is called the third party. He is so called because the person making the claim is not one of the two parties to the insurance contract – insured and insurer.
- ***Third party insurance:*** It is the insurance of third party against suffering caused to them due to mistakes of person driving the vehicle. This insurance is compulsorily provided with other kind of insurances related to vehicles to safeguard the interest of people on road.
- ***Travel accident policy:*** A policy covering only accidents while an insured person is travelling, usually on a commercial carrier.
- ***Workers' compensation insurance:*** Insurance against liability imposed on certain employers to pay benefits and furnish care to injured employees, and to pay benefits to dependents of employees killed in the course of working or any circumstances arising out of their employment.

The main player of this sector is Life Insurance Corporation of India (LIC). But the sector is very strong and well built. Let us go through brief composition of all the institutions of this sector.

1. ***Bajaj Allianz Life Insurance:*** Bajaj Allianz Life Insurance is a union between Allianz SE, one of the largest Insurance Company and Bajaj Finserv. Allianz SE is a leading insurance conglomerate globally and one of the largest asset managers in the world, managing assets worth over a Trillion (Over INR. 55, 00,000 Crores). Allianz SE has over 115 years of financial experience and is present in over 70 countries around the world.

   At Bajaj Allianz Life Insurance is customer delight and their philosophy is to ensure excellent insurance and investment solutions by offering customised products, supported by the best technology.

2. ***Birla Sun Life Insurance Company Limited:*** Birla Sun Life Insurance pioneered the unique Unit Linked Life Insurance Solutions in India. Within 4 years of its launch, BSLI cemented its position as a leading player in the Private Life Insurance Industry. With the focus on Investment Linked Insurance Products, supported with protection products to maintain leadership in product innovation, it relies on Multi Distribution Channels like Direct Sales Force, Alternate Channels and Group offering convenient channels of purchase to customers. BSLI was the first to have issued policies over the Internet and to have an operational Business Continuity Plan.

   BSLI works with a mission to help people mitigate risks of life, accident, health and money at all stages and under all circumstances and also to enhance the financial future of its customers, including enterprises.

3. ***HDFC Standard Life Insurance Company Limited:*** HDFC Standard Life Insurance Company Ltd. is one of India's leading private insurance companies, which offers a range of individual and group insurance solutions. It is a joint venture between Housing Development Finance Corporation Limited (HDFC Limited), India's leading housing finance institution and a Group Company of the Standard Life Plc, UK.

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HDFC Standard Life Insurance Company has a range of individual and group solutions, which can be easily customised to specific needs. Their group solutions have been designed to offer complete flexibility combined with a low charging structure.

4. ***ICICI Prudential Life Insurance Company:*** ICICI Prudential Life Insurance Company is a joint venture between ICICI Bank - one of India's foremost financial services companies- and Prudential plc - a leading international financial services group headquartered in the United Kingdom. Total capital infusion stands at ₹ 47.80 billion, with ICICI Bank holding a stake of 74% and Prudential plc holding 26%.

   The company began its operations in December 2000 after receiving approval from Insurance Regulatory Development Authority (IRDA). Today, their nation-wide team comprises of 2099 branches.

   ICICI Prudential is the first life insurer in India to receive a National Insurer Financial Strength rating of AAA (Ind) from Fitch ratings. AS obvious, the company has a commitment to deliver world-class financial solutions to customers all over India.

5. ***ING Vysya Life Insurance Company Limited:*** ING Vysya Life Insurance Company Limited is a global financial institution of Dutch origin offering banking, insurance and asset management to over 85 million private, corporate and institutional clients in over 40 countries. In India, it started its business in September, 2001. With a diverse workforce of approximately 125,000 people, ING is dedicated to setting the standard in helping our clients manage their financial future.

   ING Life follows a "customer centric approach" while designing its products. The Company's product portfolio offers products that cater to every financial requirement, at all life stages. ING Life has developed an exclusive tool - the LifeMaker, a simple tool which helps the customers choose a plan most suitable to them, based on their needs, requirements and current life stage. This tool helps build a complete financial plan for life at every lifestage, whether the requirement is Protection, Savings, Retirement or Investment.

6. ***Life Insurance Corporation of India:*** Life Insurance Corporation of India was created on 1st September, 1956, with the objective of spreading life insurance much more widely and in particular to the rural areas with a view to reach all insurable persons in the country, providing them adequate financial cover at a reasonable cost.

   LIC functions with 2048 fully computerized branch offices, 100 divisional offices, 7 zonal offices and the Corporate office. LIC's Wide Area Network covers 100 divisional offices and connects all the branches through a Metro Area Network. LIC has tied up with some Banks and Service providers to offer on-line premium collection facility in selected cities. LIC's ECS and ATM premium payment facility is an addition to customer convenience. Apart from on-line Kiosks and IVRS, Info Centres have been commissioned at Mumbai, Ahmedabad, Bangalore, Chennai, Hyderabad, Kolkata, New Delhi, Pune and many other cities. With a vision of providing easy access to its policyholders, LIC has launched its SATELLITE SAMPARK offices. The satellite offices are smaller, leaner and closer to the customer. The digitalized records of the satellite offices will facilitate anywhere servicing and many other conveniences in the future.

   LIC continues to be the dominant life insurer even in the liberalized scenario of Indian insurance and is moving fast on a new growth trajectory surpassing its own past records. LIC has issued over one crore policies during the current year. It has crossed the milestone of issuing 1,01,32,955 new policies by 15th Oct, 2005, posting a healthy growth rate of 16.67% over the corresponding period of the previous year.

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From then to now, LIC has crossed many milestones and has set unprecedented performance records in various aspects of life insurance business. The same motives which inspired our forefathers to bring insurance into existence in this country inspire us at LIC to take this message of protection to light the lamps of security in as many homes as possible and to help the people in providing security to their families.

7. ***Max New York Life Insurance Company Ltd.:*** Max New York Life Insurance Company Ltd. is a joint venture between New York Life; a Fortune 100 company and Max India Limited; one of India's leading multi-business corporations. The company has positioned itself on the quality platform. In line with its vision to be the Most Admired Life Insurance Company in India, it has developed a strong corporate governance model based on the core values of excellence, honesty, knowledge, caring, integrity and teamwork. The strategy is to establish itself as a Trusted Life Insurance Specialist through a quality approach to business.

   Incorporated in 2000, Max New York Life started commercial operation in 2001. In line with its values of financial responsibility, Max New York Life has adopted prudent financial practices to ensure safety of policyholder's funds.

   The company has multi-channel distribution that includes the agency distribution, partnership distribution, bancassurance, distribution focused on emerging markets and alliance marketing through employed sales force. The company currently has 33 bancassurance relationships, 14 corporate agency tie-ups and direct sales force at 14 locations.

   Max New York Life offers a suite of flexible products. It now has 36 products covering both life and health insurance and 8 riders that can be customized to over 800 combinations enabling customers to choose the policy that best fits their need. Besides this, the company offers 6 products and 7 riders in group insurance business.

8. ***MetLife India Insurance Company Limited (MetLife):*** MetLife India Insurance Company Limited (MetLife) is an affiliate of MetLife, Inc. and was incorporated as a joint venture between MetLife International Holdings, Inc., The Jammu and Kashmir Bank, M. Pallonji and Co. Private Limited and other private investors. It serves its customers by offering a range of innovative products to individuals and group customers at more than 600 locations through its bank partners and company-owned offices.

   MetLife, Inc., through its affiliates, reaches more than 70 million customers in the Americas, Asia Pacific and Europe. Affiliated companies, outside of India, include the number one life insurer in the United States (based on life insurance inforce), with over 140 years of experience and relationships with more than 90 of the top one hundred FORTUNE 500 companies. The MetLife companies offer life insurance, annuities, automobile and home insurance, retail banking and other financial services to individuals, as well as group insurance, reinsurance and retirement and savings products and services to corporations and other institutions.

9. ***Kotak Mahindra Old Mutual Life Insurance:*** Kotak Mahindra Old Mutual Life Insurance is a joint venture between Kotak Mahindra Bank Ltd., its affiliates and Old Mutual plc. The company is one of the fastest growing insurance companies in India and has shown remarkable growth since its inception in 2001.

   The group's mission is to emerge as the leading company offering a comprehensive range of life insurance and pension products at competitive prices, ensuring high standards of customer satisfaction and world class operating efficiency, and become a model life insurance company in India in the post liberalization period.

10. ***SBI Life Insurance Company Limited:*** SBI Life Insurance Company Limited is a joint venture between the State Bank of India and BNP Paribas Assurance. SBI Life Insurance is

registered with an authorized capital of ₹ 2000 crores and a Paid-up capital of ₹ 1000 crores. SBI owns 74% of the total capital and BNP Paribas Assurance the remaining 26%.

State Bank of India enjoys the largest banking franchise in India. Along with its 7 Associate Banks, SBI Group has the unrivalled strength of over 14,500 branches across the country, arguably the largest in the world.

BNP Paribas Assurance is the life and property & casualty insurance unit of BNP Paribas - Euro Zone's leading Bank. BNP Paribas, part of the world's top 6 group of banks by market value and a European leader in global banking and financial services, is one of the oldest foreign banks with a presence in India dating back to 1860. BNP Paribas Assurance is the fourth largest life insurance company in France, and a worldwide leader in Creditor insurance products offering protection to over 50 million clients. BNP Paribas Assurance operates in 41 countries mainly through the bancassurance and partnership model.

SBI Life has a unique multi-distribution model encompassing Bancassurance, Agency and Group Corporate. SBI Life extensively leverages the SBI Group as a platform for cross-selling insurance products along with its numerous banking product packages such as housing loans and personal loans. SBI's access to over 100 million accounts across the country provides a vibrant base for insurance penetration across every region and economic strata in the country ensuring true financial inclusion.

Agency Channel, comprising of the most productive force of more than 63,000 Insurance Advisors, offers door to door insurance solutions to customers.

11. ***Tata AIG Life Insurance Company Limited (Tata AIG Life):*** Tata AIG Life is a joint venture company, formed by the Tata Group and American International Group, Inc. (AIG). Tata AIG Life combines the Tata Group's pre-eminent leadership position in India and AIG's global presence as one of the world's leading international insurance and financial services organization. The Tata Group holds 74 per cent stake in the insurance venture with AIG holding the balance 26 per cent. Tata AIG Life provides insurance solutions to individuals and corporates. Tata AIG Life Insurance Company was licensed to operate in India on February 12, 2001 and started operations on April 1, 2001.

12. ***Reliance Life Insurance:*** Reliance Life Insurance offers you products that fulfil your savings and protection needs. Our aim is to emerge as a transnational Life Insurer of global scale and standard.

    Reliance Life Insurance is an associate company of Reliance Capital Ltd., a part of Reliance - Anil Dhirubhai Ambani Group. Reliance Capital is one of India's leading private sector financial services companies, and ranks among the top 3 private sector financial services and banking companies, in terms of net worth. Reliance Capital has interests in asset management and mutual funds, stock broking, life and general insurance, proprietary investments, private equity and other activities in financial services.

13. ***Aviva Insurance:*** Aviva is UK's largest and the world's fifth largest insurance Group. It is one of the leading providers of life and pensions products to Europe and has substantial businesses elsewhere around the world. In India, Aviva has a long history dating back to 1834. At the time of nationalisation it was the largest foreign insurer in India in terms of the compensation paid by the Government of India. Aviva was also the first foreign insurance company in India to set up its representative office in 1995.

    In India, Aviva has a joint venture with Dabur. Aviva holds a 26 per cent stake in the joint venture and the Dabur group holds the balance 74 per cent share.

    With a strong sales force of over 30,000 Financial Planning Advisers (FPAs), Aviva has initiated an innovative and differentiated sales approach to the business. Through the

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"Financial Health Check" (FHC) Aviva's sales force has been able to establish its credibility in the market. The FHC is a free service administered by the FPAs for a need-based analysis of the customer's long-term savings and insurance needs. Depending on the life stage and earnings of the customer, the FHC assesses and recommends the right insurance product for them.

Aviva pioneered the concept of Bancassurance in India, and has leveraged its global expertise in Bancassurance successfully in India. Currently, Aviva has Bancassurance tie-ups with ABN Amro Bank, the Lakshmi Vilas Bank Ltd., Punjab & Sind Bank, IndusInd Bank, Co-operative Banks and Regional Rural Banks.

When Aviva entered the market, most companies were offering traditional life products. Aviva started by offering the more modern Unit Linked and Unitised With Profit products to the customers, creating a unique differentiation.

Aviva has 223 Branches in India supporting its distribution network. Through its Bancassurance partner locations, Aviva products are available in close to 3,000 towns and cities across India. Aviva is also keen to reach out to the underprivileged that have not had access to insurance so far. Through its association with Basix (a micro financial institution) and other NGOs, it has been able to reach the weaker sections of the society and provide life insurance to them.

14. ***Sahara India Life Insurance Company Ltd. (SILICL):*** Sahara India Life Insurance Company Ltd. (SILICL) is today the first wholly Indian-owned Life Insurance Company in the private sector. They launched the operations on 30 October 2004 after being granted license to operate as a life insurer in India by Insurance Regulatory and Development Authority on 6 February 2004 .

15. ***Shriram Life Insurance Company:*** Shriram Life Insurance Company is the joint venture between the Shriram Group and the Sanlam Group.

    The Shriram Group is one of the largest and well-respected financial services conglomerates in India. The Group's main line of activities in financial services include chit fund, truck financing, consumer durable financing, stock broking, insurance broking and life insurance.

    Sanlam Life Insurance Limited, a part of the Sanlam Group, is one of the largest providers of life insurance in South Africa with 3.2 million individual policies under administration. It has a significant presence across South Africa, United Kingdom and Namibia and is a major provider of life insurance, retirement annuities, saving and investment products, personal loans, home loans and trust services to individuals.

16. ***Bharti AXA Life Insurance:*** Bharti AXA Life Insurance is a joint venture between Bharti, one of India's leading business groups with interests in telecom, agri business and retail, and AXA, world leader in financial protection and wealth management. The joint venture company has a 74% stake from Bharti and 26% stake of AXA.

    The company launched national operations in December 2006. Today, Their business philosophy is built around the promise of making people "Life Confident".

17. ***Future Generali:*** Future Generali is a joint venture between the India-based Future Group and the Italy-based Generali Group. Future Generali is present in India in both the Life and Non-Life businesses as Future Generali India Life Insurance Co. Ltd. and Future Generali India Insurance Co. Ltd.

    Future Group is one of India's leading business houses with multiple businesses spanning across the consumption space. While retail forms the core business activity of Future Group, group subsidiaries are present in consumer finance, capital, insurance, leisure and

entertainment, brand development, retail real estate development, retail media and logistics.

Established in Trieste on December 26, 1831, Generali is an international group present in more than 40 countries with insurance companies and companies mostly operating in the financial and real estate sectors. Over the years, the Generali Group has reconstructed a significant presence in Central Eastern Europe and has started to develop business in the principal markets of the Far East, including China and India.

18. ***IDBI Fortis Life Insurance Co Ltd.:*** IDBI Fortis Life Insurance Co Ltd is a joint venture between three leading financial conglomerates - India's premier development and commercial bank, IDBI, India's leading private sector bank, Federal Bank and Europe's premier Bancassurer, Fortis, each of which enjoys a significant status in their respective business segments. In this venture, IDBI owns 48% equity while Federal Bank and Fortis own 26% equity each.

    IDBI Fortis launched its first set of products across India in March 2008, after receiving the requisite approvals from the Insurance Regulatory Development Authority (IRDA). Today, the group offers its services through a vast nationwide network across the branches of IDBI Bank and Federal Bank in addition to a sizeable network of advisors and partners.

    IDBI Bank Ltd. is India's premier industrial development bank. Created in 1956 to support India's industrial backbone, IDBI Bank has since evolved into a powerhouse of industrial and retail finance. Today, it is amongst India's foremost commercial banks, with a wide range of innovative products and services, serving retail and corporate customers in all corners of the country from over 538 branches and more than 921 ATMs.

    Federal Bank is one of India's leading private sector banks, with a dominant presence in the state of Kerala. It has a strong network of over 600 branches and 600 ATMs spread across India. The bank provides over four million retail customers with a wide variety of financial products. Federal Bank is one of the first large Indian banks to have an entirely automated and interconnected branch network.

    Fortis is an international insurance group composed of Insurance Belgium, a leader in life and non-life insurance in Belgium distributing its insurance products through the network of Fortis Bank and independent insurance brokers and Insurance International with subsidiaries in the UK, France, Hong Kong, Luxembourg (Non-life), Germany, Turkey, Russia and Ukraine, and joint ventures in Luxembourg (Life), Portugal, China, Malaysia, Thailand and India.

19. ***Canara HSBC Oriental Bank of Commerce Life Insurance Company Limited:*** Canara HSBC Life, is popular for providing its customers simplicity and excellence. The shareholding pattern of the Joint Venture is as follows - Canara Bank holds 51% equity, HSBC Insurance (Asia Pacific) Holdings Ltd 26% and Oriental Bank of Commerce 23%. The Venture has an initial paid up capital of INR 325 crores which will further increase in line. The Company commenced business 16th of June, 2008 after receiving requisite approvals from the Insurance Regulatory Development Authority (IRDA).

20. ***AEGON Religare Life Insurance Company Limited:*** AEGON, one of the world's largest life insurance and pension groups, Religare, one of India's leading integrated financial services groups and Bennett Coleman & Company, India's largest media house, have come together to launch AEGON Religare Life Insurance Company Limited. The business philosophy is to help people plan their life better. In an industry first, AEGON Religare Life Insurance offers policy servicing on the phone via Interactive Voice Response System (IVR) by issuing the customer a T-Pin for authentication. It is also the first company to include the customer's medical report in the policy kit.

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AEGON's businesses serve over 40 million customers in over 20 markets throughout the Americas, Europe and Asia, with major operations in the United States, the Netherlands and the United Kingdom. With headquarters in The Hague, the Netherlands, AEGON companies employ almost 32,000 people worldwide. The company's common shares are listed on four stock exchanges: Amsterdam, London, New York and Tokyo.

Religare Enterprises Limited (REL) is one of the leading integrated financial services groups of India. REL's businesses are broadly clubbed across three key verticals - the Retail, Institutional and Wealth spectrums, catering to a diverse and wide base of clients. REL offers a multitude of investment options and a diverse bouquet of financial services with its pan India reach.

Bennett, Coleman & Co. Ltd. (BCCL), part of the Times Group, is India's largest media house. It reaches out to 2468 cities and towns all over India. The group owns and manages powerful media brands like The Times of India, The Economic Times, Maharashtra Times, Navbharat Times, Femina, Filmfare, Grazia, Top Gear, Radio Mirchi, Zoom, Times Now, Times Music, Times OOH, Private Treaties and indiatimes.com.

Task Compare the performances of various life insurance companies in India and make an analysis of the same.

13.8 General Insurance

The main player of this sector is General Insurance Corporation or GIC as it is widely known. Let us know in brief about the main players of the sector. The reading has been arranged in alphabetical order.

1. ***Bajaj Allianz General Insurance Co. Ltd.:*** It deals in motor, home, health and travel insurance.
2. ***ICICI Lombard General Insurance Co. Ltd.:*** It deals in personal , business, NRI and rural insurance.
3. ***IFFCO Tokio General Insurance Co. Ltd.:*** It deals in various general insurance products.
4. ***National Insurance Co. Ltd.:*** National Insurance Company Limited was incorporated in 1906 with its registered office in Kolkata. Consequent to passing of the General Insurance Business Nationalisation Act in 1972, 21 Foreign and 11 Indian Companies were amalgamated with it and National became a subsidiary of General Insurance Corporation of India (GIC) which is fully owned by the Government of India. After the notification of the General Insurance Business (Nationalisation) Amendment Act, on 7th August 2002, National has been de-linked from its holding company GIC and presently operating as a Government of India undertaking.

   National Insurance Company Ltd (NIC) is one of the leading public sector insurance companies of India, carrying out non life insurance business. Headquartered in Kolkata, NIC's network of about 1000 offices, manned by more than 16,000 skilled personnel, is spread over the length and breadth of the country covering remote rural areas, townships and metropolitan cities. NIC's foreign operations are carried out from its branch offices in Nepal.

   Befittingly, the product ranges, of more than 200 policies offered by NIC cater to the diverse insurance requirements of its 14 million policyholders. Innovative and customized policies ensure that even specialized insurance requirements are fully taken care of.

National transacts general insurance business of Fire, Marine and Miscellaneous insurance. The Company offers protection against a wide range of risks to its customers. The Company is privileged to cater its services to almost every sector or industry in the Indian Economy viz. Banking, Telecom, Aviation, Shipping, Information Technology, Power, Oil & Energy, Agronomy, Plantations, Foreign Trade, Healthcare, Tea, Automobile, Education, Environment, Space Research etc. National Insurance is the second largest non life insurer in India having a large market presence in Northern and Eastern India.

NIC has been accorded "AAA/STABLE" financial strength rating by CRISIL rating agency, which reflects the highest financial strength to meet policyholders' obligations.

5. ***The New India Assurance Co. Ltd.:*** Established by Sir Dorab Tata in 1919, New India is the first fully Indian owned insurance company in India.

   New India was a pioneer among the Indian Companies on various fronts, right from insuring the first domestic airlines in 1946 to satellite insurance in 1980. The latest addition to the list of firsts is the insurance of the INSAT-2E.

   With a wide range of policies New India has become one of the largest non-life insurance companies, not only in India, but also in the Afro-Asian region. It offers personal, industrial, commercial, liability and social insurance.

6. ***Oriental Insurance Company Ltd.:*** The Oriental Insurance Company Ltd was incorporated at Bombay on 12th September 1947. The Company was a wholly owned subsidiary of the Oriental Government Security Life Assurance Company Ltd and was formed to carry out General Insurance business. The Company was a subsidiary of Life Insurance Corporation of India from 1956 to 1973 (till the General Insurance Business was nationalized in the country). In 2003 all shares of our company held by the General Insurance Corporation of India has been transferred to Central Government.

   The Company is a pioneer in laying down systems for smooth and orderly conduct of the business. The strength of the company lies in its highly trained and motivated work force that covers various disciplines and has vast expertise. Oriental specializes in devising special covers for large projects like power plants, petrochemical, steel and chemical plants. The company has developed various types of insurance covers to cater to the needs of both the urban and rural population of India. The Company has a highly technically qualified and competent team of professionals to render the best customer service.

   Its main objective is to contribute to the socio economic objectives of the nation by being a vibrant and viable organization catering to the growing insurance needs of the community. Towards this end we will strive for effective management of business operations.

7. ***Reliance General Insurance:*** Reliance General Insurance is one of India's leading private general insurance companies with over 94 customized insurance products catering to the corporate, SME and individual customers. The Company has launched innovative products like India's first Over-The-Counter health & home insurance policies. Reliance General Insurance has an extended network of over 200 offices spread across 173 cities in 22 states, a wide distribution channel network, 24x7 customer service assistance and a full fledged website. It is also India's first insurance company to be awarded the ISO 9001:2000 certification across all functions, processes, products and locations pan-India.

8. ***Royal Sundaram Alliance Insurance Co. Ltd.:*** It deals in accident, car, family, home, health, hospital and travel insurance.

9. ***Tata AIG General Insurance Company Limited (Tata AIG General):*** Tata AIG General is a joint venture company, formed by the Tata Group and American International Group, Inc.

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(AIG). Tata AIG General combines the Tata Group's pre-eminent leadership position in India and AIG's global presence as the world's leading international insurance and financial services organization. The Tata Group holds 74 per cent stake in the insurance venture with AIG holding the balance 26 percent. Tata AIG General Insurance Company, which started its operations in India on January 22, 2001, offers complete range of general insurance for motor, home, accident & health, travel, energy, marine, property and casualty, liability as well as several specialized financial line.

10. ***United India Insurance Co. Ltd.:*** UI is a leading General Insurance Company with more than three decades of experience in non-life Insurance business. Formed by the merger of 22 companies consequent to nationalisation of General Insurance, it head quarters at Chennai. Its corporate mission is to provide insurance protection to all, to ensure customer satisfaction, to function on sound business principles and to help minimise national waste and to help develop the Indian economy

11. ***Cholamandalam MS General Insurance:*** It is a joint venture between the Murugappa Group and Mitsui Sumitomo Insurance Group.

    The Murugappa Group, headquartered in Chennai, India. It has 29 companies under its umbrella, of which eight are listed and actively traded on the National Stock Exchange and the Bombay Stock Exchange. With 40 units spread across 12 states in India, the Murugappa Group is one of India's oldest business houses. It has a presence in the UK, the USA, Australia, Canada, South Africa, UAE, Thailand, and China.

    Mitsui Sumitomo Insurance Group is one of the largest insurance groups in the world. Today the group operates in non-life insurance, life insurance, financial services and risk management services.

12. ***HDFC ERGO General Insurance Co. Ltd.:*** HDFC ERGO General Insurance Company Limited is a 74:26 joint venture between HDFC Limited, India's premier Housing Finance Institution & ERGO International AG, the primary insurance entity of Munich Re Group.

    HDFC ERGO focuses on providing the "Right Insurance Solution" for all. they offer a complete range of general insurance products ranging from Motor, Health, Travel, Home and Personal Accident in the retail space and customized products like Property, Marine and Liability Insurance in the corporate space.

    HDFC ERGO has been expanding its presence across the country and is present across 46 cities with 52 branch offices. The company has a right balance of distribution channel comprising of Dealerships, Brokers, Retail and Corporate Agents, Bancassurance and Direct Sales Team.

13. ***Star Health and Allied Insurance Company Limited:*** It works with a mission of ultimate Customer Satisfaction and provide healthcare options.

14. ***Apollo DKV Insurance Company Limited:*** Committed to bring world class health care within the reach of every individual, Apollo Hospitals Group has joined hands with DKV, a world leader in the field of health insurance. The joint venture is poised to make good the conviction of both the partners that Indian health insurance market is on the brink of explosive growth.

    Apart from the above discussed organisations, there are several other players like Export Credit Guarantee Corporation of India Ltd, Agriculture Insurance Co. of India Ltd., Future Generali India Insurance Company Limited, Universal Sompo General Insurance Co. Ltd., Shriram General Insurance Company Limited, Bharti AXA General Insurance Company

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Limited and Raheja QBE General Insurance Company Limited that deal in various general insurance products and services.

Self Assessment

Fill in the blanks:

7. United India Insurance is a leading General Insurance Company with more than three decades of experience in ..... Insurance business.
8. IDBI Fortis Life Insurance Co Ltd is a joint venture between ..... leading financial conglomerates.
9. Future Generali is a joint venture between the India-based Future Group and the ..... based Generali Group.
10. The Insurance Regulatory and Development Authority (IRDA) Act of 1999 deregulated the insurance sector in India and allowed the entry of ..... into the insurance sector.
11. Insurance is actually a contract between 2 parties whereby one party called insurer undertakes in exchange for a fixed sum called ..... .

13.9 Summary

- Mutual funds can be described as open-ended funds operated by an investment company which raises money from shareholders and invests in a group of assets, in accordance with a stated set of objectives.
- In return for the money they give to the fund when purchasing shares, shareholders receive an equity position in the fund and, in effect, in each of its underlying securities.
- For most mutual funds, shareholders are free to sell their shares at any time, although the price of a share in a mutual fund will fluctuate daily, depending upon the performance of the securities held by the fund. Benefits of mutual funds include diversification and professional money management.
- There are many types of mutual funds like Value stocks, Growth stock, Based on company size, large, mid, and small cap, Income stock, Index funds, Enhanced index, Stock market sector, Defensive stock, International, Real estate, Socially responsible, Balanced funds, Tax efficient, Convertible, Junk bond, Mutual funds of mutual funds, Closed end, Exchange traded funds, etc.
- Mutual funds have emerged as the best in terms of variety, flexibility, diversification, liquidity as well as tax benefits.
- Besides, through MFs investors can gain access to investment opportunities that would otherwise be unavailable to them due to limited knowledge and resources. MFs have the capability to provide solutions to most investors' needs, however, the key is to do proper selections and have a process for monitoring.
- The insurance sector in India has come to a full circle from being an open competitive market to nationalisation and back to a liberalised market again.
- Tracing the developments in the Indian insurance sector reveals the 360-degree turn witnessed over a period of almost two centuries.

Notes

13.10 Keywords

Balanced Funds: The investor may wish to balance his risk between various sectors such as asset size, income or growth. Therefore the fund is a balance between various attributes desired.

Convertible Bonds: Bonds or Preferred stock which may be converted into common stock.

Defensive Stock: The securities in this fund are chosen from a stock which usually is not impacted by economic down turns.

Insurance: A social device to reduce or eliminate risk of life and property.

Rating: An opinion regarding securities, expressed in the form of standard symbols or in any other standardised manner, assigned by a credit rating agency and used by the issuer of such securities, to comply with a requirement specified by these regulations.

13.11 Review Questions

1. Critically evaluate the performance of UTI in the last decade.
2. What have been the major points of concern for Indian mutual funds market in past 5 years?
3. Where do you see Indian Mutual Fund market heading towards in next 5 years and why?
4. What has been the biggest limitation of the government supported mutual funds in India?
5. What do you think is better in performance and why- public mutual funds/private mutual funds?
6. How do analyse Indian Mutual fund market as compared to that of developed economies?
7. What are the five main reasons for mutual funds to have got so popular in recent times?
8. What do you mean by insurance? What are the main insurance companies in public sector in India?
9. Critically evaluate the effect of IRDA on insurance sector of India.
10. Insurance sector in India has come of age. Comment.
11. Which insurance company do you prefer for general insurance and why?
12. If you were to join the insurance sector in India, which company would you prefer to join as an employee and why?
13. What is more important- life insurance or general insurance and why? (You cannot say both are equally important)

Answers to Self Assessment

1. Strategy
2. Minimize
3. SEBI
4. 1963
5. Value stocks
6. Securities, investment management
7. Non-life

Notes

8. three
9. Italy
10. private companies
11. premium

13.12 Further Readings

Books

G. M. Meier and R. E. Baldwin, Economic Development, Theory, History, Policy, John Wiley & Sons, INC, New York, 1957, p.2.

Statistics on Working of Capital Issues Control, Ministry of Finance, India

Compendium on Industrial Policy & Procedure, Ministry of Industry, India

Reserve Bank of India Bulletin, 2006, 2007, 2008 2009.

Online links

www.sebi.org

www.induscorpque.com

www.rbi.com

www.amfiindia.com/

Case Study

IRDA's New Guidelines are a Step in the right Direction

With the latest guidelines, new products may appear more attractive than older ones. But investors may stand to lose if they change policies.

The Insurance Regulatory and Development Authority (IRDA) has continued its drive towards reforming the most criticised insurance product. In comparison to its earlier guidelines, the latest circular is likely to have far-reaching impact on the way ULIPs are sold in the market.

The most notable change in the recent guidelines pertain to surrender charges, five-year lock-in period, a cap on difference between gross yield to net yield for investment periods less than 10 years and a minimum guaranteed return on pension products. First, the details on the changes:

Surrender charges that punished policyholders for early discontinuance have undergone substantial changes. IRDA has recommended two slabs, one for an annual premium up to ₹ 25,000 and other for investment above this threshold. For an annualised premium of up to ₹ 25,000, the first year surrender charges are capped at 20 per cent of the premium or fund value subject to a maximum of ₹ 3,000, while this goes down to as low as 5 per cent or ₹ 1000 for surrendering in the fourth year. From the fifth year, ULIPs will not suffer any surrender charges.

Contd...

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Surrender Charges

Policies with annual premium of above ₹ 25,000 will suffer lower charges but the maximum charges are almost twice that in the other case. The new rule is far superior to the practice of deducting 30-40 per cent of the first year's premium when the policy holder discontinues the premium within the first three years.

The minimum three-year lock-in period in ULIP, which actually triggered this episode, would henceforth be extended to five years. The biggest advantage of the change is that policyholders, instead of suffering higher upfront charge, would henceforth pay the distribution charges evenly till the lock-in period, thereby a higher amount of the premium will go towards investment.

Continuing its macro management of the net yield to policyholders, the regulator has fixed net yields for periods less than 10 years. In its earlier guidelines it has prescribed the difference between gross yield (return) to net yield at 300 basis points (3 percentage points) for a policy maturity of 10 years and 225 basis points for maturity above 15 years. Now, a difference of 400 basis points has been prescribed for five years, which gradually reduces to 300 basis points in the tenth year. The charges still appear higher in comparison to mutual funds that are allowed annual expenses of 2.25 per cent (mortality charges, if added, will further increase charges).

According to the new regulation, unit-linked pension plans would carry a minimum guarantee of 4.5 per cent (if all premiums are paid) and no partial withdrawal will be allowed during the accumulation period.

It appears attractive but there is catch, IRDA retains the right to review this guaranteed rate according to macroeconomics developments. This means that the return can vary over the term of the policy and investors will not be sure of the maturity value. On vesting date policyholders can commute up to one-third of the accumulated value as lump sum. As insurers are required to guarantee the return, major portion of the premium may find its way into debt instruments.

If the pension plan without any rider is not generating a minimum return of at least 8 per cent that has been guaranteed under PPF (it has favourable tax treatment in the proposed Direct Taxes Code compared to these pension plans) investor interest in pension plans is likely to wane at least for those investing up to ₹ 70,000 towards retirement.

What to do?

With the new set of guidelines, new products may appear more attractive than older ones. Investors who bought ULIPs in earlier years may be tempted to surrender their products in favour of new ones. Should they?

It may not be prudent to close the existing policy in favour of new products that are likely to be launched from September mainly on account of charges.

Consider this, an investor invested ₹ 1 lakh on June 2009. After deducting premium allocation charge of 30 per cent, the rest would have been invested in equity. Assume in the one year the investment has grown at 30 per cent and the current value is₹ 91,000 (risk charge is ignored for the calculation). If the policyholder surrenders it he would suffer a charge of 30 per cent of the first year premium – ₹ 30,000. The fund value of ₹ 61,000 will be transferred to suspense account for next two years without any accretion, after which he will be paid the sum. Alternatively if he is continuing the existing policy for another 9 years and if it earns 10 per cent net of charges, the maturity value will be ₹ 16.4 lakh.

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As it's too early to predict the product structure, let's look at a case where he buys a new ULIP for a nine-year term and it has a 20 per cent premium allocation and other charges for first two years. If the ULIP earns 10 per cent net of charges, the maturity value will be ₹ 13.7 lakh.

If he invests the old policy proceeds of ₹ 61,000 after two years at a net interest of 10 per cent the maturity value will be ₹ 1.20 lakh. His investment would then be worth ₹ 15 lakh, still short of the sum he would made on his older policy. Hence it is advisable for the investors to continue with the current policy since it has already suffered charges.

Question

Make a critical analysis of new guidelines issued by IRDA form customers as well as insurance companies' point of view.

Source: http://www.thehindubusinessline.in

Notes

Unit 14: Financial Regulations

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14.3.3 Objectives of Credit Control

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Objectives

After studying this unit, you should be able to:

- Learn the concept of financial regulations;
- Understand objectives and task of SEBI;
- Understand objectives and task of RBI;
- Understand objectives of credit control;
- Understand instruments of credit control.

Introduction

Markets depend upon credibility and fairness. A sound regulatory framework is expected to provide transparency, maintain market integrity, fairness and ensure investor protection. There is a school of thought which believes that markets are inherently efficient and over-regulation leads to inefficiency in the market. This school of thought argues for minimal or no regulations. However, it is seen that lack of adequate regulations can lead to manipulations and market abuses, which endanger the integrity of the market and damages the confidence of the investors.

Besides, fairness in the market is essential for price discovery, which in turn leads to better investor participation. Regulation also helps in reducing the systemic risk in the market.

The perception of sound regulation is as important as the reality of regulation. The very existence of a regulatory body improves the confidence of the market participants and investors.

To sustain the growth of the markets and crystallize the increased awareness and interests of a discerning and growing pool of investors, it was essential to overcome the inadequacies and curb the malpractices in the market. It can be observed from the global experience that capital markets cannot develop in a healthy manner without effective regulations for disclosures, listing, trading, liquidity, intermediation, settlements, accounting, etc. The regulatory policy must focus on visible and effective maintenance of market discipline and professionalization of intermediary and support services.

Regulation of financial institutions is very important for a structured growth of a country. As you know that the financial institutions play the key role in the growth of an economy so it is important to regulate the financial institutions. In India Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) are the main regulators of financial institutions.

14.1 Regulatory Framework of Security Market

The four main legislations governing the securities market are: (a) the SEBI Act, 1992 which establishes SEBI to protect investors and develop and regulate securities market; (b) the Companies Act, 1956, which sets out the code of conduct for the corporate sector in relation to issue, allotment and transfer of securities, and disclosures to be made in public issues; (c) the Securities Contracts (Regulation) Act, 1956, which provides for regulation of transactions in securities through control over stock exchanges; and (d) the Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of demat securities.

Legislations

SEBI Act, 1992: The SEBI Act, 1992, establishes SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. Its regulatory jurisdiction extends over corporate entities in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with the securities market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and also to penalise them in case of violations of the provisions of the Act, rules and regulations made thereunder. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

Securities Contracts (Regulation) Act, 1956: It provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities. It gives the Central Government/SEBI regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition of recognition, a stock exchange complies with the prescribed conditions of the Central Government. Organised trading activity in securities takes place on a specified recognised stock exchange. The stock exchanges determine their own listing regulations, which have to conform to the minimum listing criteria set out in the Rules.

Depositories Act, 1996: The Depositories Act, 1996, provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing

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for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of ownership of securities electronically by book entry, without making the securities move from person to person. The Act has made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with.

Regulators

The responsibility for regulating the securities market is shared by Department of Economic Affairs (DEA), Ministry of Company Affairs, Reserve Bank of India (RBI) and SEBI. The activities of these agencies are coordinated by a High Level Committee on Capital Markets. The orders of SEBI under the securities laws are appealable before a Securities Appellate Tribunal.

Most of the powers under the SCRA are exercisable by DEA while a few others by SEBI. The powers of the DEA under the SCRA are also concurrently exercised by SEBI. The powers in respect of the contracts for sale and purchase of securities, gold related securities, money market securities and securities are derived from these securities and the RBI exercises carry forward contracts in debt securities concurrently. The SEBI Act and the Depositories Act are mostly administered by SEBI. The powers under the Companies Act relating to issue and transfer of securities and non-payment of dividend are administered by SEBI in case of listed public companies.

Regulation of Secondary Market

As noted above, Securities Contracts (Regulation) Act 1956 and the rules made there under, namely the Securities Contracts (Regulation) Rules, 1957 are the main laws governing stock exchanges in India.

The Preamble to the Securities Regulation Act states that it is "an act to prevent undesirables transaction in Securities by regulating the business of dealing therein, by prohibiting options and by providing certain other matters connected therewith". This Act provides for the direct and indirect control of virtually all aspects of securities leading and the running of the stock exchange. The Act makes every transaction in securities in any notified state area illegal and punishable by fine and/or imprisonment if it is not entered into between or with members of a recognized stock exchange in the state or area.

The Act thus prohibits the existence of other than recognized stock exchanges and provides the mechanism recognizing stock exchanges. Application to the Central Government for recognition must include a copy of the rules relating in general to the constitution of the stock exchange and in particular to, among other things, the admission into the stock exchanges of various bases of members, the exclusion, expulsion and readmission of members, and the procedure for registration of a stock exchange. In determining whether to grant recognition, the Central Government may make whatever require is necessary and impose in the rules and bylaws of the stock exchanges, whatever conditions are required to ensure "fair dealing" and to "protect investors" These conditions concern, inter alia, the qualification for members, the manner in which contracts are to be entered into and enforced, the representation of not more than three Central Government nominees on the board of the stock exchange, and the maintenance of books and record by members and their audit by chartered accountants. The Central Government has the power to impose further conditions, other than in the rules and bylaws, such as limiting the number of members. Finally, the Central Government has the power unilaterally to withdraw recognition.

After it recognizes a stock exchange, the Central Government exerts regulatory control over it, and reports are furnished to the Central Government. Certain books and records are maintained for a period years. The Central Government can make an equity itself, or through an appointment

of a third party, into the stock exchange or any of its members. All officers, directors, members, and others who have had dealings in matters under inquiry, are required to produce requested documents, statements, or information.

The Central Government retains control over the stock exchange's bylaws and its rule amendment. The stock exchange, subject to previous Central Government approval, has the authority to make bylaws for regulation and control of contracts and the regulation of trading. Similarly, no rule amendments have effect unless they are approved by the Central Government. The Central Government, furthermore, has the power to direct the stock exchange to amend its rules; and if it fails to do so, the Government may directly amend the rules of such a stock exchange. The suspension of business may be complete or subject to conditions. Suspensions may not be of more than seven days initially, but may be extended from time to time. The Central Government may supervise the governing body of any exchange of declaration and then appoint any person or group of persons to exceed and perform all the power and duties of the governing body.

Other powers granted to the Central Government include the authority to stop further trading in a specified round for the purpose of preventing undesirable speculations, and the power to compel a public company "in the initial of the trade or in the public interest" to list its securities on any of the recognized exchanges.

The Securities Regulation Rules specifically provide for membership of an exchange. No person can be eligible for membership if he is less than twenty-one years of age, is not a citizen of India, has been adjudged bankrupt, or has been convicted of an offence involving fraud or dishonesty. Under Section 8, rules relative to the membership of stock exchanges are given which are reproduced as below.

Regulation of OTCEI

The functioning and operations of the OTCEI are subject to the provision of the Securities Contracts (Regulation Act, 1956, the Companies Act, 1956 and other relevant laws, which are applicable to Indian Stock Exchanges of operations are supervised by SEBI and Government of India. The criteria for admission of members, licensed dealers and companies on the OTCEI are prescribed as follows.

Criteria for Admission of Members

The members would be public financial institutions, scheduled banks, mutual funds, banking subsidiaries, SEBI-registered merchant banks, venture capital funds and venture capital companies, non-banking financial companies having a minimum financial net worth as specified by OTCEI. The applicant should satisfy the elegant requirements of the Securities Contracts (Regulation) Rules, 1957.

The member should posses the necessary skills, resources and capabilities to appraise project/ common establish its viability, analyze a company's financial worth, evaluate a company's management and determine value for a company's products.

The member should have the necessary status and standing to be able to carry the confidence of the members and licensed dealers while recommending any scrip for investment.

The member should have sufficient financial reserves to 'sponsor' and trade in the scrip.

The member should be authorized by SEBI for carrying out merchant banking activities.

The member should have adequate organizational infrastructure to establish and manage the OTC count (that is, office space, computers, PTI scam, telephones, telex, fax and any other data communication equipped specified).

The net worth of the member should be a minimum of ₹ 2.50 crores.

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Criteria for admission (for listing) of companies.

The company should be sponsored by a member of the OTCEI. The sponsor has to certify that all the scrips proposed to be offered for trading on OTC Exchange have already been subscribed to by members and licensed dealers of OTCEI.

The company has to agree to abide by all statutory and OTCEI's provisions for listing.

The company to agree to entered into an agreement with the OTCEI in a prescribed format.

The company will comply with the provisions laid down in the Notification to be issued by the Government of India; subscribed to by members and licensed dealers of OTCEI.

The company to agree to abide by all statutory and OTCEI's provisions for listing.

The company will comply with the provisions laid down in the Notification to be issued by the Government of India, for listing on the OTC Exchange of India.

The issues of securities by companies and their listing on the OTCEI will be governed by the following guidelines:

1. The minimum issued equity share of accompany for eligibility for listing on the OTCEI will be ₹ 30 lakhs subject to a minimum public offer of equity shares worth ₹ 20 lakhs in face value.
2. For companies with an issued equity capital of more than ₹ 30 lakhs but less than ₹ 300 lakhs, the return public offer should be 40% of the issued capital or ₹ 20 lakh worth of shares in value, whichever is higher in relaxation of rule 19(2)(b) of the Securities Contracts (Regulation) Rules, 1957.
3. Companies with an issued equity capital of more than Rs.300 lakhs seeking listing on the OTCEI will have to comply with the listing requirements and guidelines as are applicable to such companies for enlistment on other organized stock exchanges; for venture capital companies, a minimum of 20% of capital has to be issued for listing in OTCEI.
4. Companies covered under the MRTO Act/FERA may be listed on the OTCEI only if they satisfy the conditions for listing on other recognized stock exchanges, such as minimum issued equity capital of ₹ 300 lakhs and such other limit as may be prescribed from time to time.
5. A company with an issued equity share capital of more than ₹ 25 crore will be eligible for listing on the OTCEI.
6. Companies, which are engaged in investments, leasing, finance, hire-purchase, amusement parks, etc. will not be eligible for listing on the OTCEI.
7. The minimum number of centres for collection of application forms in respect of issue of securities by companies, under the OTCEI shall be four, one each from the Northern, Western, Southern, Eastern regions of the country. However, OTCEI shall have the power to increase the number of centres depending upon the size and nature of securities made by a company.
8. The Securities and Exchange Board of India (SEBI) vide its letter dated July 16, 1992 has inter alia classified as regards issue of shares through OTC Exchange of India as follows.
9. Where a direct public issue is made through OTC without the sponsor taking any shares, the normal guidelines for disclosures and investor protection shall apply.
10. Where the shares of a company have been taken by the sponsor, such shares may be offered to the public calculated at such price as the sponsor may deem fit, in accordance with the regulations of OTC subject to the following conditions.

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11. The promoters, after such offer, retain at least 25% of the total issued capital with lock-in-period of five years from the date of the sponsor taking up the shares.
12. The sponsor agrees to act as market-maker for the shares at least for a period of three years on a compulsory basis and also finds an additional market maker for such compulsory market making.
13. The sponsor compulsorily gives two-way quotes based on minimum or maximum trading prices as stipulated by the OTC in respect of the scrip.

With a view to making markets more competitive and compliant, SEBI has brought in the following new regulations:

1. SEBI (Prohibition of Fraudulent and Unfair Trade Practices - relating to Securities Market) Regulations, 2003
2. SEBI (Ombudsman) Regulations, 2003
3. SEBI (Central Listing Authority) Regulations, 2003
4. SEBI (Central Database for Market Participants) Regulations, 2003
5. SEBI (Self Regulatory Organizations) Regulations, 2004
6. SEBI (Criteria For Fit and Proper Person) Regulations, 2004

As a measure of regulatory pro-activeness, the existing regulations were reviewed and the following amendment to the above regulations was notified:

1. SEBI (Foreign Institutional Investors) (Amendment) Regulations, 2003
2. SEBI (Mutual Funds) (Amendment) Regulations, 2003
3. SEBI (Depositories and Participants) (Amendment) Regulations, 2003
4. SEBI (Debenture Trustees) (Amendment) Regulations, 2003
5. SEBI (Prohibition of Insider Trading) (Amendment) Regulations, 2003
6. SEBI (Issue of Sweat Equity) (Amendment) Regulations, 2003
7. SEBI (Stock Brokers and Sub-Brokers) (Amendment) Regulations, 2003
8. SEBI (Stock Brokers and Sub-Brokers) (Second Amendment) Regulations, 2003
9. SEBI (Procedure for Holding Enquiry and Imposing Penalty) (Amendment) Regulations, 2003
10. SEBI (Ombudsman) (Amendment) Regulations, 2003
11. SEBI (Foreign Institutional Investors) (Amendment) Regulations, 2004

14.2 Securities and Exchange Board of India

14.2.1 Evolution and Objectives of SEBI

Securities market in India witnessed a phenomenal growth in the 1980s leading to financial disintermediation with corporate sector, placing increasingly greater reliance on the market for satisfying their long-term financial needs, and emergence of new intermediaries and institutions in the country and thereby developing a new awareness and interest in investment opportunities. However, the quality of transactions in the securities market was not adequate and there was lack of professionalism and healthy competition among the various players in the market. As a

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result, interests of the investors suffered grievously. It was, therefore, considered necessary to set up an apex body at the national level to provide the investors with an organized and well-regulated market place. Accordingly, the SEBI was established in 1988 by the Government of India through an executive resolution, and was subsequently upgraded as a fully autonomous body in the year 1992 with the passing of the SEBI Act on 30th January, 1992. Thus, in place of government control, a statutory and autonomous regulatory board with defined powers and responsibilities, to cover both development and regulation of the market, was set up.

The basic objectives of the SEBI were identified as:

1. To protect the interests of investors in securities;
2. To promote the development of the securities market;
3. To regulate the securities market; and
4. Also for matters connected therewith or incidental thereto.

14.2.2 Tasks of the SEBI

So as to ensure that interests of the investors are well protected and the development of the securities market is well fostered, the SEBI has been assigned two major tasks, viz., regulatory and developmental.

Under regulatory function, the SEBI is required to carry out the job of regulating the business in stock exchanges and other securities market, registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, merchant bankers, underwriters, etc., and regulating the working of collective investment schemes including mutual funds. Another regulatory function of the SEBI is to prohibit fraudulent and unfair trade practices and take power of companies.

The SEBI has to perform as a development institution in order to serve as an effective body to develop securities market and safeguard interests of the investors. The SEBI has to educate investors and make them aware of their rights in clear and specific terms and train intermediaries. It is also required to promote self-regulating organization. The SEBI is also expected to help the corporate sector in raising funds through securities without any problem and at a low cost. The SEBI is required to develop a proper infrastructure so that the market automatically facilitates expansion and growth of business to middlemen like brokers, jobbers, commercial bankers, mutual funds, etc. It is also expected to make more effective the law in the existing status as far as they relate to the industrial securities, mutual funds, investment in units, LIC savings plan, Chit fund companies and securities issued by housing/industrial societies and corporations with the purpose of making investment in housing/industrial projects. The SEBI has to create the framework for more open, orderly and objective conduct in respect of takeovers and mergers so as to ensure fair and equal treatment to all security holders and facilitate such takeovers and mergers in the efficient manner by prescribing a mechanism for a more orderly conduct.

Finally, the SEBI is expected to conduct research and publish information useful to all market players.

14.2.3 Powers of SEBI

The SEBI has been vested with powers both by the SEBI Act and the SCR Act.

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Under the SEBI Act

Section 11(1) of the SEBI Act has empowered the SEBI in the following respects:

1. ***Regulation of stock exchange:*** The SEBI is empowered to regulate the business of stock exchanges so as to prohibit fraudulent and unfair trade practices in securities market. For this purpose, it can call for information, undertake inspection, conduct enquiries and audits of the stock exchanges, intermediaries and self-regulatory organizations in the securities market.
2. ***Regulation of Stockbrokers:*** The SEBI has been vested with power to register and regulate the working of stockbrokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisors and such other intermediaries as may be associated with securities market in any manner.
3. The SEBI is empowered to levy fees and other charges for carrying out the purposes of Section 11 of the Act.

Under the SCR Act

The SCR Act has granted the following powers to the SEBI:

1. The SEBI can call for periodic returns from stock exchanges. It can prescribe maintenance of certain documents by the exchanges. It can call for an explanation/information relating to the affairs of the governing body of the exchange.
2. Regarding regulation of stock exchanges, the SEBI commands the following powers:
   (a) Approval of bylaws of the exchange for regulation and control of contracts,
   (b) Licensing of dealers in securities in certain areas,
   (c) Compel a public company to list its shares,
   (d) Procuring annual report by recognized stock exchanges,
   (e) Issuing directives to the stock exchanges in general or a stock exchange in particular to make rules or to amend rules,
   (f) Superseding the governing body of a recognized stock exchange,
   (g) Suspension of business of a recognized stock exchange,
   (h) Prohibit contracts in certain cases,
   (i) Grant of recognition to stock exchanges,
   (j) Withdrawal of recognition of a stock exchange,
   (k) Making or amending rules or articles of association of a stock exchange regarding voting rights of members of a stock exchange at any meeting,
   (l) Regulation and control of the business of dealing in spot delivery contracts,
   (m) Hearing appeals submitted by companies against refusal of a stock exchange to list their securities,
   (n) Issue of a notification specifying any class of contracts as contracts to which the SCR Act or any provision contained therein would not apply, and

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(o) To make regulations pertaining to the conditions for registration certificate, fee for registration, cancellation/suspension of registration of intermediaries, issue of capital, transfer of securities and so on.

Did u know? In the wake of the financial fraud at Satyam Computers detected in January 2009, the SEBI has decided to make it mandatory for promoters of listed companies to disclose to the exchanges the quantum of shares they have pledged with lenders to raise money.

14.2.4 Administration of SEBI

The SEBI is administered by a Board of Members consisting of a Chairman and five members - one each from the Department of Finance and Law of the Central Government, one from the RBI and two other persons. The SEBI has its head office in Mumbai and regional offices in Delhi, Kolkata and Chennai. The government reserves the right to terminate the services of the Chairman or any member of the Board. The Board decides the issues in the meeting by a majority vote with the Chairman having a second or casting vote.

14.2.5 Operations of SEBI – An Evaluation

If one realizes the sordid fact that the regulation of securities market is challenging, the going turns out to be always tough. Since its inception, the SEBI has been working toward deepening and strengthening primary and secondary markets, improving operational efficiency and liquidity and reducing intermediation cost and investment risks and thereby safeguarding the interests of investors, especially of the small investors. The SEBI has sought to do the above through the comprehensive regulatory measures, prescribing registration norms, the eligibility criteria, the guidelines and code of obligations and code of conduct for different intermediaries. It has framed bylaws, risk identification and risk management systems for clearing houses of stock exchanges, surveillance system, etc., which have made dealing in securities both safe and transparent to the end investors.

A brief outline of important measures taken by the SEBI to improve the functioning of the primary and secondary markets is set out above:

Measures in the Primary Market

1. Free entry and free price
2. Minimum public offer of 20% of paid up capital to be eligible for listing on stock exchanges out of which half is reserved for investors applying for ₹ 10,000 and less.
3. Minimum subscription by promoters and directors at 25% for issues less than ₹ 100 crores and 20% for paid up capital of more than ₹ 1000 crores.
4. For issues above ₹ 100 crores, booking building requirement has been introduced.
5. FIIs are allowed to operate both in new issue market and stock market but through Indian brokers.

   In December, 2006, FIIs investment up to 49 percent were allowed in infrastructure companies.
6. The pricing of preferential allotment has to be at market related levels and there is a five years lock-in period for such allotments.

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7. Companies making their first public issue are eligible to do only if they have three years of dividend paying track record preceding an issue. Those not meeting this requirement can still make an issue if their projects are appraised by banks or financial institutions with minimum 10 percent participation in the equity capital of the issuer, or if their securities are listed on the OTCEI.
8. Private placement of non-transferable shares of promoters and directors was prohibited as also the sale of shares under discount to institutions and mutual funds, etc.
9. There must be a gap of 12 months between the public or right issue and bonus issue. The promoters should bring in their share capital before the public issue.
10. The reservation for employees should not be more than 10% at present and this quota is non-transferable for 3 years and subject to a maximum allotment of 200 shares per employee.

Measures in Secondary Market

1. The SEBI has been carrying out inspection of all the stock exchanges to determine, inter alia, the extent of compliance with its directives.
2. Computerized or scree-based trading has been achieved on all exchanges.
3. Corporate membership allowed, and encouraged and articles of association of the stock exchanges amended so as to increase their membership.
4. All the stock exchanges have been directed to establish either a clearing house or clearing corporation.
5. Demat forum of trading was made compulsory in many scrips.
6. Rolling settlement on T+2 system for all listed securities across the stock exchanges.
7. By the Securities Amendment Act, 1999 ban on forward trading was lifted. Trading in derivatives was allowed and derivatives were made securities eligible for trading. Mutual funds and financial institutions were allowed trading in derivatives for hedging purpose. In November 29, 2007, the SEBI approved derivative products to mini contracts on equity indices, options with longer tenure, volatility index and futures and options contracts, exchange traded currency futures and options.
8. Created the facility of depository in all stock exchanges, thus, providing for the establishment of depositories in securities with the objective of ensuring free transferability of securities, its speed, accuracy and security.
9. Directed the stock exchanges to set up service centres for investors to enable them to have a forum for recording and counselling their grievances as well as access to financial and other information of companies and government policies, rules and regulations, etc.
10. The capital adequacy norms of 3 percent for individual brokers and 6 percent for corporate brokers introduced.
11. Compulsory audit of the brokers' books and filing of the audit report with the SEBI has been made mandatory.
12. A system of market making in less liquid scrips on selected stock exchanges has been introduced.
13. Insider trading has been prohibited and such trading has been made a criminal offence.
14. The SEBI lifted ban on forward trading in securities.

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Thus, it is evident from the above discussions that in its endeavour to achieve its objectives, the SEBI took several incredible measures with commendable zeal and dexterity leading to the creation of enabling regulatory structure for the securities market and its development. It has taken significant reformatory measures to modernize the stock exchanges and improve their operational efficiency. Through introduction of disclosure norms, and automated working procedures, creation of depository system, installation of hassle free settlement system, strengthening of the surveillance system in stock exchanges, installation of grievance redressal system and prescribing prudent code of governance in listed companies, the SEBI tried to foster interests of the investors and inspire their confidence in the working of the stock exchanges. To cope with the rapid changes in the sphere of global financial markets, the SEBI took a host of initiatives for the faster integration of the Indian securities market with the rest of the world.

However, a peep into its working may lead one to conclude that the SEBI is overstepping its role. The manner in which guidelines and notifications are being issued by the SEBI from time to time, one may notice that the SEBI has become a body now to exercise control over capital issues and also in pricing which was not expected of it. A plethora of rules prescribed by the SEBI and revising them from time-to-time has not only complicated the operations of the market but also increased uncertainty and confusion. Ineffectiveness of the SEBI in monitoring the operations of stock exchanges and brokers and taking deterrent action against the wrongdoers is evidenced by the occurrence of several major scams. The regulatory ineffectiveness of the SEBI in certain cases has been due to its concentration on symptoms rather than the root causes. The existing settlement or delivery system leaves ample scope for manipulative operations and unhealthy speculation. Finally, the system of handling complaints of investors has not been friendly particularly to smaller shareholders. Periodic surveys conducted by experts from time to time confirm that the investors have suffered because of weak investor protection system.

Role ambiguity among market intermediaries is posing regulatory hurdles to smooth functioning of the securities market. Worse, regulatory action taken by the SEBI against market intermediaries for allegedly not playing the gate keeper's role despite the regulatory framework not providing for such a role, has led to regulatory fear among intermediaries, which in turn, leads to an acute state of indecisiveness in their administration. The SEBI would do well to review the specific issue of the role of gatekeepers and ensure that designated horses along run designated courses.

Thus, the SEBI still needs to take initiatives to render the market friendly to small investors and improve further customers' grievances procedures. It is also important to note that the SEBI has been acting at the behest of Ministry of Finance and not as an independent body. The government has overwhelming powers over the management of the SEBI and its working. This needs to be corrected to make the SEBI more efficacious and effective in its operations.

Self Assessment

Fill in the blanks:

1. In India …….. and ……..are the main regulators of financial institutions.
2. Regulation of …….is very important for a structured growth of a country.
3. The SEBI is empowered to regulate the business of ……..so as to prohibit fraudulent and unfair trade practices in securities market.
4. Companies making their first public issue are eligible to do only if they have ……years of dividend paying track record preceding an issue.
5. Periodic surveys conducted by experts from time to time confirm that the investors have suffered because of ……investor protection system.
6. ……among market intermediaries is posing regulatory hurdles to smooth functioning of the securities market.

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14.3 Reserve Bank of India

RBI is the Central Bank of India and controls the entire money issue, circulation and control by its monetary policies and lending policies by periodical updates or corrections to discipline the economy. It acts as an advisor to the Govt. of India and States Government, implement Forex polices; it works in tandem with the Govt. of India in promoting trade and as the account holder of foreign currency transactions and the Balance of Payment (BOP). It is also known as the bank of last resort.

14.3.1 Organisation and Management of RBI

The Reserve Bank of India was established on April 1, 1935, under the Reserve Bank of India Act, 1934. The main functions of the Bank are to act as the note-issuing authority. Banker's Bank, Banker to the government and to promote the growth of the economy within the framework of the general economic policy of the government, consistent with the need to maintain price stability. The Bank also performs a wide range of promotional functions to support the pace of economic development. The Reserve Bank is the controller of foreign exchange. It is the watchdog of the entire financial system. The Bank is the sponsor bank of a wide variety of top ranking banks and institutions such as SBI, IDBI, NABARD and NHB.

The Bank sits on the board of all banks and it counsels the Central and State Government and all public sector institutions on monetary and money matters. No central bank, even in the developed world, is saddled with such onerous responsibilities and functions. The RBI, as the central bank of the country, is the center of the Indian Financial and Monetary System. As the apex institution, it has been guiding, monitoring, regulating, controlling, and promoting the destiny of the IFS since its inception. It is quite young compared with such central banks as the Bank of England, Risk bank of Sweden, and the Federal Reserve Board of the US.

However, it is perhaps the oldest among the central banks in the developing countries. It started functioning from April 1, 1935 on the terms of the Reserve Bank of India Act, 1934. It was a private shareholders' institution till January 1949, after which it became a state-owned institution under the Reserve Bank (Transfer to Public Ownership) of India Act, 1948. This act empowers the central government, in consultation with the Governor of the Bank, to issue such directions to it, as they might consider necessary in the public interest. Further, the Governor and all the Deputy Governors of the Bank are appointed by the Central Government.

The Bank is managed by a Central Board of Directors, four Local Boards of Directors, and a committee of the Central Board of Directors. The functions of the Local Boards are to advise the Central Board on matters referred to them; they are also required to perform duties as are delegated to them. The final control of the Bank vests in the Central Board, which comprises the Governor, four Deputy Governors, and fifteen Directors nominated by the central government.

The committee of the Central Board consists of the Governor, the Deputy Governors, and such other Directors as may be present at a given meeting. The internal organisational set-up of the Bank has been modified and expanded from time to time in order to cope with the increasing volume and range of the Bank's activities. The underlying principle of the internal organization is functional specialisation with adequate coordination.

In order to perform its various functions, the Bank has been divided and sub-divided into a large number of departments. The pattern of central banking in India was initially based on the Bank of England. England had a highly developed banking system in which the functioning of the central bank as a banker's bank and their regulation of money supply set the pattern. The central bank's function as 'a lender of last resort' was on the condition that the banks maintain stable

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cash ratios as prescribed from time to time. The effective functioning of the British model depends on an active securities market where open market operations can be conducted at the discount rate. The effectiveness of open market operations however depends on the member banks' dependence on the central bank and the influence it wields on interest rates. Later models, especially those in developing countries showed that central banks play an advisory role and render technical services in the field of foreign exchange, foster the growth of a sound financial system and act as a banker to government.

14.3.2 Reserve Bank Objectives

The objectives of Reserve Bank were set out earlier but can be summarized as follows:

1. To maintain the internal value of the nations currency;
2. To preserve the external value of the currency;
3. To secure reasonable price stability; and
4. To promote economic growth with rising levels of employment, output and real income.

These objectives are common to all countries, developed and developing. More relevant to the developing countries like India are those of economic growth price stability in these countries.

14.3.3 Objectives of Credit Control

Modern economies are all based on money, which consists of both cash and credit. Cash can be created by only the Reserve Bank, while banks can extend credit. Since such credit creation can be both excessive and deficient as compared to the requirements of the economy, some control on them is exercised by the Central Bank of the country, which is the monetary authority, the apex bank and banker to banks. The need for credit control was explained by De Knock by saying that credit has "come to play a predominant part in the settlement of monetary and business transactions of all kinds and thus to represent a powerful force for good or evil."

The objectives of credit control are as follows:

1. Stabilisation of prices with out inflation and deflation by adjusting credit creation to the needs of the economy.
2. Keeping the exchange rates stable through proper adjustments of credit creation to the inflows and outflows of funds and sterilization of excess of inflows and outflows.
3. Stabilization of short-term money markets by the Central Bank through its influence on cost and availability of credit.
4. Promotion of economic growth by making credit available for all productive activities and controlling it for non-productive activities.

Self Assessment

Fill in the blanks:

7. The ……is the controller of foreign exchange. It is the watchdog of the entire financial system.
8. The main functions of the Bank are to act as the …….authority.
9. RBI is the Central Bank of India and controls the entire …….issue.

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10. The objective of credit control is ……of prices without inflation and deflation by adjusting credit creation to the needs of the economy.

14.3.4 Instruments of Credit Control

The operation of credit control is through various instruments of policy. These instruments are classified in to quantitative or general controls and qualitative or selective controls.

Quantitative or general controls are:

1. Bank rate policy.
2. Open market operations.
3. Variable cash reserve requirements and liquidity requirements.
4. Quantitative credit limits and other direct credit controls.

Selective controls are:

1. Variation in margin requirements.
2. Consumer's credit control and control on quantum of flow of funds to stock and commodity markets.

Notes Selective credit controls are controls on consumer credit or credit flowing in to the various sectors of the economy or for various purposes and against various securities or commodities.

Other Controls

In addition to general and selective controls, Central Banks also use direct controls, moral suasion and others to influence the credit by banks and other financial institutions and to make them follow certain policies or priorities in lending.

Monetary Policy and Economic Variables

In broad terms, monetary policy should also aim at a desirable level of monetary growth. In India, the existence of unorganized and subsistence sectors and a vast parallel economy necessitates a constant adjustment of the monetary policy to the changing economic scenario.

Besides it is generally assumed in any discussion or monetary budget and in monetary policy that the velocity of circulation of money remains constant. But in India with frequent shifts of public preferences from cash to deposit money and vice versa and as between black economy and organized economy, there are frequent fluctuations in the velocity of money.

Bank Rate and Interest Rates

Bank rate is the standard rate of discount charged by the Central Bank of the country to eligible parties. It is the minimum official rate at which the Central Bank rediscounts first class bills of exchange from the discount houses and commercial banks. By bank rate policy, we mean the terms and conditions under which the money market can have temporary access to the Central Bank in the form of discounts and rediscounts or secured advances. This policy would influence both the cost and availability of credit. The cost is the interest rate of commercial banks and market rate of interest, both of which are influenced by changes in the bank rate. The availability

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of credit is influenced by appropriate changes in the conditions under which the Central Bank provides credit to commercial banks such as difficult access or easy access. Thus, rising of the bank rate makes credit dearer through more or less equivalent changes in the commercial banks interest rate and in the market rate of interest rate and vice versa. Thus, the bank rate policy has the following effects:

1. Commercial banks find it difficult or easy to approach the Central Bank for loans, which limits or increases their ability to create credit respectively.
2. Commercial banks are expected to raise their rate of interest or reduce it. This affects the market rates of interest accordingly. The credit either becomes dearer or cheaper as the case may be. Accordingly, there are anti expansionary or pro expansionary effects on credit creation.

Interest Rate Policy in India

The RBI has been operating the interest rate policy in a flexible manner in tune with the development requirements of the economy. The bank rate is their standard rates of discount or advance to both banks and financial institutions. It provides refinance to banks varying rates, depending upon the purpose and security under section 17 of the RBI Act. Although the bank rate is its standard rate, it is not applicable to all lending by the RBI. Similarly, bank's borrowing and lending rates have been fixed by the RBI with in a broad spectrum, from a low rate of 4% for DRI loans to weaker section to a maximum lending rate of 17% for general purposes. There are multiplicities of rates to suit the needs of sectarian developments and to meet the socio economic obligations of the government. Some rationalization of these rates is also attempted to the RBI in tune with the recommendations of the Chakravarthy Committee referred to later. The discount and rediscounts rates on bills, government borrowing rates, etc. have been revised recently to bring them in line with the more realistic market oriented rates. The bank rate fixed by the RBI in 1990 to 91 was 10% per annum and has since been brought down by stages to 6% p.a. by 2004 to 2005.

Refinance Rates

There are many rates of refinance charged by the RBI for the financial accommodation to banks, depending up on the purpose and/or security. While the standard lending rate is the bank rate, there are special rates or refinance rates for lending against export bills or against banks food credits. There are also other rates for stand by refinance and discretionary refinance provided by the RBI. The net effective rate of refinance provided by the RBI is, therefore, different from the bank rate. The Repo rate is the prevailing rate of RBI by which it controls the call money and short-term rates, and Repo deals are referred to later.

Importance of Bank Rate

Bank rate is the leader among interest rates and sets the pace for other rates. Any change in it indicates a change in the Central Bank policy. Bank rate and changes in interest rates or the major instruments of monetary policy, which are activated in India since 1996, are now operated in a flexible manner.

In India, due to the needs of cheap Government finance and developmental needs of the economy, bank rate changes have been kept to the minimum, while other refinance rates have been changed, depending on the requirements of the economy.

Impact of Bank Rate Policy

Bank rate influences the economy both on the domestic and external fronts. On the domestic front, changes in bank rate affect investment and income in the economy through corresponding

changes in interest rates. In particular, changes in interest rates and these in turn influence investment and income in the economy influence the holding of inventories and fixed assets formation.

On the external front, bank rate changes influences inflow and outflow of funds of both short term and long term nature, namely, those for speculative and investment purposes. But in India due to the prevailing all-pervading exchange regulations, these external effects are limited for all practical purposes.

Limitations of Bank Rate Policy

The efficacy of the bank rate policy would depend on the following factors:

1. ***Link with Market Rates of Interest:*** The link between the bank rate and other interest rates should be strong and close so that changes in the bank rate would lead to consequent changes in the other interest rates in the economy. If the markets were not close and integrated, this would not be possible.
2. ***Extent of Cash Reserves:*** If there are excess reserves with the banks and there is no need to borrow from the Central Bank, then the bank rate changes would not percolate to other segments of the money market and its effectiveness will be limited.
3. ***Interest Elasticity of Investment:*** If the interest elasticity of investment is low and the demand for credit is interest rate policy or bank rate changes would not affect significantly the real economic variables such as investment, income and employment.
4. ***Flexibility and Cost and Prices:*** For the bank rate policy to work effectively there should be flexibility in cost and prices and interest cost should be a significant variable in the cost of production of industries.
5. ***Business Psychology:*** For effectiveness of the bank rate policy, particularly in a period of depression, it should be capable of influencing the business psychology on which investment outlays would depend generally. As the bank rate cannot influence this psychology in depressed conditions, it is said that the bank rate policy may work during an inflationary period but not at times of depression.
6. ***Extent of Money Market Development:*** For the bank rate policy to work, there should be a developed bill or money market, in which the Central Bank operates. In the absence of eligible bill for discount or because of undeveloped money markets as is India, the efficiency of bank rate policy will be limited.

Efficacy of Bank Rate Policy in India

1. The efficacy of bank policy in India is limited because of the multiplicity of refinance rates and the relative low elasticity of savings and investments to interest rates. This is due to the fact that the bulk of investments in India is in the public sector and by the government.
2. As an indicator of the policy, the bank rate is, harbinger of changes in credit policy. It no doubt influences the cost and availability of bank funds. So far as the organized financial sector is concerned, changes in other interest rates follow the changes in the bank rate. In India, deposit rates and lending rates of banks, including the various rates charged by banks on loans for different purposes, are controlled by the RBI. The government in consultation with the RBI fixes the interest rates charged by financial institutions and post officers. The short term and long-term rates and whole spectrum of interest rates change

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in tune with the bank rate. But in India these changes are not autonomous as the RBI fixes all rates and the government and simultaneous changes take place in the whole spectrum of interest rates. But the effect of these changes on the economy is limited to their impact on the organized financial system.

3. Bank rate influences the willingness and ability of banks to lend due to change in policy and consequently, the level of inventory holdings and investments in the economy are affected.

Open Market Operations (OMO)

OMO are an important instrument of monetary policy and refer to the purchases and sales by the Central Bank of government securities, treasury bills, gold, foreign exchange etc. in India, section 17 of the RBI Act authorizes the reserve bank to purchase and sell government securities- Central and State - and those fully guaranteed by the Central Government. At present, the RBI puts through the transactions only in Central Government securities. The reasons for this are as follows;

1. The securities have the highest degree of liquidity and easily marketable.
2. These are held by the reserve bank in its own investment account and also by the banks and financial institutions which facilitates the reserve banks operations in these securities on a daily bases.
3. There is a ready market for them in major cities in terms of quotations of prices, yields etc.

Control of Credit by the Reserve Bank of India

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a license from the Reserve Bank of India to do banking business within India, the license can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

1. It holds the cash reserves of all the scheduled banks.
2. It controls the credit operations of banks through quantitative and qualitative controls.
3. It controls the banking system through the system of licensing, inspection and calling for information.
4. It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

Notes

Caselet

CRR Hike Slightly Aggressive: Economists

Economists were "slightly surprised" by the extent of the cash reserve ratio (CRR) hike (of 0.75 per cent) but felt that the Reserve Bank's move was strongly influenced by rising inflationary pressures and the compelling need to rein them in.

"The market was expecting a 0.50 per cent hike in CRR and I feel the 0.75 per cent is slightly aggressive. It is more a pre-emptive move to control inflationary expectations," Bank of Baroda's Chief Economist, Rupa Rege Nitsure, told PTI here.

The Reserve Bank today upped the cash reserve ratio from 5 per cent to 5.75 per cent, a move expected to flush out ₹ 36,000 crore from the system. It also pegged expected inflation by March end at 8.5 per cent, sharply up from its earlier projection of 6.5 per cent. "The move is targeted at combating the liquidity over hang in the system," Nitsure said.

Crisil's Director and Principal Economist, D K Joshi, said, "today's move is a clear enunciation that inflation has emerged as a major concern for the RBI. This is clear from the fact that the apex bank hiked CRR by 0.75 per cent instead of by the widely expected 0.50 per cent."

While interest rate pressures are seen, there may not be an immediate increase in rates, the economists said.

Source: www.thehindubusinessline.com

Self Assessment

Fill in the blanks:

11. …….are controls on consumer credit or credit flowing in to the various sectors of the economy.
12. …….also use direct controls, moral suasion and others to influence the credit by banks and other financial institutions.
13. ……..is the standard rate of discount charged by the Central Bank of the country to eligible parties.
14. The efficacy of bank policy in India is limited because of the multiplicity of refinance rates and the relative low elasticity of savings and investments to……... .
15. ……..are an important instrument of monetary policy and refer to the purchases and sales by the Central Bank of government securities, treasury bills, gold, foreign exchange etc. in India.

Task Visit RBI website regularly to have a better understanding of the periodical updating of the measures initiated by it.

14.4 Summary

- The SEBI Act was enacted to establish the SEBI to protect the interests of investors and develop and regulate securities market. The SEBI has been vested with vast powers by the

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SCR Act as well as by the SEBI Act to regulate the activities of primary and securities markets and their various players. The SEBI has also been charged with the responsibility of developing the securities market in India.

- The SEBI has taken several measures to improve the functioning of the stock exchanges, modernize their infrastructure and create incredible investment climate. It has also taken measures to increase integration of the country's market with global securities market. However, the SEBI has not been found effective in monitoring the operations of the exchanges and the brokers. This suggests a strong need to develop robust monitoring system by the SEBI.
- RBI is also known as the bank of last resort. It is empowered with the responsibility of regulator, advisor and monitor of the monetary system of the country. RBI is the Central Bank of India and controls the entire money issue, circulation and control by its monetary policies and lending policies by periodical updates or corrections to discipline the economy. It acts as an advisor to the Government of India and states Governments, implements Forex polices; it works in tandem with the Govt. of India in promoting trade and as the account holder of foreign currency transactions and the Balance of Payment (BOP).

14.5 Keywords

Bank rate: Bank rate is the standard rate of discount charged by the Central Bank of the country to eligible parties. It is the minimum official rate at which the Central Bank rediscounts first class bills of exchange from the discount houses and commercial banks.

CRR: Cash Reserve Ratio.

Instruments of Credit Control: The operation of credit control is through various instruments of policy. These instruments are classified in to quantitative or general controls and qualitative or selective controls.

Open market operations: OMO are an important instrument of monetary policy and refer to the purchases and sales by the Central Bank of government securities, treasury bills, gold, foreign exchange etc. in India.

SLR: Statutory Liquidity Ratio.

14.6 Review Questions

1. Explain about the role of RBI as a regulator of the monetary system.
2. What are the functions of RBI?
3. Describe about how it monitors the economy for growth.
4. Why was the SEBI constituted? How far has the SEBI been successful in achieving its objectives?
5. What are the functions and powers of the SEBI?
6. What steps have the SEBI taken to regulate the primary market in India?
7. Assess the efforts made by the SEBI in regulating and developing the stock market of the country.

Answers to Self Assessment

1. Reserve Bank of India, Securities and Exchange Board of India
2. financial institutions
3. stock exchanges

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4. three
5. weak
6. Role ambiguity
7. Reserve Bank
8. note-issuing
9. money
10. Stabilisation
11. Selective credit controls
12. Central Banks
13. Bank rate
14. interest rates
15. OMO

14.7 Further Readings

Books

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Online links

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Case Study

RBI asks Banks to fund Self-help Groups Directly

Alarmed at micro-finance institutions' exposure to SHGs.

Both public and private sector banks were too "lethargic" in financing and re-financing SHGs, which has "led to MFIs taking advantage and becoming aggressive lenders at high rate of interest".

Alarmed at micro-finance institutions' exposure to self-help groups (SHGs), the Reserve Bank of India has asked public and private-sector banks to step up lending to SHGs. This directive also comes at a time when micro-finance institutions (MFIs) have been asked to reduced their high rate of interest being offered to their customers.

Speaking at a Dharwad District Consultative Committee meet recently, an RBI official said that both public and private sector banks were too "lethargic" in financing and re-financing SHGs, which has "led to MFIs taking advantage and becoming aggressive lenders at high rate of interest".

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He also pointed out that MFIs were "funding too much to SHGs".

According to a report released by Sa-Dhan, which has 264 members, the total loan outstanding for all 264 MFIs that reported to Sa-Dhan is ₹ 18,343.9 crore reaching out to 2.67 crore active borrowers, and an additional ₹ 4,200 crore of outstanding portfolio is being managed by MFIs on behalf of banks and other financial institutions, taking the total outstanding portfolio managed by MFIs to about ₹ 22,544 crore.

In contrast, a Nabard report on the 'status of microfinance in India 2010', says that during 2009-10, banks in India financed 15.87 lakh SHGs, including repeat loan to the existing SHGs, with loans of ₹ 14,453.30 crore, registering a growth of 17.9 per cent over the previous year in loans disbursed. As on March 31, 2010, 48.51 lakh SHGs had outstanding bank loans of ₹ 28,038.28 crore, a growth of 23.6 per cent in bank loans outstanding against SHGs.

The RBI official said that with active help from Nabard, Central and State agencies, public and private sector banks should "aggressively fund SHG projects directly instead of present practice of using MFIs as middlemen".

As banks have access to cheap credit, they should take advantage and fund SHGs at village level, he suggested. "Through this, banks can win over the trust and lay a strong foundation for financial inclusion and creating joint liability groups at village or taluk level," he added.

With banks now on a wait-and-watch mode as far as lending to MFIs goes, the present crisis in Andhra Pradesh could well present them good avenues to reach out to SHGs better, said an official with a public sector bank. "Banks can offer direct linkage to SHGs at within 12 per cent, and even after including the SHG margin of 3 per cent, credit is available at around 15 per cent, which is much lower than the high rates of interest that MFIs charge," he explained. This is one way of tackling the MFI issue.

Some banks like Canara Bank, which were not aggressive lenders to MFIs, want to continue having direct credit-linkage to SHGs. "We have always thought of lending directly, and there is no need for a change in that philosophy now. And we have never been aggressive lenders to the MFI sector," Mr S. Raman, Chairman and Managing Director, Canara Bank, told Business Line recently.

This fiscal, the bank has disbursed credit of ₹ 1,000 crore to SHGs directly, and expects to close the year with a 25 per cent growth in this portfolio.

As banks are now looking at direct credit-linkage to SHGs aggressively, MFIs are now forced to operate on a low-margin high-volume model. With MFIs being forced to reduce their rate of interest, "margins will be significantly impacted for several of them," pointed out Mr Suresh K. Krishna, Managing Director, Grameen Koota.

The drop in margins could be as high as 30-40 per cent for those who offer higher rates now. "But others, who currently offer loans at less than 30 per cent interest rate, there wouldn't be much of a difference," he added.

Question

Discuss the role of RBI in helping the Self Help Groups.

Source: http://www.thehindubusinessline.in