Vipul's

Accounting & Finance Series

(COMMERCE - II)

FINANCIAL MARKET OPERATIONS

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UNIT – I: AN OVERVIEW OF THE FINANCIAL SYSTEM

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INTRODUCTION TO FINANCIAL SYSTEM:

The financial system is a set of complex and closely connected or intermixed institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. It consists of specialized and non-specialized institutions. Procedures and practices adopted in the financial markets are also a part of the financial system. A well-developed financial system can contribute materially to the economic development of a country. Thus, the role of the financial system is to accelerate the rate of economic development and thereby improve the general standard of living and increase and social welfare. This can be achieved through the mobilization of savings and investment. The function of a financial is to be established between the savers and the investors and thereby help the mobilization of savings and investments. A financial system also directly helps to increase the volume and rate of savings by supplying a diversified portfolio of financial instruments, offering investment inducements and choices based on savers preferences.

SAVINGS AND INVESTMENT/CAPITAL FORMATION:

The major changes that have taken place in the savings and investment trends.

It indicates that the Indian Financial System has fulfilled one of its basic functions, namely the promotion of savings and investment.

It has been also indicated that the major part of saving has been due to the household sector. The contribution of the private corporate sector has been increasing but the contribution of the public sector has shown a negative trend.

The household sector has been the only surplus sector in India and the investment in private corporate and public sector has been far exceeded their respective savings.

Savings and capital formation have shown a remarkable increase in recent years. Savings have almost doubled while capital formation has reduced increasing net domestic savings.

The Reserve Bank of India has taken a keen interest in the development of the money, government securities, and foreign exchange markets because of their crucial role in overall growth and development of the economy and particularly in the transmission mechanism of monetary policy.

The initiative taken by the RBI has brought about a significant transformation of various segments of the financial market. These developments by improving the depth and liquidity in domestic financial markets have contributed to better price discovery of interest rates and exchange rates which have led to greater efficiency in resource allocation in the economy.

The increase in size and depth of financial markets has paved the way for the flexible use of indirect instruments. Greater depth, liquidity and freedom to market participants have also strengthened the integration of various segments of the financial markets.

ROLE AND IMPORTANCE OF FINANCIAL SYSTEM IN ECONOMIC DEVELOPMENT:

The financial system is a set of multifaceted and closely interweaved financial institutions, financial markets, financial instruments and services which enable the transfer of funds. Financial institutions mobilize funds from lenders and provide these funds to borrowers. On the contrary, the financial markets are also essential for the movement of funds from savers to intermediaries and from intermediaries to investors. In short, the financial system is a mechanism by which savings are altered into investments:

(1) It links the savers and investors.

(2) It helps in mobilizing and allocating the savings efficiently and effectively.

(3) It plays a crucial role in economic development through the saving-investment process.

(4) It helps to monitor corporate performance.

(5) It provides a mechanism for managing uncertainty and controlling risk.

(6) It provides a mechanism for the transfer of resources across geographical boundaries.

(7) It offers portfolio adjustment facilities (provided by financial markets and financial intermediaries).

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

(9) It promotes the process of capital formation.

(10) It helps in promoting the process of financial deepening and broadening. Financial deepening means growing financial assets as a percentage of GDP and financial broadening means structuring an increasing number and variety of participants and instruments.

FUNCTIONS OF FINANCIAL SYSTEM:

(1) **Savings Function:** The global system of financial markets and institutions provides a channel for the public's savings. Bonds, stocks, and other financial instruments which are traded in the money and capital markets provide a profitable, relatively low-risk outlet for the public's savings, moving through the financial markets into an investment so that additional value-added goods and services could be produced (i.e., rise in productivity), increasing the world's standard of living. Circulation of money in markets will encourage savings.

(2) **Wealth Function:** Financial system also makes sure that one can liquidate his or her savings whenever he or she wants it and therefore individuals can have both the things, encompassing return on investments as well as comfort that they can liquidate their investments whenever they wish to Hence it helps in creating wealth.

(3) **Liquidity Function:** Financial system also makes sure that one can liquidate his or her savings whenever he or she wants it and therefore individuals can have both the things, involving return on investments as well as comfort that they can liquidate their investments whenever they wish to Hence it helps in creating wealth.

(4) **Transferring Resources Across Time and Space:** A well-developed financial system provides a way to transfer economic resources through time and across geographic regions and industries. Loans help the transfer of funds from the future to today, and savings products from today to future, but the underlying function for these two seemingly different products is the same. Student loans, borrowing to buy a house, and saving

for retirement are all actions that shift resources from one point in time to another. The financial system also provides mechanisms to shift resources from one place to another.

(5) **Economic Development:** The financial system forms an integral part in reallocating capital and thus providing the basis for the constant restructuring of the economy that is required to support growth. In countries with a highly developed financial system, a larger share of investment is allocated to relatively fast-growing sectors. India is a mixed economy. The Government intervenes in the financial system to impact macro-economic variables like interest rate or inflation. Thus, credits can be made available to corporate at a cheaper rate resulting in the economic development of the nation.

(6) **Payment Function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the simplest and convenient methods of payment in the economy. The cost and time of transactions are substantially reduced.

(7) **Risk Function:** The financial markets protect against life, health and income risks. These guarantees are achieved through the sale of life, health insurance and property insurance policies.

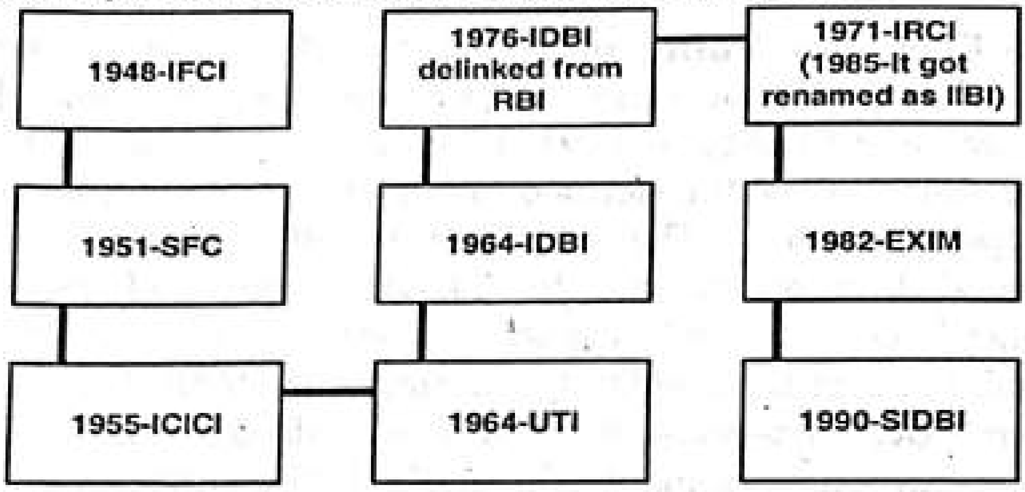
GROWTH AND DEVELOPMENT OF INDIAN FINANCIAL SYSTEM:

At the time of independence in 1947, there was an absence of strong financial institutional mechanisms in the country. The manufacturing sector had no access to the savings of the community. The capital market was nascent and shy. The private and unorganized sector played a significant role in the provision of liquidity. On the contrary, there was chaos and confusion in the financial system. After independence, the government embraced a mixed economic system. A scheme of planned economic development was evolved in 1951 to achieve the broad economic and social objective. The government started creating innovative financial institutions to supply finance both for agricultural and industrial development. It also gradually started nationalizing some important financial institutions so that the flow of finance might be in the right direction.

The following are the developments took place in the Indian financial system:

(1) Nationalization of Financial Institutions: RBI was recognized as a private institution in 1935. It was nationalized in 1949 making it the leader of the financial system. This was followed by the nationalization of the Imperial Bank of India. One of the important milestones in the economic growth of India was the nationalization of 245 Life Insurance Corporation in 1956. As a result, Life Insurance Corporation of India came into reality on 1st September 1956. A new significant development was the nationalization of 14 major commercial banks in 1969. In 1980, 6 more banks were nationalized. Another milestone was the nationalization of general insurance business and setting up of General Insurance Corporation in 1972.

(2) Establishment of Development Banks: In 1949, RBI undertook a comprehensive study to find out the requirement for specialized institutions. The first development bank Industrial Finance Corporation of India (IFCI) was established in 1948. In 1951, Parliament passed the State Financial Corporation Act. In 1955, The Industrial Credit and Investment Corporation of India (ICICI) were set up supported by the Government of India, the World Bank, etc. The UTI was established in 1964 as a public sector institution to collect the savings of the people and make them accessible for productive ventures. The Industrial Development Bank of India (IDBI) was recognized on 1st July 1964 as a wholly-owned subsidiary of the RBI. On February 16, 1976, the IDBI was delinked from RBI. It became an independent financial institution coordinating the activities of all other financial institutions. In 1971, the IDBI and LIC mutually set up the Industrial Reconstruction Corporation of India with the main objective of reconstruction and rehabilitation of sick industrial undertakings. The IRCI was transformed into a statutory corporation in March 1985 and renamed as Industrial Reconstruction Bank of India recently known as Industrial Investment Bank of India (IIBI). In 1982, the Export-Import Bank of India (EXIM Bank) was set up to provide financial assistance to exporters and importers. The Small Industries Development Bank of India (SIDBI) was set up as a wholly-owned subsidiary of IDBI on April 2, 1990. The SIDBI has taken over the accountability of administrating the Small Industries Development Fund and the National Equity Fund.



(3) **Establishment of Institution for Agricultural Development:** RBI set up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects, minor irrigation, farm mechanization, land development, etc. in the year 1963. In the year 1982, to meet the credit needs of agriculture and rural sector, the National Bank for Agriculture and Rural Development (NABARD) was established. The main aim of the establishment of NABARD is to extend short term, medium-term and long term finance to agriculture and allied activities.

(4) **Establishment of an Institution for Housing Finance:** In July 1988, the National Housing Bank (NHB) has been set up as an apex institution to mobilize the resources for the housing sector and promoting housing finance institutions.

(5) **Establishment of Stock Holding Corporation of India (SHCIL):** In 1987, Stock Holding Corporation of India Ltd, was set up to reinforce the stock and capital markets in India. Its sole objective was to provide rapid share transfer facilities, clearing services, support services etc. to investors.

(6) **Establishment of Mutual Funds and Venture Capital Institutions:** Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public and investing them in a diversified portfolio. They offer investment avenues for small investors who find it difficult to participate in the equities of big companies. Venture capital is an extensive term risk capital to finance high technology projects. In 1986, the

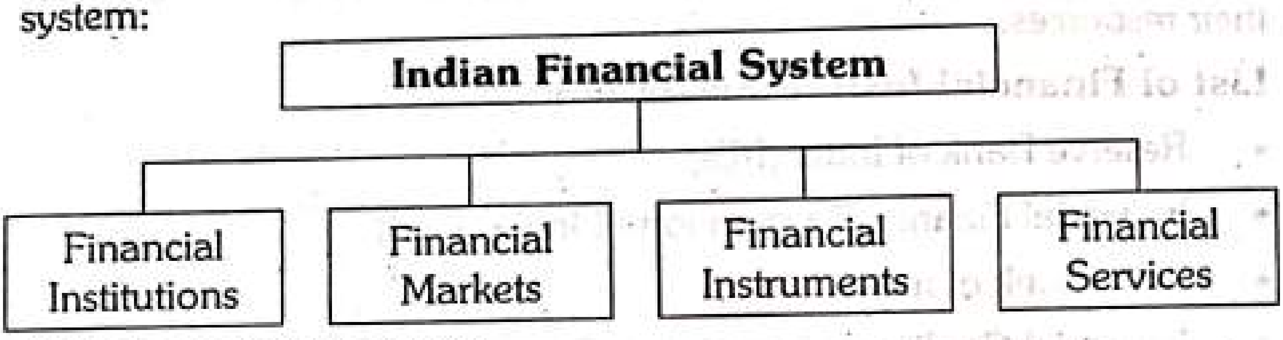
IDBI venture capital fund was set up. In 1988 ICICI and the UTI have jointly set up the Technology Development and Information Company of India Ltd. to offer venture capital.

(7) New Economic Policy of 1991: The Indian financial system has suffered gigantic changes since the announcement of the new economic policy in 1991. Liberalization, Privatization, and Globalization have transformed the Indian economy from closed to open economy. The corporate industrial sector also has endured fluctuations due to the de-licensing of industries, financial sector reforms, capital markets reforms, disinvestment in public sector undertakings, etc. Since the 1990s, Government control over financial institutions has diluted systematically. Public or development financial institutions have been transformed into companies, allowing them to issue equity/bonds to the public. The government has permitted the private sector to enter into the banking and insurance sector. Foreign companies were moreover endorsed to enter into the insurance sector in India.

There has been substantial progress in the financial development of India. Financial institutions have also grown up over some time. They also occupy a significant place in the financial structure of our country. The secondary markets in different financial assets have remained under development. The markets for many financial instruments are narrow and are confirmed to a few financial institutions. The Indian Financial System has now become more integrated than ever before. The financial sector is almost owned and controlled by the Government. The authorities like RBI and SEBI closely monitor and regulate financial institutions and markets. This system has been liberalized since 1991. The viability of some banks and financial institutions has become endangered. They have failed to build up an effective, efficient and safe credit delivery system. Their functioning has become endangered. They have failed to build up an effective, efficient and safe credit delivery system. Their functioning has become grossly politicized. Therefore, the investors feel cheated in respect of risk, return and liquidity of financial assets. However, there is a great scope for improving the operational or financial efficiency of the financial institutions in India, particularly after liberalization. Opening up of the economy for foreign companies, competition, privatization will have adverse effects on the financial system in India. However, it will improve operational efficiency and the customers will be benefited from better services and cost reduction.

CONSTITUENTS OF INDIAN FINANCIAL SYSTEM:

The financial system was fairly well developed on the eve of planning. The following are the constituents of Indian financial system:



(1) Financial Markets:

The arrangements that provide facilities for buying and selling of financial claims and services are known as financial markets. The participants in these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and others who are inter-linked by the laws, contracts and communication networks of the country. Financial markets can be classified as primary and secondary markets. The primary market deals in a new financial claim; therefore it is called the new issue market. On the other hand, secondary markets deal in securities already issued or existing securities. The stock market is an example of a secondary market. The financial market can also be classified as money market and capital market. The money market deals with short term claims with a maturity of less than one year. The capital markets deal with long term claim i.e. more than one year. The capital market is co-extensive with the stock market and it is also wider than the stock markets. The money market includes the Treasury Bill Market, Call Money Market and Commercial Bill Market, and Government Bond Market.

(2) Financial Institutions:

Financial institutions are business organizations that performing as mobilizers and depositories of savings. They also deliver various financial services to society. Financial institutions are divided into the institutions participate in the country's payments mechanism i.e. to provide transaction services, create deposit or credit. The banking system in India comprises commercial banks, co-operative banks, and non-banking financial institutions. Life Insurance Corporation, Unit Trust of India, Industrial Development Bank of India is some of the important non-banking financial institutions. Non-banking financial intermediaries also include Investment Trust, Nidhis, and Mutual Funds, Merchant Bankers, Hire Purchase and Leasing companies. Banks can advance credit by creating claims against themselves but non-banking finance companies can lend only out of their resources.

List of Financial Institutions in India:

- Reserve Bank of India (RBI)
- Industrial Finance Corporation of India (IFCI)
- State Bank of India
- Industrial Credit and Investment Corporation India Ltd. (ICICI)
- Life Insurance Corporation of India (LIC)
- Export Credit Guarantee Corporation of India (ECGC)
- Industrial Development Bank of India (IDBI)
- General Insurance Corporation (GIC)
- Regional Rural Banks
- Housing Development and Finance Corporation Ltd. (HDFC)
- EXIM Bank
- Unit Trust of India
- Board for Industrial and Financial Reconstruction
- Securities and Exchange Board of India (SEBI)
- National Housing Bank
- Small Industries Development Bank of India (SIDBI)

(3) Financial Instruments:

The Financial System deals in financial services and claims which are known as financial instruments, or financial assets or securities. Financial instruments can be classified as primary and secondary instruments. The primary instruments are issued by the ultimate investors directly to the savers as in case of ordinary shares, debentures, or bonds where the companies are ultimate investors and the people who but these instruments (individuals or institutions) are savers Shares are ownership instruments and debenture or bonds are debt instruments. The important characteristics of the financial instruments are transferability, liquidity, marketability, transaction costs, and risk of default, maturity, and tax exemption. There are varieties of instruments, which are used in financial markets in India. These are Treasury Bills, Commercial Bills, Commercial Papers, Public Deposits, Certificate of Deposits, Unit of Mutual Funds, Life Insurance Policies, and Postal Saving Instruments such as NSC, Kisan Vikas Patra, and Monthly Income Certificate, etc.

(4) Financial Assets:

Financial assets are those contracts that do not consist of possibility, i.e. Inspite of any conditions, generate financial dues having demonstrable worth over which ownership rights are imposed, individually or mutually, out of which economic benefits can be derived by using or holding them. The concept of financial instruments is broader than the notion of a financial asset as defined in the System of National Accounts, 1993. Thus, financial instruments are categorized into financial assets and financial instruments. The arrangement of financial assets is based on their two principal characteristics, liquidity, and legal characteristics.

(5) Financial Services:

Indian financial system has a strong group of financial institutions diverse in nature. They are financial intermediaries who provide a variety of financial services to the business and community. They are specialized financial institutions in the field of Insurance, Hire Purchase and Leasing Deposit Insurance and Guarantees, Merchant Banking, Credit Rating, Consultancy; Discounting, Underwriting, Funds Transfer, Brokerage, Managing Capital Issues, and Portfolio Management. New services have also started like credit, stock trading, depositories, etc.

TYPES OF FINANCIAL SERVICES:

(1) Banks: A bank is an institution that accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions. Banks are such institutions that have sole authority in creating credit by accepting deposits and making advances. Banks are the main contributors to the financial system in India. The Banking sector offers numerous facilities and opportunities to their customers. All the banks safeguard the money, valuables and also offer loans, credit, and payment services, such as checking accounts, money orders, and cashier's cheques. Various investment and insurance products are also offered by banks. The organized banking sector mechanism focuses on the financial system to provide loans, accept deposits and provide other services to their clients. E.g.: SBI, HDFC, ICICI, Axis, Bank of Baroda, Indian Bank etc.

(2) **Insurance:** Insurance is a way of reducing your potential financial loss or hardship. It can work towards covering the cost of unexpected events such as theft, illness or property damage. It can also provide a financial payment upon death. Several insurances provide comprehensive coverage with affordable premiums. Premiums are periodical payments with different insurers offering dissimilar premium options. The periodical insurance premiums are calculated in accordance to the total insurance amount. Generally insurance is used as an effective tool of **risk management** so as to insured the quantified risks of different volumes. Insurances are of various types-it could be life insurance or General Insurance. According to the needs of individuals or entities, different policies are been offered so as to cover the stipulated risk.

(3) **Mutual Funds:** A 'mutual fund' is an investment vehicle that allows several investors to pool their resources in order to purchase stocks, bonds and other securities. The sum total of funds usually referred as Assets under Management or AUM are invested by an expert fund manager appointed by an Asset Management Company (AMC) which is a mutual fund company. The joint underlying holding of the fund is known as the 'portfolio', and each investor possesses a portion of this portfolio in the form of units. E.g.: Axis Mutual Fund, HDFC MF, Kotak MF, Nippon MF etc. These Asset management companies offer various funds investing in different categories. For example- Aditya Birla Sunlife Mutual Fund (ABSLMF) is the largest AMC

in India offering 4 types of funds catering to Equity, Debt, Income and ELSS funds.

(4) **Merchant Banking:** Merchant banking implies investment management. Corporates raise capital by issuing securities in the market. Merchant bankers act as intermediaries between the issuers of capital and the investors who purchase these securities. Merchant banking is the financial intermediation matching the entities that wish to borrow capital and those who wish to lend capital for investment. The services provided by merchant bankers comprises management of mutual funds, public issues, trusts, securities and international funds involving the deals with the corporate clients and advising them on various issues like- mergers, acquisitions, public issues, etc. E.g.: Kotak Mahindra Capital, Morgan Stanley, Credit Suisse, Bank of America and Citi were the merchant bankers/advisors for Zomato who earned about Rs 229 crore as fees, making it one of the largest payouts for any Indian IPO.

(5) **Venture Capital:** Venture Capital is a form of "risk capital". In further words, capital that is invested in a project like in case of a business where there is a substantial element of risk relating to the future creation of profits and cash flows. Risk capital is financed in form of equity shares rather than a loan and the investor requires a higher "rate of return" to compensate him for his risk. E.g.: Byjus India which is an e-learning startup has been able to raise $1229 mn of startup funding through the way of venture capital investments. Footpath ventures, GSV ventures, Blackstone, UBS, ADQ, Owl Ventures, B capital Group, Prosus Ventures, Silver lake are the names of VC investors in Byjus.

(6) **Factoring:** Factoring is a financing option for the receivables management. In other words it is the alteration of credit sales into cash. In factoring, a financial institution who is known as (factor) buys the accounts receivable of a company who is known as (Client) pays up to 80% (rarely up to 90%) of the amount immediately on agreement. Factoring company pays the remaining amount i.e. remaining 20% Balance finance is cost-operating cost to the client when the customer pays the debt. Debt recovery from the customer is done either by the factor or the client depending upon the type of factoring. The account receivables in factoring can either one for a product or service.

At present there are only 7 NBFC's in India registered with RBI for factoring named as- Canbank Factors Limited, IFCI Factors Ltd, Bibby Financial Services (India) Pvt. Ltd., SBI Global Factor Ltd., India Factoring & Finance Solutions Pvt. Ltd., Pinnacle Capital Solutions Private Limited, Seimens Factoring Pvt. Ltd. Recently certain laws has been amended in Factoring act enabling additional 9000 NBFC's to participate in the Factoring Market.

(7) **Forfeiting:** It is a source of trade finance. For many years, forfeiting has attracted people's interest in the banking sector and international trade because forfeiting is the most efficient instrument in the sector of export finance. Forfeiting is the purchase of exporter's receivables at a discounted price by paying cash. In the case of forfeiting, the buyer is known as the forfeiter who undertakes all risks while collecting the receivables. Due to this, the cash flow improves, but income gets reduced. Forfeiting enables improvement in cash flows as along with mitigating various types of risk such as credit risk, transfer risk and foreign exchange risk. Forfeiting is usually more costly than commercial lender financing as it results in higher export costs.

CHARACTERISTICS OF FINANCIAL SERVICES:

Financial services have same characteristics as of those services offered in an economy. Following are its characteristics:

(1) **Intangibility:** Services are those which cannot be seen, touched or heard. They are intangible in nature. For financial services to be created and marketed successfully, financial institutions should provide them with good confidence.

(2) **Customer Orientation:** Financial services could be satisfactorily provided only when it studies needs of its customers in detail. Only with customer interaction, new innovative services could be created and offered. Cost, maturity period, liquidity criteria could be decided only after interacting with customers.

(3) **Inseparability:** Services are produced and consumed at same point. It cannot be stored and consumed later on. Production and supply takes place simultaneously, which demands for perfect understanding between financial service firms and their clients.

(4) Perishability: Financial services have to be created and delivered to their target clients. They cannot be stored. They need to be supplied as per the requirements of their customer. Thus a supplier should match between demand and supply.

(5) Dynamism: Financial services have to be dynamic in nature. They need to be change as per social needs. Financial institutions must be proactive in nature and evolve new services by visualizing expectations of the market.

SCOPE OF FINANCIAL SERVICES:

The financial services can be broadly categorized into two:

(a) Fund based services: These services are related to the funds transfer from one place to another place and one person to another person.

(b) Non-fund services (or fee-based services): Today, customers are not satisfied with mere provision of finance. They expect more from financial service companies. Henceforth, the financial service companies or financial intermediaries deliver services on the basis of non-fund activities also. Such services are known as fee based services.

Let us, now, study these services in detail.

FUND BASED SERVICES

(1) Equipment leasing/Lease financing: 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 becomes the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. A lease is a contract whereby the owner of an asset (the lessor) grants to another person (the lessee) exclusive right to use the asset for an agreed period of time, in return for the payment of a rent (called lease rental). Capital assets like land, buildings, equipment's, machinery, vehicles are the usual assets which are generally acquired on lease basis. The lessor remains the owner of the asset, but the possession and economic use of the asset is vested in the lessee. E.g.: The Government of India will raise Rs. 88,000 crore in current year of 2021 by leasing infrastructure assets of central government ministries and state-run companies under a Rs. 6 trillion National Monetization Pipeline (NMP).

(2) Hire purchase: Hire purchase is another method of acquiring a capital asset for use, without paying its price immediately. Under hire purchase arrangement goods are let on hire, the hirer (user) is allowed to pay the purchase price in installments and enjoys an option to purchase the goods after all the installments have been paid. Thus the ownership in the asset is passed on to the hirer on payment of the last installment. The amount and number of installments is fixed at the time of delivering the asset to the hirer. If the hirer makes default in making payment of any installment, the seller is entitled to recover the asset from the hirer. The hirer may, on his own also, return the asset to the hiree without any commitment to pay the remaining installments. The installments for this purpose are treated as hire charges. Thus, the property in the asset remains vested in the seller (hiree) till, the right of purchase is exercised by the hirer after making payment of all the installments.

(3) Bill discounting: Bill discounting is an attractive fund based financial service provided by the finance companies. In the case of time bill which is usually payable after a specified period of time, the holder needs not wait till maturity or due date. If he is in requirement of money, he can get that bill discounted with his banker. After deducting a certain amount i.e. discounting the banker credits the net amount in the customer's account. Thus, the bank purchases the bill and credits the customer's account with the amount of the bill less discount. On the due date, the drawee makes the payment to the banker. In case he fails to make payment, the banker will recover the amount from the customer who has discounted the bill. In simple words, bill discounting means giving loans on the basis of the guarantee of a bill of exchange.

(4) Venture capital: Venture Capital is a form of "risk capital". In further words, capital that is invested in a project like in case of a business where there is a substantial element of risk relating to the future creation of profits and cash flows. Risk capital is financed in form of equity shares rather than a loan and the investor requires a higher "rate of return" to compensate him for his risk. Venture capital provides long-term, committed share capital, to help unlisted companies expand and succeed. If an entrepreneur is looking to start-up, expand, buy-into a business, buy-out a business in which he works, turnaround or revitalize a company, venture capital could help do this. Obtaining venture capital is substantially difficult as compare to raising debt or a loan from a lender. Lenders have a legal right to interest on a loan and repayment of the capital, inspite of the success or failure of a business. Venture capital is capitalized in exchange for an equity stake in the business. As a shareholder, the venture capitalist's return is dependent on the progression and profitability of the business. This return is normally earned when the venture capitalist "exits" by selling its shareholding when the business is sold to another owner.

(5) **Housing finance:** Housing finance simply refers to providing finance for house building. It began as a fund based financial service in India with the establishment of National Housing Bank (NHB) in 1988 by the RBI making it as an apex housing finance institution in the country. Till now, a number of specialised financial institutions/companies have entered in the field of housing finance. Certain of the institutions are HDFC, LIC Housing Finance, Citi Home.

(6) **Insurance services:** Insurance is a contract between two parties insured and the insurer. Insured is the person whose life or property is insured with the insurer. That is, the person whose risk is insured is called insured. Insurer is the insurance company to whom risk is transmitted by the insured. That is, the person who insures the risk of insured is called insurer. Thus insurance is a contract between insurer and insured in which the insurance company undertakes to insure the insured on the happening of assured event for a payment of consideration. It is an agreement between the insurer and insured underneath which the insurer undertakes to pay the insured for the loss arising from the risk insured against.

(7) **Factoring:** Factoring is an arrangement under which the factor purchases the account receivables (arising out of credit sale of goods/services) and makes immediate cash payment to the supplier or creditor. Thus, it is a contract in which the account receivables of a firm (client) are purchased by a financial institution or banker. Thus, the factor provides finance to the client (supplier) in detail of account receivables. The factor accepts the obligation of collecting the account receivables. The

financial institution (factor) undertakes the risk. For this type of service as well as for the interest, the factor charges a fee for the superseding period. This fee or charge is called factorage.

(8) **Forfaiting:** Forfaiting is a method of financing of receivables relating to international trade. It is a non-recourse acquisition by a banker or any other financial institution of receivables rising from export of goods and services. The exporter surrenders his right to the forfaiter to receive future payment from the buyer to whom goods have been supplied. Forfaiting is a technique helping the exporter to sell his goods on credit and yet receives the cash well before the due date. In short, forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pay ready cash to the exporter. The exporter need not trouble about collection of export bill except concentrating on export trade.

(9) **Mutual fund:** Mutual funds are financial intermediaries which mobilize savings from the people and invest them in a mix of corporate and government securities. The mutual fund managers actively manage the portfolio of securities from whereby they earn income through dividend, interest and capital gains. The returns on investment are eventually passed on to mutual fund shareholders.

NON-FUND BASED/FEE BASED FINANCIAL SERVICES

(1) **Merchant banking:** Merchant banking implies investment management. Corporates raise capital by allotting securities in the market. Merchant bankers act as intermediaries between the issuers of capital and the investors who purchase these securities. Merchant banking is the financial intermediation that ties the entities that need capital with those that have capital for investment. The services provided by merchant bankers include management of mutual funds, public issues, trusts, securities and international funds. It involves dealing with corporate clients and advising them on various issues like- mergers, acquisitions, public issues, etc."

(2) **Credit rating:** Credit rating means obtaining an expert opinion by a rating agency on the comparative willingness and ability of the issuer of a debt instrument to meet the financial obligations on due date or till succession. It measures the relative risk of an

issuer's ability and willingness to repay both interests along with principal over the period of the rated instrument. It is a judgment about a firm's financial and business prospects. In short, credit rating means evaluating the creditworthiness of a company by an independent organisation.

(3) **Stock broking:** These days stock broking has emerged as a professional advisory service. Stock broker is an associate of a recognized stock exchange. He buys, sells, or deals in shares/ securities. It is mandatory for each stock broker to get himself/herself registered with SEBI in order to act as a broker. As a member of a stock exchange, he will have to abide by its rules, regulations and bylaws.

(4) **Custodial services:** These forms of services are provided by a custodian are known as custodial services. It is an institution or a person who is handed over securities by the security owners for safekeeping. He is a caretaker of public property or securities. They act as intermediaries between companies and clients (i.e. security holders) and institutions (financial institutions and mutual funds). There is a planning and agreement between custodian and real owners of securities or properties to act as custodians of the underlying holdings. A custodian must safeguard the securities or documents under safe custody. The work of custodian is very risky and costly. The remuneration for rendering custodial services is called custodial charges. Therefore the custodial service is the service of safeguarding the securities on behalf of somebody else for a remuneration called custodial charges. E.g.: Axis Bank, BNP Paribas, Citi Bank, Edelweiss Custodial Services Limited etc

(5) **Loan syndication:** Loan syndication is a procedure where a group of banks participate to provide funds for a single loan. In loan syndication, a group of banks comprising 10 to 30 banks participate to provide funds wherein one of the banks is the lead manager. This lead bank is decided upon by the corporate enterprises, based on confidence in the lead manager. A single bank cannot give a huge loan. Hence several banks come together to form a syndicate. This is known as loan syndication. Thus, loan syndication is very similar to consortium financing. Recently on the recommendation of RBI, Secondary Loan Market Association (SLMA) is been formed for the development

of loan syndication in Indian Financial Markets. There are 10 major lenders associated in SLMA- SBI, ICICI Bank, Canara Bank, HDFC, Standard Chartered Bank, Kotak Mahindra Bank, Deutsche Bank, Bank of Baroda, Punjab National Bank, Axis Bank.

(6) **Securitization (of debt):** Securitization is a financial innovation. It is alteration of existing or future cash flows into marketable securities that can be sold to investors. It is the procedure by which financial assets such as loan receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed into securities. Thus, any asset with anticipated cash flows can be securitised. Securitisation is defined as a process of transformation of illiquid asset into security which may be traded later in the opening market. In short, securitization is the alteration of illiquid, non- marketable assets into securities which are liquid and marketable assets. It is a process of conversion of assets of a lending institution into negotiable instruments. E.g.: The 594 km- Ganga Expressway between Meerut and Prayagraj which is yet to be constructed has received funding of 5,100 crore in the form of securitization based loan from Punjab National Bank, whereas the total estimated cost of project is 36,230 Crore.

Table showing various Financial Institutions and services offered by them:

Financial Institutions	Financial Services Offered
Banks	Loans and advances (Fund Based Services)
Development Banks	(a) Direct Finance (b) Indirect Finance/Refinance
Merchant Bankers	(a) Management of debt and equity offerings (b) Placement and Distribution (c) Corporate advisory services (d) Project advisory services (e) Loan Syndication (f) Providing venture capital financing
Asset Management Company	Mutual Funds
Insurance Companies	Insurance

FINANCIAL INTERMEDIARIES IN CAPITAL MARKET:

There are many intermediaries in the primary market or capital market. Important players are as follows:

(1) **Merchant bankers:** Merchant bankers play a vital role in attracting public money to capital issues. They act as issue managers, lead managers or co- managers.

(2) **Registrars to the issue:** Registrars are intermediaries who undertake all activities connected with new issue management. They are appointed by the company in consultation with the merchant bankers to the issue.

(3) **Bankers:** Some commercial banks act as collecting agents and some act as coordinating bankers. Some bankers act as merchant bankers and some are brokers. They play an important role in transfer, transmission and safe custody of funds.

(4) **Brokers:** They act as intermediaries in the purchase and sale of securities in the primary and secondary markets. They have a network of sub-brokers spread throughout the length and breadth of the country.

(5) **Underwriters:** Generally investment bankers act as underwriters. They agreed to take a specified number of shares or debentures offered to the public if the issue is not fully subscribed by the public. Underwriters may be financial institutions, banks, mutual funds, brokers etc.

FINANCIAL INNOVATION:

(1) **Financial innovation:** It is a broad term that is used to describe the generation of new and creative approaches to different financial circumstances. The term is sometimes used concerning the creation of new types of securities or else innovation is something to do with new and interesting approaches to money management or investment. Under any circumstances, financial innovation is all about offering an idea or financial instrument that is different from what has gone before and has the potential to be extremely desirable in the long run.

(2) **Types of Financial Innovation:** Financial innovation enhances the sustainability of institutions and their outreach to the poor. There are different types of financial innovations such as:

(a) **Financial system/institutional innovations:** Such innovations can affect the financial sector as a whole relate to changes in business structures, to the establishment of new types of financial intermediaries, or changes in the legal and supervisory framework. Important examples include the use of the group mechanism to retail financial services, formalizing informal finance systems, reducing the access barriers for women, or setting up a completely new service structure.

(b) **Process innovations:** Such innovations cover the introduction of new business processes leading to increased efficiency, market expansion, etc. Examples include office automation and the use of computers with accounting and client data management software.

(c) **Product innovations:** Product innovations include the introduction of new credit, deposit, insurance, leasing, hire purchase, and other financial products. Product innovations are introduced to respond better to changes in market demand or to improve the efficiency of financial service.

CHALLENGES FACED BY FINANCIAL SECTOR:

(1) In the context of the banking sector, there is the issue of consolidation, which is the current buzzword in the banking industry worldwide.

(2) The second issue of import is the management of costs. Cost containment is a key to the sustainability of bank profits as well as their long-term viability.

(3) Another related challenge is in reducing the cost of funds of the banking sector.

(4) The issue of credit delivery systems has come into focus of late.

(5) Another issue is the management of NPA (Non-Performing Assets).

(6) Another issue concerns the management of risks. Banking in modern economies is all about risk management. Over the past few years, the Reserve Bank has initiated several steps to promote adequate risk management systems across market participants.

(A) DEVELOPMENTAL CHALLENGES:

A key issue in most fast-growing economies is how to ensure adequate availability of finance to support investment and growth. Most countries rely on a combination of the banking sector, other financial institutions and capital market for channelizing funds to the corporate. Each country, however, has its unique set of dilemmas in their financial sectors. India is no different in this respect.

There are several key issues, which are of particular relevance to India for the country to meet the challenges of globalization.

(B) INTER-LINKAGES AMONG FINANCIAL MARKETS:

The first step towards LPG is the integration of various segments of the domestic financial markets. The dream of all central banks is to see the various segments of financial markets working in a smooth and well-coordinated manner. Well-developed financial markets help central banks to effectively conduct monetary policy with the use of market-based instruments.

These markets also generate appropriate reference rates for pricing other financial assets. A necessary prerequisite for the smooth operation of the financial markets is the integration of domestic markets so that impulses can flow smoothly across different market segments and the resource allocation process becomes more efficient. The inter-linkages between the money market.

The government securities market and foreign exchange market are now fairly well established. However, as in financial markets in other developing economies, the capital markets in India are not yet fully integrated with the other segments of the markets. While the extent of integration between capital market and other segments of financial markets is much deeper in the developed economies, a consensus is yet to emerge on the role that equity prices should lay in monetary policy formulation. This is more so because typically equity prices are more sensitive to "news" than to the underlying "fundamentals". In India, there have been some episodes of volatility spillovers between markets in times of uncertainty. Because of the progressive integration of various segments of financial markets, the Reserve Bank keeps a close watch on activity in the equity market to guard against any possible spillover of disturbances to the money, the Government securities and the foreign exchange markets. In such situations, concerted policy response from the regulators can contain to a great extent the risks of transmission of volatility. This is the first crucial step toward being globally competitive.

CHALLENGES TO REGULATION AND SUPERVISION:

As the Indian financial system undergoes structural changes relating to ownership, competition, and integration with global financial markets, the necessity of an ongoing restructuring of the regulatory framework and improved monitoring of the embedded risks in the financial system has been recognized.

CHALLENGES IN PAYMENT AND SETTLEMENT SYSTEMS:

Governance Issues:

Finally, Governance issues in banks as also in capital markets have come to occupy center-stage in recent times. The quality of corporate governance becomes critical as competition intensifies, ownership is diversified and banks strive to retain their client base. The Reserve Bank has, on its part, made significant efforts to improve governance practices in banks, drawing upon international best practices.

Corporate Debt Market:

The development of a deep and liquid corporate bond market is essential for funding projects with long gestation lags and also for lending sustenance to the process of asset securitization. Typically, the corporate bond markets continue underdeveloped in most emerging economies. Despite long tradition, the corporate debt market in India is still in a nascent stage of development.

Long-term Financing/Infrastructure Financing:

Perhaps the biggest challenge in Indian financial sector at this juncture is to find resources for funding investments in long gestation projects including infrastructure. As in most other emerging markets economies, corporate sector in India is often credit constrained. The shortage is particularly marked with respect to longer-term finance with the constraint being particularly severe for the small and medium-size firms.

Venture Capital:

For financing start-up firms, the role of venture capital can hardly be over-emphasized. Venture capital financing is especially important as it can focus on sunrise industries and also provide guidance to start-up firms in the initial stages of their development. They show a very valuable role in solving the problem of pre-IPO financing. Venture financing has not shown satisfactory growth in India due to stringent regulations. Several concerns relating to lock-in of shares, exit options, freedom to invest in various types of instruments, modes of investment, and some tax-related issues need to be addressed to encourage the flow of venture capital funds in India.

In sum, the Indian financial sector has taken several steps in the right direction, but much more needs to be done to ascend to commanding heights. A careful approach towards increasing efficiency within the framework of overall financial stability can expressively contribute towards India becoming a leading financial force in the world.

SUMMARY

- Financial system is a set of complex and closely interlinked financial institutions, financial markets, financial instruments and services which facilitate the transfer of funds.
- There are various functions of financial markets: Savings function, wealth function, liquid function, transferring resources across time and space, economic development, payment and risk function.
- There are various constituents of Indian financial system: Financial markets, financial institutions, financial instruments, financial assets and financial services.
- Financial innovation is a broad term that is used to describe the generation of new and creative approaches to different financial circumstances. There are various types of financial innovations.

QUESTIONS

(1) Multiple Choice Questions (MCQs):

(a) Which of the following are functions of a financial system?

(i) The operation of a payments system (ii) Providing the means of portfo adjustment (iii) Helping to reduce unemployment (iv) Channelling fund between lenders and borrowers (v) Helping speculators to bet on pric movements

(b) Which of the following are characteristic of a financial intermediary?

(i) It introduces borrowers to lenders (ii) It has assets which exceed liabilitie (iii) It increases liquidity for lenders (iv) It reduces transaction costs fo borrowers and lenders (v) It makes an excess profit

(c) The central banking functions in India are performed by the ______. *(Oct. 17)*

(i) Central Bank of India (ii) Reserve Bank of India (iii) State Bank of Indi (iv) Punjab National Bank

(d) The BSE Sensex consists of a basket of ______ stocks.

(i) 50 (ii) 100 (iii) 30 (iv) 66

(e) ______ is the function of financial system. *(Oct. 17)*

(i) Saving function (ii) Nationalization of financial institutions (iii) Establishmen of Development banks (iv) Intermediaries control

(f) ______ deals with short term claims with a maturity of less than one year.

(i) Money Market (ii) Primary Market (iii) Secondary Market (iv) Capital Market

(g) The ______ deals in new financial claim; therefore it is called new issue market.

(i) Money Market (ii) Primary Market (iii) Secondary Market (iv) Capital Market

(h) ______ act as intermediaries in the purchase and sale of securities in the primary and secondary markets.

(i) Underwriters (ii) Merchant Banker (iii) Broker (iv) Factoring

(i) ______ is the purchase of exporter's receivables at a discounted price by paying cash.

(i) Underwriters (ii) Merchant Banker (iii) Forfeiting (iv) Factoring

(j) ______ agrees to take a specified number of shares or debentures offered to the public if the issue is not fully subscribed by the public.

(i) Underwriters (ii) Merchant Banker (iii) Forfeiting (iv) Factoring

(k) ______ is chairman of the central Board of directors of RBI.

(i) Finance Minister (ii) Governor (iii) President

(l) The financial service can also be called ______.

(i) Financial intermediations (ii) Financial derivatives

(m) Saving is defined as ______ income minus personal Consumption expenditure. *(March 19)*

(i) Personal Disposable (ii) Savings

(n) Forfeiting is usually more costly than ______ as it results in higher export costs.

(i) Banking (ii) Commercial Lending (iii) Retail Lending Factoring

[Ans.: (a – iv), (b – i), (c – ii), (d – iii), (e – i), (f – i), (g – ii), (h – ii), (i – iv), (j – iii), (k – ii), (l – i), (m – i), (n – ii)]

2) **Fill in the blanks:**

(a) __________ is a set of complex and closely connected or intermixed institutions, agents, practices, markets, transactions, claims and liabilities in the economy.

(b) RBI was nationalized in __________.

(c) __________ has been set up in July 1988 as an apex institution to mobilise resources for the housing sector and to promote housing finance institutions.

(d) The arrangements that provide facilities for buying and selling of financial claims and services are known as __________.

(e) __________ deals in new financial claim; therefore it is called new issue market.

(f) __________ deals with short term claims with a maturity of less than one year.

(g) __________ is a way of reducing your potential financial loss or hardship.

(h) __________ act as intermediaries between the issuers of capital and the investors who purchase these securities.

(i) Capital that is invested in a project where there ~~is~~ a substantial element of risk relating to the future creation of profits and cash flows is known as __________.

(j) Services are those which cannot be seen, touched, or heard which means they are __________ in nature.

(k) __________ enables improvement in cash flows as along with mitigating various types of risk such as credit risk, transfer risk and foreign exchange risk.

[Ans.: (a) Financial System, (b) 1949, (c) The National Housing Bank (NHB), (d) Financial Markets, (e) Primary Market, (f) Money Market, (g) Insurance, (h) Merchant bankers, (i) Venture Capital, (j) Intangible, (k) Forfeiting]

(3) **True or False:**

(a) Stocks are securities that are a claim on the earnings and assets of a corporation.

(b) Financial system is a set of complex and closely interlinked financial institutions, financial markets, financial instruments and services which facilitate the transfer of funds.

(c) The settlement cycle is now T + 1.

(d) RBI, the leader of the financial system, was established as a private institution in 1945.

(e) Financial Innovation is a broad term that is used to describe the generation of new and creative approaches to different financial circumstances.

(f) Bill Discounting is the purchase of exporter's receivables at a discounted price by paying cash.

(g) Fund based and fee based are types of financial services.

(h) Secondary market deals with listed securities.

(i) Financial instruments are those instruments issued by government.

(j) Mutual fund is a way of reducing your potential financial loss or hardship.

(k) Financial services are a part of financial system. ***(March 19)***

(l) Financial system of any country consists of only one ingredient. ***(March 19)***

(m) Interest rates influence the level of investment in an Economy. ***(March 19)***

(n) Provision of liquidity is not a function of financial services. ***(March 19)***

[Ans.: (a) True, (b) True, (c) False, (d) False, (e) True, (f) False, (g) True, (h) True, (i) False, (j) False, (k) True, (l) False, (m) True, (n) False]

(4) **Match the columns:**

Group "A"		Group "B"	
(a)	Financial Market	(i)	Risky Capital
(b)	Primary Market	(ii)	1935
(c)	RBI	(iii)	Lease Financing
(d)	Fund Based	(iv)	Fee-Based Services
(e)	Merchant Banking	(v)	Capital and Money Market
(f)	Venture Capital	(vi)	New Issue Market
(g)	Equity Shares	(vii)	Money Market
(h)	T-Bill	(viii)	Capital Market
(i)	Securitization	(ix)	Financial Intermediaries
(j)	Banks	(x)	Financial Innovation

[Ans.: (a – v), (b – vi), (c – ii), (d – iii), (e – iv), (f – i), (g – viii), (h – vii), (i – x), (j – ix)]

(5) Explain in detail the role and importance of Financial System. ***(March 18)***

(6) Explain an overview of Indian Financial System with reference to savings and investment in India. ***(Oct. 18; March 19)***

(7) What are the various Functions of Financial System?

(8) Explain various financial services offered in the financial system. ***(Oct. 17)***

(9) Phase out the growth and development of Indian financial system.

(10) Explain in detail the various constituents of Indian financial System. ***(Oct. 17)***

(11) State various financial intermediaries involved in financial system.

(12) What are the characteristics of financial services? ***(Mar 18)***

(13) What are the various challenges faced by financial sector?

(14) What is a financial service? Explain its features and importance. ***(Oct. 18)***

(15) Explain in detail capital formation. ***(March 19)***

(16) **Write short notes on:**

(a) Financial Innovation.

(b) Financial Services.

(c) Financial Intermediaries.

Chapter 2

INTERMEDIARIES V/S NON-INTERMEDIARIES

- Introduction to Intermediaries
- Definition of Intermediaries
- Role of Intermediaries in Financial Market
- The Functions of Intermediaries
- Financial Intermediaries
- Banking Intermediaries
- Non-Banking Intermediaries
- Summary
- Questions

INTRODUCTION TO INTERMEDIARIES:

- Market intermediaries are the institutions that facilitate the smooth functioning of the securities market. They enable the issuers of securities to interact with the investors in the primary as well as the secondary market. They are an important constituent of the securities market. These intermediaries are useful for both the investors as well as to the corporates. They help the investors by providing investment consultancy by their expertise in market analysis and also help the corporates for fundraising by their marketing skills.
- These intermediaries are vital links between investor, issuer, and regulator. The objective of these intermediaries is to ease the process of investment and to establish a link between the investors and the users of funds. Corporations and Governments do not market their securities directly to investors. As an alternative, they hire the services of the market intermediaries to represent them to the investors.
- Market intermediaries aid investors to select investments by providing investment consultancy, market analysis, and credit rating of investment instruments. To operate in the secondary market, the investors have to transact through sharebrokers. Registrars and Share Transfer Agents, Custodians, and Depositories are capital market intermediaries that provide important infrastructure services for both primary and secondary markets.

In simple words:

All those, institutions or individuals, who help to bring the savers and seekers of capital and enable a regular flow of funds from supply to demand points are intermediaries. All intermediaries are service providers and are an integral part of the Securities Market. These market intermediaries provide different types of financial services to investors. They are constantly operating in the financial market.

DEFINITION OF INTERMEDIARIES:

According to SEBI (Intermediaries) Regulations, 2008:

"Intermediary" means a person mentioned in clauses (b) and (ba) of sub-section (2) of section 11 and sub-section (1) and (1A) of section 12 of the Act and includes an asset management company concerning the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, a clearing member of a clearing corporation or clearinghouse and a trading member of a derivative segment or currency derivatives segment of the stock exchange but does not include foreign institutional investor, foreign venture capital investor, mutual fund, collective investment scheme, and venture capital fund.

ROLE OF INTERMEDIARIES IN FINANCIAL MARKET:

- Intermediaries make the market vibrant which helps the market to function smoothly and continuously.
- Intermediaries possess professional expertise and play a promotional role in organizing a perfect match between the supply and demand for capital in the market.
- Intermediaries bring efficiency to corporate fundraising by developing expertise in pricing new issues and marketing them to the investors.
- Investors, mainly small investors, find it hard to make the direct investment. A small investor desiring to invest may not find a willing and desired borrower. He may not be able to vary across borrowers to reduce risk. He may not be equipped to assess and monitor the credit risk of borrowers.

THE FUNCTIONS OF INTERMEDIATION:

Financial intermediation can improve economic efficiency by the following functions:

(1) **Providing safekeeping, accounting, and payment mechanisms for resources:** Banks is an obvious example for the safekeeping of money in accounts, the records of payments, deposits and withdrawals, and the use of debit/ATM cards. Financial intermediaries can do all of this much more cheaply than individuals because they take advantage of economies of scale. All of these services are standardized and automated on a large scale, so per unit transaction costs are minimized.

(2) **Providing liquidity**: Financial intermediaries make is easy to transform various assets into a means of payment through ATMs, credit cards, debit cards, etc. while acting this, financial intermediaries manage many short-term outflows and

investments with long-term outflows and investments to meet their obligations while profiting from the spread between long and short term interest rates.

(3) Diversifying risk: Financial intermediaries help investors diversify in ways they would be unable to do on their own. Banks spread depositor funds over many types of loans, so the default of any one loan does not put depositor funds in jeopardy.

(4) Collecting and processing information: Financial intermediaries are experts at gathering and processing information to precise device the risk of various investments and to price them accordingly. Individuals do not likely have to tools or know-how to do the same, and positively could not do so as cheaply as financial intermediaries (once again, economies of scale are important here). This need to gather and process information comes from a fundamental asymmetric information problem inherent in financial markets.

FINANCIAL INTERMEDIARIES:

(i) Banking: Reserve Bank of India (RBI), Commercial Banks, Co-operative Banks, Foreign banks, RRB's.

(ii) Non-Banking: Provident and Pension Funds, Small Savings Organizations, Life Insurance Corporation (LIC), General Insurance Corporation (GIC), Unit Trust of India (UTI), Mutual Funds, Investment Trusts, Investment Companies, Finance Corporations, Nidhis, Chit Funds, Hire-Purchase Finance Companies, Lease Finance Companies, National Housing Bank (NHB), Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC) and other housing finance companies, Manufacturing companies accepting public deposits, Venture Capital Funds and National Cooperative Bank of India (NCBI).

BANKING INTERMEDIARIES:

(1) RESERVE BANK OF INDIA (RBI):

- The Reserve Bank of India is the Central Bank of our country. The Reserve Bank of India is the apex financial institution of the country's financial system entrusted with the task of control, supervision, promotion, development and planning.

- o Reserve Bank of India came into existence on 1st April 1935 as per the Reserve Bank of India act 1935. But the bank was nationalized by the government after Independence.
- o It became the public sector bank from 1st January 1949. Thus, the Reserve Bank of India was established as per the Act 1935 and empowerment took place in Banking Regulation Act 1949.
- o Reserve Bank of India is the queen bee of the Indian financial system which influences the commercial banks' management in more than one way.
- o The Reserve Bank of India influences the management of commercial banks through its various policies, directions, and regulations.
- o The fundamental object of the Reserve Bank of India is to discharge purely central banking functions in the Indian money market, i.e., to act as the note-issuing authority, bankers' bank and banker to the government, and to encourage the growth of the economy within the framework of the general economic policy of the Government, consistent with the need of maintenance of price stability.

2) COMMERCIAL BANKS:

Commercial banks are those banks that accomplish all kinds of banking functions such as accepting deposits, advancing loans, credit creation, and agency functions. They usually advance short-term loans to customers. A commercial bank is one mainly engaged in deposit and lending activities to private and corporate clients in wholesale and retail banking. Other services classically include bank and credit cards, private banking, custody and guarantees, cash management and settlement as well as trade finance.

Features of Commercial Banks:

- It operates for profit.
- It accepts deposits from the general public and extends loans to the households, the firms and the government.
- Withdrawal employing an instrument, whether a cheque or otherwise.

- Another distinguishing feature of a commercial bank is that a large part of their deposits is demand deposits withdrawable and transferable by cheque.

(3) CO-OPERATIVE BANKS:

Cooperative banks are a part of the set of institutions, which are engaged in financing rural and agriculture development. Cooperative banks were assigned the important role of delivering fruits of economic planning at the grassroots level. The cooperative banking structure is viewed as a vehicle for the democratization of the Indian financial system. They were conceived to supplant moneylender and indigenous bankers by providing adequate short-term and long term institutional credit at reasonable rates of interest.

(4) FOREIGN BANKS:

- The foreign banks are branches of joint-stock companies incorporated abroad, but operating in India.
- They are foreign in origin and have their head office located in their parent country. Many foreign banks opened their offices and expanded branches after the opening up of the Indian economy in the 1990s.
- These banks created an entirely new plying field in the banking sector through their range of products and services including ATMs, electronic services, credit cards, and portfolio management.
- They provide foreign currencies for bona fide purposes like trade, travel or study abroad.
- Most foreign banks have a very strong parent bank commitment, superior technology, and provide a very high level of customer service.

(5) REGIONAL RURAL BANK (RRBs):

- The government of India set up Regional Rural Banks (RRBs) to provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural labourers, and small entrepreneurs.
- There are several concessions enjoyed by the RRBs by Reserve Bank of India such as lower interest rates and refinancing facilities from NABARD like lower cash ratio,

lower statutory liquidity ratio, the lower rate of interest on loans taken from sponsoring banks, managerial and staff assistance from the sponsoring bank and reimbursement of the expenses on staff training.

- The RRBs are under the control of NABARD. NABARD has the responsibility of laying down the policies for the RRBs, to oversee their operations, provide refinance facilities, to monitor their performance and to attend their problems.
- The Regional Rural Banks (RRBs) have been set up to supplement the efforts of cooperative and commercial banks to provide credit to the rural sector.
- The following were the reasons or need to set up the RRBs:
  (1) To free the rural poor, small and marginal farmers from the clutches of money lenders.
  (2) To provide credit to small farmers, marginal farmers, rural artisans, landless labourers who do not fulfil the criterion of creditworthiness as per the banking principles.
  (3) To provide banking services to the rural community at a relatively lower cost by adopting a different staffing pattern, wage structure and banking policies.

NON-BANKING INTERMEDIARIES:

INSURANCE

(1) Insurance is a way of reducing your potential financial loss or hardship. It can help cover the cost of unexpected events such as theft, illness, or property damage. It can also provide a financial payment upon death.

(2) Several insurances provide comprehensive coverage with affordable premiums. Premiums are periodical payment and different insurers offer miscellaneous premium options. The periodical insurance premiums are planned according to the total insurance amount.

Mostly insurance is used as an effective tool of **risk management** as quantified risks of different volumes can be insured.

CHARACTERISTICS OF INSURANCE:

(1) Pooling of losses:

- Pooling is the spreading of losses incurred by the few over the entire group so that in the process, the average loss is substituted for actual loss.
- The actuary seldom knows the true likelihood and harshness of loss. Consequently, estimates of both the average frequency and the average severity of loss must be based on previous loss experience.
- The primary drive of pooling, or the sharing of losses, is to reduce the variation in possible outcomes as measured by the standard deviation or some other measure of dispersion, which reduces risk.

(2) Payment of fortuitous losses: A fortuitous loss is one that is unexpected and unexpected and happens as a result of chance. The Law of a large number is based on the statement that losses are accidental and occur randomly losses are accidental and occur randomly. Insurance policies do not cover intentional losses.

(3) Risk transfer: Risk transfer means that a pure risk is transferred from the insured to the insurer, who typically is in a stronger financial position to pay the loss than the insured.

(4) Indemnification: Indemnification means that the insured is restored to his or her approximate financial position prior to the occurrence of the loss.

(5) Co-operative Device: The most important feature of every insurance plan is the co-operation of large number of persons who, in effect, agree to share the financial loss arising due to a particular risk which is insured. Such a cluster of persons may be brought together voluntarily or through advertising or solicitation of the agents.

An insurer would be unable to reimburse all the losses from his capital. So, by insuring or underwriting a large number of persons, he can pay the amount of loss. Like all cooperative devices, there is no obligation here on anybody to purchase the insurance policy.

(6) **Value of Risk:** The risk is evaluated before insuring to charge the amount of share of an insured, herein called, consideration or premium. There are several methods of evaluation of risks. If there is the anticipation of more loss, a higher premium may be charged. So, the likelihood of loss is calculated at the time of insurance.

(7) **Payment at Contingency:** The payment is made at a definite contingency insured. If the contingency occurs, payment is made. Since the life insurance contract is a contract of certainty, because the contingency, the death or the expiry of the term, will certainly occur, the compensation is certain. In other insurance contracts, the possibility is the fire or the marine perils, etc., may or may not occur. So, if the contingency occurs, payment is made, else no amount is given to the policy-holder.

Correspondingly, in certain types of life policies, payment is not certain due to the uncertainty of a particular contingency within a particular period. For example, in term-insurance then, payment is made only when the death of the assured occurs within the stated term, maybe one or two years. Similarly, in Pure Endowment payment is made only at the survival of the insured at the expiry of the period.

NEED AND PURPOSE OF INSURANCE:

Insurance not only serve the ends of individuals, or of special groups of individuals, it tends to saturate and to alter our modern social order, too.

Insurance caters to the 3 areas:

(i) individual,

(ii) a special group of individuals, viz., to business or industry, and

(iii) and society.

NDIVIDUAL:

1) **Insurance provides Security and Safety:**

- The insurance provides safety and security in contradiction to the loss of a particular event. In the case of life insurance payment is made when death happens or the term of insurance is expired.

- The loss to the family at a premature death and payment old age is effectively provided by insurance. In other word security against premature death and old age sufferings a delivered by life insurance.
- The insurance provides safety and security against the lo of earning at death or in the golden age, against the loss the fire, against the loss at damage, destruction disappearance of property, goods, furniture, and machin etc.

(2) Insurance affords Peace of Mind:

- The security send 6.

(3) Insurance eliminates dependency:

- The economic independence of the family is reduced sometimes, lost totally if insurance is taken.
- The insurance is here to back them and provides adequa amount at the time of sufferings.

(4) Life Insurance encourages saving:

Life insurance inculcates the habit of saving among poli holders as they are supposed to pay the premium on time.

(5) Life Insurance fulfils the needs of a person:

The needs of a person are divided into (A) Family nee (B) Old-age needs, (C) Special needs.

(a) **Family Needs:** The provision for children up to th reaching earning period and for widow up to long l should be made. Any other provision except life insuran will not sufficiently meet this financial requirement of t family. Whole life policies are improved means of meeti such requirements.

(b) **Old-age heeds:** The provision for old-age is requir wherever the person is surviving more than his earni period. The decrease in income in old-age is serious to t person and his family.

(c) **Special Needs:** There is a definite special requirement the family which is fulfilled by the earning member of t family. If the member becomes inactivate to earn t income due to old age or death, those needs may rema unsatisfied and the family will suffer.

(i) **Need for Education:** There are certain insurance policies and annuities which are valuable for the education of the children irrespective of the death or survival of the father or guardian.

(ii) **Marriage:** The daughter may endure unmarried in case of a father's death or in case of inadequate provision for meeting the expenses of marriage. The insurance can offer funds for the marriage if the policy is taken for the purpose.

(iii) **Insurance needs for settlement of children:** After education, settlement of children takes time and in the absence of adequate funds, the children cannot be well placed and all the education goes waste.

BUSINESS:

The insurance has been useful to the business society also. Some of the uses are discussed as follows:

(1) Uncertainty of business losses is reduced:

- By purchasing policy, he can be sure of his earning because the insurer will pay a served amount at the time of death.
- Again, the owner of a business might foresee emergencies that would bring great loss. To meet such situations they might decide to set aside yearly a reserve, but it could not be accumulated due to death. Though, by making an annual payment, to secure immediately, insure policy can be taken.

(2) Business-efficiency is increased with insurance:

- When the owner of a business is free from the risk of facing losses, he will certainly devote much time to the business. The carefree owner can work better for the expansion of the profit.
- The fresh, as well as old businessmen, are guaranteed payment of a certain amount with the insurance policies at the death of the person; at the damage, destruction or disappearance of the property or goods.
- The uncertainty of loss may affect the mind of the businessmen adversely. The insurance, eliminating the uncertainty, stimulates the businessmen to work hard.

(3) Enhancement of Credit:

- The business can get a loan by pledging the policy as collateral for the loan. The insured persons are getting more loans due to the certainty of payment at their deaths.
- The amount of loan that can be gained with such pledging of policy, with interest thereon will not exceed the cash value of the policy. In case of death, this price can be utilized for the setting of the loan along with the interest.

(4) Business Continuation:

- The insurance policies provide sufficient funds at the time of death. Each partner may be insured for the amount of his interest in the partnership and his dependents may avail that amount at the death of the partner.
- With the help of property insurance, the property of the business is endangered against disasters and the chance of disclosure of the business due to the terrific waste or loss.

(5) Welfare of Employees:

- The welfare of employees is the responsibility of the employer. Employees work for employer, hence the employer is responsible to look after the employee's welfare from which provision can be made for early death, disability, and old age.
- These requirements are easily met by life insurance, accident and sickness benefit, and pensions which are generally provided by group insurance. The premium for group insurance is generally paid by the employer. This plan is the cheapest form of insurance for employers to fulfil their responsibilities.

SOCIETY:

Some of the usages of insurance to society are discussed in the following sections:

(1) Wealth of society is protected:

- The loss of a certain wealth can be protected with insurance. Life insurance provides a loss of human wealth. The human material, if it is solid, educated, and care-free, will generate more income.

- Equally, the loss or damage of property at the fire, accident, etc., can be well indemnified by the property insurance; cattle, crop, profit, and machines are also sheltered against their accidental and economic losses.

:) **Economic Growth of the Country:**

- For the economic growth of the country, insurance delivers protection against loss of property and adequate capital to yield more wealth.
- This sort of protection excites more production hi agriculture, in industry, the factory premises, machines, boilers, and profit insurances provide more confidence to start and operate the industry welfare of employees create a conducive atmosphere to work: Suitable capital from insurers accelerate the production cycle.

Similarly in business, too, the property and human material are protected against certain losses; capital and credit are expanded with the help of insurance. Thus, insurance meets all the necessities of the economic growth of a country.

;) **Reduction in Inflation:**

- The insurance reduces the inflationary resource in two ways. First, by extracting money in supply to the amount of premium collected and secondly, by providing sufficient funds for production narrow down the inflationary gap.

MUTUAL FUNDS

Mutual Fund is a collective investment vehicle. It is a pool of investor's money invested according to pre-specified investment objectives. The benefits from the investment of the pooled money accrue to those that contribute to the pool. There is thus mutuality in the contribution and the benefit. Hence the name 'mutual fund'.

A 'mutual fund' is an investment vehicle that permits several investors to pool their resources to purchase stocks, bonds, and other securities. These collective funds referred to as Assets under Management or AUM are then capitalized by an expert fund manager appointed by a mutual fund company (called Asset Management Company or AMC).

- The combined underlying holding of the fund is known as 'portfolio', and each investor owns a portion of this portfolio the form of units.

INVESTMENT OBJECTIVE:

A mutual fund is a pool of investor's money, invested in portfolio of securities as per the stated objective.

Capital Appreciation	Capital Preservation	Regular Income
Real Estate	Savings A/c	Post Office MIS
Equity Market	Liquid Mutual Fund	Debt Mutual Fund
Equity Mutual Fund		

Fig. 2.1 – Investment Objectives

ROLE OF MUTUAL FUND:

- For investors, Mutual Fund offers an investment opportunity a for issuers, it acts as an institutional investor.
- The balance represents the mutual fund, it is an import financial intermediary in the system.

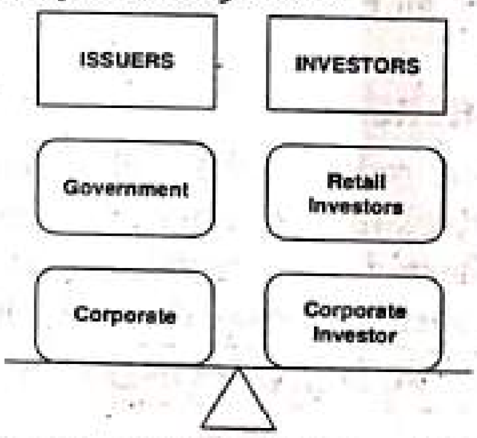


Fig. 2.2 – Role of Mutual Fund

TYPES OF FUNDS:

Extensive variety of Mutual Fund Schemes exists to provide to the needs such as financial position, risk tolerance and return expectations, etc. The table below indicates the existing types schemes in the Industry.

(A) By Structure	**(1)** Open Ended Funds
	(2) Close Ended Funds
	(3) Interval Funds

(B) By Investment Objectives	(4) Growth Funds (5) Income Funds (6) Balanced Funds (7) Money Market Funds
(C) Other Schemes	(8) Tax Saving Funds (9) Special Funds (10) Index Funds (11) Sector Specific Funds

(A) BY STRUCTURE:

(1) Open-ended funds:

- An open-ended mutual fund is the one whose units can be easily sold and repurchased by the investors. Such funds are not listed since the Asset Management Companies (AMCs) provide the facility for buyback of units from unit-holders either at the NAV, or NAV-linked prices.

(2) Close-ended funds:

- Closed-ended mutual funds have a fixed number of units, and a fixed tenure (3, 5, 10, or 15 years), after which their units are redeemed or they are made open-ended.
- These funds have various objectives: generating steady income by investing in debt instruments, capital appreciation by investing in equities, or both by making an equal allocation of the corpus in debt and equity instruments.

(3) Interval funds:

- These funds combine features of both open-ended and close-ended schemes.
- They are mainly close-ended but become open-ended at pre-specified intervals.

(B) BY INVESTMENT OBJECTIVE:

(1) Growth Funds:

- The goal of growth funds is to provide capital appreciation over the medium to long-term. Such schemes generally invest a majority of their corpus in equities.

- Returns from such funds outperform most other kinds of investments held over the long term.
- Growth schemes are ideal for investors having a long-term outlook seeking growth over some time.

(2) Income Funds:

- Income funds provide a regular and steady income to investors.
- Such schemes normally invest in fixed income securities such as bonds, corporate debentures, and Government securities.
- Income Funds are best for capital stability and regular income.

(3) Balanced Funds:

- Balanced funds provide both growth and regular income. Such schemes periodically allocate a part of their earning and invest both in equities and fixed income securities in the proportion designated in their offer documents.
- In an increasing stock market, the NAV of these schemes may not normally keep pace, or fall equally when the market falls. These are ideal for investors looking for a grouping of income and moderate growth.

(4) Money Market Funds:

- Money market funds are to offer easy liquidity, preservation of capital, and moderate-income.
- These schemes largely invest in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper, and inter-bank call money.
- Returns on these schemes may fluctuate liable upon the interest rates prevailing in the market.
- These are ideal for Corporate and individual investors as a means to park their surplus funds for short periods.
- AIG India Liquid Fund, DSP Black Rock Liquidity Fund, ICICI Prudential Liquid Plan, Tata Money Market Fund and UTI Money Market fund are some of the examples of these funds.

(5) Equity Funds:

- The goal of equity funds is to provide capital appreciation over the medium to long-term. Such schemes generally invest a majority of their corpus in equities.
- An equity fund is a mutual fund that invests principally in stocks. It can be actively or passively (index fund) managed. Equity funds are also known as stock funds.
- Equity funds could be sector-specific, indexed funds, ELSS, or special funds.

(C) OTHER SCHEMES:

(1) Tax Saving Funds/ELSS Schemes (Equity Linked Saving Schemes):

- These schemes deal with tax rebates to the investors under specific provisions of the Indian Income Tax laws as the Government offers tax incentives for investment in specified avenues.
- Investments made in Equity Linked Savings Schemes (ELSS) and Pension Schemes are allowed as deduction u/s 88 of the Income Tax Act, 1961.
- The Act also provides opportunities to investors to save capital gains u/s 54EA and 54EB by investing in Mutual Funds, provided the capital asset has been sold before April 1, 2000 and the amount is invested before September 30, 2000.

(2) Special Funds:

- Industry-Specific Schemes.
- Industry-Specific Schemes invest only in the industries specified in the offer document. The investment of these funds is limited to specific industries like InfoTech, FMCG, and Pharmaceuticals etc.

(3) Index Funds:

- Index Funds attempt to imitate the performance of a particular index such as the BSE Sensex or the NSE 50.
- Their portfolios will comprise of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weightage.

- The returns from such schemes would be more or less eq to those of the Index.

(4) Sectoral Funds:

- Sectoral Funds finance completely in a specified industry a group of industries or various segments such as 'A' Gr shares or initial public offerings.
- Sector funds invest in a definite sector of the economy c specified industry only as information technology, oil a gas companies, or in specified products.
- They carry the risk and return associated with th industries.
- The major drawback of investment in these funds is t being sector-specific, they lack diversification and their r profile is also high.
- Sector funds are appropriate for investors who have alrea decided to invest in a particular sector or segment.
- Baroda Pioneer Banking and Financial Services Fun Reliance Media and Entertainment Fund, SBI Magnu Sector Funds Umbrella–Pharma, JM Telecom Sector Fun UTI Auto Sector Fund are some of the sector funds in Indi

(5) Exchange-Traded Funds (ETF):

Exchange-traded funds (ETFs) are a new range of mutu fund that was first introduced in 1993. ETFs are occasional described as more "tax-efficient" than traditional equity mutu funds since in current years, some large ETFs have made min distributions of realized and taxable capital gains than mo mutual funds. In short, they are comparable to index mutu funds but are traded more like a stock.

(6) Gold Exchange Traded Funds:

In India according to the announcement made by th Honourable Finance Minister in his Budget Speech fo 2005-06, SEBI appointed a Committee for the introduction o the Gold Exchange Traded Fund (GETF) in India.

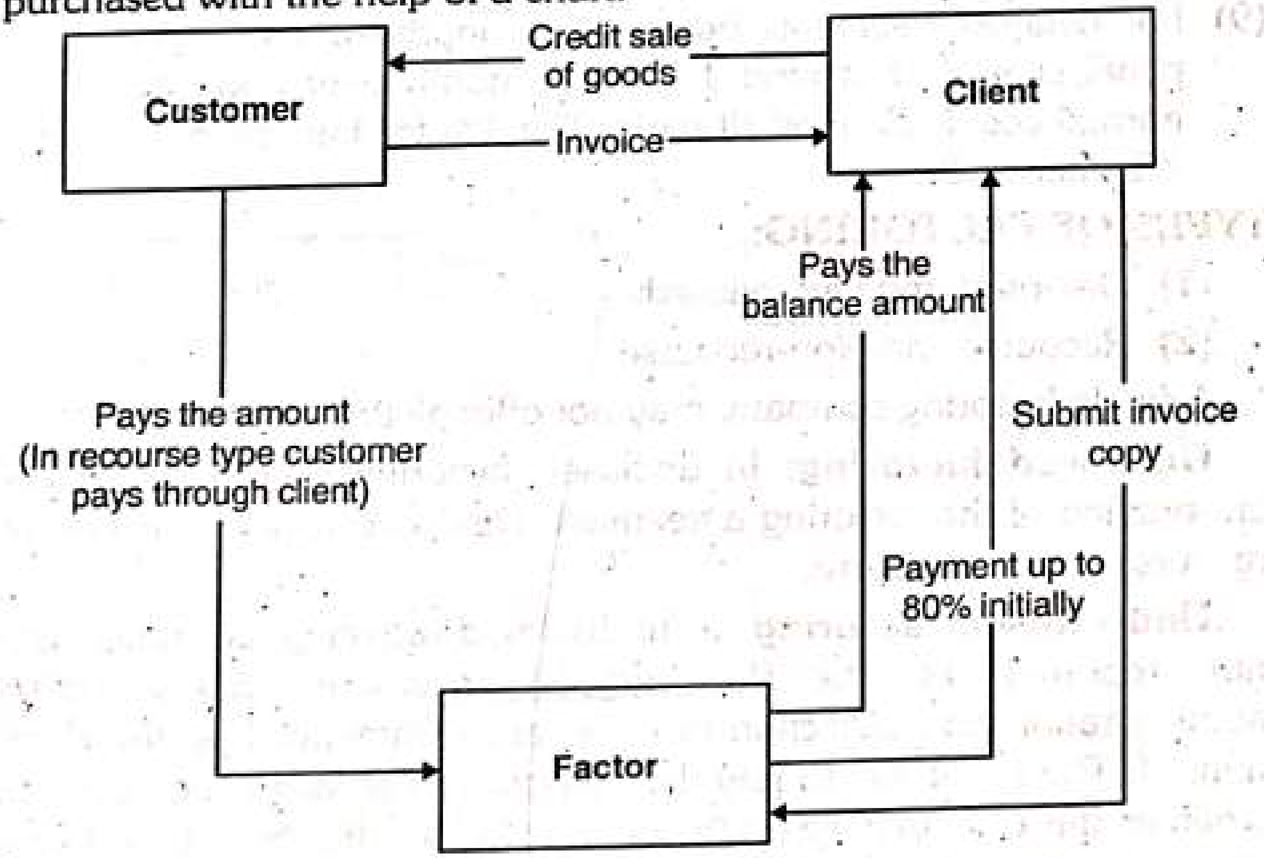
FACTORING

Factoring is a monetary option for the management of receivables. In simple definition, it is the alteration of credit sales into cash. In factoring, a financial institution (factor) purchases the accounts receivable of a company (Client) and pays up to 80% (rarely up to 90%) of the amount immediately on agreement. The factoring company pays the remaining amount (Balance 20%-finance cost-operating cost) to the client when the customer pays the debt. The collection of debt from the customer is done whichever by the factor or the client depending upon the type of factoring. The account receivables in factoring can whichever is for a product or service.

Illustrations are factoring in contradiction of goods purchased, factoring for construction services (usually for government contracts where the government body is capable of paying back the debt in the specified period of factoring. Contractors submit invoices to get cash instantly), factoring against medical insurance, etc.

Factoring is a simple way to obtain additional financing for companies compared to traditional financing methods that require a lot of paperwork and long waiting times.

Let us see how factoring is done against an invoice of goods purchased with the help of a chart:



CHARACTERISTICS OF FACTORING:

(1) Generally, the period for factoring is 90 to 150 days. Some factoring companies permit even more than 150 days.

(2) Factoring is measured to be a costly source of finance compared to other sources of short term borrowings.

(3) Factoring receivables is an ultimate financial solution for new and emerging firms without strong financials. This is because creditworthiness is assessed based on the financial strength of the customer (the debtor). Later these companies can leverage the financial strength of their customers.

(4) Bad debts will not be measured for factoring.

(5) A credit rating is not obligatory. But the factoring companies generally carry out a credit risk analysis before agreeing.

(6) Factoring is a technique of off-balance sheet financing.

(7) Cost of factoring = finance cost + operating cost. Factoring costs vary according to the transaction size, financial strength of the customer, etc. The cost of factoring varies from 1.5% to 3% per month liable upon the financial strength of the client's customer.

(8) Indian firms deal factoring for invoices as low as Rs. 1,000.

(9) For delayed payments beyond the approved credit period, a penal charge of around 1-2% per month over and above the normal cost is charged (it varies like 1% for the first month and 2% afterward).

TYPES OF FACTORING:

(1) Disclosed and Undisclosed

(2) Recourse and Non-recourse

A single factoring company may not offer all these services.

Disclosed factoring: In disclosed factoring client's customers are notified of the factoring agreement. Disclosed type can either be recourse or non-recourse.

Undisclosed factoring: In undisclosed factoring, customers are not reported of the factoring arrangement. Sales ledger administration and collection of debts are commenced by the client himself. The client has to pay the amount to the factor regardless of whether the customer has paid or not. But in disclosed type factor may or may not be responsible for the collection of debts depending on whether it is recourse or non-recourse.

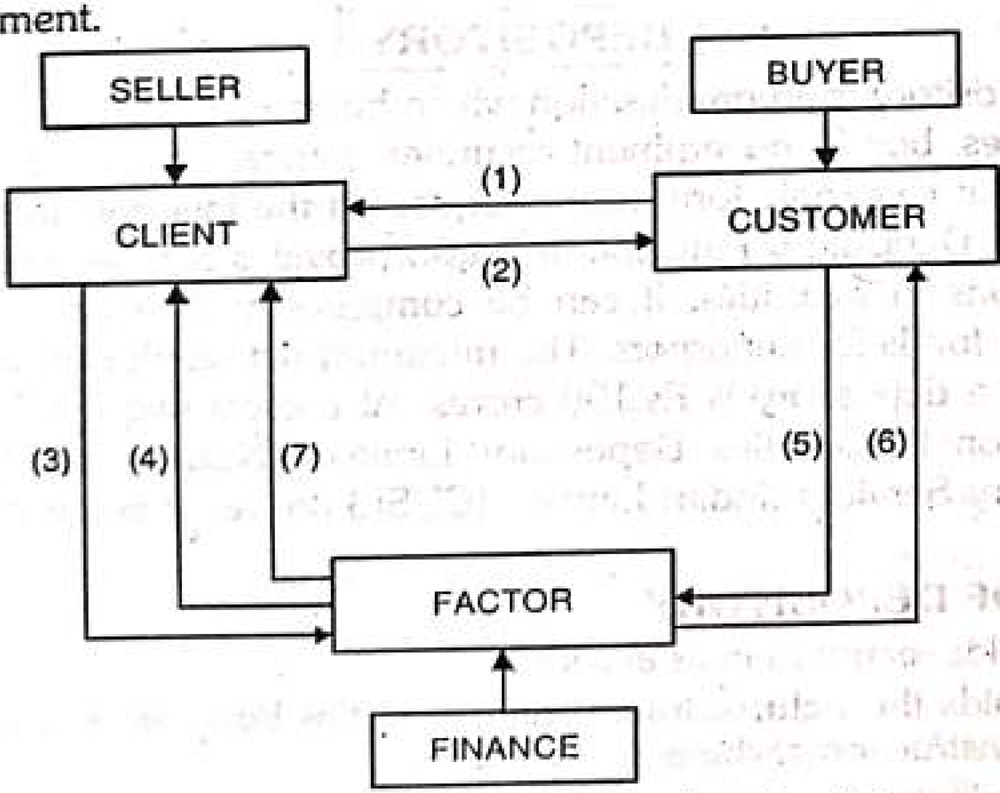
Recourse factoring: In recourse factoring, the client assumes to collect the debts from the customer. If the customer refuses to pay the ımount on maturity, the factor will recover the amount from the :lient. This is the utmost common type of factoring. Recourse actoring is offered at a lower interest rate since the risk by the factor s low. The remaining amount is paid to the client when the customer ɔays the factor.

Non-recourse factoring: In non-recourse factoring, factor ındertakes to collect the debts from the customer. The Balance ımount is paid to the client at the end of the credit period or when he customer pays the factor whichever comes first. The advantage of ıon-recourse factoring is that continuous factoring will eliminate the ıeed for credit and collection departments in the organization.

?ARTIES INVOLVED IN FACTORING:

The main function of factoring services is the realization of credit ;ales. The factor mainly works in between the seller and the buyer. Γhe three parties involved in a domestic factoring arrangement are :lient or seller, customer or buyer, and the factor.

The figure given below illustrates the mechanism of factoring. Let ıs now study each component involved in a domestic factoring ırrangement.



(1) The customer places an order with the client for goods and services on credit.

(2) The client invoices his customer, by giving a notification that the invoice is allocated to and must be paid to a factor.

(3) The client sells the invoice to the factor as per factoring contract, along with the other valid proof of dispatch. To facilitate the transaction smoothly, the client gets the prior approval of the buyer from the factor.

(4) Factor provides pre-payment of up to 80-90 percent of the invoice value immediately to the client.

(5) The factor follows up with the customers for the realization of payment due.

(6) The customer pays money to the factor on the due date which is called a collection of book debts.

(7) The factor makes the balance payment of the invoice value to the client.

The factor maintains the sales ledger for the buyer and statements of accounts, employing invoices presented that are sent to the seller on a monthly basis. The factor takes over the collection of book debts and sends reminders when the invoices are overdue. The client gets information about all the factoring transactions through monthly and weekly reports provided by the factor.

DEPOSITORY

A depository is an organisation which holds securities (like shares, debentures, bonds, government securities, mutual fund units etc.) of investors in electronic form at the request of the investors through a registered Depository Participant. It also provides services related to transactions in securities. It can be compared with a bank, which holds the funds for depositors. The minimum net worth stipulated by SEBI for a depository is Rs.100 crores. At present two Depositories viz. National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL) are registered with SEBI in India.

ROLE OF DEPOSITORY:

(1) It holds securities in its account.

(2) It holds the right of transferring securities between accounts on the instruction of the account holder.

(3) It facilitates the transfer of ownership to others without having to handle securities as the transfer takes place directly from the account.

(4) It facilitates the safekeeping of securities.

BENEFITS OF HOLDING DEPOSITORY ACCOUNT:

- A safe and easiest way to hold securities;
- Speedy transfer of securities;
- No stamp duty on transfer of securities;
- Elimination of risks associated with physical certificates such as bad delivery, fake securities, delays, thefts etc.
- Decrease in paperwork involved in transfer of securities;
- Decrease in transaction cost;
- No odd lot problem, even one share can be traded;
- Nomination facility;
- Change in address noted with DP gets registered with all companies in which investor holds securities electronically abolishing the need to correspond with each of them separately;
- Diffusion of securities is done by DP eradicating correspondence with companies;
- Automatic credit into Demat account of shares, rising out of bonus/split/consolidation/merger etc.
- Holding investments in equity and debt instruments in a single account.

NSDL (NATIONAL SECURITIES DEPOSITORY LIMITED):

The enactment of Depositories Act in August 1996 covered the way for the establishment of NSDL, the first depository in India. This depository promoted by institutions of national stature responsible for the economic development of the country has since recognized a national infrastructure of international standards that handles most of the securities held and settled in dematerialised form in the Indian capital market.

Using innovative and flexible technology systems, NSDL works to support the investors and brokers in the capital market of the country. NSDL aims at ensuring the safety and reliability of Indian marketplaces by developing settlement solutions that increase efficiency, minimise risk and reduce costs. NSDL plays a central role in developing products and services that will continue to nurture the growing requirements of the financial services industry. In the depository system, securities are held in depository accounts, which is more or less comparable to holding funds in bank accounts. Transfer of ownership of securities is completed through simple account transfers. This method does away with all the risks and irritation normally associated with paperwork. Accordingly, the cost of transacting in a depository environment is considerably lower as compared to transacting in certificates.

CDSL (CENTRAL DEPOSITORY SERVICES (INDIA) LIMITED):

A Depository simplifies holding of securities in the electronic form and enables securities transactions to be processed by book entry by a Depository Participant (DP), who as an agent of the depository offers depository services to investors. According to SEBI guidelines financial institutions, banks, custodians, stockbrokers, etc. are eligible to act as DPs. The investor who is known as beneficial owner (BO) has to open a demat account through any DP for dematerialisation of his holdings and transferring securities.

The balances in the investors account noted and maintained with CDSL can be obtained through the DP. The DP is required to provide the investor, at regular intervals, a statement of account which gives the details of the securities holdings and transactions. The depository system has successfully eliminated paper-based certificates which were prone to be fake, forged, counterfeit resulting in bad deliveries. CDSL offers an efficient and prompt transfer of securities.

CDSL was promoted by Bombay Stock Exchange Limited (BSE) jointly with leading banks such as State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Union Bank of India and Centurion Bank.

CDSL was set up with the objective of providing convenient, reliable and secure depository services at affordable cost to all market participants.

NHB (NATIONAL HOUSING BANK)

NHB was set up on July 9, 1988 under the National Housing Bank Act, 1987. NHB is wholly owned by Reserve Bank of India, which funded the entire paid-up capital. The Head Office of NHB is at New Delhi. The vision of NHB is "Promoting inclusive expansion with stability in housing finance market".

NHB has been recognised to achieve, inter alia, the following objectives:

(a) To promote a sound, healthy, viable and cost effective housing finance system to provide to all segments of the population and to integrate the housing finance system with the whole financial system.

(b) To promote a network of dedicated housing finance institutions to sufficiently serve various regions and different income groups.

(c) To augment resources for the sector and channelise them for housing.

(d) To make housing credit more affordable.

(e) To control the activities of housing finance companies grounded on regulatory and supervisory authority derived under the Act.

(f) To inspire augmentation of supply of buildable land and also building materials for housing and to promote the housing stock in the country.

(g) To inspire public agencies to emerge as facilitators and suppliers of serviced land, for housing.

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.

A lease is a contract whereby the owner of an asset (the lessor) grants to another person (the lessee) exclusive right to use the asset for an agreed period of time, in return for the payment of a rent (called lease rental). Capital assets like land, buildings, equipments, machinery, vehicles are the usual assets which are generally acquired on lease basis. The lessor remains the owner of the asset, but the possession and economic use of the asset is vested in the lessee.

BENEFITS OF LEASING:

Several benefits are derived by the lessee by acquiring the assets on lease basis, as compared to buying the same. These benefits are:

Convenience in case of short-term need: If the capital asset is needed for a short period only, say a year or two, leasing is a very convenient and appropriate method of acquiring. It dispenses with the formalities and expenses incurred in purchasing the asset and selling it soon after the need is over.

No Risk of Technological Obsolescence: In case of owning the asset, the firm bears the risk of the asset becoming obsolete. In the present age of technological innovations, risks in owning an asset with outdated and old technology cannot be ignored. With such equipments, the firm cannot compete with its competitors and will incur heavy losses. Leasing provides a shield against all these hazards by shifting the risk of obsolescence of equipment to the lessor. This is true of operating leases which are for short duration and cancellable at the option of the lessee. The lessee can cancel an old lease agreement and enter into a new one in case a technologically superior product is available in the market. It is true that lease rentals for such equipments tend to be higher, but this disadvantage is more than off-set by the benefits the lessee derives by passing on the risk of obsolescence to the lessor.

Efficient Maintenance Services: Under operating or full service lease, the lessee avails of the maintenance and other services provided by the lessor, who is well equipped, qualified and experienced to provide such services efficiently. Of course, the lessee pays for such services in the form of higher rentals.

Low Administrative and Transactions Costs: Many leasing companies specialise in leasing a few types of equipments, machines or vehicles only. They can easily bargain with the suppliers/ manufacturers etc. and acquire the assets at better prices and can economise in other administrative expenses also. The lessee may get a concession in lease rent on the basis of the economies derived by the lessor.

Debt-Equity Ratio remains unchanged: When an asset is acquired on lease basis, lease rentals are shown as an expense in the firm's profit and loss account. Neither the leased asset nor the liability under the lease agreement is shown in the Balance Sheet. Hence the debt-equity ratio remains unaffected as compared to a firm which buys the asset with borrowed funds.

Benefit of Tax Shield: The lessee claims lease rentals as tax deductible expenses every year during the lease period. Thus, his tax liability is reduced to that extent.

In case he buys the asset with borrowed funds, he can claim **(i)** depreciation, and **(ii)** interest on borrowed funds as tax deductible expenses. To the extent the lease rental exceeds the depreciation and interest burden, his deductible expenses are larger and his tax liability is lower. The net burden, in such cases, is neutralised by the benefits derived by the lessee as enumerated above.

In the books of the lessor, lease rentals received are taxable, under the head 'Profits and Gains from Business or Professions', after deducting: **(i)** depreciation on the assets, and **(ii)** interest on the borrowed funds, if any.

DISADVANTAGES OF LEASING:

(1) No Benefit of Residual Value: When a firm purchases an asset, it has full rights to the value of the asset at the end of its useful life. But this benefit is not available to the lessee in case of lease. This is particularly important in assets like land, building and certain kinds of machinery, because their prices are always rising rapidly. If the lessee is required to purchase such an asset at the end of the lease, he may have to pay very heavy price. In case of certain financial leases, the option to purchase the asset at the end of the lease is given to the lessee. The price is either determined at the time of making lease agreement or is fixed at the expiration of lease, on the basis of market price ruling at that time. In case of certain types of assets, the right to buy the asset is given to the lessee from the beginning. But even here the residual value that may be prevailing then is taken into consideration.

(2) High Cost of Leasing: It is the experience that leasing is more costly than borrowing. The rate of interest charged is very much higher than that on borrowing. This is because the lease rental includes the cost of asset, some profit to the lessor, payment for employing experts by the lessor and also payment for related services. Of course, if the lessor is making purchase of asset on large scale, he gets the benefit of lower cost and this can be passed on to the lessee in the form of lower rent.

(3) No Benefit of Ownership: The lessee does not get any benefit, which would be available, if he were the owner of the asset, e.g. if price of an asset has increased considerably, the lessee cannot sell it. He cannot raise finance on the security of such assets.

(4) Not Flexible: In case the lessee is not able to arrange for finance for buying an asset, he will have to lease the asset. In that case, the amount of lease rent is fixed in advance for the whole period. If the rate of interest declines in the market, the borrowing can be returned and interest can be saved. But that is not possible in a lease, because rent amount, is not changed.

(5) Chances of disputes: As there is no legislation, covering only lease transactions, certain problems may arise between lessor and lessee. This may lead to unnecessary complications and tensions.

TYPES OF LEASES:

The terms and conditions on which an asset is leased and the rights and obligations of the lessor and the lessee are clearly incorporated in the Lease Agreement. On the basis of variations in all these, leases are classified into the following categories:

(1) Operating Lease: In case of operating lease, the lessor not only leases the asset of which he remains the owner throughout, but also undertakes to provide services attached to such assets, e.g., maintenance; repairs, technical advice, etc. Such lease is also called service lease. Computers, office equipments, automobiles and trucks are the typical capital assets which are leased under operating lease arrangement. The main features of an operating lease are as follows:

(i) The lease contract is generally for a period which is considerably shorter than the useful life of the leased asset. For example, a machine may be acquired on lease for a period of 5 years, while its useful life may be 10 years.

(ii) The lessor does not, therefore, recover the full cost of the asset from one lessee only. The leased asset is returned back to the lessor at the end of the lease period and is, thereafter, leased again to another lessee for another lease period.

(iii) After its useful life is over, it is sold off and its scrap value is realized by the lessor. Operating lease generally contains a cancellation clause also, wherein the lessee retains the right to cancel the lease any time before the lease period is over.

Such clause is beneficial to the lessee as he may terminate the lease, if the asset becomes obsolete or his need for the asset is over.

(iv) The lease agreement contains a maintenance clause whereby the lessor is required to maintain the leased assets. Thus, necessary repairs, fuel, support staff may be provided by the lessor, as agreed upon.

(v) The lease rental includes: **(a)** a part of the amortisation of the cost of the equipment, **(b)** cost of the maintenance services provided, and **(c)** profit of the lessor.

(2) Financial lease: In case of a financial lease, the lessor remains the owner of the leased asset during the lease period, but does not undertake its necessary maintenance. The rental received by the lessor fully amortises the cost of the equipment and earns a profit for him. These leases are non-cancellable. Ultimately, the ownership of the leased asset may be transferred to the lessee at an agreed price. The lessor thus acts as a financier only and earns a return on his investment in the leased asset by way of rentals. Financial leases are for the major part of the useful life of the asset.

This is another type of lease arrangement wherein the lessee who already owns the assets, sells the same to the lessor, and thereafter takes the same asset from him on lease basis. This is called 'Sale and Lease Back arrangement'. Under this arrangement, the lessee immediately recovers the value of his already owned assets from the lessor. Thereafter, the lessee makes payment of the lease rentals periodically as usual. Such a lease arrangement enhances the liquid resources of the lessee immediately, which can be utilised otherwise to meet his working capital requirements or to purchase another asset on cash payment basis. This type of lease is an alternative to a mortgage of the assets.

(3) Ordinary lease: In case of an ordinary lease, the lessor purchases the asset with an appropriate mix of debt and equity. But the creditor (i.e., supplier of the debt funds) does not have recourse to the lessee. In other words, in case the lessor defaults in making repayment of the debt, the creditor cannot claim the same from the lessee. He will have recourse to the lessor only.

(4) Leveraged lease: Leveraged lease is just opposite to the above. In such case, the creditor remains entitled to have recourse to the lessee, i.e., he can recover his claims from the lessee also. The lease rental is assigned to the creditor. The lessee is required to pay the lease rental directly to the creditor of the lessor. Generally this transaction is undertaken through a trustee, who receives the lease rental and appropriates it as debt service component to the creditor and the balance amount to the lessor.

(5) Domestic Lease and International Lease: This classification is based on the domicile of the parties to a lease contract. If all the parties, viz. equipment supplier, lessor and the lessee are residing in the same country, the lease is called domestic lease. If they are residing in different countries, it is called international lease. If the lessor and the lessee are domiciled in the same country and equipment is imported from another country, it is called import lease. If the lessor and lessee are domiciled in different countries, the lease is called cross-border lease. In such cases, the equipment supplier may be the resident of any country. In case of international lease, there are two additional risks, i.e., country risk and currency risk.

HIRE PURCHASE

Hire purchase is another method of acquiring a capital asset for use, without paying its price immediately. Under hire purchase arrangement goods are let on hire, the hirer (user) is allowed to pay the purchase price in installments and enjoys an option to purchase the goods after all the installments have been paid. Thus the ownership in the asset is passed on to the hirer on payment of the last instalment. The amount and number of installments is fixed at the time of delivering the asset to the hirer. If the hirer makes default in making payment of any instalment, the seller is entitled to recover the asset from the hirer. The hirer may return the asset to the hiree without any commitment to pay the remaining installments. The installments for this purpose are treated as hire charges. Thus, the property in the asset remains vested in the seller (hiree) till the right of purchase is exercised by the hirer after making payment of all the installments.

The hire purchase transaction takes place in the following manner:

(1) The seller (hiree) purchases the asset from the supplier/ manufacturer and hires it to the hirer who is required to make a cash down payment of, say 20-25% of the cost of the asset.

(2) The balance of the cost price of the asset with interest thereon is payable in equated monthly installments either in advance or in arrears, over a predetermined period which ranges between 36 months to 48 months.

(3) Sometimes, in place of cash down payment, a fixed deposit is required to be made with the seller and the entire amount of the cost is recovered through EMIs. The amount of FDR plus interest is returned to the hirer on payment of the last installment.

(4) Each installment comprises of the **(a)** cost of the asset, and **(b)** interest thereon. Interest is computed on the basis of a flat rate of interest. Thereafter the effective rate of interest is applied to the reducing balance of the original cost of asset to find out the interest component of each installment. The effective rate of interest happens to be higher than the flat rate of interest.

(5) The hirer is entitled to terminate the hire purchase contract by giving due notice to the seller (hiree).

(6) A hire purchase transaction is to be distinguished from an installment payment sale. In the installment payment sale, the ownership in the asset is passed on to the user (buyer) on payment of the first installment itself. Moreover, the buyer does not enjoy the right of termination of the agreement before making payment of all the installments.

VENTURE CAPITAL

Venture Capital is a form of "risk capital". In other words, capital that is invested in a project (in this case a business) where there is a considerable element of risk relating to the future creation of profits and cash flows. Risk capital is capitalized as shares (equity) rather than as a loan and the investor needs a higher "rate of return" to compensate him for his risk.

Venture capital offers long-term, committed share capital, to help unquoted companies grow and succeed. If an entrepreneur is looking to start-up, expand, buy-into a business, buy-out a business in which he operates, turnaround or rejuvenate a company, venture capital could help do this. Obtaining venture capital is considerably different from raising debt or a loan from a lender. Lenders have a legal right to interest on a loan and repayment of the capital, regardless of success or failure of a business. Venture capital is invested in exchange for an equity stake in the business. As a shareholder, the venture capitalist's return is reliant on the growth and profitability of the business. This return is usually earned when the venture capitalist "exits" by selling its shareholding when the business is sold to another owner.

FEATURES OF VENTURE CAPITAL FINANCING:

Starting and growing a business always require capital. There are several alternative methods to fund growth. These comprise of the owner or proprietor's capital, arranging debt finance, or seeking an equity partner, as is the instance with private equity and venture capital.

Private Equity: Private equity is a broad term that states to any type of non-public ownership equity securities that are not listed on a public exchange. Private equity encompasses both early-stage (venture capital) and later stage (buy-out, expansion) investing. In the broadest sense, it can also include mezzanine, fund of funds and secondary investing.

Equity financing: Venture capital is a means of equity financing for rapidly-growing private companies. Finance may be essential for the start-up, development/expansion or purchase of a company. Venture Capital firms invest funds on a professional basis, regularly focusing on a limited sector of specialization.

With venture capital financing, the venture capitalist purchases an agreed proportion of the equity of the company in return for the funding. Equity finance offers the substantial advantage of having no interest charges. It is a "patient" capital that seeks a return through long-term capital gain rather than instant and regular interest payments, as in the case of debt financing. Given the nature of equity financing, venture capital investors are therefore exposed to the risk of the company failing. As a result, the venture capitalist must look to invest in companies that have the ability to grow very positively and provide higher than average returns to compensate for the risk.

VARIOUS STAGES OF VENTURE CAPITAL FINANCING:

Investment Process: The investment process initiates with the venture capitalist conducting an initial review of the proposal to determine if it fits with the firm's investment criteria. Further, a meeting will be arranged with the entrepreneur/management team to discuss the business plan.

Preliminary Screening: The initial meeting provides a chance for the venture capitalist to meet with the entrepreneur and key members of the management team to review the business plan and conduct initial due diligence on the project. It is a significant time for the management team to demonstrate their understanding of their business and capability to achieve the strategies sketched in the plan. The venture capitalist will look prudently at the team's functional skills and backgrounds.

Negotiating Investment: This includes an agreement between the venture capitalist and management of the terms of the term sheet, often called a memorandum of understanding (MoU). The venture capitalist will then continue to study the feasibility of the market to estimate its potential. Often they use market forecasts which have been independently arranged by industry experts who specialize in estimating the size and growth rates of markets and market segments. The venture capitalist also studies the industry carefully to obtain information about competitors, entry barriers, potential to exploit substantial niches, product life cycles, and distribution channels. The due diligence may continue with reports from other consultants.

Approvals and Investment Completed: The process includes due diligence and disclosure of all related business information. Final terms can then be negotiated and an investment proposal is classically submitted to the venture capital fund's board of directors. If accepted, legal documents are prepared.

The investment process can take up to two months, and occasionally longer. It is vital therefore not to expect a speedy response. It is advisable to plan the business's financial needs early on to allow appropriate time to protect the required funding.

Venture capital has several advantages over other forms of finance, such as:

- It inserts long term equity finance which delivers a solid capital base for future growth.
- The venture capitalist is a business partner, allocating both the risks and rewards. Venture capitalists are contented by business success and capital gain.

- The venture capitalist can deal with practical advice and assistance to the company based on experience with other companies that were in similar situations.
- The venture capitalist also has a link of contacts in many areas adding value to the company, like in areas of recruiting key personnel, providing contacts in international markets, introductions to strategic partners, and if needed co-investments with other venture capital firms when additional rounds of financing are required.
- The venture capitalist may be accomplished by providing additional rounds of funding should it be required to finance growth.

Venture capital firms usually source the majority of their funding from large investment institutions such as funds of funds, financial institutions, endowments, pension funds and banks. These institutions classically invest in a venture capital fund for a period of up to ten years.

To compensate for the long term commitment and lack of both security and liquidity, investment institutions presume to receive very high returns on their investment. Consequently, venture capitalists invest in either company with high growth potential where they can exit through either an IPO or a merger/acquisition. Though the venture capitalist may receive some return through dividends, their primary return on investment comes from capital gains when they ultimately sell their shares in the company, normally between three to five years after the investment.

Venture capitalists are thus in the business of promoting growth in the companies they invest in and managing the connected risk to protect and enhance their investors' capital.

BANKING INTERMEDIARY AND NON-BANKING INTERMEDIARY SUPPORTS EACH OTHER:

- Banks and other non-banking financial institutions differ in some functional area. NBFCs lend and make investments and hereafter their activities are akin to that of banks.
- NBFCs are financial intermediaries involved primarily in the business of

  (1) Loans and advances.

(2) Acquisition of shares/stock/bonds/debentures/ securities issued by the government or local authority or other securities of like marketable nature.

(3) Leasing.

(4) Hire-purchase.

(5) Insurance business.

(6) Chit business.

- Only 34% of Indian individuals have access to banks, which clearly states that the remaining portion takes help from NBFCs. These NBFC borrow money from banks which bring about interdependency and help in economic growth.
- Banks have a lot of constraints in lending but NBFC does not.
- NBFC has higher risk-taking ability whereas banks don't.
- In infrastructure financing credit risk evaluation is the main job. For collecting the dues they use human resources and pay them lower than what banks pay, banks lack here.
- In-home finance, housing finance companies (HFC) flourish with higher focus and better customer service. NBFCs are the top priority in housing finance.

SUMMARY

- All those, institutions or individuals, who help to bring the savers and seekers of capital and enable a regular flow of funds from supply to demand points are intermediaries. All intermediaries are service providers and are an integral part of the Securities Market.
- These market intermediaries provide different types of financial services to the investors. They are constantly operating in the financial market.
- Intermediaries make the market vibrant which helps market to function smoothly and continuously.
- There are many intermediaries in the primary market or capital market. Important players are Merchant bankers, Registrars to issue, Brokers and underwriters.
- There are many functions performed by intermediaries.
- There are two types of intermediaries in the system: **(1)** Banking and **(2)** Non-Banking.

QUESTIONS

(1) Multiple Choice Questions (MCQs):

(a) Banking Regulation Act, 1949 conferred wide powers upon __________ to supervise and control affairs of banking companies in India.

(i) Commercial Banks (ii) RBI (iii) Private Banks

(b) __________ is chairman of central board of directors of RBI.
(i) Finance Minister (ii) Governor (iii) President

(c) __________ means a bank included in the second schedule of the Reserve Bank of India Act, 1934.
(i) Schedule (ii) Non-Schedule (iii) Co-operative (iv) Commercial

(d) Those banks which are not included in the second schedule of the Reserve Bank of India Act are termed as __________.
(i) Schedule (ii) Non-Schedule (iii) Co-operative (iv) Commercial

(e) __________ are a part of the set of institutions, which are engaged in financing rural and agriculture development.
(i) Schedule (ii) Non-Schedule (iii) Co-operative (iv) Commercial

(f) The Central Co-operative Bank works at the __________ Level. *(March 18)*
(i) Base (ii) First (iii) Co-operative (iv) Apex

(g) The __________ are branches of joint stock companies incorporated abroad but operating in India.
(i) Schedule (ii) Foreign (iii) Co-operative (iv) Commercial

(h) All presidency banks were amalgamated to form the Imperial Bank of India which was run by European Shareholders in the year ______.
(i) 1990 (ii) 1921 (iii) 1935 (iv) 1949

(i) __________ banking structure is viewed as a vehicle for the democratization of the Indian financial system.
(i) Schedule (ii) Foreign (iii) Co-operative (iv) Commercial

(j) The Central Bank Functions in India as performed by the __________. *(March 18)*
(i) Central Bank of India (ii) Reserve Bank of India (iii) State Bank of India

(k) __________ is the most important type of deposit bank. *(Oct. 18)*
(i) Commercial Bank (ii) Co-operative Bank

[Ans.: (a – ii), (b – i), (c – ii), (d – ii), (e – iii), (f – iv), (g – ii), (h – ii), (i – iii), (j – ii), (k – i)]

(2) Fill in the blanks:

(a) A __________ is an institution which accepts deposits from the public and in turn advances loans by creating credit.

(b) The __________ is at the top of the Reserve Bank's organizational structure.

(c) A __________ means a bank included in the second schedule of the Reserve Bank of India Act, 1934.

(d) __________ banks are a part of the set of institutions, which are engaged in financing rural and agriculture development.

(e) The __________ are been set up to supplement the efforts of cooperative and commercial banks to provide credit to rural sector.

(f) The unorganized sector is largely made up of ________ and ________.

(g) Since nationalization in __________, RBI is fully owned by the Government of India.

(h) A State Co-operative Bank works at the __________ level.

(i) The __________ are branches of joint stock companies incorporated abroad but operating in India.

(j) The __________ set up Regional Rural Banks (RRBs) so as to provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural labourers, and small entrepreneurs.

[Ans.: (a) Bank, (b) The Central Board of Directors, (c) Scheduled bank, (d) Cooperative, (e) Regional Rural Banks (RRBs), (f) money lenders and indigenous bankers, (g) 1949, (h) Apex, (i) foreign banks, (j) Government of India]

(3) **True or False:**

(a) Since nationalization in 1949, RBI is fully owned by the Government of India.

(b) The organized sector is largely made up of money lenders and indigenous bankers.

(c) A scheduled bank means a bank included in the second schedule of the Reserve Bank of India Act, 1934.

(d) The Central Co-operative Bank works at the apex Level.

(e) The Regional Rural Banks (RRBs) have not been set up to supplement the efforts of cooperative and commercial banks to provide credit to rural sector.

(f) The reserve bank of India is a central bank and was established in April 1, 1935 in accordance with the provisions of reserve bank of India act 1934.

(g) All nationalized banks and almost all the private sector banks are commercial scheduled banks in India.

(h) Those banks which are not included in the second schedule of the Reserve Bank of India Act are termed as non-scheduled banks.

(i) Cooperative banks are a part of the set of institutions, which are engaged in financing rural and agriculture development.

(j) The Central board of directors is at the top of the Reserve Bank's organizational structure.

[Ans.: (a) True, (b) False, (c) True, (d) False, (e) False, (f) True, (g) True, (h) True, (i) False, (j) True]

(4) **Match the columns:**

Group "A"		Group "B"	
(a)	1870	(i)	Nationalization of SBI subsidiaries
(b)	1935	(ii)	Nationalization of 7 banks with deposits over 200 Crores
(c)	1949	(iii)	Enactment of Banking Regulation Act
(d)	1955	(iv)	Nationalization of State Bank of India
(e)	1959	(v)	Bank of Hindustan
(f)	1961	(vi)	Insurance cover extended to deposits
(g)	1969	(vii)	Nationalization of 14 major Banks
(h)	1971	(viii)	Creation of credit guarantee corporation
(i)	1975	(ix)	Creation of regional rural banks
(j)	1980	(x)	Reserve Bank of India

[Ans.: (a – v), (b – x), (c – iii), (d – iv), (e – i), (f – vi), (g – vii), (h – viii), (i – ix), (j – ii)]

(5) Who is an intermediary? Explain the role of intermediaries in the development of the financial market.

(6) Explain various functions of financial intermediaries. ***(Oct. 17)***

(7) Explain various types of financial intermediaries.

(8) Explain Mutual funds act as an intermediary. ***(March 18)***

(9) Elaborate the role of insurance in the development of the financial market.

(10) Explain in detail on non-banking financial institutions. ***(March 19)***

(11) **Write short notes on:**

(a) Leasing.

(b) Hire Purchase.

(c) NHB.

(d) CDSL.

(e) Equity Funds. ***(March 19)***

UNIT – II: FINANCIAL MARKETS

Chapter 3

FINANCIAL MARKETS

- Introduction to Financial Markets
- Classification of Financial Markets
- Organized and Unorganized
- Capital and Money Market
- Primary and Secondary Market
- Regulatory Framework for Financial Markets
- RBI: Role and Functions
- Financial Market Infrastructures Regulated by RBI
- RBI and Inflation
- SEBI: Objectives, Composition, Powers and Functions
- IRDA
- PFRDA
- Summary
- Questions

INTRODUCTION TO FINANCIAL MARKETS:

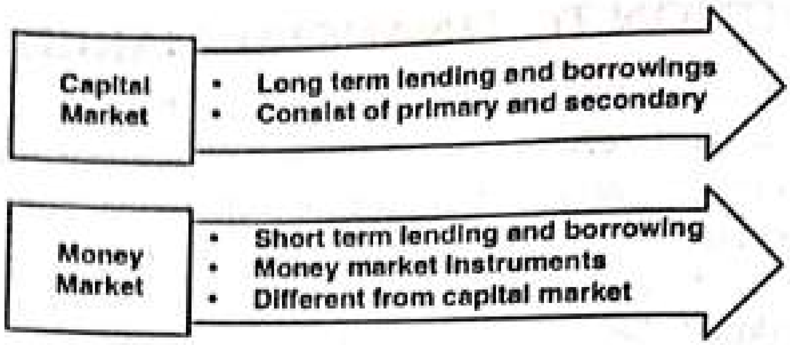
The arrangements that provide facilities for buying and selling of financial claims and services are known as financial markets. The participants in these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and others who are inter-linked by the laws, contracts and communication networks of the country. Financial markets can be classified as primary and secondary markets. The primary market deals in new financial claim; therefore it is called new issue market. On the other hand, secondary markets deal in securities already issued or existing securities. Stock market is an example of secondary market. Financial market can also be classified as money market and capital market. The money market deals with short term claims with a maturity of less than one year. The capital markets deals with long term claims i.e. more than one year. Capital market is co-extensive with the stock market and it is also wider than the stock markets. Money market includes the Treasury Bill Market, Call Money Market and Commercial Bill Market and Government Bond Market.

CLASSIFICATION OF FINANCIAL MARKETS:

The classification of financial markets in India can be as following:

(1) Unorganized Markets: In unorganized markets, there are a number of money lenders, indigenous bankers, traders, etc. who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc. whose activities are not controlled by the RBI. The RBI has already taken some steps to bring unorganized sector under the organized fold.

(2) Organized Markets: In the organized markets, there are standardized rules and regulations governing their financial dealings. There is also a high degree of institutionalization and instrumentalization. These markets are focused on strict supervision and control by the RBI and other regulatory bodies. These organized markets can be further categorized into two. They are: **(i)** Capital Market and **(ii)** Money Market.



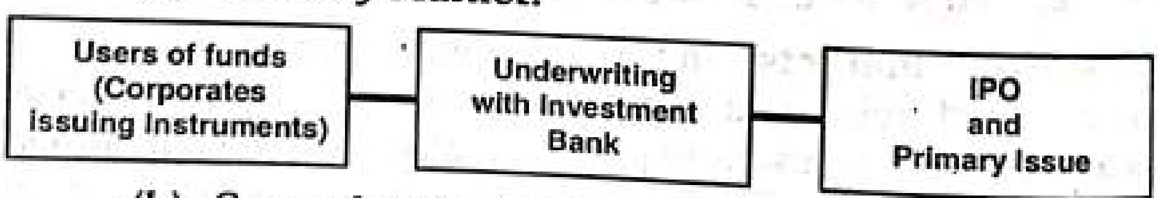
A financial market consists of two major segments:

(a) Money Market; and **(b)** Capital Market. While the money market deals in short-term credit, the capital market switches the medium term and long-term credit.

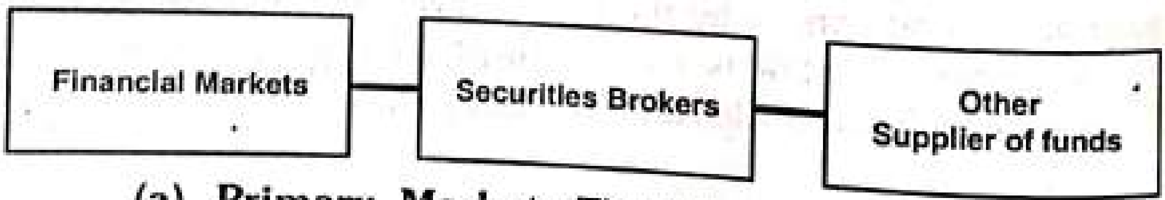
(i) Capital Market: Capital Market may be defined as a market trading in medium and long-term funds. It is an institutional prearrangement for borrowing medium and long-term funds and which provides facilities for marketing and trading of securities. So it systematizes all long-term borrowings from banks and financial institutions, borrowings from foreign markets and raising of capital by issue various securities such as shares debentures, bonds, etc.

The market where securities are traded known as Securities market. It consists of two different segments namely primary and secondary market. The primary market deals with fresh issue of securities and is, consequently, also known as new issue market; whereas the secondary market provides a place for purchase and sale of existing securities and is often termed as stock market or stock exchange.

(a) Primary Market:



(b) Secondary Market:



(a) Primary Market: The Primary Market involves the arrangements facilitating the procurement of long- term funds by companies by making fresh issue of shares and debentures. At the formation stage a company needs to make fresh issue of shares and/or debentures and, if necessary, which is followed by borrowing subsequently for the expansion of business. It is frequently done through private placement to friends, relatives and financial institutions or by making public issue. The corporates are required to follow a well-established legal procedure and involve a number of intermediaries such as underwriters, brokers, etc. who form an integral part of the primary market. Year 2021 turned out to be an year of IPOs in India as stated by RBI. Financial Markets in India has witnessed oversubscription on IPOs like Zomato, Devyani International, Exxaro Tiles, CarTrade and many such others. Yet in Future Paytm, NYKaa, Policy Bazaar, MobiKwik, ESAF bank are expected to issue their IPOs.

(b) **Secondary Market:** The secondary market known as stock market or stock exchange plays an correspondingly vital role in mobilising long-term funds by providing the necessary liquidity to holdings in shares and debentures. It provides a place where these securities can be encashed without any difficulty and delay. It is an organised market where shares, and debentures are traded regularly with high degree of transparency and safety. In fact, an active secondary market simplifies the growth of primary market as the investors in the primary market are guaranteed of a continuous market for liquidity of their holdings. The major performers in the primary market are merchant bankers, mutual funds, financial institutions, and the individual investors; and in the secondary market you have all these and the stockbrokers who are members of the stock exchange facilitating the trading.

DISTINCTION BETWEEN PRIMARY MARKET AND SECONDARY MARKET:

The focal points of distinction between the primary market and secondary market are as follows:

(1) Function: The foremost function of primary market is to raise long-term funds through fresh issue of securities, whereas, the main function of secondary market is to provide continuous and ready market for the existing long-term securities.

(2) Participants: Although the major players in the primary market are financial institutions, mutual funds, underwriters and individual investors, the major players in secondary market are all of these and the stockbrokers who are members of the stock exchange.

(3) Listing Requirement: Even though only those securities can be dealt with in the secondary market, which have been approved for the purpose (listed), there is no such requirement in case of primary market.

(4) Determination of prices: In instance of primary market, the prices are determined by the management with due compliance with SEBI requirement for new issue of securities. But in case of secondary market, the price of the securities is determined by forces of demand and supply of the market and keeps on fluctuating.

KFC, Pizza Hut and Costa Coffee operator Devyani International came up with an IPO offer.
Details of IPO were as follows (Primary Market Transaction)
IPO Opening Date: Aug 4, 2021
IPO Closing Date: Aug 6, 2021
IPO Price: Rs.86 to Rs.90 per equity share
Offer for Sale: 155,333,330 Eq Shares of Re. 1 each

Post bidding- Devyani International was listed on BSE and NSE on 16th August,2021, whereby share got listed at 56% premium at Rs. 141 in Secondary Market.

(ii) Money Market: The money market is a market for short-term funds, which deals in financial assets whose period of maturity is upto one year. Money market does not deal in cash or money as such but simply provides a market for credit instruments like bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are nearby substitute of money. These instruments help the business units, other organizations and the Government to borrow the funds to meet their short-term requirement.

Money market does not imply to any specific market place. Relatively it refers to the whole networks of financial institutions dealing in short-term funds, which provides an outlet to lenders and a source of supply for such funds to borrowers. Utmost money market transactions are taken place on telephone, fax or Internet. The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialized financial institutions. The Reserve Bank of India is the spearhead of the money market in India. Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC, GIC, UTI, etc. also operate in the Indian money market.

MONEY MARKET INSTRUMENTS:

Following are some of the important money market instruments or securities:

(a) **Call Money:** Call money is used by the banks to meet their temporary requirement of cash. They borrow and lend money from each other normally daily. It is repayable on demand with its maturity period varying between one day to a fortnight. The rate of interest paid on-call money loan is known as call rate.

(b) **Treasury Bill:** A treasury bill is a promissory note allotted by the RBI to meet the short-term requirement of funds. Treasury bills are extremely liquid instruments, which means, at any time the holder of treasury bills can transfer of or get it discounted from RBI. These bills are usually issued at a price less than their face value; and redeemed at face value. So the modification between the issue price and the face value of the treasury bill represents the interest on the investment. These bills are secured instruments and are issued for a period of not exceeding 364 days. Banks, Financial institutions and corporations usually play main role in the Treasury bill market.

(c) **Commercial Paper:** Commercial paper (CP) is a widespread instrument for financing the working capital requirements of companies. The CP is an unsecured instrument issued in the system of promissory note. In 1990 this instrument was introduced so as to enable the corporate borrowers to raise short-term funds which can be issued from a period ranging from 15 days to one year. Commercial papers are transferable by endorsement and delivery. The highly reputed companies (Blue Chip companies) are the chief player of commercial paper market. Eg- NLC India Limited which deals in coal, lignite mining and power generation has allotted 10,000 Nos. of Commercial Paper of a face value of Rs5 lakh each, aggregating to Rs. 500 cr.

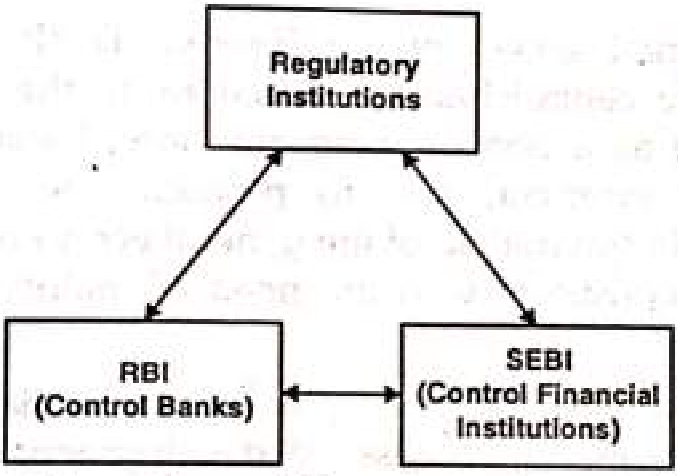
(d) **Certificate of Deposit:** Certificate of Deposit (CDs) are short-term instruments issued by Commercial Banks and Special Financial Institutions (SFIs), characterized as freely transferable from one party to another. The maturity period of CDs ranges from 91 days to one year. CDs are issued to individuals, co-operatives and companies.

(e) **Trade Bill:** Usually the traders buy goods from the wholesalers or manufactures on credit. The sellers get compensation after the end of the credit period. In case any seller does not want to delay or in immediate need of money he/she can draw a bill of exchange in favour of the buyer. When buyer agrees the bill it becomes a negotiable instrument and is termed as bill of exchange or trade bill. This trade bill can now be discounted with a bank earlier its maturity. On maturity the bank gets the payment from the drawee i.e., the buyer of goods. When trade bills are accepted by Commercial Banks it is known as Commercial Bills. So trade bill is an instrument, which enables the drawer of the bill to get funds for short period to meet the working capital needs.

DISTINCTION BETWEEN CAPITAL MARKET AND MONEY MARKET:

Capital Market differs from money market in many ways. Firstly, although money market is related to short-term funds, the capital market linked to long term funds. Secondly, even though money market deals in securities like treasury bills, commercial paper, trade bills, deposit certificates, etc., the capital market deals in shares, debentures, bonds, and government securities. Thirdly, while the participants in the money market are Reserve Bank of India, commercial banks, non-banking financial companies, etc., the participants in the capital market are stockbrokers, underwriters, mutual funds, financial institutions, and individual investors. Fourthly, while the money market is regulated by the Reserve Bank of India, the capital market is regulated and controlled by the Securities Exchange Board of India (SEBI).

REGULATORY FRAMEWORK FOR FINANCIAL MARKETS:



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

Both RBI and SEBI administer, legislate, supervise, monitor, control and discipline the entire financial system. RBI is the apex of all financial institutions in India. All financial institutions are under the control of RBI. The financial markets are under the control of SEBI.

1) RESERVE BANK OF INDIA:

The Reserve Bank of India is the Central Bank of our country. The Reserve Bank of India is the apex financial institution of the country's financial system entrusted with the task of contro[l], supervision, promotion, development and planning.

- Reserve Bank of India came into existence on 1st April, 1935 a[s] per the Reserve Bank of India act 1935. But the bank wa[s] nationalized by the government after Independence.
- It became the public sector bank from 1st January, 1949. Thu[s] Reserve Bank of India was established as per the Act 1935 and empowerment took place in Banking Regulatiȯn Act, 1949.
- Reserve Bank of India is the queen bee of the Indian financi[al] system which influences the commercial banks' management i[n] more than one way.
- The Reserve Bank of India influences the management o[f] commercial banks through its various policies, directions and regulations.
- The fundamental object of the Reserve Bank of India is t[o] perform purely central banking functions in the Indian mone[y] market, acting as a note- issuing authority, bankers' bank and banker to government, and to promote the growth of the economy within the outline of the general economic policy of the Government, consistent with the need of maintenance of pric[e] stability.
- A noteworthy object of the Reserve Bank of India has also been to assist the planned process of development of the Indian economy.
- The most significant provision of the Banking regulation act i[s] supervision and regulation of banks. Section 35 of the act says that RBI can inspect any branch of Indian Bank located in o[r] outside the country. Further, it issued licensing for the banks and can establish new branches to maintain regional balance in the country.
- It also arranges for training colleges to the banks employees and officers.
- The Reserve Bank of India is empowered to buy and se[ll] government securities from the public and financial institutions. The Reserve Bank of India is empowered to buy and se[ll] government securities, treasury bills and other approve[d]

securities. The central bank uses the weapon to overcome seasonal stringency in funds during the slack season.

- The money market comes within the direct purview of the Reserve Bank of India regulations. The Reserve Bank of India influences liquidity and interest rates through a number of operating instruments such as CRR, Open Market Operations, repos, change in bank rates, etc.

ROLE OF RBI:

RBI plays various roles as per the requirement of the economic situation:

(1) To manage adequate money and credit in the country.

(2) To maintain the stability of rupee internally and externally.

(3) Balanced and well-managed banking development in the country.

(4) To develop a well organized money market.

(5) To provide adequate agriculture credit.

(6) To manage public debt.

(7) To seek international monetary co-operation.

(8) Centralization of cash reserves of commercial banks.

(9) To set up Government banks.

FUNCTIONS OF RBI:

(A) Traditional/Monetary Functions

(B) Supervisory Functions

(C) Promotional Role

(A) TRADITIONAL/ MONETARY FUNCTIONS:

(1) Currency Issue:

- According to the Reserve Bank of India Act, 1934, "...*it is expedient to constitute a Reserve Bank of India to regulate the issue of Banknotes and the keeping of reserves to secure monetary stability in India and generally to operate the currency and credit system of the country to its advantage*".
- RBI has specified the statutory function of note issue on a monopoly basis.

- RBI accomplishes the circulation of money through currency chests. Currency Chests are magazines in which stocks of issuable and new notes are stored along with rupee coins.
- Currency Chests are repositories operated by RBI, SBI, subsidiaries of SBI, public sector banks, Government Treasuries and Sub treasuries. Currency Chests help in the expansion and contraction of currency in the country.

(2) Banker Bank:

- Central bank performs as the custodian of the cash reserve for the commercial banks.
- Commercial banks are obliged by law or customs, and a certain proportion of money is collected from the public and kept in central bank as deposits, known as cash reserves.
- Commercial banks can borrow currency from the central bank during the busy season and pay in surplus during the slack season. Commercial banks look for guidance and directions from the central bank.
- RBI also acts as an adviser to Government on economic and financial matters. In short, RBI renders the following functions as a banker to the Government the:
  - Collects taxes and makes payments on behalf of the Government.
  - Accepts deposits from the Government.
  - Collects cheques and drafts deposited in the Government accounts.
  - Provides short-term loans to the Government.
  - Provides foreign exchange resources to the Government.
  - Keep the accounts of various Government departments.
  - Maintains currency chests in treasuries at some important places for the convenience of the government.
  - Advises governments on their borrowing programmes.
  - Maintains and operates the Central Government's IMF accounts.

(3) Custodian of Foreign Exchange Reserves:

- Under the gold standard, the central banks were required by law to maintain gold reserves against note-issue. And now, after the abandonment of Gold standards, the central banks are supposed to keep both gold as well as foreign currency reserve against note-issue.
- The RBI is the custodian of the country's foreign exchange reserves, it is vested with the responsibility of managing the investment and utilization of the reserves in the most advantageous manner.
- The RBI achieves this through buying and selling of foreign exchange market, from and to schedule banks, which, are the authorized dealers in the Indian foreign exchange market.
- The Reserve Bank brings about the investment of reserves in gold counts abroad and the shares and securities issued by foreign governments and international banks or financial institutions.

(4) Bank of Central Clearance, Settlement and Transfer:

- RBI acts as the clearing house for settlement of banking transactions in India. The functioning of clearing house is to enable the other banks to settle their interbank claims easily.
- The complete clearing house operations carried on by RBI are computerized. The inter-bank cheque clearing settlement is completed twice a day. There is a distinct route for clearance of high-value cheques of Rs. 1.00 lakh and above. Cheques drawn on banks in metropolitan cities are cleared on the same day.
- The RBI conveys this function through a cell known as National Clearing Cell.

(5) Lender of last resort:

- Central banks undertake the accountability of meeting directly or indirectly all reasonable demands for financial accommodation from commercial banks, discount houses and certain other credit institutions.

- The central bank is the final source from which the commercial banks can get emergency credit to meet the demand for cash on the part of the panic-stricken people.
- The RBI performs as a lender of last resort or emergency fund provider to the other member banks. In case, if the commercial banks are not able to get financial assistance from any other sources, then as a last resort, they can approach the RBI for the necessary financial assistance.
- In critical situations of funds raising, the RBI provides credit facilities to the commercial banks on eligible securities including genuine trade bills which are usually made available at Bank Rate.
- RBI rediscounts bills under Section 17 (2) and 17 (3) and grants advances against securities under Section 17 (4) of RBI Act. However, many of these transactions are practically carried out through separate agencies like DHFI, Securities Trading Corporation of India, primary dealers.

(6) Controller of Credit:

- In modern times, bank credit has converted into the most important source of money in the country, relegating coins and currency notes to a minor position. As a controller of credit, central bank attempts to influence and control the volume of bank credit and also to stabilize business condition in the country.
- Price stability is crucial for economic development. The Reserve Bank controls the money supply following the varying requirements of the economy.
- The Reserve Bank makes widespread use of various quantitative and qualitative techniques to effectively control and regulate credit in the country.
- Quantitative controls comprise the bank rate policy, open market operations, and the variable reserve ratio. On the other hand, the Qualitative also known as selective credit control, includes rationing of credit, margin requirements, direct action, moral suasion publicity, etc.

(B) SUPERVISORY FUNCTIONS:

The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and cooperative banks, related to licensing and establishment, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation.

(1) Granting License to Banks:

- The RBI grants a license to the banks, which like to instigate their business in India. Licenses are also essential to open new branches or closure of branches.

(2) Function of Inspection and Enquiry:

- RBI examines and makes enquiry in respect of various problems covered under Banking Regulations Act and RBI Act. The inspection of commercial banks and financial institutions are conducted in terms of the provisions contained in Banking Regulation Act.
- This kind of examination is carried on periodically once a year or two covering all branches of banks.
- Banks are indulged to take remedial measures on the lapses/deficiencies pointed out during an inspection.
- RBI currently inspects commercial banks, Development Financial Institutions like IDBI, NABARD, etc. Urban Co-operative Banks and non-banking financial companies like Lease Financing Companies, Loan Companies.

(3) Controls the Non-Banking Financial Corporations:

- RBI issues obligatory directions to the Non-Banking financial corporations and conducts inspections through which it exercises control over such institutions. Deposit-taking NBFCs seeks permission from RBI for their operations.

(C) PROMOTIONAL ROLE:

With economic growth presuming a new urgency since independence, the range of the Reserve Bank's functions has gradually widened. The banks now accomplish development and proportional functions, which were observed as outside the normal scope of central banking. The Reserve bank was asked to promote the banking habit, extend banking facilities to rural and semi-urban areas, and establish new specialized financing agencies.

(1) Promotion of Banking Habits:

- The RBI institutionalizes saving by promoting the banking habit and expansion of the banking system territorially and functionally.
- To carry on promotional activities, RBI has set up Deposit Insurance Corporation in 1962, Unit Trust of India in 1964, the IDBI in 1964, the Agricultural Refinance Corporation in 1963, Industrial Reconstruction Corporation of India in 1972, NABARD in 1982 and the National Housing Bank in 1988, Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India for industrialization of the country.

(2) Provides Refinance for Export Promotion:

- The RBI takes the initiative for broadening facilities for the provision of finance for foreign trade, particularly of exports.
- The Export Credit and Guarantee Corporation (ECGC) and EXIM Bank encourage exports as the rate of interest on export credits to remain to be prescribed by RBI at a lower rate.
- The ECGC offers an insurance cover on Export receivables. EXIM Bank extends long term finance to project exporters and foreign currency credit for the promotion of Indian exports.

(3) Facilities for Agriculture:

- Keeping in view the agricultural sector, RBI extends indirect financial facilities through NABARD whereby it provides short-term and long-term financial facilities to agriculture and allied activities. It recognized NABARD for the overall administration of agricultural and rural credit. Indian agriculture would have suffered from cheap credit but for the institutionalization of rural credit by RBI.

(4) Facilities to Small Scale Industries:

- The RBI takes dynamic steps to increase the supply of credit to small industries.
- It inspires commercial banks to provide guarantee services to SSI sector. Banks loans to SSI sector are classified under priority sector advances.
- RBI has instructed commercial banks to open specialized SSI bank branches providing the adequate financial and technical assistance to SSI branches.

(5) Provisions of Training: The RBI has always tried to provide essential training to the staff of the banking industry. The RBI has set up the bankers' training colleges at several places. National Institute of Bank Management i.e. NIBM, Bankers Staff College i.e. BSC and College of Agriculture Banking i.e. CAB are few to mention.

(6) Collection of Data: Being the apex monetary authority of the country, the RBI collects process and disseminates statistical data on several topics. It comprises of interest rate, inflation, savings and investments, etc. This data proves to be fairly useful for researchers and policy makers.

(7) Publication of the Reports: The Reserve Bank has its separate publication division. This division gathers and publishes data on several sectors of the economy. The reports and bulletins are frequently published by the RBI. It comprises of RBI weekly reports, RBI Annual Report, Report on Trend and Progress of Commercial Banks India., etc. This information is readily available to the public at cheaper rates.

FINANCIAL MARKET INFRASTRUCTURES REGULATED BY RBI:

The following FMIs are regulated by the RBI:

(1) Real-Time Gross Settlement System (RTGS): RTGS system was implemented in March 2004. RTGS system is owned and operated by the RBI. It is a Systemically Important Payment System (SIPS) where the inter-bank payments settle on a 'real' time and on gross basis in the books of the RBI. RTGS system also settles Multilateral Net Settlement Batch (MNSB) files originating from other ancillary payment systems including the systems operated by the Clearing Corporation of India Limited. RBI is in the process of executing the Next Generation RTGS (NG-RTGS) built on ISO20022 standards with advance liquidity management functions, future date functionality, scalability, etc.

(2) **Securities Settlement Systems (SSS):** The Public Debt Office (PDO) of the RBI manages and activates the Securities Settlement Systems for the Government securities, both for outright and repo transactions directed in the secondary market. Government securities (outright) are settled on a T+1 basis. Repos are settled on T+0 or T+1 basis. Moreover, the PDO system also acts as a depository for dematerialized government securities. With the application of the Core Banking Solution (CBS) in the RBI, the securities settlement system has been drifted to the CBS platform.

(3) **Clearing Corporation of India Ltd. (CCIL):** CCIL is a Central Counterparty (CCP) which was originated in April 2001 to provide clearing and settlement for transactions in Government securities, foreign exchange and money markets in the country. CCIL acts as a central counterparty in several segments of the financial markets regulated by the RBI viz. the government securities segment, collateralized borrowing and lending obligations (CBLO) - a money market instrument, USD-INR and forex forward segments. Additionally, CCIL delivers non-guaranteed settlement in the rupee-denominated interest rate derivatives like Interest Rate Swaps/Forward Rate Agreement market. It allocates non-guaranteed settlement of cross-currency trades to banks in India by the way of Continuous Linked Settlement (CLS) bank by acting as a third party member of a CLS Bank settlement member.

CCIL also operates as a trade repository for OTC interest rate and forex derivatives transactions.

RBI AND INFLATION:

Interest rate and inflation:

The lower interest rate will increase the money supply in the economy and **thus causes inflation to rise. Higher inflation cause higher prices of the products. Thus, consumption will**

decrease and reduces investment. Thus affect the growth of the economy.

Interest rate and Money Supply: In case of interest rate, a higher interest rate will reduce the money supply in the economy. The **higher interest rate** causes lower investment and therefore **lower the growth of the economy.** Thus the balance between the **interest rate and inflation rate needs to be maintaining in the monetary policy.**

Generally, there is a long lag between changes in the interest rate and the consequential changes in the economy. Therefore, most central banks have changed the interest rate slowly and then waited to see what effect it would have. Because of this lag, many economists sought a rule that would allow central bankers to choose an interest rate that would more closely achieve their economic objectives than would be possible with just discretion. This gives rise to the interest rate forecasting model, Taylor Rule.

Diagrammatic representation of dual objectives:

RBI Dual Objectives

- Promoting Economic Growth
  - Lower interest rate. Increase in borrowings. Increasing money supply. Increasing inflation. Promotes economic growth
  - Higher interest rate. Decrease in borrowings. Decline money supply. Deflation. Restricts economic growth.
- Restricting Inflation
  - Lower interest rate. Increase in borrowings. Increasing money supply. Increasing inflation.
  - Higher interest rate. Decrease in borrowings. Decline money supply. Deflation.

Inflation:

Inflation is a process in which the price level is rising and money losing value. Inflation is a rise in the price level, not in the price of particular commodity.

Causes of Inflation:

There are two main causes of inflation:

(a) Demand-Pull Inflation:

Demand-pull inflation is inflation that effects an initi increase in aggregate demand. Keynesian has given this theo of demand-pull stating that "an excess of aggregate demar over aggregate supply will generate an inflationary rise prices." It could be due to:

(1) Demand-pull inflation can result from any factor tha increases aggregate demand.

(2) Two factors controlled by the government are increases in the quantity of money and increases in governmen purchases.

(3) A third possibility is an increase in exports.

(b) Cost-push inflation:

Cost-push inflation is inflation that results from an initial increase in costs. There are two main sources of increased costs:

(1) an increase in the money wage rate or

(2) an increase in the money price of raw materials, such as oil.

(3) A rise in the wage rate could be due to the strong bargaining power of the trade unions. The price of raw materials could increase due to the profit push margin by suppliers.

Types of Inflation:

(1) Creeping inflation: Creeping is a circumstance of mild inflation where the inflation of a nation increases gradually with 3% or less a year. This inflation is used by the government to stabilize the economy where there is a rise of 2% or less in prices leading to economic growth. A gradual increase in price will help to enhance the demand for goods and services, as consumers now want to buy a lot to beat future prices.

(2) **Walking inflation:** Walking is tougher inflation as compared to creeping inflation whereby the price rise is between 3% to 10% a year. Walking inflation is harmful to the economy, as it quickens economic growth aggressively. This rise in price forces the consumers to start purchasing goods/services more than their requirement creating the speculation and more price rise, due to more demand and less supply. Thus this type of inflation widens the gap between rich and poor by making things out of their reach.

(3) **Galloping inflation:** When inflation increases up to 10% of more, there's chaos bushed on the economy. The currencies drop the value so radically that incomes of employees and businesses can't retain up with prices and costs. This leads to uncertainty in the Economy and loss in the trustworthiness of the government leaders. This is the type of inflation that must be prohibited at all costs.

(4) **Hyperinflation:** An upsurge in inflation beyond the inflation range of 2% or 3%, could lead to hyperinflation, it is a condition where inflation rapidly augmentations out of control. Hyperinflation occurs when prices hit the roof more than 50% a month. Hyperinflation is a rare phenomenon.

(5) **Stagflation:** Stagflation is the state of inflation when the growth in the economy becomes stagnant. This superficially inconsistent phenomenon is infrequent like hyperinflation but can create chaos in the economy by merging high unemployment rate, severe inflation and poor economic growth. Stagflation is a gigantic challenge to Central banks, due to an increase in risks connected with monetary and fiscal policy. Central banks typically upsurge interest rates to contest high inflation, but doing so during stagflation could increase unemployment more. Consequently, central banks need to keep a limit on their ability to decline rates during stagflation.

(2) SECURITIES EXCHANGE BOARD OF INDIA (SEBI):

- The Securities and Exchange Board of India (SEBI) is the nodal agency to control the capital market and other related issues in India. It is an administrative body established in 1988 and was given statutory recognition in January 1992 under the SEBI Act, 1992 which came into force on January 30, 1992.

- Securities and Exchange Board of India has been performing active role in the Indian Capital Market to attain the objectiv enshrined in the Securities and Exchange Board of India A 1992.

OBJECTIVES OF SEBI:

The major objective of the SEBI may be summarised as follows:

(i) To provide a degree of protection to the investors ar safeguard their rights and to ensure that there is a stead flow of funds in the market.

(ii) To promote fair dealings by the issuer of securities an ensure a market where they can raise funds at a relativel low cost.

(iii) To regulate and develop a code of conduct for the financia intermediaries and to make them competitive an professional.

(iv) To provide for the matters connecting with or incidental to the above.

COMPOSITION OF SEBI:

- Section 4(1) of SEBI Act provides that the SEBI Board shal consist of the following members, namely:

(a) a Chairman;

(b) two members from amongst the officials of the Ministry of the Central Government dealing with Finance and administration of the Companies Act, 2013;

(c) one member from amongst the officials of the Reserve Bank;

(d) five other members of whom at least three shall be the whole time members, to be appointed by the Central Government.

The Chairman and the other members shall be persons of ability, integrity and standing who have shown capacity in dealing with problems relating to securities market or have special knowledge or experience of law, finance, economics, accountancy, administration or in any other discipline which, in the opinion of the Central Government, shall be useful to SEBI.

POWERS AND FUNCTIONS OF SEBI:

- Section 11 of the SEBI Act deals with the powers and functions of the SEBI as follows:

  (i) It shall be the duty of Board to protect the interests of the investors in securities and to promote the development of and to regulate the securities market by measures as deemed fit.

  (ii) Promoting investors education and training of intermediaries of securities markets.

  (iii) Prohibiting insider trading in securities.

  (iv) Regulating substantial acquisition of shares and take-over of companies.

  (v) 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.

  (vi) Calling for information from undertaking, inspection, concluding inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market intermediaries and self-regulatory organizations in the securities market.

  (vii) SEBI has to also concentrate on:

    (a) Eligibility norms for companies issuing securities.

    (b) Pricing of securities by companies.

    (c) Promoters contribution and lock-in requirements.

    (d) Pre-issue obligations of the merchant bankers.

    (e) Contents of the prospectus/abridged prospectus letter of offer.

    (f) Post issue obligation, of merchant bankers.

    (g) Guidelines on advertisements, issue of debt instruments, book building process, public offer through stock exchange, issue of capital by financial institutions, preferential issues of securities, bo issues, Other operational and miscellaneous matte

(3) IRDA (INSURANCE REGULATORY AN DEVELOPMENT AUTHORITY):

- Insurance Regulatory and Development Authority (IRDA) is autonomous apex statutory body which regulates and develo the insurance industry in India.
- It was constituted by a parliament of India act called Insuran Regulatory and Development Authority Act, 1999 and d passed by the government of India.
- The agency operates its headquarters at Hyderabad, Telanga where it shifted from Delhi in 2001. Promote and ensu orderly growth of the insurance business and re-insuran business.
- IRDA issue the applicant a certificate of registration, rene modify, withdraw, suspend or cancel such registration ar Protect the interests of the policy holders in matters concernin assigning of policy, nomination by policy holders, insurab interest, settlement of insurance claim, surrender value of polic and other terms and conditions of contracts of insurance.
- Moreover, it regulates investment of funds by insuranc companies, regulating the maintenance of margin of solvency adjudication of disputes between insurers and intermediaries c insurance intermediaries.

THE MAIN FUNCTIONS OF IRDA:

The duties, powers and functions of IRDA are laid down in sectio 14 of IRDA Act, 1999 as:

- To regulate, promote, and ensure orderly growth of the insurance business and re-insurance business.
- The issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration.
- To protect interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance.

- To specify requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents and specifying the code of conduct for surveyors and loss assessors.
- To regulate the investment of funds by insurance companies, regulating the maintenance of margin of solvency, adjudication of disputes between insurers and intermediaries or insurance intermediaries.

(4) PFRDA (PENSION FUND REGULATORY AND DEVELOPMENT AUTHORITY):

- Pension Fund regulatory is a pension-related authority, which was established in the year 2003 on 23rd August by the Indian Government.
- It is authorized by the Finance Ministry, and it helps in promoting income security of old age by regulating and also developing pension funds.
- This group can also help in protecting the interest rate of the subscribers, associated with the schemes of pension money along with the related matters.
- PFRDA is also responsible for the appointment of different other intermediate agencies like Pension fund managers, CRA, NPS Trustee Bank and more.

SUMMARY

- The arrangements that provide facilities for buying and selling of financial claims and services are known as financial markets.
- Financial markets are classified into Organized and Unorganized Market. Organized market is further classified into Capital and Money Market. Capital Market is further classified into Primary and Secondary Market.
- The money market is a market for short-term funds, which deals in financial assets whose period of maturity is upto one year. Money market does not deal in cash or money as such but simply provides a market for credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc.
- Financial institutions, financial markets, financial instruments and financial services are all regulated by regulators like Ministry of Finance, the Company Law Board, RBI, SEBI, IRDA, Dept. of Economic Affairs, Department of Company Affairs etc. The two major Regulatory and Promotional Institutions in India are Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI).

QUESTIONS

(1) **Multiple Choice Questions (MCQs):**

(a) Which of the following are functions of a financial system?

(i) The operation of a payments system (ii) Providing the means of por adjustment (iii) Helping to reduce unemployment (iv) Channelling f between lenders and borrowers (v) Helping speculators to bet on movements

(b) Which of the following are characteristic of a financial intermediary?

(i) It introduces borrowers to lenders (ii) It has assets which exceed liabil (iii) It increases liquidity for lenders (iv) It reduces transaction costs borrowers and lenders (v) It makes excess profit

(c) The central banking functions in India are performed by the ________.

(i) Central Bank of India (ii) Reserve Bank of India (iii) State Bank of I (iv) Punjab National Bank

(d) The BSE Sensex consists of a basket of ________ stocks.

(i) 50 (ii) 100 (iii) 30 (iv) 66

(e) ________ is the function of financial system.

(i) Saving function (ii) Nationalization of financial institutions (iii) Establishm of Development banks (iv) Intermediaries control

(f) ________ deals with short term claims with a maturity of less than one yea

(i) Money Market (ii) Primary Market (iii) Secondary Market (iv) Capital Mark

(g) The ________ deals in new financial claim; therefore it is called new iss market.

(i) Money Market (ii) Primary Market (iii) Secondary Market (iv) Capital Marke

(h) ________ act as intermediaries in purchase and sale of securities in th primary and secondary markets.

(i) Underwriters (ii) Merchant Banker (iii) Broker (iv) Factoring

(i) ________ is the purchase of exporter's receivables at a discounted price b paying cash.

(i) Underwriters (ii) Merchant Banker (iii) Forfeiting (iv) Factoring

(j) ________ agrees to take a specified number of shares or debenture offered to the public, if the issue is not fully subscribed by the public

(i) Underwriters (ii) Merchant Banker (iii) Forfeiting (iv) Factoring

[Ans.: (a – iv), (b – i), (c – ii), (d – iii), (e – i), (f – i), (g – ii), (h – ii), (i – iv), (j – iii)]

(2) **Fill in the blanks:**

(a) ________ is a set of complex and closely connected or intermixed institutions, agents, practices, markets, transactions, claims and liabilities in the economy.

(b) RBI was nationalized in ________.

(c) ________ has been set up in July 1988 as an apex institution to mobilise resources for the housing sector and to promote housing finance institutions.

(d) The arrangements that provide facilities for buying and selling of financial claims and services are known as ________.

(e) ________ deals in new financial claim; therefore it is called new issue market.

(f) ________ deals with short term claims with a maturity of less than one year.

(g) The primary market deals in new financial claim; therefore it is called __________.

(h) __________ market is example of secondary market in India.

(i) __________ is a popular instrument for financing working capital requirements of companies.

(j) Services are those which cannot be seen, touched or heard which means they are __________ in nature.

(k) The arrangements that provide facilities for buying and selling of financial claims and services are known as __________.

(l) The primary market deals in new financial claim; therefore it is called __________.

(m) __________ market is example of secondary market in India.

(n) __________ is a popular instrument for financing working capital requirements of companies.

[Ans.: (a) Financial System, (b) 1949, (c) The National Housing Bank (NHB), (d) Financial Markets, (e) Primary Market, (f) Money Market, (g) New issue market, (h) Stock Exchange, (i) Commercial Paper, (j) Intangible, (k) financial markets, (l) new issue market, (m) Stock Exchange, (n) Commercial paper]

(3) **True or False:**

(a) Stocks are securities that are a claim on the earnings and assets of a corporation.

(b) The financial system is a set of complex and closely interlinked financial institutions, financial markets, financial instruments, and services that facilitate the transfer of funds.

(c) The settlement cycle is now T + 1. ***(Oct. 17)***

(d) Issuing Shares in the Primary market is mandatory before Listing on the Stock Exchange.

(e) Primary market deals in the new financial claim; therefore it is called the New issue Market. ***(Oct. 17)***

(f) Stock Exchanges are not visible.

(g) Fund based and fee-based are types of financial services.

(h) The secondary market deals with listed securities.

(i) Financial instruments are those instruments issued by the government.

(j) Mutual fund is a way of reducing your potential financial loss or hardship.

(k) An interest rate is also a tool for controlling deflation. ***(March 19)***

(l) The Stock Exchange is the market for old securities. ***(March 19)***

[Ans.: (a) True), (b) True, (c) False, (d) True, (e) True, (f) False, (g) True, (h) True, (i) False, (j) False, (k) True, (l) True]

(4) **Match the columns:**

Group "A"	Group "B"
(a) Financial Market ***(March 18)***	(i) Risky Capital
(b) Primary Market	(ii) 1935
(c) RBI ***(March 18)***	(iii) Lease Financing
(d) Fund Based ***(March 18)***	(iv) Fee-Based Services
(e) Merchant Banking	(v) Capital and Money Market
(f) Venture Capital	(vi) New issue market
(g) Equity Shares	(vii) Money Market

(h)	T-Bill	(viii)	Capital Market
(i)	Securitization	(ix)	Financial Intermediaries
(j)	Banks *(March 18)*	(x)	Financial Innovation

[Ans.: (a – v), (b – vi), (c – ii), (d – iii), (e – iv), (f – i), (g – viii), (h – vii), (i – x), (j – ix)]

(5) Explain in detail the organized and unorganized financial markets.

(6) Elaborate capital markets and their instruments.

(7) Elaborate money markets and their instruments.

(8) Explain in detail the operations of the Primary market in India.

(9) What are the various operations carried out in the Secondary Market?

(10) What are the factors responsible for the growth of the Capital market?

(11) Elaborate on the role of the capital market in economic development.

(12) Explain in detail the regulatory framework for financial markets.

(13) What are inflation and its causes? *(Oct. 18)*

(14) Explain the classification of financial markets. *(March 19)*

(15) What is inflation? What are the various types of inflations? *(March 19)*

(16) **Write short notes on:**

(a) RBI.

(b) SEBI.

Chapter 4

INDIAN CAPITAL MARKET

- Introduction to Capital Market
- Characteristics and Role of Capital Market
- Reforms and Developments in Capital Market
- Capital Market Instruments
- Classification and Sub-Segments of Capital Market
- Primary Market/New Issue Market (NIM)
- Features and Functions of Primary Market
- Players or Participants (or Intermediaries) in the Primary Market/Capital Market
- Role of Merchant Banker in the Primary Market
- Problems with Indian Primary Market
- Methods of Raising Fund in the Primary Market (Methods of Floating New Issues)
- IPO Process
- Valuation Models of IPO
- Concepts Used in Book Building Process
- Secondary Market / Stock Exchange
- Meaning and Characteristics of a Stock Exchange
- Functions and Benefits of Stock Exchange
- Red Herring Prospectus and Abridged Prospectus
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INTRODUCTION TO CAPITAL MARKET:

Capital market is often termed as a market for long term funds which deals in buying and selling of equity, debt, and other securities. Usually, it deals with long term securities that have a maturity period of above one year. Capital market is a vehicle through which long term finance is channelized for the several needs of industry, commerce, govt. and local authorities.

According to **W. H. Husband** and **J. C. Dockerbay**, "*the capital market is used to designate activities in long term credit, which is characterized mainly by securities of investment type.*" Thus, the capital market may be defined as an organized mechanism for the effective and smooth transfer of money capital or financial resources from the investors to the entrepreneurs.

CHARACTERISTICS OF CAPITAL MARKET:

(1) It is a vehicle through which capital flows from the investors to borrowers.

(2) It generally deals with long term securities.

(3) All operations in the new issues and existing securities occur in the capital market.

(4) It deals with many types of financial instruments. These include equity shares, preference shares, debentures, bonds, etc. These are known as securities. It is for this reason that capital market is known as 'Securities Market'.

(5) It functions through a number of intermediaries such as banks, merchant bankers, brokers, underwriters, mutual funds etc. They serve as links between investors and borrowers.

(6) The constituents (players) in the capital market include individuals and institutions. They include individual investors, investment and trust companies, banks, stock exchanges, specialized financial institutions etc.

ROLE OF CAPITAL MARKET:

(1) Mobilization of savings: Capital market helps in mobilizing the savings of the country. It allows the individual investors to employ their savings in more productive channels.

(2) Capital formation: Large amount is required to invest in infrastructural foundation. Such a large amount cannot be collected from one individual or few individuals. Capital market provides an opportunity to collect funds from a large number of people who have investible surplus. In short, capital market plays a vital role in capital formation at a higher rate.

(3) **Economic development:** With the help of capital market, idle funds of the savers are channelized to the productive sectors. In this way, capital market helps in the rapid industrialization and economic development of a country.

(4) **Integrates different parts of the financial system:** The different components of the financial system include new issue market, money market, stock exchange etc. It is the capital market which helps to establish a close contact among different parts of the financial system. This is essential for the growth of an economy.

(5) **Promotion of stock market:** A sound capital market promotes an organized stock market. Stock exchange provides for easy marketability to securities. A readymade market is available to buyers and sellers of securities.

(6) **Foreign capital:** Multinational Corporations and foreign investors will be ready to invest in a country where there is a developed capital market. Thus capital market not only helps in raising foreign capital but the foreign technology also comes within the reach of the local people.

(7) **Economic welfare:** Capital market facilitates increase in production and productivity in the economy. It raises the national income of the country. In this way, it helps to promote the economic welfare of the nation.

(8) **Innovation:** Introduction of a new financial instrument, finding new sources of funds, introduction of new process etc. are some of the innovations introduced in capital market. Innovation ensures growth.

REFORMS IN CAPITAL MARKET:

- In last 17 years many reforms took place in Indian capital market with its foundations laid in socialist based economy of four decades along with rigid government control over private sector participation, foreign trade and foreign direct investment, India released its gates to the outside world in the early 1990s.
- In the economic crisis of the late 1980s, economy and financial markets underwent radical changes. The government

mechanism on foreign trade and investment were released and the barriers to entry in the days of the license raj were relaxed.

- The emergence of Securities and Exchange Board of India (SEBI) as the supreme capital market regulator presented India's commitment to come across as a strong economic force, through establishing market best practices of improved corporate disclosure and augmented investor protection.
- The formation of National Stock Exchange (NSE), a state-of-the-art exchange, with sophisticated technology to improve trading practices and reduce unethical dealings, supported by a strong legal framework and technological base to strengthen the governance structure, has been the highlight of the Indian capital market in the last decade.
- The opening up of the economy has augmented the flow of Foreign Direct Investment (FDI) and has put India on the global map, as a new-age economic force to figure with. The increased level of superiority in the market has been duly supported by increasingly complex instruments like derivatives and other structured products.
- Though, the recent global meltdown has made us aware of the perils of sophisticated markets, the learning has been to follow a path of caution while maintaining a steady pace. Numerous steps have been taken by the regulator to enhance the level of corporate governance and reporting requirements of the Indian stock market.
- Substantial legislation has taken place in this area to curb market malpractices. The large scams and frauds have trained us that growth without a vigorous governance structure falls short of global expectations.

The regulators have been active in responding to such events and in certain cases have undertaken proactive measures to stop such events from recurring.

DEVELOPMENT IN CAPITAL MARKET:

- With every ongoing year, SEBI keeps announcing far-reaching reforms to promote the capital market and protect investor's interest. Reforms in the capital market have focused on three main areas: structure and functioning of stock exchanges, automation of trading and post trade systems, and the introduction of surveillance and monitoring systems.

- The capital market reforms in 1991 were headed by a regime which guaranteed almost complete control of the state over the financial markets.
- Initial Public Offerings (IPO) were organized through the Capital Issues Control Act. The Controller of Capital Issues (CCI) controlled the price and quantity of IPO and trading practices were lacking transparency.
- The banking sector too was significantly controlled. There were few private banks and those faced challenges on their expansion plans. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. After the nationalisation of large banks in 1969 and 1980, the government-owned banks controlled the banking sector.
- The Reserve Bank of India (RBI) controlled the interest rates and the financial sector was replete with entry barriers, significantly restricting opportunities for the establishment of new banks, insurance companies, mutual funds and pension funds.
- The Unit Trust of India (UTI) created in 1964 was the only mutual fund and it enjoyed complete monopoly of the mutual fund business up until 1988. The resource mobilization by mutual funds demonstrates UTI's dominance in the early 1990s.
- The early 1990s therefore, was a time when the primary role of the financial system in India was to channel resources from the excess to the deficit.
- The role of technology was restricted and customer relationship and service was not a priority.
- Risk management procedures and prudential norms were frail, affecting asset portfolio and profitability.
- There have been substantial reforms in the regulation of the securities market since 1992 in conjunction with the overall economic and financial reforms. A key component of the reform strategy was building a strong independent market regulator. The SEBI Act, which came into force in early 1992, established SEBI as an autonomous body.
- SEBI was empowered to regulate the stock exchanges, brokers, merchant bankers and market intermediaries.

- The Act provided SEBI the necessary powers to ensure investor protection and orderly development of the capital markets. The introduction of free pricing in the primary capital market has significantly de- regulated the pricing control instituted by the erstwhile CCI regime.
- While the issuers of securities can now raise capital without seeking consent from any authority relating to the pricing however the issuers are required to meet the SEBI guidelines for Disclosure and Investor Protection, which, in general, cover the eligibility norms for making issues of capital (both public and rights) at par and at a premium by various types of companies.
- The freeing of the pricing of issues led to an unprecedented upsurge of activity in the primary capital market as the corporate mobilised huge resources. However, it did expose the inadequacies of the regulations. In order to address these inadequacies, SEBI strengthened the norms for public issues in April 1996.
- The disclosure standards were enhanced to improve transparency and uphold the objective of investor protection. The issuers are now required to disclose information on various aspects, such as, the track record of profitability, risk factors, etc. Issuers now also have the option of raising resources through fixed price floatations or the book building process.
- Clearing houses have been established by the stock exchanges and all transactions are mandatorily settled through these clearing houses and not directly between the members, as was practiced earlier.
- The practice of holding securities in physical form has been replaced with dematerialised securities and now the transfer is done through electronic book keeping, thereby eliminating the disadvantages of holding securities in physical form. Two depositories are operating in the country. The margin system, limits on intra-day, trade and settlement guarantee funds are some of the measures that have been undertaken to ensure the safety of the market.
- The trading and settlement cycles have been significantly reduced. The cycles were initially shortened from 14 days to 7 days. The settlement cycles were additionally reduced to T+3

for all securities in 2002. The settlement cycle is now T+2. Listed companies are required to supply unaudited financial results to the stock exchanges and also publish the same quarterly.

- To increase the level of disclosure by the listed companies, SEBI decided to modify the Listing Agreement to incorporate the segment reporting, accounting for taxes on income, consolidated financial results, consolidated financial statements, related party disclosures and compliance with accounting standards.
- The last few years have seen significant interaction with the international capital markets. A major step towards that was the inclusion of Foreign Institutional Investors (FIIs) such as mutual funds, pension funds and country funds to operate in the Indian markets. As a quid pro quo, Indian firms have also raised capital in international markets through issuance of Global Depository Receipts (GDRs), American Depository Receipts (ADRs), Euro Convertible Bonds (ECBs), etc.
- One of the most notable achievements of the Indian capital markets over the past few years has been the development of the derivative market. It has significantly enhanced the sophistication and maturity of the market. In India, derivative trading began in June 2000, with trading in stock index futures.
- By the fourth quarter of 2001, both BSE and NSE had four equity-derivative products: futures and options for single stocks, and futures and options for their respective stock indices. The NSE has become the largest exchange in single stock futures in the world, and by June 2007, it ranked fourth globally in trading index futures, a sign of an evolving and maturing market.
- Since 1992, Market liquidity too has increased greatly. This was primarily accredited to settlement rules and the introduction of derivatives trading. The move from fixed period to rolling settlements, shortened settlement periods, and a dramatic increase in derivatives trading contributed to gradually increasing market liquidity.
- The introduction of technology to the markets has been largely attributed to the National Stock Exchange (NSE). NSE introduced the screen based trading and settlement system, supported by a state-of-the-art technology platform.

- A substantial step towards that initiative was the launch of Integrated Market Surveillance System (IMSS) in 2006. The IMSS equipped the regulator to identify doubtful market activity. The IMSS's primary objective is to monitor the market activities across various stock exchanges and market segments including both equities and derivatives. IMSS collects and analyses data not only from the stock exchanges but also from National Securities Depository, Limited. (NSDL), Central Depository Services (India) Limited. (CDSL), clearinghouses, and clearing corporations.
- The RBI introduced the electronic fund's transfer system, "The Reserve Bank of India National Electronic Funds Transfer System" (referred to as "NEFT System" or "System"). The objective of the system was to establish an electronic funds transfer system to facilitate an efficient, reliable, secure and economical system to funds transfer and clearing in the banking sector throughout India.

CAPITAL MARKET INSTRUMENTS:

(1) Equity Shares: Equity shares are instruments issued by companies to raise capital and it represents the title to the ownership of a company. Equity shareholders become owners of a company by subscribing to its equity capital entitled to benefits of ownership like share in the distributed profit (dividend) etc. The returns earned in equity depend upon the profits made by the company. Company's future growth etc.

(2) Debt (loan instruments):

(a) Corporate debt: Debentures are instruments issued by companies to raise debt capital whereby it promises to pay interest at a fixed rate (usually payable half yearly on specific dates) and to repay the loan amount on specified maturity date.

(b) Bonds: Bonds are broadly similar to debentures. They are issued by companies, financial institutions, municipalities or government companies and are normally not secured by any assets of the company (unsecured).

(c) Government debt: Government securities (G-Secs) are instruments issued by Government of India to raise money. G Secs pays interest at fixed rate on specific dates on half-yearly basis. It is available in wide range of maturity, from short dated (one year) to long dated (up to thirty years).

(3) **Mutual Funds:** Mutual funds accumulate money from many investors and invest this corpus in equity, debt or a combination of both, professionally and transparently. In turn investor receives units of mutual funds, after deduction of management fees. Mutual funds offer different schemes to cater to the needs of the investor are regulated by Securities and Exchange Board of India (SEBI).

CLASSIFICATION AND SUB SEGMENTS OF CAPITAL MARKET:

The capital market in India can be classified into:

(1) Gilt-edged Market on Government and Semi-government Securities;

(2) Industrial Securities Market;

  (A) Primary Market.

  (B) Secondary Market.

(3) Non-banking Financial Companies (NBFC).

(1) THE GILT-EDGED MARKET:

The Gilt-edged market is the market for Government and semi-government securities, which carry fixed interest rates and backed by RBI. The securities traded in this market are stable in value and are much sought after by banks and other institutions.

(2) INDUSTRIAL SECURITIES MARKET:

The industrial securities market is termed as the market for equities and debentures of companies of the corporate sector. This market is classified into **(a)** New Issues Markets; for raising fresh capital in the form of shares and debentures (Primary Market), and **(b)** Old Issues Market (Secondary Market).

(A) PRIMARY MARKET/NEW ISSUE MARKET (NIM):

- Every company needs funds. Funds may be vital for short term or long term. Short term requirements of funds can be encountered through banks, lenders, institutions etc. When a company desires to raise long term capital, it goes to the primary market.

- Primary market is an important component of a capital market. In the primary market the security is purchased directly from the issuer.
- The primary market is a market for fresh issues also referred New issue market. In simple words, it is a market for fresh capital dealing with the new securities which were not earlier available to the investing public.
- Corporate enterprises and Government advances long term funds from the primary market by issuing financial securities. Both the new and the existing companies can issue fresh securities on the primary market.
- It also shields raising of fresh capital by government or its agencies. The primary market encompasses of all institutions dealing in fresh securities. These securities may be in the form of equity shares, preference shares, debentures, right issues, deposits etc.
- The applicant.

FEATURES OF PRIMARY MARKET:

(1) The foremost vital feature of the primary market is its relation with the new issues. Every time a company issues new shares or debentures, it is known as Initial Public Offer (IPO).

(2) The main players of primary markets are the private and public companies offering the equity or debt based securities such as stocks and bonds to raise money for their operations such as business expansion, modernization and so on.

(3) Primary market transactions are carried out before secondary market operations.

(4) There are several methods of raising funds from primary markets: public issue, right issue, tender offer, private placement and offer for sale.

Instruments in Primary Market:

Primary instruments are instruments which are directly issued by the ultimate investors to the ultimate savers. For example, shares and debentures openly issued to the public.

FUNCTIONS OF PRIMARY MARKET:

The main role of a primary market can be divided into three service functions. They are: origination, underwriting & distribution.

(1) **Origination:** Origination mentions to the work of investigation, analysis and handling of new project proposals. Origination begins before an issue is floated in the market. The role of origination is done by merchant bankers who may be commercial banks, all India financial institutions or private firms.

(2) **Underwriting:** When a company issues shares to the public it is not guaranteed that all the shares will be subscribed by the public. Consequently, to ensure the full subscription of shares (or at least 90%) the company may underwrite its shares or debentures. The act of safeguarding the sale of shares or debentures of a company even before offering to the public is called underwriting. It is a contract between a company and an underwriter (individual or firm of individuals) by which he agrees to assume that part of shares or debentures which has not been subscribed by the public. The firms or persons who are involved in underwriting are called underwriters.

(3) **Distribution:** It is a task of selling the securities to the ultimate investors with the brokers and agents acting as an intermediary. They uphold a direct and regular contact with the ultimate investors.

PLAYERS OR PARTICIPANTS OR INTERMEDIARIES IN THE PRIMARY MARKET / CAPITAL MARKET:

There are numerous players (intermediaries) in the primary market (or capital market). Important players are as follows:

(1) **Merchant bankers:** Merchant bankers play a vital role in attracting public money to capital issues. They also act as issue managers, lead managers or co- managers.

(2) **Registrars to the issue:** Registrars are intermediaries who undertake all activities connected with new issue management. These registrars are appointed by the company in discussion with the merchant bankers to the issue.

(3) **Bankers:** Certain commercial banks act as collecting agents and few act as coordinating bankers. Selected bankers act as merchant bankers and some are brokers playing an important role in transfer, transmission and safe custody of funds.

(4) Brokers: They perform as intermediaries in purchase and sale of securities in the primary and secondary markets maintaining a network of sub brokers spread throughout the length and breadth of the country.

(5) Underwriters: Normally investment bankers act as underwriters. They agreed to take a specified number of shares or debentures offered to the public, if the issue is not fully subscribed by the public. Underwriters may be financial institutions, banks, mútual funds, brokers etc.

ROLE OF MERCHANT BANKER IN PRIMARY MARKET:

- 'Merchant Banker' is any person engaged in the business of issue management by making arrangements régarding selling buying or subscribing to securities or acting as manager/ consultant/advisor or translating corporate advisory services concerning such issue management. Amongst the important financial intermediaries are the merchant bankers.
- They are the main intermediary among the company and issue of capital. It is fairly mutual to come across reference to Merchant Banking and financial services as though they are distinct categories.
- The services provided by Merchant Bankers depend on their inclination and resources - technical and financial. Merchant bankers (Category I) are mandated by SEBI to take care of public issues (as lead managers) and open offers in take-over.
- These two activities have key implications for the integrity of the market affecting the investors' interest and, therefore, transparency has to be ensured.
- Merchant Bankers are interpreting diverse services and functions including the organizing and extending finance for investment in projects, assistance in financial management, raising Eurodollar loans and issue of foreign currency bonds.
- Diverse merchant bankers specialised in different services. SEBI has advised that merchant Bankers shall commence only those activities which relate to securities market. These activities are:

  (a) Handling of public issue of securities;

(b) Underwriting associated with the aforesaid public issue management business;
(c) Managing/Advising on international offerings of debt/ equity i.e. GDR, ADR, bonds and other instruments;
(d) Private placement of securities;
(e) Primary or satellite dealership of government securities;
(f) Corporate advisory services linked to securities market including takeovers, acquisition and disinvestment;
(g) Stock broking;
(h) Advisory services for projects;
(i) Syndication of rupee term loans;
(j) International financial advisory services.

The activities of the Merchant Bankers in the India capital market are regulated by SEBI (Merchant Bankers) Regulations, 1992.

PROBLEMS WITH INDIAN PRIMARY MARKET:

The India primary market has the following problems:

(1) The new issue market is not able to mobilise adequate savings from the public. Only 10% of the savings of the household sector go to the primary market.

(2) The merchant bankers do not play adequate attention to the technical, managerial and feasibility aspects while appraising the project proposal. They do not seem to play a development role. As a result, the small investors are duped by the companies.

(3) There is inordinate delay in the allotment process. This will discourage the small investors to approach the primary market for investing their funds.

(4) Generally there is a tendency on the part of the investors to prefer fixed income bearing securities like preference shares and debentures. They hesitate to invest in equity shares. There is a risk aversion in the new issue market. This stands in the way of a healthy primary market.

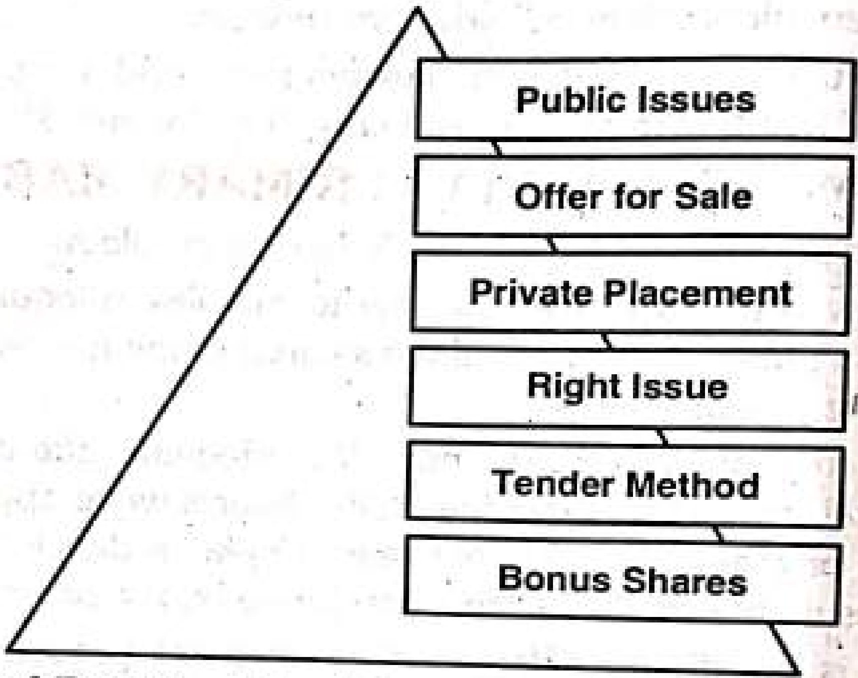
(5) There is a functional and institutional gap in the new issue market. A wholesale market is yet to develop for new issue or primary market.

(6) In the case of investors from semi-urban and rural areas, they have to incur more expenses for sending the application forms to

centres where banks are authorized to accept them. The expenses in connection with this include bank charges, postal expenses and so on. All these will discourage the small investors in rural areas. Over the years, SEBI, and Central Government have come up with a series of regulatory measures to give a boost to new issue market.

METHODS OF RAISING FUND IN THE PRIMARY MARKET (METHODS OF FLOATING NEW ISSUES):

A company can advance capital from the primary market through numerous methods. The techniques include public issues, offer for sale, private placement, right issue, and tender method.



Methods of Raising Funds:

(a) Public Issues:

- This is the common method of raising long term capital. It means raising funds directly from the public.
- Under this method, the company invites subscriptions from the public through the issue of prospectus (and issuing advertisements in newspapers). On the origin of offer in the prospectus, the investors apply for the number of securities they are willing to take. In reply to application for securities, the company makes the allotment of shares, debentures etc.

- **Initial Public Offering (IPO):** IPO is an offering of either a fresh issue of securities or an offer for sale of existing securities or both by an unlisted company for the first time in its life to the public. In short, it is a method of raising securities in which a company sells shares of stock to the general public for the first time.
- **e-IPOs:** A company proposing to issue capital to the public through the on-line system of the stock exchanges has to agree with the stock exchange(s). SEBI registered brokers should be selected to accept applications and place orders with the company. The issuer company must appoint a Registrar to the Issue having electronic connectivity with the Exchanges. The issuer company can apply for listing of its securities on any Exchange except the Exchange through which it has offered its securities. The lead manager coordinates all the activities amongst various intermediaries connected to the issue/system.
- **Follow-on Public Offering (FPO):** FPO is an offer of sale of securities by a listed company. It is an offering of either a fresh issue of securities or an offer for sale to the public by a previously listed company through an offer document.

Different Terms Associated With Public Offering:

- **Issuer:** The Company or the organization that issues the equity shares.
- **Investment Banker (also known as Merchant Banker):** The institutional player that enables the entire process of the public offering for the issuer. They are similarly known as lead manager and with help of them companies appoint underwriters to the issues. The underwriters guarantee to subscribe to the issue in case of under-subscription.
- **Registrar:** They are selected by the company to act as transfer agents and handle investor queries. Registrars routes application, allots shares as per rules of the regulator, safeguard transfer shares to the investors and money to the issuing company.
- **Bankers:** The institution that collects the cash on behalf of the issuing company from the applicants.
- **Brokers:** These are registered members of stock exchanges through whom the investors transact.

- **Prospectus:** An offer document shelters all the relate information to help an investor to make his/her investment decision. The document needs to examine by the regulator (SEBI) for adequate disclosure of information.
- **Issue Price:** The price at which shares are offered for subscription by potential investors. The price can remain fixed or within a band of floor and cap. One can perceive that at present companies opt for price band instead of fixed price. The upper band is overlaid at a certain percentage above the lower band. The final price is fixed depending upon the bids made by investors for different prices within the band.
- **Book Building and Book Runner:** This process ensures generation, and recording of investor demand for shares at different prices during an IPO or a FPO. It is a mutual practice for public offering. Book building process is anticipated to ensure transparency and price discovery. The party undertaking this exercise is known as book runner.
- **Dutch Auction:** After the termination of bid by the investors, the price of the share is fixed at a value where all the shares get subscribed. In case of Dutch auction, the price is unvarying for all the investors regardless of the higher bid price stated by them. The investors who have bid low are not allocated any shares.
- **Greenshoe Option:** While initiating the public issue, the issue size is stated by the issuer. However with a greenshoe option, the issuer can retain over subscription upto certain limit as specified during the announcement of the offer.
- **Pro rata Allotment:** When number of shares applied is more than the number of shares offered, the investors are made the allotment proportionately.
- **ASBA (Application Supported by Blocked Amounts) in Application for Shares in IPOs/FPOs:** Previously, while relating to equity shares the money get transferred to the issuing company whether the investors are vastly successful in getting allotment of shares or not. If unsuccessful, the investors get back their money after certain period. As a result the investors loose the interest. As per ASBA, the amount in the investor's bank account get blocked and not transferred to the issuing company.

The money gets transferred only when shares allotted to the applicant.

IPO PROCESS:

The IPO process is ultimately regulated by the Securities and Exchange Board of India (SEBI), since the end state is the sale of common stock in the company "going public." A. stepwise explanation of the process appears below:

(1) **Selecting an Investment Bank:** Acts as an advisor and performs the underwriting function. Companies usually select the investment bank based on their industry experience. The underwriter creates the schedule for the issue, pricing of the stock, as well as the distribution of shares.

(2) **Letter of Intent:** Drafted between the issuing company and Investment Bank/underwriter. This letter spells out the terms and conditions by which the issuing company and underwriter will conduct the IPO. This contains the fee structure, as well as a firm commitment by the underwriter. A firm commitment is an agreement by the underwriter to purchase all issues of the security. The underwriter would then resell these securities to the public.

(3) **Assemble Syndicate:** If the issue is large, the underwriter will engage a syndicate of underwriters to help with the sale of the securities.

(4) **SEBI Filing:** With the help of the underwriter, the company will file a Form S-1 with the SEBI. This form will contain basic business and financial information with respect to the securities offered. The form will also be the basis for a prospectus to aid in the marketing of the initial public offering. This document is often referred to as a Red Herring prospectus.

(5) **Marketing of the IPO:** Once the S-1 is approved by the SEBI, the underwriter will begin the process of marketing the IPO to both private investors as well as institutional investors. These investors can place "market orders" for shares of the IPO. No shares can be sold at this point, only orders are recorded.

(6) **Effective Date:** Once the marketing phase of the IPO is completed, the underwriter will file an acceleration request with the SEBI. This request will establish the date of the IPO.

(7) **Underwriting Agreement:** Just prior to the date of the IPO the underwriter will enter into a final agreement with the issuing company. This will establish both the price of the offering as well as the number of shares to be issued.

(8) **Stabilization:** The underwriter is not only obligated to bring the shares of stock to market, but also responsible for stabilizing the price of the offering. Generally, the underwriter will actively trade the stock for several months, and sometimes years, after the IPO. By doing so, the underwriter lowers the perceived risk of the issue, and increases demand for the offering.

VALUATION MODELS OF IPO:

- **P/E Ratio:**

  Formula:

$$\text{Price/Earnings Ratio} = \frac{\text{Stock Price per Share}}{\text{Earnings per Share (EPS)}}$$

P/E of similar type of firm could be assumed at same rate and then IPO price could be decided.

- **Discounted Cash Flow:**

  Formula:

  EBIT-TAX = NOPAT + Non-cash expenses – capital expenditure = Free cash flows

  EBIT- Earnings before interest and tax

  NOPAT- Net Operating profit after tax

	1999	2000	2001
EBIT	112	119	126
Tax 30%	34	36	38
NOPAT	78	83	88
Add: Depreciation	30	33	37
Less: Capital expenditure	33	35	36
Increase/ decrease I working capital	15	16	(5)
Free cash flows	59	71	94

IPO value: Free cash flows/r

r = discount rate

on the basis of discount rate price could be calculated.

Book building:

Methods of Determination of Prices of New Shares Equity offerings by companies are offered to the investors in two forms:

(a) Fixed price offer method, and

(b) Book building method.

(a) **Fixed Price Offer Method:** In this case, the company fixes the issue price and then advertises the number of shares to be issued. If the price is very high, the investors will apply for fewer numbers of shares. On the other hand, if the issue is under-priced, the investors will apply for more number of shares. This will lead to huge over subscription.

(b) **Book-building Method:** It was introduced on the basis of recommendations of the committee constituted under the chairmanship of Y. H. Malegam in October, 1995. Under this method, the company does not price the securities in advance. As an alternative, it offers the investors an opportunity to bid collectively. It formerly uses the bids to arrive at a consensus price. All the applications received are arranged and a final offer price (known as cut off price) is arrived at. Usually the cut off price is the weighted average price at which the majority of investors are willing to buy the securities. It involves sale of securities to the public and institutional bidders on the basis of predetermined price range or price band. The price band cannot exceed 20% of the floor price.

CONCEPTS USED IN BOOK BUILDING PROCESS:

(1) The price band is a band of price within which investors can bid. The spread amongst the floor and the cap of the price band shall not be more than 20%. The price band can be revised. If reviewed, the bidding period shall be extended for a further period of three days, subject to the total bidding period not exceeding thirteen days.

(2) The floor price is the minimum price at which bids can be made by the investors. It is fixed by the merchant banker in consultation with the issuing company.

(3) "Cut-off" option is accessible for only retail individual investors i.e. investors who are applying for securities worth up to

Rs. 1,00,000 only. Such investors are required to tick the cut-off option which indicates their willingness to subscribe to shares at any price discovered within the price band. Contrast to price bids (where a specific price is indicated) which can be invalid, if price indicated by applicant is lower than the price discovered, the cut-off bids always remain valid for the purpose of allotment.

(4) Book Running Lead Manager (BRLM) in close consultation with the issuer arrives at a price at which the security offered by the issuer, can be issued.

(a) Developments in Book building issue:

- In case an issuer company makes an issue of 100% of the net offer to public through 100% book building process: **(a)** Not less than 35% of the net offer to the public shall be available for allocation to retail individual investors; **(b)** Not less than 15% of the net offer to the public shall be available for allocation to non-institutional investors i.e. investors other than retail individual investors and Qualified Institutional Buyers; **(c)** Not more than 50% of the net offer to the public shall be available for allocation to Qualified Institutional Buyers.
- In event of compulsory Book-Built Issues at least 50% of net offer to public being allotted to the Qualified Institutional Buyers (QIBs), fading which the full subscription cash shall be refunded.
- In the occasion of the book built issues are made pursuant to the requirement of mandatory allocation of 60% to QIBs in terms of Rule 19(2)(b) of Securities Contract (Regulation) Rules, 1957, the relevant figures are 30% for RIIs and 10% for NIIs.

(b) Offer for sale:

- Under this method, as an alternative of offering shares directly to the public by the company itself, they are offered through the intermediary such as issue houses / merchant banks / investment banks or firms of stock brokers.
- Under this technique, the sale of securities takes place in two stages. In the first stage, the issuing company sells the shares to the intermediaries such as issue houses and brokers at an arranged price. In the second stage, the intermediaries resell the securities to the last investors at a market related price. This price will be higher.

- The dissimilarity between the purchase price and the issue price represents profit for the intermediaries. The intermediaries are responsible for meeting various expenses. Offer for sale method is also named as bought out deal.

(c) Private Placement:

- Private placement is the issue of securities of a company direct to one investor or a small group of investors. Classically the investors are the financial institutions or further existing companies or designated private persons such as friends and relatives of promoters.
- A private company cannot issue a prospectus. Hence it typically raises its capital by private placement. A public limited company can also raise its capital by placing the shares privately and without inviting the public for subscription of its shares.
- Company law defines a privately placed issue to be the one seeking subscription from 50 members. In a private placement, no prospectus is allotted. In this case the elaborate technique required in the case of public issue is avoided. Therefore, the cost of issue is minimal. The process of raising funds is also very simple. But the number of shares that can be supplied in a private placement is generally limited.
- Private placement refers to the direct sale of newly issued securities by the issuer to a small number of investors through merchant bankers.
- When an issuer makes an issue of securities to a select group of persons not exceeding 49, and which is neither a rights issue nor a public issue, it is called a private placement. Private placement of shares or convertible securities by listed issuer can be of two types:
  - (i) **Preferential allotment:** When a listed issuer issues shares or convertible securities, to a specific cluster of persons in terms of provisions of Chapter XIII of SEBI (DIP) guidelines, it is called a preferential allotment. The issuer is obliged to comply with various provisions which inter-alia include pricing, disclosures in the notice, lock-in etc., in addition to the requirements specified in the Companies Act.
  - (ii) **Qualified institutions placement (QIP):** When a listed issuer issues equity shares or securities convertible in to

equity shares to Qualified Institutions Buyers only in terms of provisions of Chapter XIIIA of SEBI (DIP) guidelines, it is called a QIP.

(d) Right Issue:

- When an issue of securities is made by an issuer to its shareholders prevailing as on a particular date fixed by the issuer (i.e. record date), it is called a rights issue. The rights are offered in a specific ratio to the number of securities held as on the record date.
- Right issue is a technique of raising funds in the market by a prevailing company. Under this process, the existing company issues shares to its existing shareholders in proportion to the number of shares already held by them.
- A right issue is the issue of new shares in which existing shareholders are given pre-emptive rights to subscribe to the new issue on a pro-rata basis.
- According to Section 81 (1) of the Companies Act, when the company wants to grow the subscribed capital by issue of further shares, such shares must be allotted first of all to existing shareholders in proportion of their existing shareholding. The existing shareholders may accept or reject the right. Shareholders who do not desire to take up the right shares can sell their rights to one more person. If the shareholders neither subscribe the shares nor transfer their rights, then the company can offer the shares to public.
- A company building right issue is required to send a circular to all existing shareholders. The circular must provide information on how additional funds would be used and their consequence on the earning capacity of the company.
- The company should normally give a time limit of at least one month to two months to shareholders to exercise their rights before it is offered to the public.
- No new company can make right issue.
- Promoters offer right issue at attractive price often at a discount to the market price due to a variety of reasons. The reasons are: **(a)** they want to get their issues fully subscribed to, **(b)** to reward their shareholders, **(c)** it is possible that the market price does not reflect a share's true worth or that it is over- priced, **(d)** to

increase their stake in the companies so as to avoid preferential allotment.

(I) Tender method:

- Under tender method, the issue price is not predetermined. The company announces the public issue without representing the issue price. It invites bids from various interested parties.
- The parties contributing in the tender submit their maximum offers indicating the maximum price they are ready to pay. They should also lay down the number of shares they are interested to buy. The company, after getting various offers, may choose about the price in such a manner that the entire issue is fairly subscribed or sold to the parties participating in the tender.

(I) Bonus shares:

- When an issuer makes an issue of securities to its existing shareholders as on a record date, without any consideration from them, it is called a bonus issue.
- The shares are issued out of the Company's free reserve or share premium account in a particular ratio to the number of securities held on a record date.
- Where the accumulated reserves and surplus of profits of a company are converted into paid up capital, it is called bonus issue. It simply refers to capitalization of existing reserves and surpluses of a company.

(B) SECONDARY MARKET / STOCK EXCHANGE:

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

In the secondary market, the existing owner sells securities to another party. The secondary markets support the primary markets. The secondary market delivers liquidity to the individuals who acquired these securities. The primary market gets benefits greatly from the liquidity provided by the secondary market. This is because investors would hesitate to buy the securities in the primary market if they thought they could not sell them in the secondary market later. In India, stock market consists of recognized stock exchanges. In the stock exchanges, securities issued by the central and state governments, public bodies, and joint stock companies are operated.

MEANING OF STOCK EXCHANGE:

It is an organized market for the purchase and sale of securities of joint stock companies, government and semi- govt. Bodies. It is the centre where shares, debentures and govt. Securities are bought and sold. In short these are market places where securities that have been listed thereon may be bought and sold for either investment or speculation.

The Securities Contract (Regulation) Act, 1956, defines a stock exchange as "an association, organisation or body of individuals whether incorporated or not, established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities".

CHARACTERISTICS OF A STOCK EXCHANGE:

(1) It is an organized capital market.

(2) It could be incorporated or non-incorporated body (association or body of individuals).

(3) It is an open market for the buying and selling of securities.

(4) Only listed securities can be allocated on a stock exchange.

(5) It works under established rules and regulations.

(6) The securities are bought and sold either for investment or for speculative purpose.

FUNCTIONS OF THE STOCK EXCHANGE:

(1) **Liquidity:** The stock exchange provides a place where shares and stocks are converted into cash. People with surplus cash can invest in securities (by buying securities) and people with deficit cash can sell their securities to convert them into cash.

(2) **Continuous market for securities:** It provides a continuous and ready market for buying and selling securities. It provides a ready market for those who wish to buy and sell securities.

(3) **Mobilization of savings:** It helps in mobilizing savings and surplus funds of individuals, firms and other institutions. It directs the flow of capital in the most profitable channel.

(4) **Capital formation:** The stock exchange publishes the correct prices of various securities. Thus the people will invest in those securities which yield higher returns. It promotes the habit of saving and investment among the public.

(5) **Economic development:** It promotes industrial growth and economic development of the country by encouraging industrial investments. New and existing concerns raise their capital through stock exchanges.

(6) **Safeguards for investors:** Investors' interests are very much protected by the stock exchange. The brokers have to transact their business strictly according to the rules prescribed by the stock exchange. Hence they cannot overcharge the investors.

BENEFITS OF STOCK EXCHANGE:

(A) Benefits to Investors:

(1) The stock exchange plays the role of a friend, philosopher and guide to investors by providing information about the prices of various securities.

(2) It offers a ready market for buying and selling securities.

(3) It increases the liquidity of the investors.

(4) It safeguards the interests of investors through strict rules and regulations.

(5) It enables the investors to know the present worth of their securities.

(6) It helps investors in making wise investment decisions by providing useful information about the financial position of the companies.

(7) The holder of a listed security can easily raise loan by pledging it as a collateral security.

(B) Benefits to Companies:

(1) A company enjoys greater reputation and credit in the market. Image of the company goes up.

(2) A company can raise large amount of capital from different types of securities.

(3) It enjoys market for its shares.

(4) The market price for shares and debentures will be higher. Due to this the bargaining power of the company increases in the events of merger or amalgamation.

(C) Benefits to Community and Nation:

(1) Stock exchange encourages people to sell and invest their savings in shares and debentures.

(2) Through capital formation, stock exchange enables companies to undertake expansion and modernization.

(3) It helps the government in raising funds through sale of government securities. This enables the government to undertake projects of national importance and social value.

(4) It diverts the savings towards productive channels.

(5) It helps in better utilization of the country's financial resources.

(6) It is an effective indicator of general economic conditions of a country.

(3) NON-BANKING FINANCIAL COMPANIES (NBFC):

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares, securities, leasing, hire-purchase, insurance business, and chit business.

PROSPECTUS:

- A prospectus is an invitation to the public to subscribe to the shares and debentures offered by a company. As per Section 2(70) of The Companies Act, 2013 a prospectus means 'any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in or debentures of a body corporate'.
- A prospectus is a legal document that institutions and businesses use to describe the securities they are offering for participants and buyers.
- In simple words, a prospectus contains the terms and conditions of the issue, along with the specific feature of the security, the purpose for which the issue is made, the company's track record,

the risk inherent in the project for which the capital is being raised and so on.

RED HERRING PROSPECTUS:

- "Red Herring Prospectus" is a prospectus, which does not have facts of either price or number of shares being offered, or the amount of issue. This means that in case price is not revealed, the number of shares and the upper and lower price bands are disclosed.
- On the other hand, an issuer can state the issue size and the number of shares are determined in future.
- An RHP for an FPO can be filed with the ROC without the price band and the issuer, in such a case will notify the floor price or a price band by way of an advertisement one day preceding to the opening of the issue. In the instance of book-built issues, it is a process of price discovery and the price cannot be determined until the bidding process is completed. Hence, such details are not shown in the Red Herring prospectus filed with ROC in terms of the provisions of the Companies Act.
- Only on completion of the bidding process, the details of the final price are encompassed in the offer document. The offer document filed afterward with ROC is called a prospectus.

The red herring prospectus shall reveal, either the floor price of the securities offered through it or a price band along with the range within which the price can move, if any. However, the issuer may not disclose the floor price or price band in the red herring prospectus if the same is disclosed in case of an initial public offer, at least two working days before the opening of the bid and in case of a further public offer, at least one working day before the opening of the bid, by way of an announcement in all the newspapers in which the pre-issue advertisement was released by the issuer or the merchant banker.

Go Airlines has received approval from SEBI for Rs. 3,600 Cr. IPO. According to the Draft Red Herring Prospectus (DRHP), the airline is planning to raise capital through IPO and Private Placement.

Similarly Nykaa (E-Commerce retailer) dealing in fashion and beauty products has also file DRHP to raise Rs. 5,250 million, and an offer for sale of up to 43,111,670 equity shares.

FEATURES OF RED HERRING PROSPECTUS:

- The red herring prospectus understands substantial information on the company, including use of earnings from the offering, market potential for its product/service, financial statements, details of officers, directors and major shareholders, pending litigation, etc.
- The red herring prospectus is used to ask expressions of interest in the issue. Once the registration statement becomes active, a final prospectus that contains the final IPO price and issue size is circulated. Expressions of interest are then converted to guidelines for the issue at the buyer's option.
- Where the issuer opts not to make the disclosure of the price band or floor price in the red-herring prospectus in terms of the foregoing proviso, the following shall be additionally disclosed in the red-herring prospectus:
  - **(a)** a statement that the floor price or price band, as the case may be, shall be disclosed atleast two working days (in case of an initial public offer) and atleast one working day (in case of a further public offer) before the opening of the bid;
  - **(b)** a statement that the investors may be guided in the meantime by the secondary market prices in case of public offer;
  - **(c)** names and editions of the newspapers where the declaration of the floor price or price band would be made;
  - **(d)** names of websites (with address), journals or other media in which the said announcement will be made.

Where the issuer decides to opts for price band instead of floor price, the lead book runner shall ensure compliance with the following conditions:

(a) The cap of the price band should not be more than 20% of the floor of the band; i.e., cap of the price band shall be less than or equal to 120% of the floor of the price band.

(b) The price band can be revised during the bidding period in which case the maximum revision on either side shall not exceed 20% i.e. floor of price band can move up or down to the extent of 20% of floor of the price band disclosed in the red herring prospectus and the cap of the revised price band will be fixed in accordance with Clause (a) above;

(c) Any revision in the price band shall be widely disseminated by informing the stock exchanges, by issuing press release and also indicating the change on the relevant website and the terminals of the syndicate members.

(d) In case the price band is revised, the bidding period shall be extended for a further period of three days, subject to the total bidding period not exceeding ten working days.

(e) The manner in which the shortfall, if any, in the project financing, arising on account of lowering of price band to the extent of 20% will be met shall be disclosed in the red herring prospectus. It shall also be disclosed that the allotment shall not be made unless the financing is tied up.

ABRIDGED PROSPECTUS:

- According to Section 26 of The Companies Act, 2013, abridged prospectus means a memorandum containing the salient features of fee prospectus.
- The lead merchant banker shall ensure that a copy of the abridged prospectus containing the salient features of the prospectus accompanies every application form distributed by the issuer company or anyone else.
- The application form may be attached to form part of the abridged prospectus.
- The abridged prospectus shall not comprise matters, which are extraneous to the contents of the prospectus. Enough space shall be provided in the application form to facilitate the investors to file in various details like name, address etc.

INNOVATIVE CAPITAL MARKET INSTRUMENTS:

- Sweat Equity
- ESOP
- Right issue

SWEAT EQUITY:

- Section 2 (88) of the Companies Act, 2013 **defines "sweat equity shares"** means such equity shares as are issued by a company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the environment of intellectual property rights or value additions.

- Company issue shares at a discount or for consideration other than cash to selected employees and directors as per standards approved by the Board of Directors or any committee, like compensation committee, formed for this purpose.
- This is created on the know how provided or intellectual property rights created and given for value additions made by such directors and employees to the company. It may be noted that the intellectual property right, know how or value additions arise as of now mainly in the case of Information Technology related companies and Pharmaceutical companies.
- Categories of industries which are eligible to issue sweat equity shares have not been designated by the Government either in the Act or otherwise.
- According to Section 54 of the Companies Act, 2013 a company may issue sweat equity shares of a class of shares already issued, if the following conditions are fulfilled:
  - **(a)** The issue is authorized by a special resolution passed by the company in the general meeting.
  - **(b)** The resolution stipulates the number of shares, current market price, consideration if any and the class or classes of directors or employees to whom such equity shares are to be issued.
  - **(c)** Not less than one year has elapsed at the date of the issue, since the date on which the company was entitled to commence business.
  - **(d)** The sweat equity shares of a company whose equity shares are registered on a recognized stock exchange are issued in harmony with the regulations made by SEBI in this respect and if they are not listed the sweat equity shares are to be issued in accordance with the rule 8 of Companies (Share Capital and Debenture) Rules, 2014.

ESOP (EMPLOYEE STOCK OWNERSHIP PLAN):

- An ESOP is a type of an employee benefit plan, alike a profit-sharing plan. In an ESOP, a company sets up a trust fund, into which it pays new shares of its own stock or cash to buy existing shares.

- The ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Irrespective of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits.
- When employees exit the company, they receive their stock, which the corporate must buy back from them at its fair market value, till the time they are listed on exchange.
- Private companies must have an annual outside valuation to regulate the price of their shares. Employees need to vote their allocated shares on major issues, such as closing or relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues, in case of private companies,. In case of public companies, employees must be able to vote all issues.

> Strides Pharma Science has granted 42,500 stock options to eligible employees under the Strides ESOP Plan 2016 at Rs. 455.80 per option (exercise price).
>
> Soft Bank-backed Paytm is planning to convert its employees ESOP in equity shares before issuing IPO. As a startup company has given shares amounting to 6.1 crore valuation of IPO.

Benefits of ESOPs:

(1) **To buy the shares of a departing owner:** Owners of privately held companies can practise an ESOP to create a ready market for their shares. Under this approach, the company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares.

(2) **To borrow money at a lower after-tax cost:** ESOPs are unique among benefit plans in their ability to borrow money. The ESOP borrows cash, which it utilises to buy company shares or shares of existing owners. The company then makes tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interests are deductible.

(3) **To create an additional employee benefit:** A company can merely issue new or treasury shares to an ESOP, deducting their

value until 25% of covered pay from taxable income, or a company can contribute cash, buy shares from existing public or private owners. In public companies, which account for about 5% of the plans and about 40% of the plan participants, ESOPs are often used in conjunction with employee savings plans. Rather than matching employee savings with cash, the company will match them with stock from an ESOP, often at a higher matching level.

RIGHT ISSUE OF SHARES:

- In order to avoid dilution of stake of existing shareholders, company issues "rights" shares in proportion to their current holding. This is done when the company plans to tap the market after their IPO.
- A rights issue is once a company issues its existing shareholders a right to buy additional shares in the company. The company will offer the shareholder a definite number of shares at a specific price. The company will also fix a time limit for the shareholder to buy the shares.
- The shares are regularly offered at a discounted price to encourage existing shareholders to take the company up on their offer.
- If a shareholder does not take the company up on their rights issue then they have the option to sell their rights on the stock market unbiased as they would sell ordinary shares, nevertheless their shareholding in the company will weaken.
- When a company deals in new shares via a rights issue, it is usually at a discount to the current market rate. It means if the market price of the share is Rs. 500, the company may offer the shares for Rs. 450. So one get more shares at a cheaper rate than what they get from the market.

Subsequently the right issue is offered price of that particular stock falls in the stock market. It materializes because the number of stock of that company increases in the market. Especially if the sum of the right issue is relatively higher than the paid-up capital the price falls. Moreover the dividend yield and the PE ratio of that particular stock also falls after the right issue is offered.

India's No. 2 telecom operator Bharti Airtel seeks to support its cash reserves to pay statutory dues, expand and deepen its network and prepare for the auction of 5G airwaves and roll out of the technology through the way of issuing right shares amounting Rs. 21,000 Crore. Under Right issues, the shareholders will receive one new share for every 14 shares held at Rs. 535 each.

SUMMARY

- Capital market simply refers to a market for long term funds. It is a market for buying and selling of equity, debt and other securities. Generally, it deals with long term securities that have a maturity period of above one year.
- Many developments took place in capital markets after establishment of SEBI and various reforms were noticed.
- There are four main components of capital market. They are: (a) Primary Market, (b) Government Securities Market, (c) Financial Institutions, and (d) Secondary Market.
- Origination, underwriting and distribution are functions of primary market. There are various players involved in this market.
- There are various methods of raising funds in primary market such as public issues, offer for sale, private placement, right issue, tender method and bonus shares.

QUESTIONS

(1) **Multiple Choice Questions (MCQs):**

(a) The IPO of a bank process is ultimately regulated by the ________. ***(Oct. 17)***
(i) RBI (ii) SEBI (iii) AMFI (iv) CBI

(b) ________ is a prospectus, which does not have details of either price or number of shares being offered, or the amount of issue.
(i) Red Herring Prospectus (ii) Sweat Equity (iii) Abridged Prospectus (iv) Book Building

(c) ________ are the plans that are sponsored by most large companies.
(i) ESOP (ii) DRIPS (iii) Dividend (iv) Bonus Share

(d) ________ prospectus shall not contain matters, which are extraneous to the contents of the prospectus.
(i) Red Herring Prospectus (ii) Sweat Equity (iii) Abridged Prospectus (iv) Book Building

(e) ________ equity shares as are issued by a company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions.
(i) Red Herring Prospectus (ii) Sweat Equity (iii) Abridged Prospectus (iv) Book Building

(f) An ________ is a kind of employee benefit plan, similar in some ways to a profit-sharing plan.
(i) Red Herring Prospectus (ii) Sweat Equity (iii) ESOP (iv) Book Building

(g) A ________ is when a company issues its existing shareholders a right to buy additional shares in the company. ***(March 18)***
(i) Right Issue (ii) Sweat Equity (iii) ESOP (iv) Book Building

(h) In the __________ market the security is purchased directly from the issuer. *(Oct. 18)*
(i) Capital Market (ii) Money Market (iii) Debt Market (iv) Primary Market

(i) The __________ is a market where existing securities are traded. *(March 19)*
(i) Primary Market (ii) Secondary Market

[Ans.: (a – ii), (b – i), (c – iii), (d – ii), (e – iii), (f – i), (g – i), (h – iv), (i – ii)]

(2) Fill in the blanks:

(a) The external factor that affects the industry as a whole is termed as __________ risk, in capital market analysis.

(b) The entire pre-issue share capital, other than locked in as promoter's contribution, shall be locked- in for a period of __________.

(c) Every recognized stock exchange is required to furnish to __________ with a copy of the Annual report with prescribed particulars as per the requirements of the Securities Contracts (Regulation) Act, 1956.

(d) SBTS stands for __________.

(e) Whenever a company issues new shares or debentures, it is known as __________.

(f) __________ refers to the work of investigation, analysis and processing of new project proposals.

(g) __________ are intermediaries who undertake all activities connected with new issue management.

(h) __________ means any person engaged in the business of issue management by making arrangements regarding selling buying or subscribing to securities or acting as manager/consultant/advisor or rendering corporate advisory services in relation to such issue management.

(i) The IPO process is ultimately regulated by the __________ since the end state is the sale of common stock in the company "going public."

(j) __________ drafted between the issuing company and Investment Bank/underwriter which spells out the terms and conditions by which the issuing company and underwriter will conduct the IPO.

[Ans.: (a) systematic, (b) one year, (c) SEBI, (d) Screen Based Trading System, (e) IPO, (f) Origination, (g) Registrars, (h) Merchant Banker, (i) SEBI, (j) Letter of Intent]

(3) True or False:

(a) In the primary market the security is purchased directly from the issuer.

(b) The IPO of a bank process is ultimately regulated by the Reserve Bank of India (RBI).

(c) "Red Herring Prospectus" is a prospectus, which does not have details of either price or number of shares being offered, or the amount of issue.

(d) Sweat equity shares" means such equity shares as are issued by a company to its directors or employees at a discount or for consideration.

(e) An ESOP is a kind of employee benefit plan, similar in some ways to a profit-sharing plan.

(f) The external factor that affects the industry as a whole is termed as unsystematic risk, in capital market analysis.

(g) The entire pre-issue share capital, other than locked in as promoter's contribution, shall be locked- in for a period of one year.

(h) Every recognized stock exchange is required to furnish to RBI with a copy of the Annual report with prescribed particulars as per the requirements of the Securities Contracts (Regulation) Act, 1956.

(i) SBTS stands for simple basket trading system.

(j) The IPO process is ultimately regulated by the AMFI since the end state is the sale of common stock in the company "going public."

(k) The settlement cycle now is T+1. *(Oct. 17)*

(l) New market is a market where firms go to the public for the first time through Initial Public Offering (IPO). *(Oct. 18)*

(m) In India, Merchant Banker's do not provide the services of loan syndication. *(Oct. 18, March 19)*

(n) DIPP stands for Department of Industrial Promotion and Procurement. *(Oct. 18)*

[Ans.: (a) True, (b) False, (c) True, (d) True, (e) True, (f) False, (g) True, (h) False, (i) False, (j) False, (k) False, (l) True, (m) False, (n) True]

(4) **Match the column:**

Group "A"	Group "B"
(a) ESOP	(i) New issue market
(b) Sweat equity	(ii) Fresh issue
(c) Prospectus	(iii) Long term funds
(d) Red Herring Prospectus	(iv) Lead Managers
(e) Abridged Prospectus	(v) Direct investor
(f) Right issue of Shares	(vi) Upper and lower price bands
(g) Primary Market	(vii) Salient of fee prospectus
(h) Capital Market	(viii) Employee stock Option plan
(i) Merchant Bankers	(ix) Issue shares at a discount
(j) IPO *(March 18)*	(x) Information document

[Ans.: (a – viii), (b – i), (c – x), (d – vi), (e – vii), (f – v), (g – ix), (h – iii), (i – iv), (j – ii)]

(5) Explain characteristics of capital market. *(Oct. 17)*

(6) What are the various reforms which took place in capital market?

(7) What are the various developments that took place in capital market?

(8) What are the various components of Capital market?

(9) Elaborate the features of primary market.

(10) What are the various functions of primary market?

(11) Who are the different players or participants in the primary market/ capital market?

(12) What are various problems associated with primary market?

(13) What are the various methods of raising funds in primary market?

(14) What is capital market? What are the needs and importance of capital market? *(March 19)*

(15) Explain secondary market and its functions in short. *(March 19)*

(16) Explain advantages and disadvantages of primary markets. *(March 19)*

(17) **Write short notes on:**

(a) Public Issue.

(b) Offer for Sale.

(c) Private Placement.

(d) Right Issue.

(e) Tender Method.

(f) Bonus Shares.

Chapter 5

DEBT MARKET OPERATIONS

- Structure of Debt Market in India
- Introduction to Corporate Bonds
- Advantages of Corporate Bonds
- Disadvantages of Corporate Bonds
- Types of Corporate Bonds
- Features of Corporate Bonds
- Summary
- Questions

STRUCTURE OF DEBT MARKET IN INDIA:

The segments in the secondary debt market based on the features of the investors and the structure of the market are:

(a) **Wholesale Debt Market:** Where the investors are mostly Banks, Financial Institutions, the RBI, Primary Dealers, Insurance companies, MFs, Corporates and FIIs. Commercial Banks and the Financial Institutions are the most protruding participants in the Wholesale Debt Market in India. During the past few years, the investor base has been widened to include Co-operative Banks, Investment Institutions, Cash-rich Corporates, Non-Banking Finance Companies, Mutual Funds and high net-worth individuals. FIIs have also been permitted to invest 100% of their funds in the debt market, which is a significant increase from the earlier limit of 30%. The government also allowed in 1998-99 the FIIs to invest in T-bills with a view towards broad basing the investor base of the same. The settlement for the various trades is lastly carried out through the Clearing Corporation of India (CCIL).

(b) As far as the Broker Intermediated transactions are concerned, the settlement responsibility for the trades in the Wholesale market is primarily on the clients i.e. the market participants and the broker has no role to play in the same. The member has to report the clearance details to the Exchange for monitoring purposes. The Exchange reports the trades to RBI regularly and monitors the settlement of these trades.

(c) Retail Debt Market involving participation by individual investors, provident funds, pension funds, private trusts, NBFCs and other legal entities in addition to the wholesale investor classes.

INTRODUCTION TO CORPORATE BONDS:

- Bonds (or debentures) are issued commonly by public sector companies, financial institutions, and private sector companies. A widespread range of innovative debt securities have been formed in India, particularly from early 1990s.
- This innovation has been encouraged by a variety of factors, the most important being the increased volatility of interest rates and changes in the tax and regulatory framework. The corporate

bond market is comparatively small and illiquid, and the market for securitized assets has decreased short of expectations.

- Corporate bonds, issued by a Corporation, are intended to raise the funds for the company's expansion plans. Equity, loans from banks and corporation bonds are the main sources for corporate to raise the funds. The corporate bonds usually have the maturity period of minimum one year. If a corporation issues bonds that has short term maturity period, it is titled as commercial paper.
- The interests (coupons) on corporation bonds are taxable. Some corporations force issue corporation bonds which do not pay any interest during the life of the bond but its redemption value at the end of the maturity period may be higher.
- Corporate bonds are usually listed on major stock exchanges where they are known as listed bonds. Though, most of its trading is done in dealer-based markets. Some corporations include the call option facility in their Corporation bonds i.e. an investor can get redemption before the expiry of the maturity date although others issue convertible bonds which can be converted from bonds to equity.

ADVANTAGES OF CORPORATE BONDS:

- Corporate bonds usually offer higher interest rate when compared to government bonds as investors run a huge risk in case of company issuing the bonds going default on payments.
- Corporate bonds provide steady income to investors in the form of coupons / interest rate.
- There are many corporate bonds in the market at any point of time, giving the investors a chance to opt for bonds from different sectors.
- Corporate bonds have a huge secondary market so investors can sell them to others at higher prices, especially if the company issuing the bond has a good credibility and credit ratings.

DISADVANTAGES OF CORPORATE BONDS:

- Corporate bonds as compared to government bonds, are more risky as the risk is associated with the corporate issuing the bond which may default on payments.

- If a corporate issues a bond that is callable i.e. the bond that can be purchased back by the company issuing it after a particular time period, then the company influence re-purchase those bonds from the investors in case the interest rates decline so that it might release new bonds which will provide low interest rate. So in case the bond investors buy is callable, the investors must safeguard that they are remunerated appropriately.
- Likewise, if the corporate issuing the bond issues more such bonds in the market, their price would decrease affecting the interests of the investors.
- In case of inflation, the prices of the bond may decline again adversely affecting the investors. Changes in taxation policies also affect the benefits from the corporate bonds.

TYPES OF CORPORATE BONDS:

A brief explanation of various types of corporate bonds:

(1) **Bearer and Registered Bonds:** Bonds are also identified by the way they are owned. Bearer bonds, for example, go to the person who holds them and ownership is not otherwise recorded. Eurobonds are issued in this format. While this form of ownership carries the risk of losing the certificate, it offers the highest degree of anonymity and that is why in some countries, the United States for example, they are no longer allowed. The other mutual type of format is a fully registered bond, either in certificate form or in book entry. The owner's name is recorded with a transfer agent and interest payments are made any by cheque or electronic credit. The book entry method, where no certificate is issued and ownership is simply recorded in a ledger, is increasing in popularity because it diminishes transfer costs, simplifies handling, and decreases the probability of losing the certificate or having it stolen.

(2) **General Obligation and Revenue Bonds:** General obligation bonds usually refer to government bonds and are backed by the full faith and credit of the taxing power (country, municipality, etc.) that issues them. Revenue bonds are payable only from some specific source of taxes (highways tolls. water bills, etc.) and are not subject to the general taxing power of the issuer.

(3) **Treasury/Government Bonds:** A country's long term financing needs are met by issuing bonds that range from a period of one year up to essentially as long as a country wants and to which the public is keen to commit its money. Average lengths of such bonds are up to 20 or 30 years and are called long-term bonds. These long-term bonds are observed closely by the market as an indication of where long-term interest rates will be heading. Long -term bonds may be subject to being called before they mature. Callable means that the issuer has the right to pay off the bond rather than the maturity date. If a bond is subject to being called before it matures, both dates are stated in its listing. Thus a bond that pays 5% and matures in June 2010, but is callable after June of 2005 is referred to as the 5% of June 2005-2010. Treasury's usually issue split-date callable bonds during era of high-interest rates to have the opportunity to pay them off sooner if interest rates fall. The government would then issue new bonds at a lower rate.

(4) **Convertible Bonds:** Usually all that the bondholder is promised is the principal and interest. There is an exception to this rule and it is called a convertible bond. This is a bond that at its maturity, or some other stated date, may be converted to a stated number of common shares in a corporation. A new corporation without much money or track record for paying off bonds or a corporation with a low credit rating might offer convertible bonds because the borrowing costs of straight bonds would be prohibitive. Convertible bonds rank below conventional bonds but ahead of any equity in their claim on the assets of a company.

(5) **Fixed Rate Bonds:** These are bonds on which the coupon rate is fixed for the entire life of the bond. Most government bonds are issued as fixed rate bonds.

(6) **Floating Rate Bonds:** Floating rate bonds are securities that do not have a fixed coupon rate. The coupon is re-set at pre-announced intervals (say, every 6 months, or 1 year) by adding a spread over a base rate. In the case of most floating rate bonds issued by the Government of India so far, the base rate is the weighted average cut-off yield of the last three 364-day Treasury Bill auctions preceding the coupon re-set date, and the spread is

decided through the auction. Floating rate bonds were first issued in India in September 1995.

(7) **Zero Coupon Bonds:** Zero coupon bonds are bonds with no coupon payments. These bonds resembles like T-Bills, are issued at a discount to the face value. In 1990's, the Government of India issued such securities, post that it has never issued such zero coupon bonds. Though the bondholder forfeits immediate income from the zero, the yield to maturity is computed on the assumption that the coupon interest is reinvested at the prevailing rate when received. Accordingly, as interest rates fall the reinvestment is presumed to be at the lower rate, reducing the yield but increasing the price of the bond. Similarly, if interest rates rise, the bond's price will fall, but the coupons are reinvested at the higher rate, raising the yield to maturity. With no cash flow from coupon payments to act as a cushion, zero prices swipe rapidly up and down in reaction to even minor changes in the interest rate. In times of high interest rates, zeros are very popular in order to lock in those high rates.

(8) **Capital Indexed Bonds:** These are bonds, the principal of which is linked to an accepted index of inflation with a view to protecting the holder from inflation. Capital indexed bonds, with the principal hedged against inflation, were first issued in December 1997. These bonds matured in 2002. The government is currently working on a fresh issuance of Inflation Indexed Bonds wherein the payment of both the coupon as well as the principal on the bonds would be linked to an Inflation Index (Wholesale Price Index). In the proposed structure, the principal will be indexed and the coupon will be calculated on the indexed principal. To provide the holders protection against actual inflation, the final WPI will be used for indexation.

(9) **Bonds with Call/Put Options:** Bonds can also be issued with features of optionality, wherein the issuer can have the option to buy back (call option) or the investor can have the option to sell the bond (put option) to the issuer during the currency of the bond. The optionality on the bond could be implemented after the completion of five years from the date of issue on any coupon date falling afterwards. The government has the right to buy-back the bond. (call option) at par value

(equal to the face value), while the investor has the right to sell the bond (put option) to the government at par value at the time of any of the half-yearly coupon dates starting from July 1, 2007.

(10) Green Bonds: Green bonds are debt securities issued by financial, non-financial or public entities where the proceeds are used to finance 100 per cent green projects and assets. Indian renewable energy developers have issued green bonds worth Rs. 26,300 crore in the first half of 2021. These bonds generate higher market interest rate along with oversubscription reflecting its huge demand.

FEATURES OF CORPORATE BONDS:

(a) Collateral: Collateral represents a pledge of assets in favour of the bond holders. If serves as an insurance against any possible default by the borrower.

(b) Sinking Fund: A sinking fund provision requires the issuing firm to retire a certain percentage of the bond issue at stipulated points of time.

(c) Protective Covenants: The bond deal often contains several agreements to protect the interest of lenders. These impose restrictions on management and give bondholders greater confidence that the firm will honour its commitments. For example, contract may put limits on dividend payment, managerial compensation, and total borrowings.

SUMMARY

- The segments in the secondary debt market based on the characteristics of the investors and the structure of the market are classified into wholesale and retail segment.
- Corporate bonds, issued by a Corporation, are meant to raise the funds for the company's expansion plans. Equity, loans from banks and corporation bonds are the major sources for corporate to raise the funds.
- Corporate bonds are generally listed on major stock exchanges where they are known as listed bonds. However, most of its trading is done in dealer-based markets.
- Corporate bonds generally offer higher interest rate when compared to government bonds as investors run a huge risk in case of company issuing the bonds going default on payments.
- Corporate bonds provide steady income to investors in the form of coupons / interest rate.

- Corporate bonds, when compared to government bonds, are more risky as the corporate issuing the bond may default on payments.
- Bonds are also identified by the way they are owned. Bearer bonds, for example, belong to the person who holds them and ownership is not otherwise recorded.
- General obligation bonds usually refer to government bonds and are backed by the full faith and credit of the taxing power (country, municipality, etc.) that issues them. Revenue bonds are payable only from some specific source of taxes (highways tolls, water bills, etc.) and are not subject to the general taxing power of the issuer.
- A country's long term financing needs are met by issuing bonds that mature from anywhere after one year up to essentially as long as a country wants and to which the public is willing to commit its money. Average lengths run to 20 or 30 years and are called long-term bonds.
- Usually all that the bondholder is promised is the principal and interest. There is an exception to this rule and it is called a convertible bond.

QUESTIONS

(1) **Multiple Choice Questions (MCQs):**

(a) _________ is the Market where investors are mostly Banks, Financial Institutions, the RBI, Primary Dealers, Insurance companies, MFs, Corporates and FIIs.

(i) Capital Market (ii) Primary Market (iii) Wholesale Debt Market (iv) Retail Debt Market

(b) _________ involving participation by individual investors, provident funds, pension funds, private trusts, NBFCs and other legal entities.

(i) Capital Market (ii) Primary Market (iii) Wholesale Debt Market (iv) Retail Debt Market

(c) _________ are issued by a Corporation, are meant to raise the funds for the company's expansion plans.

(i) Equity Shares (ii) Debenture (iii) Corporate Bonds (iv) ULIPs

(d) The _________ usually have the maturity period of at least one year. *(Oct. 17)*

(i) Equity Shares (ii) Debenture (iii) Corporate Bonds (iv) ULIPs

(e) The interests (coupons) on corporation bonds are _________. *(March 18)*

(i) Taxable (ii) Non Taxable (iii) Interest Deducted (iv) Variated

(f) _________ bonds belong to the person who holds them and ownership is not otherwise recorded.

(i) Corporate (ii) Bearer (iii) Registered (iv) Unregistered

(g) _________ bonds are those bonds in which the owner's name is recorded with a transfer agent and interest payments are made either by check or electronic credit.

(i) Corporate (ii) Bearer (iii) Registered (iv) Unregistered

(h) _________ usually refer to government bonds and are backed by the full faith and credit of the taxing power.

(i) Corporate Bonds (ii) Bearer Bonds (iii) General Obligation Bonds (iv) Bonds

(i) _________ are payable from some specific source of taxes and are not subject to the general taxing power of the issuer.

(i) Corporate Bonds (iii) General Obligation Bonds (iv) Bonds

(j) __________ is a bond that at its maturity, or some other stated date, may be converted to a stated number of common shares in a corporation.

(i) Corporate Bonds (ii) Revenue Bonds (iii) General Obligation Bonds (iv) Convertible Bonds

(k) Value of money __________ with the occurrence of interest. *(Oct. 18; March 19)*

(i) Depreciates (ii) Appreciates (iii) Revaluates

(l) Bonds are __________ instruments which are issued for the purpose of raising Capital. *(March 19)*

(i) Flexible Income (ii) Fixed Income

(m) __________are debt securities issued by financial, non-financial or public entities where the proceeds are used to finance 100 per cent green projects and assets.

(i) Flexible Income (ii) Fixed Income (iii) Floating Bonds (iv) Green Bonds

[Ans.: (a – iii), (b – iv), (c – iii), (d – iii), (e – i), (f – ii), (g – iii), (h – iii), (i – ii), (j – iv), (k – ii), (l – ii), (m – iv)]

(2) Fill in the blanks:

(a) __________ markets supply long-term funds for the growth of the infrastructure or other sectors to fulfil long-term investment needs.

(b) Debt instruments which have a maturity of less than 1 year at the time of issue are called __________ instruments. *(Oct. 17)*

(c) __________ are money market instruments, i.e., short-term debt instruments issued by the Government of India, and are issued in three tenures 91 days, 182 days, and 364 days.

(d) Yield to maturity __________.

(e) __________ are bonds on which the coupon rate is fixed for the entire life of the bond.

(f) __________ bonds are securities that do not have a fixed coupon rate.

(g) __________ bonds are bonds with no coupon payments.

(h) __________ are bonds, the principal of which is linked to an accepted index of inflation with a view to protecting the holder from inflation.

(i) __________ have also been permitted to invest 100% of their funds in the debt market, which is a significant increase from the earlier limit of 30%.

(j) The interests (coupons) on corporation bonds are __________.

(k) Fixed return on bond is often termed as the __________.

[Ans.: (a) Debt, (b) Money market, (c) Treasury bills, (d) is coupon payment of a bond, (e) Fixed rate, (f) Floating rate, (g) Zero coupon, (h) Capital indexed bonds, (i) FIIs, (j) Taxable, (k) Interest rates]

(3) True or False:

(a) The corporate debt market in India basically comprises PSU bonds and private sector bonds.

(b) The benefits of debt markets include diversifying credit risks across the economy by providing an alternative to conventional bank lending.

(c) Bearer bond is a bond that at its maturity, or some other stated date, may be converted to a stated number of common shares in a corporation.

(d) Floating rate bonds are bonds on which the coupon rate is fixed for the entire life of the bond.

(e) A sinking fund provision requires the issuing firm to retire a certain percentage of the bond issue at stipulated points of time.

(f) The government has the right to buy-back the bond. (Call option) at par value (equal to the face value), while the investor has the right to sell the bond.

(g) FIIs have also been permitted to invest 100% of their funds in the debt market, which is a significant increase from the earlier limit of 30%.

(h) The Exchange reports the trades to RBI regularly and monitors the settlement of these trades.

(i) The settlement for the various trades is finally carried out through the SEBI.

(j) The interests (coupons) on corporation bonds are taxable.

(k) Government bonds are backed by state Government or Central Government. ***(March 19)***

[Ans.: (a) True, (b) True, (c) False, (d) False, (e) True, (f) True, (g) True, (h) True, (i) False, (j) True, (k) True]

(4) **Match the columns:**

	Group "A"		**Group "B"**
(a)	Registered bonds ***(Mar 18)***	(i)	Floating coupon rate
(b)	Bearer bonds	(ii)	Fixed coupon rate
(c)	General obligation bonds	(iii)	Ownership of bonds
(d)	Revenue bonds	(iv)	Index of inflation
(e)	Government bonds	(v)	Specific taxes
(f)	Convertible bonds	(vi)	Treasury bonds
(g)	Fixed rate bond	(vii)	Treasury bill
(h)	Floating rate bond	(viii)	Full faith
(i)	Zero coupon bond	(ix)	Converts to common shares
(j)	Capital indexed bond	(x)	Book entry

[Ans.: (a – x), (b – iii), (c – viii), (d – v), (e – vi), (f – i), (g – ii), (h – ix), (i – vii), (j – iv)]

(5) What are the various types of bonds? ***(Oct. 17)***

(6) Explain Features of bonds. ***(March 18)***

(7) Elaborate the role of corporate bonds in debt market.

(8) What is corporate bond? Explain its merits and demerits. ***(March 18)***

(9) Explain meaning of Bond market and explain the structure of Indian Bond Market is detail. ***(Oct. 18)***

(10) **Write short notes on:**

(a) Zero Coupon Bond.

(b) Bearer and Registered Bond.

Chapter 6

DEBT MARKET

- Introduction to Debt Market
- Evolution of Debt Market in India
- Advantages of Debt Instruments
- Contribution of Debt Market to Economy
- Characteristics that Contribute to the Development of Debt Market
- Introduction to Money Market
- Types and Features of Debt Instruments
- Regulatory Framework in Debt Market
- Corporate Debt Market in India
- Role of Corporate Debt Market in Economic Development
- Recent Developments in Corporate Debt Market
- Importance of the Development of the Corporate Debt Market
- Eligibility Criteria
- Margining Structure at the Exchange for the Retail Debt Market
- Summary
- Questions

INTRODUCTION:

- A major pointer of the level of development of an economy is the sophistication of its capital market. A well-functioning capital market which has breadth to accommodate wide variety of investor preferences and depth to absorb large volumes of transaction would ensure that capital is allocated resourcefully in the economy.
- One of the main motives for the phenomenal growth in bond markets is the increasing globalization of investor portfolios. Since governments are less cautious of allowing foreign investment in bonds as compared to equity of domestic companies, there has been an increasing supply of bonds for international investors.
- One of the largest securities markets in the world is a bond market, the Eurobond market, which has an average monthly turnover of between $300-500 billion. India can hardly choose to ignore this trend.
- Debt markets forms an essential part of the financial sector and effectively supplement the funds provided by the banking sector.
- Debt markets supply long-term funds for the growth of the infrastructure or other sectors to fulfil long-term investment needs. It can also reduce funding costs of the firm by liquidity premium on secondary market. They provide variety in financial products with elasticity to meet the specific needs of investors and borrowers. These benefits in the form of financial instruments and efficiency of the financial system with allocation of capital in the economy reduced exposure to foreign exchange risk and financial crises, and the facilitation of monetary policy.
- The corporate debt market in India essentially comprises of both PSU bonds and private sector bonds. The corporate debt market in India has factually established poor participation from the corporate sector. Quality of issued papers, lower investor base, inadequate liquidity, etc., has been the hindrances.
- The benefits of debt markets include diversifying credit risks across the economy by providing an alternative to conventional bank lending.

- The debt market in India contains of mainly two categories—the government securities or the G-Sec markets comprising central government and state government securities, and the corporate bond market. In command to funds its fiscal deficit, the government floats fixed income instruments and derives money by issuing G-Secs that are sovereign securities issued by the Reserve Bank of India (RBI) on behalf of the Government of India.
- The corporate bond market which is usually referred as non-Gsec market consists of financial institutions (FI) bonds, public sector units (PSU) bonds, and corporate bonds/ debentures.
- The G-secs are the most dominant category of debt markets and form a major part of the market in terms of outstanding issues, market capitalization, and trading value. It sets a yardstick for the rest of the market.
- The market for debt derivatives have not yet advanced significantly, although a market for OTC derivatives in interest rate products exists. The exchange-traded interest rate derivatives that were familiarised recently are debt instruments.

EVOLUTION OF DEBT MARKET IN INDIA:

- In the year 1991, the development of debt markets was given due consideration. The focus of the reforms was on setting up a comprehensive system of primary dealers, abolition of tax deductions at source on G-secs, permitting foreign institutional investors to invest in debt instruments, including government stock and sanctioning them to hedge their foreign currency risk in the forward market, and placing investments of banks in preference shares, debentures and bonds of corporates outside the 5 per cent limit.
- The relaxation of restrictions was the first step that spurred the development of the debt market with private placements gaining prominence among corporates. The Discount and Finance House of India (DFHI), which was established up by the RBI along with public sector banks in the late 1980s to develop the money market, was accredited as a Primary Dealer in 1996, in association with the Securities Trading Corporation of India

(STCI). The RBI is pulling out of DFHI and STCI to get over any conflicts of interest.

- The Narasimham Committee endorsed that the Government must borrow at market related rates. Only then a requirement was felt for Primary Dealers to enable price discovery, a debt market analyst said. While DFHI was introduced for short-term instruments such as commercial paper, STCI was floated for the development of G-secs.
- This was followed by the gradual induction of other players, local and foreign, and PD operations assembled momentum. According to dealers, one of the vital aspects of the development of debt markets has been the increase in the number of active members and the turnover. Earlier, while this segment was dominated by nationalised banks, today commercial banks, mutual funds and PDs are among the most important players.
- The central banks focus is also on the development of the money market and to this end several strategies are being adopted ranging from the Liquidity Adjustment Facility operations to the stage of withdrawal of non-bank participants that lend in the call money market.
- The debt market in India comprises mainly of two segments viz., the Government securities market consisting of Central and State Governments securities, Zero Coupon Bonds (ZCBs), Floating Rate Bonds (FRBs), T-Bills and the corporate securities market comprising of FI bonds, PSU bonds, and Debentures/Corporate bonds.
- Government securities form the major part of the market in terms of outstanding issues, market capitalization and trading value. Government securities form the oldest and most dominant part of the debt market in India. The market for government securities encompasses the securities issued by the central government, state governments and state-sponsored entities. In the recent past, local bodies such as municipal corporations have also initiated to tap the debt market for funds.

The Central Government mobilises funds mainly through issue of dated securities and T-bills, while State Governments rely solely on State Development Loans.

- The major investors in sovereign papers are banks, insurance companies and financial institutions, which usually do so to meet statutory requirements. Bonds dispensed by government-sponsored institutions like DFIs, infrastructure-related institutions and the PSUs, also establish a major part of the debt market. The steady withdrawal of budgetary support to PSUs by the government since 1991 has enlarged their reliance on the bond market for mobilizing resources.
- The favoured mode of raising capital by these institutions has been private placement, barring an occasional public issue. Banks, financial institutions and other corporate have been the chief subscribers to these issues.
- The Indian corporate sector trusts, to a great extent, on nurturing capital through debt issues, which embrace bonds and CPs. Most of the bond issues are being placed through the private placement route. These bonds are structured to suit the requirements of investors and the issuers, and include a variety of tailor-made features concerning interest payments and redemption.
- Corporate bond market has perceived a lot of innovations, including securitized products, corporate bond strips, and a variety of floating rate instruments with floors and caps. Nowadays, there has been an increase in issuance of corporate bonds with embedded put and call options. While certain securities are traded on the stock exchanges, the secondary market for corporate debt securities is however to fully develop.
- The Indian debt market also has a large non-securitized, transactions-based segment, where players can lend and borrow amongst themselves. This segment comprises of call and notice money markets, inter-bank market for term money, market for inter-corporate loans, and market for ready forward deals (repos).
- Characteristically, short-term instruments are traded in this segment. The market for interest rate derivatives like FRAs, IRSs is developing to enable banks, PDs and FIs to hedge interest rate risks.

ADVANTAGES OF DEBT INSTRUMENTS:

The various advantages of debt instruments are:

- Fixed and periodic receipts like interests.
- Capital is preserved.
- These instruments are more secured.
- Investment in government bonds (gilts) is more risk free.
- Lower volatility in comparison to equity market.
- Diversity of instruments like index linked bonds; floating rate notes.

CONTRIBUTION OF DEBT MARKET TO ECONOMY:

- Efficient utilization and allocation of resources in the economy.
- Financing the development activities of the Government.
- Diffuses risks on the banking system.
- Development of heterogeneity of market participants.
- Development of a reliable yield curve.
- Better intermediation between savers and investors.
- Avenues for long-term saving.
- Supply of long-term funds for investment.

CHARACTERISTICS THAT CONTRIBUTE TO THE DEVELOPMENT OF DEBT MARKET:

(1) **Transparency:** The market's functionality needs to be transparent both to the entity issuing the debt security, as also to the intermediary investing his money into it. Transparency also needs to exist for the regulatory bodies that oversee the capital markets. Only transactions made under a system of "full-disclosure" will increase the overall liquidity of the markets and provide all concerned parties with the level of confidence required for them to actively participate. Transparency needs to exist at the corporations and other entities issuing the debt instruments including legal, institutional and infrastructural change in the Indian system.

(2) Market unification and communication: In Indian debt market, the listing requirements of the two major exchanges – Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) – are such that they would exclude a large number of smaller companies. Consequently, extent of coverage is likely to reduce significantly as the process moves forward. Rather focus should be on setting up a communication network that can replicate the developed debt market as of US and Europe, so that everyone interested in buying a security gets a "firm" quote of the "inner market" regardless of location and information channel. The National Stock Exchange (NSE) has the potential for moving in this direction.

(3) Regulatory Autonomy and Effectiveness: The regulatory mechanism is key to fair pricing of securities, as it prevents colluding and intermediary pricing bias and inefficiencies. Without effective regulation, transparency will remain a pipe dream. In the Indian context, the regulatory functions are divided between two entities – the Securities and Exchanges Board of India (SEBI) and the Department of Company Affairs of the Government of India. The primary functions of the SEBI are to over-see the public issue of new securities, including specifying the listing conditions and disclosure norms, and to supervise the operation of the stock markets in order to prevent anti-market behaviour. Thus, as far as the secondary market is concerned, the SEBI's role is limited to market-related developments, and not to the companies themselves. This function comes in the domain of the Department of Company Affairs, and especially the Registrar of Companies. Unfortunately, the operation of these entities leaves much to be desired. Mention has already been made of the excessive confidentiality regarding company information, but the situation is even worse than that. Indian companies routinely get away with non-compliance with the reporting requirements, and quite often companies close without the regulator even being aware of the fact. As a consequence, secondary market participation is fraught with enormous informational risk arising out of poor regulatory practices.

(4) Trustworthy and transparent benchmarks: For a debt capital market to function efficiently, the existence of a credible benchmark is critical. In most markets, Government Treasury Notes play this role. It is common practice in most developing markets to use the US Treasuries as a global benchmark. Another criterion for a good benchmark is that it should be liquid and the market for it should be transparent. Although, in India, Government Bonds have been auctioned for many years, the price discovery mechanism is inefficient and heavily influenced by Government monetary policy. The minimum transactions size, even in secondary trade, is too large to permit widely dispersed participation, and therefore the prices may not reflect 'true' valuations. The main feature required of a market benchmark is that it should be a close proxy for the unrestricted "Risk Free Rate". Bonds issued by the GOI are backed by a Government guarantee, and since India's default rating is very favourable, this should not pose a problem, except that holdings are concentrated in a few hands and therefore reflect only a part of the larger market.

(5) **Competing and autonomous credit rating agencies:** Credible professional credit rating agencies that are autonomous are required to rate corporations and their securities. In India, there are at present three reasonably competent credit rating agencies, each of which has a tie-up with a major international agency. Thus, on the numbers and technical competence fronts, there is sufficiency. The major issues relate to the accessibility of the credit rating information and the perceived autonomy of the agencies. Such rating information simply does not exist, and its absence is perhaps linked to the excessive confidentiality accorded to balance sheet information. The net result is that rating information becomes available only when the companies' desire it, and not when the investors' need it. Although all the Indian credit rating agencies have been promoted as independent and autonomous entities by DFIs in collaboration with international agencies, their revenue streams are derived primarily from the companies that are being rated. This may raise problems of perception regarding their autonomy, although as yet no doubts have been raised.

(6) **Liquidity:** Liquidity is perhaps one of the most important requirements for an efficient, developed capital market. This in turn requires an efficient settlement system; and the existence of

multiple market makers. To some extent, the issue of an efficient settlement system has been addressed by the move to rolling settlements in the equity markets, and only needs to be duplicated in the context of the debt markets.

(7) **Macroeconomic stability:** Investor confidence is guided by many factors, one of the most important of which is macroeconomic stability. This is for the Government policy makers and implementers to do. In particular, interest rate management is perhaps the most important macroeconomic factor that the Government needs to monitor. Historical and empirical evidence shows that debt markets flourish in low interest rate environments. The interest rate regime in India has been traditionally kept very high, but recently the Government has taken steps to bring it down. This should encourage increased debt issuance if coupled with stable interest rate dynamics. It is pertinent to note that while low interest rates in themselves tend to push investment rupees towards the debt markets, it is important to stabilize interest rates. Excessive interest rate fluctuations would be counter-productive as they give rise to arbitrage opportunities, and intermediaries looking for short-term gains exploit the system, and this deters from the original goal of overall development and market efficiency.

(8) **Legal system:** A functioning legal system that all parties have faith in is another critical component. Without a viable legal infrastructure in place, it is very difficult to create investor confidence vis-à-vis the risk attributes of debt securities.

(9) **Developing a high yield market:** The development of a high yield market should be a secondary goal for Indian policy makers. It is commonplace to find debt markets in developing countries to tilt towards high yield securities owing to the existence of greater default risk. This tends to attract more capital, both domestic and foreign, on account of the incentive of higher return.

INTRODUCTION TO MONEY MARKET:

- The money market is a market for short-term funds, which deals in financial assets whose period of maturity is upto one year. Money market does not deal in cash or money as such but simply provides a market for credit instruments like bills of multiple market makers. To some extent, the issue of an efficient settlement system has been addressed by the move to rolling settlements in the equity markets, and only needs to be duplicated in the context of the debt markets.

(7) **Macroeconomic stability:** Investor confidence is guided by many factors, one of the most important of which is macroeconomic stability. This is for the Government policy makers and implementers to do. In particular, interest rate management is perhaps the most important macroeconomic factor that the Government needs to monitor. Historical and empirical evidence shows that debt markets flourish in low interest rate environments. The interest rate regime in India has been traditionally kept very high, but recently the Government has taken steps to bring it down. This should encourage increased debt issuance if coupled with stable interest rate dynamics. It is pertinent to note that while low interest rates in themselves tend to push investment rupees towards the debt markets, it is important to stabilize interest rates. Excessive interest rate fluctuations would be counter-productive as they give rise to arbitrage opportunities, and intermediaries looking for short-term gains exploit the system, and this deters from the original goal of overall development and market efficiency.

(8) **Legal system:** A functioning legal system that all parties have faith in is another critical component. Without a viable legal infrastructure in place, it is very difficult to create investor confidence vis-à-vis the risk attributes of debt securities.

(9) **Developing a high yield market:** The development of a high yield market should be a secondary goal for Indian policy makers. It is commonplace to find debt markets in developing countries to tilt towards high yield securities owing to the existence of greater default risk. This tends to attract more capital, both domestic and foreign, on account of the incentive of higher return.

INTRODUCTION TO MONEY MARKET:

- The money market is a market for short-term funds, which deals in financial assets whose period of maturity is upto one year. Money market does not deal in cash or money as such but simply provides a market for credit instruments like bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are nearby substitute of money. These instruments help the business units, other organizations and the Government to borrow the funds to meet their short-term requirement.

- Money market does not imply to any specific market place. Relatively it refers to the whole networks of financial institutions dealing in short-term funds, which provides an outlet to lenders and a source of supply for such funds to borrowers. Utmost money market transactions are taken place on telephone, fax or Internet. The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialized financial institutions. The Reserve Bank of India is the spearhead of the money market in India. Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC, GIC, UTI, etc. also operate in the Indian money market.
- The Reserve Bank of India is the leader of the money market in India. Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC, GIC, UTI, etc. also operate in the Indian money market. Indian money market consists of two parts:

  (a) The unorganized and

  (b) the organized sectors.

  The unorganised sector consists of indigenous bankers who pursue the banking business on traditional lines.

  The organised sector comprises the Reserve Bank, the State Bank of India and its associate banks, the 19 nationalised banks and other private sector banks, both Indian and foreign. The organised money market in India has several sub-markets such as the Treasury Bills Market: the Commercial Bills Market and the Inter-Bank Call Money Market.

TYPES AND FEATURES OF DEBT INSTRUMENTS:

The variety of debt instruments may be classified as follows:

(1) Money market instruments.

(2) Government securities and government guaranteed bonds.

(3) Corporate debentures.

(1) Money Market Instruments:

Debt instruments which have a maturity of less than 1 year at the time of issue are called money market instruments. They do not carry an explicit interest rate (or coupon rate). They are instead sold at a discount and redeemed at par value. Hence the implicit interest rate is a function of the size of the discount and the period of maturity.

(a) **Treasury bills:** Treasury bills (T-bills) are money market instruments, i.e., short-term debt instruments issued by the Government of India, and are issued in three tenures: 91 days, 182 days, and 364 days. The T-bills are zero coupon securities and pay no interest. They are issued at a discount and are redeemed at face value on maturity.

(b) **Though the yield on Treasury bills is somewhat low, they have appeal for the following reasons:**

(i) They can be transacted readily as they are issued in bearer form.

(ii) There is a very active secondary market for Treasury bills and the Discount and Finance House of India is a major market maker.

(iii) Treasury bills are virtually risk free.

(c) **Certificates of Deposit:** A certificate of deposit (CD) represents a negotiable receipt of funds deposited in a bank for a fixed period. It may be in a registered form or a bearer form. CDs are sold at a discount and redeemed at par value. Hence the implicit interest rate is a function of the size of the discount and the period of maturity.

CDs are a popular form of short-term investment for companies for the following reasons:

(i) Banks are normally willing to tailor the denominations and maturities to suit the needs of the investors.

(ii) CDs are fairly liquid.

(iii) CDs are generally risk-free.

(iv) CDs generally offer a higher rate of interest than Treasury bills or term deposits.

(d) Commercial Paper: Commercial paper represents short-term unsecured promissory notes issued by firms that are generally considered to be financially strong.

Commercial paper usually has a maturity period of 90 days to 180 days. It is sold at a discount and redeemed at par. Hence the implicit rate is a function of the size of discount and the period of maturity.

Commercial paper is either directly placed with investors of sold through dealers. Commercial paper does not presently have a well-developed secondary market in India.

The main attraction of commercial paper is that it offers an interest rate that is typically higher than offered by Treasury bills or certificates of deposit.

However, its disadvantages are that it does not have an active secondary market. Hence, it makes sense for firms that plan to hold till maturity.

(2) Government Securities:

A government security is a tradable instrument issued by the central government or the state governments. It acknowledges the government's debt obligation. Such securities are short-term (usually called treasury bills, with original maturities of less than one year) or long-term (usually called Government bonds or dated securities with original maturity of one year or more).

The largest borrowers in India are the central and state governments. The Government of India periodically sells central government securities. These are essentially medium to long- term bonds issued by the Reserve Bank of India on behalf of the Government of India. Interest payments on these bonds are typically semi-annual.

State governments also sell bonds. These are also essentially medium to long-term bonds issued by the Reserve Bank of India on behalf of state governments. Interest payments on these bonds are typically semi-annual.

Apart from the central and state governments, several governmental agencies issue bonds that are guaranteed by the central government of some state government. Interest payments on these bonds are typically semi-annual.

Types of Government Securities:

(a) **Cash Management Bills:** Cash management bills (CMBs) have the generic characteristics of T-bills but are issued for a maturity period less than 91 days. Same like the T-bills, they are also issued at a discount, and are redeemed at face value on maturity. The tenure, notified amount, and date of issue of the CMBs depend on the temporary cash requirement of the government. The statement of their auction is made by the RBI through a Press Release that would be allotted one day before the date of auction. Auction settlement is on a T+1 basis.

(b) **Dated Government Securities:** Dated government securities are long-term securities that carry a fixed or floating coupon (interest rate), which is paid on the face value, payable at fixed periods (usually half-yearly). The tenor of dated securities can be up to 30 years.

(c) **State Development Loans:** State governments also raise loans from the market. State Development Loans (SDLs) are dated securities issued over an auction similar to the auctions conducted for the dated securities issued by the central government. Interest is serviced at half-yearly intervals, and the principal is repaid on the maturity date. Like the dated securities issued by the central government, the SDLs issued by the state governments qualify for SLR. They are also qualified as collaterals for borrowing over market repo as well as borrowing by eligible entities from the RBI under the Liquidity Adjustment Facility (LAF).

(d) **Special Securities:** In addition to T-Bills and dated securities issued by the Government of India under the market borrowing program, the government also issues special securities, from time to time, to entities such as oil marketing companies, fertilizer companies, the Food Corporation of India, and so on as reimbursement to these companies instead of cash subsidies. These securities are generally long-dated securities carrying a coupon with a spread of about 20–25 basis points over the yield of the dated securities of comparable maturity. These securities are not eligible SLR securities, but can act as a collateral for market repo transactions. The beneficiary oil marketing companies may divest these securities in the secondary market to banks, insurance companies, primary dealers, etc., for raising cash

(e) **Separate Trading of Registered Interest and Principal of Securities (STRIPS):** Steps are being taken to introduce new types of instruments such as the STRIPS (Separate Trading of Registered Interest and Principal of Securities). Accordingly, guidelines for the stripping and the reconstitution of government securities have been issued. The STRIPS are instruments in which each cash flow of the fixed coupon security is converted into a separate tradable zero coupon bond and traded. These cash flows are traded separately as independent securities in the secondary market. The STRIPS in government securities will ensure the availability of sovereign zero coupon bonds, which will facilitate the development of a market-determined zero coupon yield curve (ZCYC). The STRIPS will also provide institutional investors with an additional instrument for their asset-liability management. Further, as the STRIPS have zero reinvestment risk (being zero coupon bonds), they can be attractive to retail/non-institutional investors. The process of stripping/reconstituting government securities is carried out at the RBI, the Public Debt Office (PDO) in the PDO-NDS (Negotiated Dealing System) at the option of the holder at any time from the date of issuance of government security till its maturity. All dated government securities, other than floating rate bonds, having coupon payment dates on January 2 and July 2 (irrespective of the year of maturity) are eligible for stripping/ reconstitution. The eligible government securities are held in the Subsidiary General Ledger (SGL)/ Constituent Subsidiary General Ledger (CSGL) accounts maintained at the PDO, RBI, Mumbai. Physical securities are not eligible for stripping/reconstitution. The minimum amount of securities that needs to be submitted for stripping/reconstitution will be 1 crore (face value) and multiples thereof.

(3) Corporate Debt/Bonds:

Bonds are delivered frequently by public sector companies, financial institutions, and private sector companies. A wide choice of innovative debt securities have been created in India, particularly from early 1990s.

This innovation has been inspired by a variety of factors, the most important being the amplified volatility of interest rates and changes in the tax and regulatory framework.

The corporate bond market is comparatively small and illiquid, and the market for securitized assets has fallen short of expectations.

A brief description of numerous types of corporate bonds is given below:

(a) **Fixed Rate Bonds:** These are bonds on which the coupon rate is fixed for the complete life of the bond. Most government bonds are delivered as fixed rate bonds.

(b) **Floating Rate Bonds:** Floating rate bonds are securities that do not have a fixed coupon rate. The coupon is re-set at pre-announced intervals (say, every 6 months, or 1 year) by adding a spread over a base rate. In the case of utmost floating rate bonds issued by the Government of India so far, the base rate is the weighted average cut-off yield of the last three 364-day Treasury Bill auctions preceding the coupon re-set date, and the spread is decided through the auction. Floating rate bonds were first dispensed in India in September 1995.

(c) **Zero Coupon Bonds:** Zero coupon bonds are bonds with no coupon payments. Like T-Bills, they are issued at a discount to the face value. The Government of India issued such securities in the 90s; it has not issued zero coupon bonds after that.

(d) **Capital Indexed Bonds:** These are bonds, the principal of which is linked to an accepted index of inflation with a view to protecting the holder from inflation. Capital indexed bonds, with the principal hedged against inflation, were first issued in December 1997. These bonds matured in 2002. The government is currently working on a fresh issuance of Inflation Indexed Bonds wherein the payment of both the coupon as well as the principal on the bonds would be linked to an Inflation Index (Wholesale Price Index). In the proposed structure, the principal will be indexed and the coupon will be calculated on the indexed principal. To provide the holders protection against actual inflation, the final WPI will be used for indexation.

c) **Bonds with Call/Put Options:** Bonds can also be issued with features of optionality, wherein the issuer can have the option to buy back (call option) or the investor can have the option to sell the bond (put option) to the issuer during the currency of the bond. The optionality on the bond could be exercised after the completion of five years from the date of issue on any coupon date falling thereafter. The government has the right to buy-back the bond. (call option) at par value (equal to the face value), while the investor has the right to sell the bond (put option) to the government at par value at the time of any of the half-yearly coupon dates starting from July 18, 2007.

Features of Corporate Bonds:

(a) **Collateral:** Collateral represents a pledge of assets in favour of the bond holders. If serves as an insurance against any possible default by the borrower.

(b) **Sinking Fund:** A sinking fund provision requires the issuing firm to retire a certain percentage of the bond issue at stipulated points of time.

(c) **Protective Covenants:** The bond deal often contains several agreements to protect the interest of lenders. These impose restrictions on management and give bondholders greater confidence that the firm will honour its commitments. For example, contract may put limits on dividend payment, managerial compensation, and total borrowings.

REGULATORY FRAMEWORK IN DEBT MARKET:

RBI:

- The Reserve Bank of India manages the public debt and issues new loans on behalf of the Union and the State Governments.
- It also undertakes cash and liquidity management for the Government of India and State Governments and administers the scheme of Ways and Means Advances (WMA). Internal Debt Management Department of the RBI manages internal debt.
- This involves auctioning the Government debt from time to time, introduction of new instruments, smoothening the maturity structure of debt, placing of debt at market related rates and

improving depth and liquidity of Government securities by developing active secondary market for them.

- The Government Securities Act, 2006 governs the Government Debt Market.
- The Reserve Bank of India is, therefore, the main regulator for the Money Market. Reserve Bank of India also controls and regulates the G-Secs Market. Apart from its role as a regulator, it has to simultaneously fulfil several other important objectives viz. managing the borrowing program of the Government of India, controlling inflation, ensuring adequate credit at reasonable costs to various sectors of the economy, managing the foreign exchange reserves of the country and ensuring a stable currency environment.
- RBI supervises and controls the issuance of new banking licenses to banks; how various scheduled banks raise money from depositors; and deployment of money through its policies on CRR, SLR, priority sector lending, export refinancing, guidelines on investment assets etc.
- RBI also controls on the interest rates, whereby over the years it has moved slowly towards a regime of market determined controls.
- RBI provides negotiated dealing system which is an electronic platform for facilitating dealing in Government Securities and money market instruments.

SEBI:

- SEBI supervises bond market and corporate debt market in cases where entities raise money from public through public issues. It regulates how such money are raised and ensure a fair play for the retail investor.
- The issuers are required to make the retail investor aware, of the risks inherent in the investment, by way of disclosure.
- Being regulator for the Mutual Funds in India SEBI regulates the entry of new mutual funds in the industry and also the instruments in which mutual funds can invest.

Other Regulator Apart from the two main regulators, the RBI and SEBI, there are several other regulators specific for different classes of

...vestors. The Central Provident Fund Commissioner and the ...inistry of Labour regulate the Provident Funds. Religious and ...haritable trusts are regulated by some of the State governments of ...e states, in which these trusts are located.

...ORPORATE DEBT MARKET IN INDIA:

The Indian Primary market in Corporate Debt is basically a private ...acement market with most of the corporate bond issues being ...rivately placed among the wholesale investors i.e. the Banks, ...inancial Institutions, Mutual Funds, Large Corporates and other ...arge investors.

The proportion of public issues in the total quantum of debt ...apital issued annually has decreased in the last few years. Around ...92% of the total funds mobilized through corporate debt securities in ...he Financial Year 2002 were through the private placement route.

- The Secondary Market for Corporate Debt can be accessed through the electronic order-matching platform offered by the Exchanges. BSE offers trading in Corporate Debt Securities through the automatic BOLT system of the Exchange.
- The Debt Instruments issued by Development Financial Institutions, Public Sector Units and the debentures and other debt securities issued by public limited companies are listed in the 'F Group' at BSE.
- The following are some of the different types of corporate debt securities issued:
  - Non-Convertible Debentures.
  - Partly-Convertible Debentures / Fully-Convertible Debentures (convertible in to Equity Shares).
  - Secured Premium Notes.
  - Debentures with Warrants.
  - Deep Discount Bond.
  - PSU Bonds/Tax-Free Bonds.
- The trading in corporate debt securities in the F Group are traded on the BOLT order-matching system based on price-time priority. The trades in the 'F Group' at BSE are to be settled on a rolling settlement basis with a T+2 Cycle with effect from

1st April 2003. Trading continues from Monday to Friday during the week.

- The Trade Guarantee Fund (TGF) of the Exchange covers all the trades in the 'F' Group undertaken on the electronic BOLT system of the Exchange.

ROLE OF CORPORATE DEBT MARKET IN ECONOMIC DEVELOPMENT:

(1) It supplements the existing banking system in providing the required funding to enterprises and while doing so reduces the vulnerability of the financial system to external shocks by ensuring diversification of funding sources in the economy. Previous financial crises have shown that systemic problems in the banking sector can interrupt the flow of funds from savers to investors for a significantly long period of time.

(2) It enables better pricing of credit risk, dynamic allocation of capital, realistic pricing of government debt and reduction of currency mismatches in the financial system.

(3) It provides investment options to institutions such as insurance companies and pension funds which seek high quality long term assets to match their long term liabilities.

(4) It fosters the development of credit derivative products thereby allowing efficient credit risk transmission.

RECENT DEVELOPMENTS IN CORPORATE DEBT MARKET:

- In the recent past, the corporate debt market has seen a high growth of innovative asset-backed securities. The servicing of debt and related obligations for such instruments is backed by some sort of financial assets and/or credit support from a third party.
- Over the years greater innovation has been witnessed in the corporate bond issuances, like floating rate instruments, zero coupon bonds, convertible bonds, callable (put-able) bonds and step-redemption bonds.
- These innovative issues have provided a gamut of securities that caters to a wider segment of investors in terms of maintaining a

desirable risk-return balance. Over the last five years, corporate issuers have shown a distinct preference for private placements over public issues. This has further cramped the liquidity in the market.

- The dominance of private placement in total issuances is attributable to a number of factors. Lengthy issuance procedure for public issues, in particular, the information disclosure requirements, Costs of a public issue are considerably higher than those for a private placement.
- The quantum of money raised through private placements is classically larger than those that can be garnered through a public issue. Also, a corporate can expect to raise debt from the market at finer rates than the prime-lending rate of banks and financial institutions only with an AAA rated paper. This bounds the number of entities that would find it profitable to enter the market directly.
- RBI is looking forward for the awareness and spread of Debt Market in India and hence has started focusing more on innovative approach. The interest rate future (IRF) is one of such successful traded innovation in the recent period which can be used by investors to gain or shed interest exposures.
- The National Infrastructure Pipeline envisages Rs. 111 lakh crore of investments between fiscals 2020 and 2025 for India's infrastructure build-out.
- India has become the second largest market after China in Green Bonds with $10.3billion transactions.

IMPORTANCE OF THE DEVELOPMENT OF THE CORPORATE DEBT MARKET:

The economic advantages of having a viable private DCM can be grouped into three broad categories.

(1) Diversification:

(a) It gives providers of capital access to a broader set of diversification opportunities. In India today, household wealth is parked in bank deposits, real estate and gold, with very limited stock ownership. More active insurance and pension markets, it would allow families to spread investment risks more broadly.

(b) In turn, these institutional investors would contribute to enhancing credit price disclosure as they allocate resources into interest-bearing securities.

(2) Efficiency in managing cost of capital:

(a) Access to a functioning DCM, and the multiple financing options that come with it, endows borrowers with greater efficiency in managing the cost of capital. Historical and cross-sectional experience teaches that problems in the banking sector can interrupt the flow of funds from savers to investors for a dangerously long period.

(b) Indeed, one of the lessons from the 1997 Asian financial crisis has been the importance of having non-bank funding channels open. In the wake of this crisis, several countries in the region, including Korea, Malaysia, Singapore and Hong Kong, have made progress in building their corporate debt markets.

(3) Financial stability:

(a) On-the-ground estimates indicate that the total stock of non-equity claims on India's corporate sector could be somewhere in the region of 10% of GDP. With listed securities worth just USD 21 billion, this means that roughly 80% of the market is in the form of private placements. These liabilities are negotiated and priced on the principles of relationship lending, issued with virtually no public disclosure, and are typically held to maturity by banks.

(b) This brings us to a third set of reasons why developing a debt capital market is in India's interest. The current system of financing has already, and will increasingly, become less adequate for an economy as large and as ambitious as India's.

(c) Spreading credit risk from banks balance sheets more broadly through the financial system would lower the risks to financial stability. And a deeper, more responsive interest rate market would allow the central bank greater degrees of freedom in the conduct of monetary policy. This will be particularly important as India gradually opens up its capital markets to the rest of the world.

4) Retail Debt Market:

- The Retail trading in Central Government Securities commenced on January 16, 2003 through the BOLT System of the Exchange. Central Government Securities (G-Secs.) are currently listed at the Exchange under the G Group.
- The Exchange is planning to introduce retail trading in other debt securities like State Government Securities, Treasury Bills, STRIPS, Interest Rate Derivative products.

The following are the main investor segments who could participate in the Retail Debt Market:

- Mutual Funds.
- Provident Funds.
- Pension Funds.
- Private Trusts.
- Religious Trusts and charitable organizations having large investible corpus.
- State Level and District Level Co-operative Banks.
- Housing Finance Companies.
- NBFCs and RNBCs.
- Corporate Treasuries.
- Hindu-Undivided Families (HUFs).
- Individual Investors.

ELIGIBILITY CRITERIA:

- **Eligible Members:** The Members of retail segment should possess a net-worth of ₹ 1 crore and above are eligible to trade in the Retail Debt segment. The members are required to submit additional contribution of ₹ 5 lakhs as refundable contribution towards the separate Trade Guarantee Fund for this segment. This contribution of ₹ 5 lakhs towards the Trade Guarantee Fund (TGF) could be submitted in terms of cash or FDR or Bank Guarantee. However, the Exchange has permitted the Members to earmark ₹ 5 lakhs from their additional capital for a period of one month or till such time separate contribution for TGF is provided by them, whichever is earlier.

- **Eligible Securities:** All outstanding and newly issued central government securities are eligible to be traded on the automated, anonymous, order driven system of the eligible stock exchange. The Rules, Bye-Laws and Regulations of the Exchange provide for trading in Government securities as all G-secs are deemed to be admitted to dealings on the Exchange from the date on which they are issued as per Bye-Law 22(a) and 22(b) of the Exchange.
- **Group:** The Government securities have been introduced as a new group of securities - "G" Group in the BOLT system. The G-secs are allotted a 6-digit scrip code (in the 800000 series) and a 11 characters alpha-numeric scrip ID The interpretation for the Scrip IDs of G-Secs. in BOLT is as under:
  - First 2 characters signify Central Government Security - CG.
  - Next 4 Digits signify the coupon or interest rate of the G-Sec.
  - Next 1 character is a differentiator which would be 'S' in case of a normal security and 'A' in case there exists another security with the same coupon and maturity year.
  - Next 2 Digits signify the Issue Year and the last 2 digits signify the Maturity Year.

  The date in the Scrip Name stands for the Maturity Date of the Security. The Exchange will implement and monitor the suspension of trading during the shutdown period so that no settlements fall due in the no-delivery period which is on the T-3, T-2 and T-1 days for Government Securities (where T is the interest payment date for the security).
- **Trading Methodology:** The G-Secs shall be traded on the system and settled at the same price, which will be inclusive of the accrued interest i.e. the Dirty Price as per the market parlance in the Wholesale Debt Market. This is similar to the trading on the cum-interest price as is witnessed in the case of corporate debentures. The minimum order size shall be 10 units of G-Secs with a face value Rs. 100 each equivalent to an order

value of Rs. 1,000 and the subsequent orders will be in lots of 10 securities each.

- **Trading and Exposure Limits:** The members of the Retail Debt Segment are permitted gross exposure in government securities along their gross exposure in equity segment upto 15 times of their additional capital deposited by them with the Exchange. However, no gross exposure is permitted to the members against their Base Minimum Capital + contribution of Rs. 10 lakhs towards TGF in the cash segment. Transactions done by the members in this segment along with their transactions in the equity segment would form part of their Intra-day Trading Limits and are subject to a limit of 33.33 times of the capital deposited with the Exchange. However, institutional business would not form part of these Intra-Day & Gross Exposure limits.

- **Clearing and Settlement:** The Clearing and Settlement mechanism for the Retail trading in G-Secs is based on the existing institutional mechanism available at the Stock Exchanges for the Equity Markets. The trades executed throughout the continuous trading sessions will be netted out at the end of the trading hours through a process of multilateral netting. The transactions will be netted out member-wise and then scrip-wise so as to determine the net settlement and payment obligations of the members. The Delivery obligations and the payment orders in respect of these members are generated by the clearing and settlement system of the Exchange. These statements indicate the pay-in and pay-out positions of the members for securities and funds who would then give the necessary instructions to their Clearing Banks and depositories.

MARGINING STRUCTURE AT THE EXCHANGE FOR THE RETAIL DEBT MARKET:

- **Margining - Mark to Market:** The positions in the Retail Debt segment are marked to market until settlement and mark to market margin on net outstanding position of the members is collected on all open net positions. The mark to market margin is calculated based on the prices derived from the Zero Coupon Yield Curve (ZCYC). This margin is to be collected on the T+1 day along with the margin on the outstanding positions in cash segment.

- **Margin exemption to Institutional business:** Institutional business (i.e., business done by members on behalf of Indian Financial Institutions, Foreign Institutional Investors, Scheduled Commercial Banks, Mutual Funds registered with SEBI) would be exempted from margin, as is applicable in the case of transactions in the equity segment, as the institutions are required under the relevant regulations to transact only on the basis of giving and taking delivery. The members would, however, be required to mark client type 'FI' at the time of order entry for availing of exemption from payment of margins and also exclusion of such trades from Intra-day Trading and Gross Exposure Limits. Custodial trades on behalf of Provident Funds transacting through a SGL-II account (Constituent SGL a/c) would also be eligible for margin exemption.
- **Margin Exemption against delivery:** Margin exemption for early pay-in of securities in case of sale transactions as applicable for the equities segment would also be available for this segment.

SUMMARY

- Debt markets supply long-term funds for the growth of the infrastructure or other sectors to fulfil long-term investment needs.
- The debt market in India consists of mainly two categories—the government securities or the G-Sec markets comprising central government and state government securities, and the corporate bond market. In order to finance its fiscal deficit, the government floats fixed income instruments and borrows money by issuing G-Secs that are sovereign securities issued by the Reserve Bank of India (RBI) on behalf of the Government of India.
- The Central Government mobilises funds mainly through issue of dated securities and T-bills, while State Governments rely solely on State Development Loans.
- The major investors in sovereign papers are banks, insurance companies and financial institutions, which generally do so to meet statutory requirements. Bonds issued by government-sponsored institutions like DFIs, infrastructure-related institutions and the PSUs, also constitute a major part of the debt market.
- The Indian debt market also has a large non-securitized, transactions-based segment, where players are able to lend and borrow amongst themselves. This segment comprises of call and notice money markets, inter-bank market for term money, market for inter-corporate loans, and market for ready forward deals (repos).
- The variety of debt instruments may be classified as Money market instruments, Government securities and government guaranteed bonds and corporate debentures. There are various types of government securities and corporate bonds available in debt market.

QUESTIONS

Multiple Choice Questions (MCQs):

(a) ___________ markets supply long-term funds for the growth of the infrastructure or other sectors to fulfil long-term investment needs.
(i) Debt (ii) Equity (iii) International (iv) Financial

(b) Debt instruments which have a maturity of less than 1 year at the time of issue are called ___________ instruments. *(March 18)*
(i) Debt (ii) Equity (iii) Money Market (iv) Financial

(c) ___________ are money market instruments, i.e., short-term debt instruments issued by the Government of India, and are issued in three tenures 91 days, 182 days, and 364 days.
(i) Debt (ii) Money Bill (iii) Capital Market (iv) Treasury Bills

(d) Yield to maturity ___________.
(i) is current price of a bond (ii) is coupon payment of a bond (iii) is related to price of a bond

(e) The ___________ in India basically comprises PSU bonds and private sector bonds.
(i) Corporate Debt Market (ii) Money Bill (iii) Capital Market (iv) Treasury bills

(f) ___________ are the most dominant category of debt markets and form a major part of the market in terms of outstanding issues, market capitalization, and trading value.
(i) Debt (ii) G-sec (iii) Capital Market (iv) Treasury Bills

(g) The ___________ interest rate derivatives that were introduced recently are debt instruments. *(March 18)*
(i) Debt (ii) Exchange traded (iii) Capital market (iv) Treasury bills

(h) The ___________ Committee recommended that the Government must borrow at market related rates.
(i) Narasimham (ii) CV Raman (iii) Chakraborthy (iv) Nehru

(i) ___________ is a financial market for buying and selling debt securities. *(Oct. 18)*
(i) Commodity market (ii) Debt market

[Ans.: (a – i), (b – iii), (c – iv), (d – ii), (e – i), (f – ii), (g – ii)), (h – i), (i – ii)]

(2) Fill in the blanks:

(a) Certificate of Deposit (CDs) are short-term instruments issued by ___________.
(b) ___________ is an unsecured instrument issued in the form of promissory note.
(c) The ___________ consists of indigenous bankers who pursue the banking business on traditional lines.
(d) Debt instruments which have a maturity of less than 1 year at the time of issue are called ___________.
(e) ___________ are zero coupon securities and pay no interest. They are issued at a discount and are redeemed at face value on maturity.
(f) ___________ represents a negotiable receipt of funds deposited in a bank for a fixed period.

(g) __________ usually has a maturity period of 90 days to 180 days.

(h) A __________ is a tradable instrument issued by the central government or th state governments.

(i) __________ have the generic characteristics of T-bills but are issued for maturity period less than 91 days.

(j) __________ are long-term securities that carry a fixed or floating coupon whic is paid on the face value payable at fixed time periods.

[Ans.: (a) Commercial banks, (b) Commercial Paper, (c) unorganized secto (d) money market instruments, (e) T-bills, (f) Certificate of deposit (CD), (g Commercial paper, (h) government security, (i) Cash management bills (CMBs), (j Dated government securities]

(3) True or False:

(a) The corporate debt market in India basically comprises PSU bonds and private sector bonds.

(b) The benefits of debt markets include diversifying credit risks across the economy by providing an alternative to conventional bank lending.

(c) The exchange-traded interest rate derivatives are yet not introduced.

(d) T-Bills are issued at a discount and are redeemed at face value on maturity.

(e) A certificate of deposit (CD) represents a negotiable receipt of funds deposited in a bank for a fixed period.

(f) CP is not sold at a discount and redeemed at par.

(g) Debt markets are an integral part of the financial sector and effectively supplement the funds provided by the banking sector.

(h) T-bills are the most dominant category of debt markets and form a major part of the market in terms of outstanding issues, market capitalization, and trading value.

(i) The exchange-traded interest rate derivatives that were introduced recently are debt instruments.

(j) The Narasimham Committee recommended that the Government must borrow at market related rates.

[Ans.: (a) True, (b) True, (c) False, (d) True, (e) True, (f) False, (g) True, (h) False, (i) True, (j) True]

(4) Match the columns:

Group "A"		Group "B"	
(a)	Unorganized Markets	(i)	Central Bank
(b)	Capital Market	(ii)	Short term borrowings
(c)	Money Market	(iii)	Long term borrowings
(d)	Call Money	(iv)	1949
(e)	T-bills	(v)	Investor Protection
(f)	Commercial Paper *(Mar 18)*	(vi)	Issued by Commercial Banks
(g)	Certificate of deposits	(vii)	Promissory note
(h)	RBI	(viii)	Indigenous Bankers
(i)	SEBI *(Mar 18)*	(ix)	Liquid Instruments
(j)	Banking Regulation act	(x)	Daily basis

[Ans.: (a – viii), (b – iii), (c – ii), (d – x), (e – i), (f – vii), (g – vi), (h – ix), (i – v), (j – iv)]

(5) Explain the status of debt markets in India. *(Oct. 17)*

(6) Why existence of debt market is important.in capital market? Elaborate it following its features?

(7) Explain various Money market instruments. ***(March 18)***
(8) What are the various Government securities and government-guaranteed bonds?
(9) What are the various types of Government securities?
(10) What are the various types of bonds?
(11) What are the various Features of bonds?
(12) Elaborate the role of corporate debt market in economic development.
(13) What are the recent developments in corporate debt market?
(14) Explain in detail the Importance of development in corporate debt market.
(15) **Write short notes on:**
   (a) Corporate Debt Market.
   (b) Retail Debt Market.
   (c) Types of Government Securities.
   (d) Money Market Instruments.

UNIT – III: FINANCIAL INSTRUMENTS

Chapter 7

FINANCIAL INSTRUMENTS

- Introduction to Financial Instruments
- Characteristics and Classification of Financial Instruments
- Owned and Borrowed Capital
- Introduction to Debt Instrument
- Difference between Debt and Equity Instruments
- Characteristics of Debt Instruments
- Contribution of Debt Market to Economy
- Types and Features of Debt instruments
- Introduction to Equity Instruments
- Type and Characteristics of Equity Shares
- Risk Return Trade-off
- Techniques for Managing Risk-Returns
- Repo Transactions
- Introduction to Derivatives
- Definition and Characteristics of Derivatives
- Need for Derivatives
- Ways Derivatives are Used/Functions of Derivative Markets
- Advantages and Disadvantages of Derivatives
- Derivatives Contracts
- Types of Derivatives Contracts
- Summary
- Questions

INTRODUCTION TO FINANCIAL INSTRUMENTS:

Financial instruments create a pathway towards the financial assets, securities and claims. Before investing, a financial instrument must be viewed as financial assets and financial liabilities. Financial assets characterize claims for the payment of a sum of money sometime in the future (repayment of principal) and/or a periodic payment in the form of interest or dividend. Financial liabilities are the equivalents of financial assets. They symbolise promise to pay some portion of prospective income and wealth to others.

CHARACTERISTICS OF FINANCIAL INSTRUMENTS:

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

(1) **Liquidity:** Financial instruments provide liquidity. These can be easily and rapidly converted into cash.

(2) **Marketing:** Financial instruments enable easy trading on the market. They have a organized market.

(3) **Collateral value:** Financial instruments can be guaranteed for getting loans. These instruments can be used as a collateral for obtaining any loan.

(4) **Transferability:** Financial instruments can be easily transferred from one person to another.

(5) **Maturity period:** The maturity period of financial instruments may vary from short term, medium term or long term.

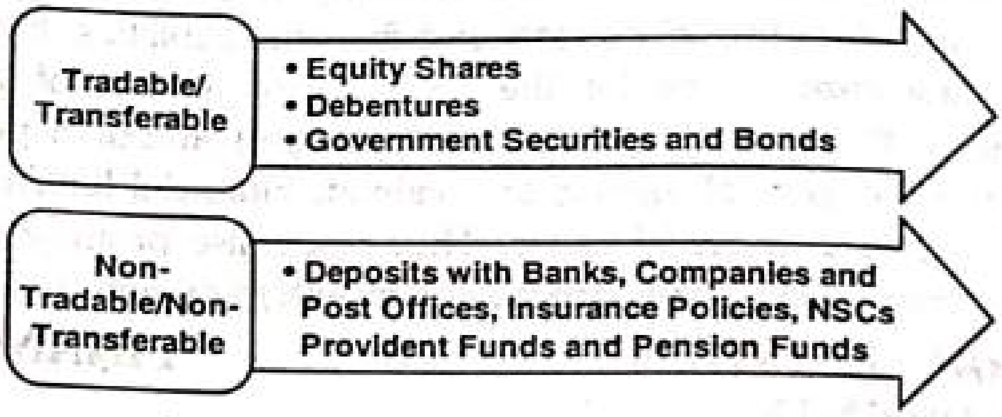
(6) **Transaction cost:** Financial instruments involve buying and selling costs. The buying and selling costs are called transaction costs which are usually lower in financial instruments investment.

(7) **Risk:** Financial instruments carry risk. This is because there is uncertainty concerning the payment of principal or interest or dividend whatever the case may be.

(8) **Future trading:** Financial instruments facilitate future trading to cover risks due to price fluctuations, interest rate fluctuations etc.

CLASSIFICATION OF FINANCIAL INSTRUMENTS:

(1)



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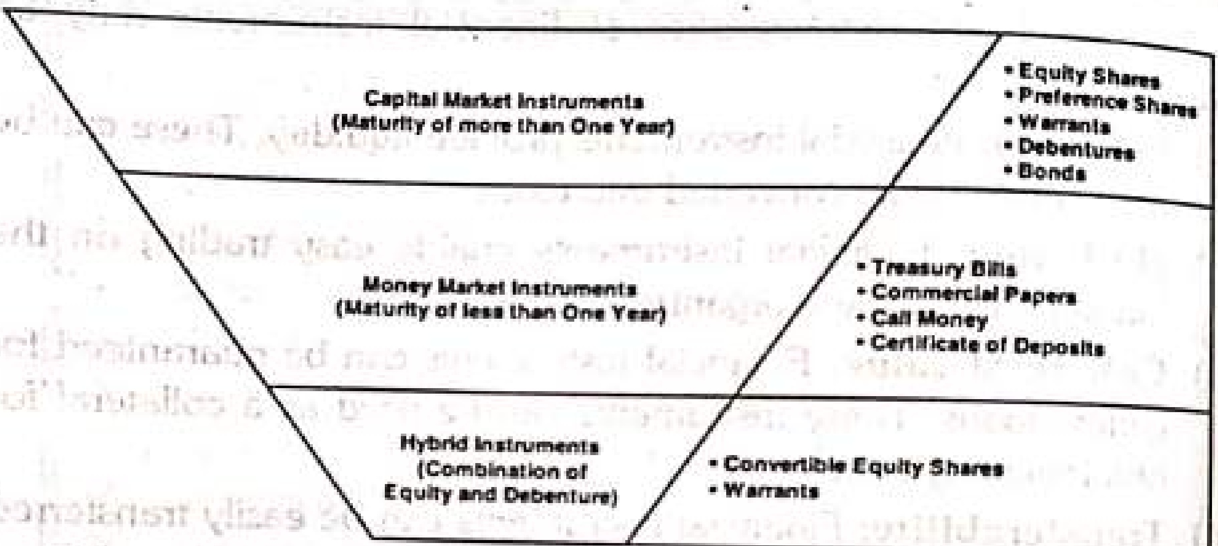

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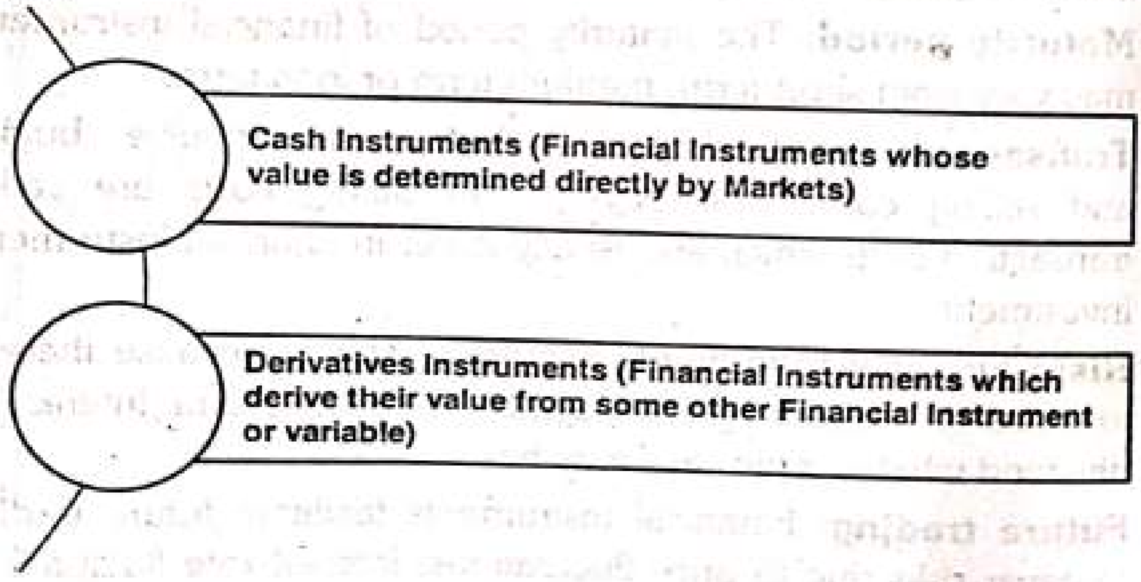

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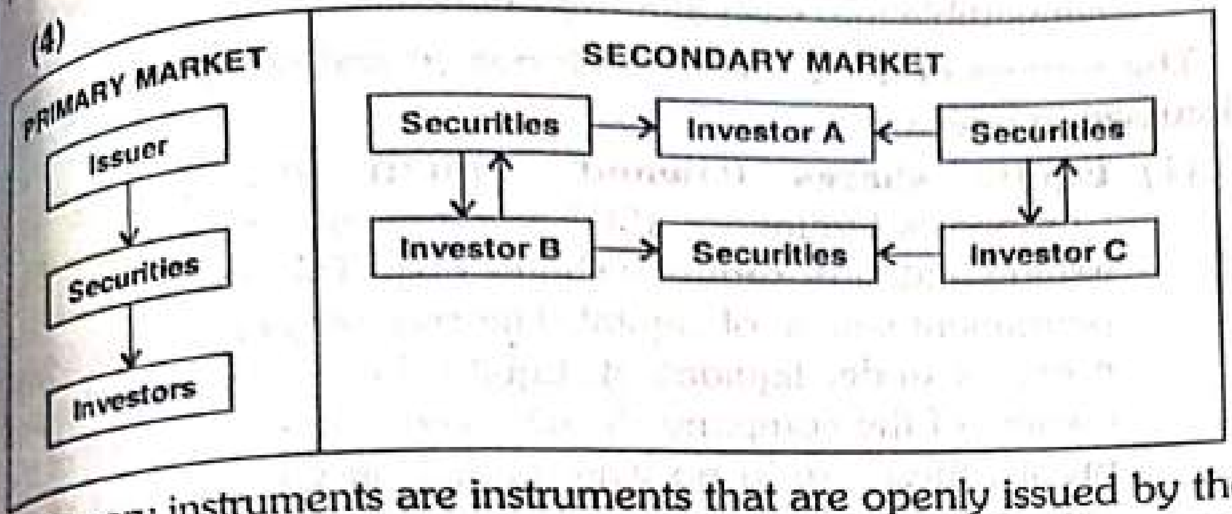


- Primary instruments are instruments that are openly issued by the ultimate investors to the ultimate savers. For example, shares and debentures directly issued to the public.
- Secondary instruments are distributed by the financial intermediaries to the ultimate savers. For example, UTI and mutual funds issue securities in the form of units to the public.

Capital is made up of debt and equity. Debt is borrowed money, for example money borrowed from financial institutions, etc. Equity is shareholders' money called equity capital. Capital is required either for new business or to expand the existing business. Capital comes from different sources. The debt holders do not have a share in the profit. They can only ask for return of money borrowed with interest. Their claim is limited to fixed return.

OWNED AND BORROWED CAPITAL:

There are two sources of raising fixed capital by a company.

(1) Owned capital.

(2) Borrowed capital.

In demand to finance fixed capital, a company depends on long term types of finance. It makes use of both the sources, owned as well as borrowed.

- Owned capital is raised up by issue of shares and ploughing back of profits.
- Borrowed capital is raised by issuing debentures, public deposits and loans from industrial and financial institutions.
- A company cannot make the error of financing fixed assets out of short term sources of finance as the funds invested in

fixed assets are enduringly sunk into the business and are not convertible into cash at a short notice.

The sources of fixed capital, both owned and borrowed, are now discussed in brief.

(1) **Equity shares (Owned capital):** According to the Companies Ordinance 1984 a company can raise capital by issuing equity or ordinary shares only. The equity shares are permanent source of capital. The company has not to refund it except under liquidation. Equity shareholders are the real owners of the company. As dividend is to be paid out of the profits, these are in no way burden on the resources of the company.

(2) **Ploughing back of profits (Owned capital):** Ploughing back of profits is the procedure of retaining profits year after year and their utilization in the business for the development of the business. The system of reinvestment of profits or ploughing back of profits is employed for making the company self-dependent for finances. This method is also engaged for expansion of business, redemption of loans and debentures etc.

(3) **Debentures (Borrowed capital):** A company may raise long term funds through public borrowing by issuing loans in the form of debentures. A debenture is an instrument issued by a company to acknowledge the loan taken under the company's seal. A debenture holder is the creditor of the company. The company pays fixed rate of interest on debentures.

(4) **Loans from industrial and financial institutions (Borrowed capital):** Another important source of raising long term finance is loans from the financial institutions. The loans are obtained both in local and foreign currency for the purchase of machinery equipment's etc.

INTRODUCTION TO DEBT INSTRUMENT:

Debt instrument is one in which the issuer agrees to pay the investor interest along with principal amount being borrowed. A debt instrument also referred to as an instrument of obligation (oblige to repay as debt instrument holders becomes creditors), it can be in the form of a note, bond, or loan. The interest payments that must be made by the issuer are fixed contractually. For example, in the case of a debt instrument that is required to make payments in Yen, the amount can be a fixed Yen amount or it can vary depending upon some benchmark. The investor in a debt instrument can reimburse only a fixed amount, due to this feature it is known as fixed- income instruments.

DIFFERENCE BETWEEN DEBT AND EQUITY INSTRUMENTS:

There are important dissimilarities between stocks and bonds. Such as:

(1) Equity financing allows a company to funds incurring debt. On the other hand, while issuing a bond increases the debt burden of the bond issuer because contractual interest payments must be paid contrasting dividends, they cannot be bargained or suspended.

(2) Those who purchase equity instruments (stocks) gain ownership of the business whose shares they hold (in other words, they gain the right to vote on the issues important to the firm). Besides, equity holders have claims on the future earnings of the firm.

In contrast, bondholders do not gain ownership in the business or have any claims to the future profits of the borrower. The borrower's only obligation is to repay the loan with interest.

(3) Bonds are considered to be less risky investments for at least two reasons. First, bond market returns are less volatile as compared to stock market returns. Second, when the company run into trouble, bondholders are paid first, before other expenses are paid. Shareholders are the last entity to receive some compensation in case of liquidity.

CHARACTERISTICS OF DEBT INSTRUMENTS:

- **Residual maturity (or redemption date)**.With the passage of time, the residual maturity of any bond shortens. Bonds are classified into 'short-term' (with duration up to five years); 'medium-term' (from five to fifteen years); 'long-term' (above fifteen years).
- Bonds pay a fixed rate of interest, called **coupon**. It is normally made in two instalments, at six-monthly intervals, each equal to half the rate indicated in the bond's coupon.

- The coupon divided by the par value of the bond (100 Dollar) gives the coupon rate on the bond. The par or redemption value of bonds is commonly 100 Dollar (or other currency). This is also the price at which bonds are first issued.
- Bond prices vary inversely with market interest rates. If market rates rise, people prefer to embrace the new, higher-yielding issues than existing bonds.

  The yields on bonds are expressed usually in two forms:

  (1) Interest yield (or running yield).

  (2) Yield to maturity or redemption yield;

  (1) **Interest yield (or running yield):** The return on a bond taking account only of the coupon payments.

  (2) **Yield to maturity or redemption yield:** The return on a bond taking account of the coupon cash flows and the capital gain or loss at redemption.

CONTRIBUTION OF DEBT MARKET TO ECONOMY:

- Efficient mobilization and allocation of resources in the economy.
- Financing the development activities of the Government.
- Diffuses risks on the banking system.
- Development of heterogeneity of market participants.
- Development of a reliable yield curve.
- Better intermediation between savers and investors.
- Avenues for long-term saving.
- Supply of long-term funds for investment.

TYPES AND FEATURES OF DEBT INSTRUMENTS:

	Market	Feature	Issuers
Long Term	Bonds	Long-term obligations to make a series of fixed payments	Governments, firms
	Convertible	Bonds that can be swapped for equity at pre-specified conditions	Firms

	Asset based securities	Securitized "receivables" presenting future streams of payments	Financial institutions, firms
	Preferred stock, subordinated debt	Debt and equity hybrid	Firms
Medium term	Notes	Medium-term obligations	Governments
	Floating-rate notes	Medium-term instruments with interest rates based on LIBOR or another index	Firms
Short term	Bills	Short term obligation	Governments
	Commercial paper	Short-term debt instruments	Firms
	Certificates of deposit	Short-term debt instruments	Banks

We have already studies this topic in detail in Chapter 6.

INTRODUCTION TO EQUITY INSTRUMENTS:

Equity shares, also referred to as ordinary share characterizes the form of fractional ownership.

According to explanation (i) to Section 43 of Companies Act, 2013 "equity share capital", with reference to any company limited by shares, means all share capital which is not preference share capital.

Section 43 further provides for equity share capital:

- **(i)** with voting rights, or
- **(ii)** with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed.
- **(iii)** Dividend declared by the company such additional capital shall be entitled to dividend rateably for the period commencing from the date of issue to the last day of the accounting.

The main focus of securities regulation is on the equities market because it attracts much more interest from the general public which are usually less sophisticated than professional or institutional investors. This market trades shares of common stocks issued by corporations.

In simple words,

EQUITY SHARE is:

(a) share or class of shares whether or not the share carries voting rights,

(b) any warrants, options or rights entitling their holders to purchase or acquire the shares referred to under (a),

or

(c) other prescribed securities.

An equity share is a perpetual liability because it signifies an owners legal demand upon the assets of the entity in which the equity share if held.

TYPES OF EQUITIES SHARES:

(1) Common Stock:

Majority of Corporations issue a stock that has the last claim on the corporation's assets. It is the first security to be issued and the last to be discharged. Common stock signifies the chief ownership of a corporation and usually is the only concern that has a vote in managing the corporation. In case of bankruptcy, bond holders and preference shareholders are to be paid first. Common stock owners are the last one to be considered, in the event the corporation becoming bankrupt or is in case of liquidation. Common stock is that privilege stock that can vote for the members of the board of directors of a corporation.

(2) Preferred Stock:

Preferred stock holder does not have any voting rights and is often retired after a certain period of time, usually about 10 years. The word preferred in its type are associated with the "preference" comes in that these shares are entitled to dividend payments or claims on assets in the case of bankruptcy before any payment to the common stock holders, but still only after all bondholders have been paid. Dividends are increasing for such stocks but at a diminishing rate. Dividends are a distributed to stockholders declared by a corporation's board of directors depending upon the profits. Dividends may be declared either in cash or additional stock. Cumulative means that if a dividend payment is missed because there are no profits to pay the dividend, the preferred stock holders must be paid all missed dividends before the common stock holders can be paid anything. Preferred stock can

...lso be issued in a form known as convertible preferred stock, ...hereby it can also be altered into common stock (much like a ...onvertible bond). When a convertible preferred stock is issued it ...sually has voting rights equal to the terms of convertibility.

Classes of Stock:

Every now and then a corporation will issue more than one class of common stock. The difference between the classes is usually based upon their voting rights. Some classes have superior (called weighted) voting rights. Some classes have no voting rights at all.

Different classes are usually labelled by letters such a class A or class B.

(a) **Stock Splits:** A stock split occurs when a company divides its shares. The split has no effect on the company's net worth or the value of the shareholder's investment. A split just spreads the investment over more shares. For example, if a corporation with 1 million shares outstanding should increase that number to 2 million, then it would be said that the corporation split the shares 2 for 1 and the price of the share would be divided by 2.

E.g.: Indian Railway Catering and Tourism Corporation (IRCTC) has announced a stock split that will divide its shares into five equity shares. Face Value of share was dropped down from Rs. 10/- each to Rs 2/- each.

(b) **Reverse Stock Split:** A reverse stock split, on the other hand, reduces the number of shares and increases the price of the stock. Some exchanges require a minimum stock price to be listed and a reverse split may be done to comply with this requirement. Very low priced shares are frequently referred to as "penny stocks", even though they may be selling for more than that and are not very well regarded by the investment community. A reverse stock split would raise the price of the stock and perhaps the profile of the company in the market place. Reverse stock splits may indicate that a company is in financial trouble.eg General Electric underwent a 1-for-8 reverse split, meaning that investors got one share for every eight owned. Reverse stock split was done so as to get the price of stock in alignment with its peer organizations.

(c) **Dividends:** Dividends, earnings from stocks, are declared by the board of directors and usually paid in either cash or additional shares. A corporation's dividend policy depends upon such factors as cash position, growth prospects, stability of earning, capital spending needs and reputation. Many investors purchases stocks because of the company's dividend history and rely on the cash distributions for income. Usually, the larger and older companies pay dividends in cash and the smaller and newer companies pay dividends, if they pay them at all, in additional shares. Subsequently cash dividends are paid out of current earnings of the company, the smaller and newer companies that find it necessary to retain the cash for future growth cannot afford to pay cash dividends. Dividends may also be paid in the form of other property, such as shares in another company such as a subsidiary. E.g.: Mining major Vedanta Limited has announced a first interim dividend of Rs 18.50 per share. BPCL, CoalIndia, ITC, HUL are large cap dividend stocks in India.

(d) **Ex-Dividend:** A stock is said to be selling ex-dividend when the dividend declared by the company is not available to the purchaser of the stock. The dividend is usually not available to the purchaser because the stock was bought too late for the purchaser to be the record holder of the security on the date necessary to receive the dividend (the record date).

On days when a stock trades ex-dividend, its market price is reduced by the amount of the dividend. The purchaser buys at the price of the stock minus the price of the dividend.

(e) **DRIPS:** Dividend Re-Investment Plans, or DRIPS as they are commonly known, are plans that are sponsored by most large companies. These plans allow the shareholder to reinvest all cash dividends directly into the purchase of additional shares of the corporation. These shares are purchased directly from the corporation in the primary market. The reinvestment is automatic and handled by the corporation. No share certificates are issued, the shares are book entry holdings, and usually include fractional shares that could not be purchased in the secondary market.

(f) **Treasury Stock:** Shares that have been issued to the public in the primary market and then repurchased by a company from its shareholders in the secondary market are referred to as treasury shares because they are returned to the treasury of the company. These shares have no voting rights, receive no dividends and are not used in the computation of earnings per share in the corporation's financial records. The corporation may use treasury stock for employee stock purchase plans, to fund executive stock options or bonuses, as a vehicle to acquire the assets of another corporation through an exchange of stock tender offer, or simply as an investment because the board of directors believes that the stock is under-priced and may even be below book value. Treasury stock, or the acquisition of treasury stock, may also be used as a defence against a raid on the company. By taking a large amount of stock out of the market, the management would have greater control because treasury stock cannot be voted against management.

(g) **Depository Receipts:** Depository receipts evidence shares of a corporation that is incorporated outside the country in which the receipts are traded. So, for example, a company domiciled in Japan (SONY) could list on the Jakarta Stock Exchange through the use of Indonesian depository receipts and be traded on the Jakarta market. Depository receipts are usually named after the country in which they sell and are usually referred to by an acronym made up of the first letter of the selling country followed by DR for depository receipts, so if an Indonesian would buy Sony IDRs.

CHARACTERISTICS OF EQUITY SHARES:

- Equity shares, have voting rights at all general meetings of the company. These votes have the effect of the controlling the management of the company.
- Equity shares have the right to share the profits of the company in the form of dividend (cash) and bonus shares. However even equity shareholders cannot demand declaration of dividend by the company which is left to the discretion of the Board of Directors.
- When the company is wound up, payment towards the equity share capital will be made to the respective shareholders only after payment of the claims of all the creditors and the preference share capital.
- Equity shareholders enjoy different rights as members under the Companies Act, 2013 such as:

(a) The right to vote on every resolution placed before the company – (Section 47).

(b) The rights to subscribe to shares at the time of further issue of capital by the company (Primitive Right) – (Section 62).

(c) Right to appoint proxy to attend and vote at the meeting on his behalf – (Section 105).

(d) Right to receive copy of annual accounts of the Company – (Section 136).

(e) Right to receive notice of the meeting of members – (Section 101).

(f) Right to inspection of various statutory registers maintained by the company.

(g) Right to requisition extraordinary general meeting of the company – (Section 100).

RISK RETURN TRADE-OFF:

- Low risks are connected with low potential returns. High risks are also linked with high potential returns.
- The risk return trade-off is an effort to achieve a balance between the desire for the lowest possible risk and the highest possible return. The risk return trade-off theory reflects "A higher standard deviation means a higher risk and therefore a higher possible return."
- Higher risk is associated with greater probability of upper return and lower risk with a greater probability of smaller return. This trade off which an investor faces between risk and return while considering investment decisions is called the risk return trade off.

TECHNIQUES FOR MANAGING RISK-RETURNS:

Diversification:

- Diversification is a risk-management technique that mixes a wide variety of investments within a portfolio in order to minimize the impact that any one security will have on the overall performance of the portfolio.
- Diversification essentially lowers the risk of your portfolio. It helps to spread portfolio among multiple investment vehicles such as cash, stocks, bonds, mutual funds, and perhaps even some real estate. It also helps to vary the risk in securities.

Asset allocation:

- Asset allocation is an investment portfolio technique that aims to balance risk and create diversification by dividing assets among major categories such as bonds, stocks, real estate, and cash.
- Each asset class has different levels of return and risk, so each will behave differently over time. At the same time that one asset is increasing in value, another may be decreasing or not increasing as much.
- Determining the proper mix of investments in portfolio is extremely important. Deciding what percentage of portfolio to be put into stocks, mutual funds, and low risk instruments like bonds and treasuries is difficult to measure.

REPO TRANSACTIONS:

- Repo or Reverse Repo are transactions or short term loans in which two parties agree to sell and repurchase the same security. They are usually used for overnight borrowing.
- Repo/Reverse Repo transactions can be done only between the parties approved by RBI and in RBI approved securities viz. Central and State Government Securities, T-Bills, PSU Bonds, FI Bonds, Corporate Bonds etc.
- Under repurchase agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Correspondingly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date at a predetermined price. Such a transaction is called a Repo from seller of the securities perspective and Reverse Repo from buyer's perspective of the securities.

INTRODUCTION TO DERIVATIVES:

Derivative is a product whose value is derived from the value of one or more underlying asset. The underlying asset can be equity, forex, commodity or any other asset.

DEFINITION OF DERIVATIVES:

In the Indian context the Securities Contracts (Regulation) Act, 1956 (SC(R)A) defines "derivative" to include-

A contract which derives its value from the prices, or index of prices, of underlying securities.

Derivatives are securities under the SC(R)A and hence the trading of derivatives is governed by the regulatory framework under the SC(R)A.

CHARACTERISTICS OF DERIVATIVES:

(1) **Value Driven:** Derivatives are the financial products which derive their value from certain underlying asset such as stocks, bonds, commodities etc. Derivatives are priced on the basis of the underlying asset.

(2) **Trading:** Derivatives are traded both in Exchange & OTC market. The authorized nature of these products is very different as well as the way they are traded, though many market participants are active in both.

(3) **Future Delivery:** Derivatives are contract for future delivery of assets at price agreed at the time of the contract. The quantity and quality of the asset is detailed in the contract. The buyer of the asset will make the cash payment at the time of delivery.

(4) **Hedge against risk:** Derivatives were introduced to minimise the risk. Derivatives help to hedge risk of volatility in market.

(5) **High returns:** Derivatives were advanced primarily to manage offset, or hedge against risk but now they are targeted towards generating high potential returns.

NEED FOR DERIVATIVES:

Financial transactions are fraught with several risk factors. Derivatives are instrumental in isolating those risk factors from traditional instruments and shifting risks to those entities that are ready to take them. Some of the basic risk mechanisms in derivatives business are:

- **Credit Risk:** When one of the two parties fails to perform its role as per the agreement, this is called the credit risk. It is also referred as default or counterparty risk varying with different sources.
- **Market Risk:** Such kind of risks takes place due to the adverse price movements of the underlying variable or instrument.
- **Liquidity Risk:** When a firm is incapable to plan a transaction at current market rates, it can be referred to as liquidity risk.
- **Legal Risk:** Legal risk arises due to change in legal proceedings due to unstable legal environment.

WAYS DERIVATIVES ARE USED/FUNCTIONS OF DERIVATIVE MARKETS:

There are different ways through which the derivatives are used:

(1) **To hedge risk:** Some of the investors have argued that, the derivative instruments are used for the risk management and basically to hedge the risk in the market, that if there is a risk in the market or there is price risk or there is a reinvestment risk in the market and we can hedge this kind of price risk on the reinvestment risk for that particular asset in the market by taking a position in the future market, which is basically a virtual market which is not existing and that will be materialized only after a certain period and they generally take the position in such a way that and they take the position on the basis of their predictive power on that basis, they can hedge the risk what they are going to face today. And this risk can be offset to the particular risk, what they are going to face today and what is the risk they are going to face in that particular date. Therefore, they generally hedge their risk by taking a position in the future market, depending upon the moments of the fundamental factors or fundamental assets on which this particular derivative is relied, derivative is derived.

E.g.: Aarnav bought 100 shares of Tata Motors which is say currently trading at Rs. 285 so he has to invest total sum amount of (Rs. 285 × 100 shares = Rs. 28,500)

Now he has 2 possibilities either to be optimistic or be a pessimistic. If he is optimistic about share he can hold it for long term. In case Tata motors fails to give expected results and he felt that share price will fall to Rs. 250 which means he can suffer a loss. Rather than investing in shares Aarnav could have purchased put options to hedge against shares.

(2) **To Speculate:** To speculate it one can gain something from the market is because that the interest rate is going down or going up, the price can go up to 10 rupees, but his prediction is price may go above the 10 rupees. Therefore, some of the people say that the derivative instruments are used to speculate in the market.

(3) **To lock in an arbitrage profit:** To lock in an arbitrage profit, if there is arbitrage opportunity, the price of the single product

cannot be have cannot have the different price in different markets at the same time. But, to lock this particular arbitrage profit in a particular time, what an investor does? He takes a position in the future market that is why, they can lock the arbitrage profit by which this price realization or the return maximization can be taken place.

(4) **To change the nature of the liability:** To change the nature of the liability, on the basis of the future liability, what the investor has and to change the nature of an investment without incurring the cost of selling one portfolio and buying another. It is basically one way of the general notion or general notion of use of the derivative instruments in the financial market.

ADVANTAGES OF DERIVATIVES:

(1) **Minimisation of Risk:** Derivatives were introduced with the aim of minimising the risk. With the proper application of contracts one can diminish risk of losses and take advantage of fluctuations by maximising the profit.

(2) **Maximisation of Profit:** With the use of Derivatives, by exercising the option at right time one can hedge the risk. By right prediction one can maximise the profit by exercising contract at a right time at a right price.

(3) **New Investment Avenue:** There was a scope in stock market for a kind of insurance product, a product which will provide returns with protection of risk. By the innovation of derivatives, market got an investment avenue which will earn them better return. So an investor rather than purchasing stock directly, he can deal with that stock by purchasing a derivative contract by which he will be indirectly investing in underlying product.

(4) **Increase in turnover:** Turnover of F&O market is highest as compared to equity trading. Turnover of index futures is Rs. 17,214.58 crores as of 1st June, 2010.

(5) **Attracting untapped population:** With the increase in awareness about derivatives contracts many individual investors who were hesitating to invest in market just because of their low risk appetite are now investing in market.

DISADVANTAGES OF DERIVATIVES:

(1) **Generation of Hot money:** With money changing hands with exercising of option by investors, more hot money is generated in market.

(2) **Encouragement to speculation:** Generation of hot money is giving encouragement to speculation activities in market thus making market.

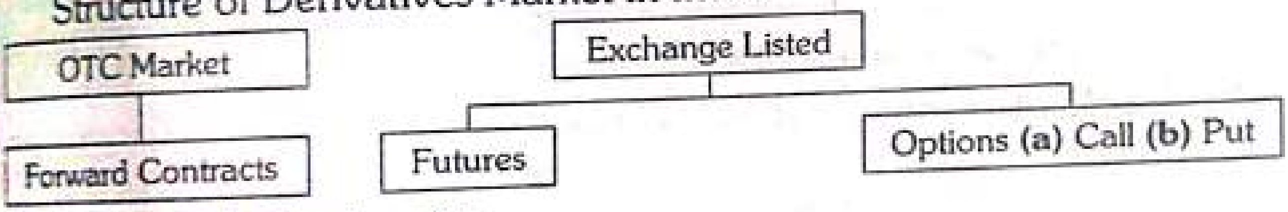
(3) **Unstable Market:** Speculation & Hot money goes hand in hand encouraging more number of speculators & discouraging long term investors, resulting in an unstable market all over.

(4) **No physical delivery:** Derivatives are settled on cash basis. No physical delivery of underlying assets takes place.

DERIVATIVES CONTRACTS:

Derivatives help to hedge risk of investors due to market fluctuations. There are various types of derivatives products available in market it depends upon the customer which investment option it wants to invest. There are contracts like Forwards, Futures, Options, Swap etc. Every contract has its own specifications. It is only investor's decision which type of contract is best suitable for him.

Structure of Derivatives Market in India:



(1) Forward Contracts:

A forward contract is an agreement to buy or sell an asset on a specified date for a definite price. One of the parties to the contract accepts a long position and agrees to buy the underlying asset on a certain specified future date for a definite specified price. The other party assumes a short position and decides to sell the asset on the same date for the same price. Other contract details like delivery date, price and quantity are negotiated bilaterally by the parties to the contract. The forward contracts are usually traded outside the exchanges. Example of farmer can be treated as forward contract.

Features of Forward Contracts:

(1) **Bilateral contract:** Contract is an agreement between the two parties. Buyer and Seller both plays an important role in forward contract to make it implemented.

(2) **Counter Party risk:** As this contract involves two parties thus there is exposure of counter party risk wherein one party can defraud the other.

(3) **Unique:** Forward contracts are customised in nature made in accordance with the consent from both the parties. Consent could be obtained in relation to a predetermined price, maturity date, underlying asset, payment mode etc.

(4) **Compulsory Settlement:** On date of the expiry a forward contract has to be settled that means buyer has to take possession of underlying asset. Even though if both the parties wishes to extend the contract they can do so only by settling previous contract & then starting with a new one.

(5) **Standardised:** Forward contracts are not standardised they differ from parties to parties.

(6) **Trading:** Forward contracts are traded in OTC (Over the counter) market. There is no specific exchange where forwards are listed as contracts are not standardised in nature.

Limitations of Forward Markets:

(1) **Counterparty risk:** Although derivative product means a product which help to hedge all types of risk but then too forward being a derivative product is exposed to counter party risk just because it is not standardised one.

(2) **Lack of centralization of trading:** As forward contracts are traded in OTC market there is lack of centralisation. There is no proper central authority where frauds in these types of contracts could be handled.

(3) **Lack of transparency:** Due to trading being taken place in OTC market there is lack of transparency in these types of contracts.

(4) **Illiquidity:** Forwards are bilateral contracts which are not listed on any exchange & are exposed to counter party risk. If whichever party fails to execute the contract it led to illiquidity.

Although all limitations in forward contracts can be overcome but there is no solution to counter party risk. With limitations in these contracts a need arise in the market for a hedging product which is much more stabilised.

(2) Future Contracts:

A futures contract is an agreement among two parties to buy or sell an asset at a certain time in the future at a certain price. In contrast to forward contracts, the futures contracts are standardized and exchange traded. To enable liquidity in the futures contracts, the exchange stipulates certain standard features of the contract. It is a standardized contract with standard underlying instrument, a standard quantity and quality of the underlying instrument that can be delivered, and a standard timing of such settlement. A futures contract may be balance prior to maturity by entering into an equal and opposite transaction. Further 99% of futures transactions are offset this way.

Features of Future Contracts:

(1) **Exchange Traded:** Futures contracts are listed on exchange and traded like other investment products.

(2) **Settlement:** Futures contracts are settled before the maturity date on "Marked to Market" basis. In Marked to Market (MTM) prices of contract are marked with market price on daily basis.

(3) **Transparency:** Future contracts are transparent as they are standardised and are listed on exchange.

(4) **Integrated Price:** As future contracts are listed on exchange, stability & transparency in price is being maintained.

Forwards v/s Futures:

Forward and Futures work on same grounds but still there are many differences between these contracts which are as follows:

Features	Forward	Futures
Operational Mechanism	Traded directly between two parties (not traded on the exchanges).	Traded on the exchanges.
Market	Traded in OTC (Over the counter) Market.	Traded on exchange.
Contract Specifications	Differ from trade to trade.	Contracts are standardized Contracts.
Counter-party risk	Level of existence is high.	Risk exists but clearing corporation becomes counterparty & helps in settlement. Chances of default are nil.

Liquidity	Less Liquid.	More Liquid.
Settlement	At the end of maturity period.	Follows daily settlement.
Centralisation	Customised due to which it is decentralised.	Listed on exchange resulting in centralisation of authority.
Examples	Currency market in India.	Commodities futures, Index. Futures and Individual stock Futures in India.

(3) Options:

In a futures contract, the two parties to the contract have dedicated themselves to doing something at a future date. The transaction has to be settled on a future date whether it is profitable or not. To overcome this limitation and to have this privilege of doing the transaction at a future only if it is a profitable, Options were introduced in market.

Options provides the holder or buyer of the option the right to do something. An option contract is an arrangement between two parties to buy or to sell an asset (a stock) at a fixed price and a fixed date in the future. This financial instrument is called an option because the buyer has the right but not the obligation to carry out the transaction. If, over the life of the contract, the asset value decreases, the buyer can simply decide not to exercise his or her right to buy or sell the asset.

There are two types of option:

Option	
Call Option	**Put Option**
(1) Right to Buy **(2)** No Obligation to Buy	**(1)** Right to sell **(2)** No Obligation to sell

If the option is a call option, the buyer or holder has the right to buy the number of shares mentioned in the contract at the agreed strike price.

If the option is a put option, the buyer of the option has a right to sell the number of shares mentioned in the contract at the agreed strike price. The holder of the buyer does not have to exercise this right. Therefore on the expiry of the day of the contract the option may or may not be exercised by the buyer.

- Call options provides the buyer the right to buy the underlying asset.

Put options provides the buyer the right to sell the underlying asset.

SUMMARY

- Owned capital is raised by issue of shares and ploughing back of profits.
- Borrowed capital is raised by issuing debentures, public deposits and loans from industrial and financial institutions.
- According to explanation (i) to Section 43 of Companies Act, 2013 "equity share capital", with reference to any company limited by shares, means all share capital which is not preference share capital.
- According to the Companies Ordinance 1984 a company can raise capital by issuing equity or ordinary shares only. The equity shares are permanent source of capital.
- The National Stock Exchange (NSE), established in 1994, has a higher turnover in the cash segment in terms of value as well as trades than the Bombay Stock Exchange (BSE) established in 1875.

QUESTIONS

1) **Multiple Choice Questions (MCQs):**

(a) __________ capital is raised by issue of shares and ploughing back of profits.
(i) Owned Capital (ii) Borrowed Capital (iii) Fixed Capital (iv) Floating Capital

(b) __________ capital is raised by issuing debentures, public deposits and loans from industrial and financial institutions.
(i) Owned Capital (ii) Borrowed Capital (iii) Fixed Capital (iv) Floating Capital

(c) A __________ holder is the creditor of the company.
(i) Equity (ii) Preference share (iii) Debenture holder (iv) Bonus issue

(d) A __________ occurs when a company divides its shares which does not affect the company's net worth or the value of the shareholder's investment.
(i) Stock holding (ii) Stock spilt (iii) Bonus shares (iv) Right issue

(e) __________ are plans that are sponsored by most large companies.
(i) ESOP (ii) DRIPS (iii) Dividend (iv) Bonus shares

(f) __________ markets supply long-term funds for the growth of the infrastructure or other sectors to fulfil long-term investment needs.
(i) Debt (ii) Equity (iii) International (iv) Financial

(g) Debt instruments which have a maturity of less than 1 year at the time of issue are called __________ instruments.
(i) Debt (ii) Equity (iii) Money Market (iv) Financial

(h) __________ are money market instruments, i.e., short-term debt instruments issued by the Government of India, and are issued in three tenures 91 days, 182 days, and 364 days.
(i) Debt (ii) Money bill (iii) Capital market (iv) Treasury bills

(i) Yield to maturity __________.
(i) is current price of a bond (ii) is coupon payment of a bond (iii) is related to price of a bond (iv) is principal amount of bond

(j) __________ is a product whose value is derived from the value of one or more underlying asset.
(i) Debenture (ii) Equity (iii) Insurance (iv) Derivative

(k) Equity derivatives are derivative instruments with underlying assets based on __________. *(Oct. 18)*
(i) Equity securities (ii) Preference securities

(l) __________ is the person who buys the right conveyed by the option. *(Oct. 18)*
(i) Option Holder (ii) Future

(m) __________ are in business to take advantage of discrepancy between prices in two different markets. *(March 19)*
(i) Arbitrageurs (ii) Brokers

***[Ans.:** (a – i), (b – ii), (c – iii), (d – i), (e – ii), (f – i), (g – iii), (h – iv), (i – ii), (j – iv), (k – i), (l – i), (m – i)]*

(2) Fill in the blanks:

(a) A put option contains the right to __________ a futures contract.

(b) __________ reduces the number of shares and increases the price of the stock.

(c) __________ increases the number of shares and reduces the price of the stock.

(d) __________ help to hedge risk of investors due to market fluctuations.

(e) __________ represent claims for the payment of a sum of money sometime in the future and/or a periodic payment in the form of interest or dividend.

(f) __________ represent promise to pay some portion of prospective income and wealth to others.

(g) A __________ also referred to as an instrument of indebtedness, can be in the form of a note, bond, or loan.

(h) A stock is said to be selling __________ when the dividend declared by the company is not available to the purchaser of the stock.

(i) __________ shares are purchased directly from the corporation in the primary market.

(j) __________ are instruments that are directly issued by the ultimate investors to the ultimate savers.

***[Ans.: (a)** Sell, **(b)** Reverse Stock split, **(c)** Stock Split, **(d)** Derivatives, **(e)** Financial assets, **(f)** Financial liabilities, **(g)** debt instrument, **(h)** ex-dividend, **(i)** Dividend Re-Investment Plans, **(j)** Primary instruments]*

(3) True or False:

(a) The corporate debt market in India basically comprises PSU bonds and private sector bonds.

(b) The benefits of debt markets include diversifying credit risks across the economy by providing an alternative to conventional bank lending.

(c) The exchange-traded interest rate derivatives are yet not introduced.

(d) T-Bills are issued at a discount and are redeemed at face value on maturity.

(e) A certificate of deposit (CD) represents a negotiable receipt of funds deposited in a bank for a fixed period.

(f) CP is not sold at a discount and redeemed at par.

(g) Forward and future derivative contract are of same nature.

(h) Option premiums are set at predetermined levels by the exchange.

(i) If a person is a "bull", then they expect prices to rise. *(Oct. 17)*

(j) Options contracts are on the underlying futures contract and not the commodity itself.

(k) Equities don't represent the ownership in a company. *(Oct. 18)*

(l) Hedger don't face risk associated with the price of an asset. *(Oct. 18)*

(m) Speculators wish to bet on future movements in the price of an assets. *(Oct. 18)*

(n) SWAPS are private agreements between two parties to exchange cash flows in the future according to pre-arranged formula. *(March 19)*

[Ans.: (a) True, (b) True, (c) False, (d) True, (e) True, (f) False, (f) False, (g) False, (h) True), (i) True, (k) False (l) False, (m) True, (n) False]

Match the columns:

Group "A"		Group "B"	
(a)	G-sec	(i)	90 to 180 days
(b)	T-Bills	(ii)	Negotiable instrument
(c)	CD	(iii)	Zero interest securities
(d)	Commercial Paper	(iv)	RBI
(e)	Derivative *(March 18)*	(v)	Dividend Re-Investment
(f)	DRIPS	(vi)	Hedging
(g)	Stock spilt	(vii)	Reduces the number of shares and increases the price of the stock
(h)	Reverse stock spilt	(viii)	Division of shares

[Ans.: (a – iv), (b – i), (c – ii), (d – iii), (e – vi), (f – v), (g – viii), (h – vii)]

Explain various sources of capital in an organization. ***(Oct. 17; March 18)***

Explain characteristics of financial instruments. ***(Oct. 17)***

What are the various classes of stocks available in the financial market?

Which are the various participants involved in Equity Market?

Describe in short current status of equity market in India.

What is the current status of debt market in India?

Why existence of debt market is important in capital market? Elaborate it following its features.

What are the various Money market instruments?

What are the various Government securities and government-guaranteed bonds?

What are the various types of Government securities?

What are the various types of bonds?

What are the various Features of bonds?

Elaborate the role of corporate debt market in economic development.

What are the recent developments in corporate debt market?

Explain in detail the Importance of development in corporate debt market.

Explain how Derivatives are used. ***(Oct. 17)***

Explain Forward v/s Futures contracts. ***(Oct. 17)***

Explain classification of financial instruments in detail. ***(Oct. 18)***

What is financial instrument? Explain different types of financial instrument. ***(March 19)***

What is Derivative market? What are the benefits of derivative markets with reference to India? ***(Oct. 18)***

Explain derivative markets in India. What are its types? ***(March 19)***

What is future contracts? Explain its features. ***(March 19)***

Write a note on functions of derivative markets. ***(March 19)***

Write short notes on:

(a) Derivative contracts.

(b) DRIPS. ***(March 18)***

(c) REPO transactions.

(d) Owned and borrowed capital.

UNIT – IV: FINANCIAL SERVICES

Chapter 8

FINANCIAL SERVICES

- Introduction
- Merchant Banking and Commercial Banking
- Scope / Services Offered by Merchant Bankers
- Progress of Merchant Banks
- Corporate Advisory Services
- SEBI Guidelines for Merchant Banker in India
- Problems / Challenges Faced by Merchant Bankers
- Karvy Investor Services Limited
- Summary
- Questions

INTRODUCTION:

Financial services refer to services delivered by the finance industry. The finance industry comprises of a broad range of organizations dealing with the management of money. These organizations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises. Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities.

Merchant banking is a kind of financial service which implies investment management. Companies raise capital by issuing securities in the market. Merchant bankers act as intermediaries between the issuers of capital and the investors who purchase these securities. Merchant banking is the financial intermediation matching the entities that need capital and those that have capital for investment.

As planning and industrial policy envisaged the setting up of new industries and technology, greater financial sophistication and financial services are required. According to Goldsmith, there is a well proven link between economic growth and financial technology. Economic development requires specialist financial skills: savings banks to marshal individual savings; finance companies for consumer lending and mortgage finance; insurance companies for life and property cover; agricultural banks for rural development; and a range of specialised government or government sponsored institutions. With the growth of industrial units, the additional requirement of capital is required, which cannot be fulfilled by banks or by raising sources from private sources. Like the local banking system and the trade before, the local system of family enterprises was unsuited for raising large amounts of capital. Public equity or debt issue was the logical source of funds.

Merchant banks serve a dual role within the financial sector. Through deposits or sales of securities, they obtain funds for lending to their clients (SEBI forbids lending by them): a function similar to most institutions. Their other role is to act as agents in return for fee. SEBI visualizes a mandatory role for merchant banks in exercising due diligence apart from issue management, in buy-backs and public offer in takeover bids. Their underwriting and corporate financial services are all fees rather than fund based and their importance is not reflected in their total assets of the industry. SEBI has been pressing for merchant banks to be primarily fee based institutions.

MERCHANT BANKING AND COMMERCIAL BANKING:

(1) Commercial banks serve the requirements of the general public, like individuals, small-scale entrepreneurs and so on. Though, merchant banks, commonly called as investment banks tend to serve mostly the needs of large corporations or very rich people.

(2) Commercial banks verify and uphold savings accounts of individuals; provides loans and mortgages to individuals or small-scale businesses. But, merchant banks operate as fiscal consultants to large-scale companies.

(3) Commercial banking is easily accessible to everyone for elementary banking requirements, whereas merchant banking is concerned to hand out mainly large corporations and very wealthy persons.

(4) An investment bank does not have an inventory of cash deposits to lend as a commercial bank does. The core role of an investment bank is to acts as an intermediary, and matches sellers of stocks and bonds with buyers of stocks and bonds.

(5) Investment banks underwrite stock offerings just as they do bond offerings. In the course of issue of shares, a company sells a portion of the equity/ownership of itself to the investing public. The very first time a company chooses to sell equity, this offering of equity is transacted through a process called an initial public offering of stock. Commercial banks legally underwrite debt, and some of the largest commercial banks have developed significant expertise in underwriting public bond deals. So, not only do these banks make loans utilizing their deposits, they also underwrite bonds through a corporate finance department.

SCOPE / SERVICES OFFERED BY MERCHANT BANKERS:

The services provided by merchant bankers include management of mutual funds, public issues, trusts, securities and international funds. It involves dealing with the corporate clients and advising them on various issues like- mergers, acquisitions, public issues, etc.

(1) **Management of debt and equity offerings:** The main function of the merchant banker is to manage its debt and equity ratio. Banker also assists the companies in raising funds from the market. The undertaking tasks include instrument designing, pricing the issue, registration of the offer document, underwriting support, marketing of the issue, allotment and refund and listing on stock exchanges.

(2) **Placement and Distribution:** The merchant banker benefits in allocating various securities like equity shares, debt instruments, mutual funds, insurance products, and commercial paper, to name a few. The distribution network of the merchant banker can be classified as institutional and retail in nature. The institutional network comprises of mutual funds, foreign institutional investors, private equity funds pension funds, financial institutions, etc.

(3) **Advisory services:** Merchant bankers offer customized solutions to their clients' financial problems. Financial structuring includes determining the right debt-equity ratio and the framing of appropriate capital structure theory.

(4) **Project advisory services:** Merchant bankers help their clients in various stages of the project undertaken by the clients. They assist them in conceptualizing the project idea in the initial stage. Once the idea is formed, they conduct feasibility studies to examine the viability of the proposed project.

(5) **Loan Syndication:** Merchant bankers arrange to tie up loans for their clients. This takes place in a series of steps. Firstly, they analyse the pattern of the client's cash flows, based on which the terms of the borrowings can be defined. Then the merchant banker formulates a detailed loan memorandum, which is spread to various banks and financial institutions and they are invited to participate in the syndicate. The banks then negotiate

the terms of lending on the basis of which the final allocation is done.

(6) **Providing venture capital financing:** Merchant bankers aids companies in obtaining venture capital financing for financing their new and innovative strategies.

PROGRESS OF MERCHANT BANKS:

(1) Setting up of Banks Subsidiaries.

(2) Re-organization of Private Firms.

(3) Establishment of SUA.

(4) Securities and Exchange Board of India (SEBI).

(5) Discount and Finance House of India (DFHI).

(6) Credit Rating Information Services of India Ltd. (CRISIL).

(7) Stock-Holding Corporation of India Ltd. (SHC).

(1) **Setting up of Banks Subsidiaries:** In competitive era of the growing demand for broad-based financial services from the corporate sector more effectively, the merchant banking divisions of the nationalized Banks have started establishing independent subsidiaries. These subsidiaries offer more specialized services with professional expertise and skills. SBI Capital Markets Ltd. was incorporated as the first such subsidiary of SBI on 2nd July, 1986. Then Canara bank Financial Services Ltd. was set up as wholly owned subsidiary of Canara Bank in 1987. PNB Capital Services Ltd. was promoted by PNB during mid-1988. Many more subsidiaries are being set up by other nationalized banks.

(2) **Re-organization of Private Firms:** Imagining tough competition from increasing number of merchant banking subsidiary companies of nationalized banks, private merchant bankers have also started restructuring their activities e.g., J.M. Financial & Investment Consultancy Ltd., LKP Merchant Financing Ltd. etc. are some of the private sector firms of merchant bankers who have taken steps to change their activities.

(3) **Establishment of Stockbroker Underwriters Association:** In view to educate and protect the interest of investors, to provide information about new issues of capital market, to develop a code of conduct for underwriters and to concentrate

legal and other services to members and public, the Stockbroker Underwriters Association (SUA) was established in 1984. SUA works in co-ordination with merchant bankers and proceeds towards the stages for promoting the activities of capital market.

(4) **Securities and Exchange Board of India (SEBI):** Merchant banks serve a dual role within the financial sector. Through deposits or sales of securities they obtain funds for lending to their clients (SEBI forbids lending by them): a function similar to most institutions. Their other role is to act as agents in return for fee. SEBI visualizes a mandatory role for merchant banks in exercising due diligence apart from issue management, in buy-backs and public offer in takeover bids.

(5) **Discount and Finance House of India (DFHI):** DFHI was incorporated as a company under the Companies Act, 1956 with an authorized and paid up capital of Rs. 100 crores, where by, Rs. 51 crores has been funded by RBI, Rs. 16 crores by financial institutions and 33 crores by public sector banks. It would also have appearances of credit from public sector banks; refinance facility from the Reserve Bank of India to meet the working capital requirements. DFHI targets at providing liquidity in money market as it deals largely in commercial bills.

(6) **Credit Rating Information Services of India Ltd. (CRISIL):** CRISIL has been set up in 1987 to deliver help to investors, merchant bankers, underwriters, brokers, banks and financial institutions etc. CRISIL rates various types of instruments such as debt, equity and fixed return securities offered to the public. It supports the investors in taking investment decisions.

(7) **Stock-Holding Corporation of India Ltd. (SHC):** SHC was set up in 1986 by the All India Financial Institutions to take precaution of safe custody, delivery of shares and collect sale proceeds of the securities and to create transpar market.

CORPORATE ADVISORY SERVICES:

The literal meaning of corporate advisory services in India is the activity of advising organizations, which include corporations, institutions and Government bodies about the transactions that can change the ownership of a company or business such as mergers and acquisitions.

The requirement of corporate advisory service is increasing at a rapid rate. There are many corporate advisors providing an advisory service including corporate strategies and restructuring advices to the companies which are not well settled or facing problem in business growth.

The corporate advisory services are as follows:

- Planning and Advising for Mergers and Acquisition.
- Corporate Restructuring and Reformation.
- Financial Re-engineering.
- Business Valuation.
- Business Negotiation.
- Equity Divestments.
- Strategic Sale.

Planning and Advising for Mergers and Acquisition:

The role of Merchant Bankers is complementary to the role of Accountants of Financial Consultants. He has to advise the management about the commercial soundness of the merger plan. He also advices on the status of legal requirements and helps in the preparation of offer documents and circular to be sent to shareholders of both the companies. He has to ensure compliance of all formalities prescribed by SEBI.

Corporate restructuring and reformation:

Most corporate bodies that endure over an extended period need to adapt to changing circumstances. Organisations generally find it very difficult to adapt to change especially where it is severe sudden and completely unexpected. Even when changes are gradual many organisations frequently fail to recognise them and to make the necessary changes in good time.

It is these failures that lead for the need of corporate restructuring. This is normally a radical process where, following a period of intense analysis, major changes are made relating to the nature and the management of the business.

Usually these activities result in some form of major cost-cutting (normally a reduction in personnel employed) and frequently changes in the management team.

Financial Re-engineering:

Initially 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. Nowadays, merchant banker plays multiple roles which include those of an entrepreneur, a management advisor, an investment banker, and a transaction broker.

Other Corporate Advisory Services:

Merchant bankers offer customized solutions to solve the financial problems of their clients. Advice is sought in areas of financial structuring and reengineering. 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.

SEBI GUIDELINES FOR MERCHANT BANKER IN INDIA:

Regulatory framework: The merchant banking activity in India is governed by SEBI (Merchant Bankers) Regulations, 1992. Registration with SEBI is mandatory to carry out the business of merchant banking in India. An applicant should comply with the following norms:

(i) The applicant should be a corporate body.

(ii) The applicant should not carry on any business other than those connected with the securities market.

(iii) The applicant should have necessary infrastructure like office space, equipment, manpower, etc.

(iv) The applicant must have at least two employees with prior experience in merchant banking.

(v) Any associate company, group company, subsidiary or interconnected company of the applicant should not have been a registered merchant banker.

(vi) The applicant should not have been involved in any securities scam or proved guilt for any offence.

(vii) The applicant should have a minimum net worth Rs. 50 million.

PROBLEMS / CHALLENGES FACED BY MERCHANT BANKERS:

Specific discrepancies and deficiencies in the performances of Indian merchant banks have spoiled the smooth progress of capital market recently. Among thousands of SEBI's registered merchant bankers on the SEBI's register, only few of them functions effectively. The challenges faced by Merchant bankers are as follows:

- SEBI guidelines have controlled their operations of Issue Management and Portfolio Management to some extent, thereby affecting the smooth functioning of operational system.
- The net worth requirement is very high in categories I and II in particular, so many professionally experienced person/ organizations are restricted in their operations.
- Under subscription of new issues in India is dehydrating the business of the merchant bankers.
- Frequent changes in the SEBI guidelines also have been affecting the growth of merchant banking business.
- Limited range of merchant banking activities handed by public sector banks and inferior quality of the services in contrast to lending private sector merchant bankers and foreign merchant bankers is also responsible for the depression in merchant banking services.
- Innovation and Product development is one of the weak areas of the public sector banks. No attempt has been made to introduce non fund based products. This has to be taken care of if the public sector banks are to survive in a competitive environment.

Merchant Bankers in India	
c r ers	SBI Capital Markets, Punjab National Bank, IFCI Financial Services, Bank of Maharashtra, Karur Vysya Bank Ltd., State Bank of Bikaner and Jaipur
ate or kers	ICICI Securities, Axis Bank, Bajaj Capital, Tata Capital Markets, Kotak Mahindra Capital Company, Reliance Securities, Yes Bank
ign chant kers	Goldman Sachs (India) Securities, Morgan Stanley India, Barclays Securities (India), Bank of America, Citigroup Global Markets India, DSP Merrill Lynch Ltd., FEDEX Securities Ltd.

SUMMARY

- Merchant banking implies investment management. Companies raise capital by issuing securities in the market. Merchant bankers act as intermediaries between the issuers of capital and the investors who purchase these securities. Merchant banking is the financial intermediation that matches the entities that need capital and those that have capital for investment.
- Commercial banks serve the requirements of the general public, like individuals, small-scale entrepreneurs and so on. However, merchant banks, generally called investment banks tend to serve mostly the needs of large corporations or very rich people.
- The services provided by merchant bankers include management of mutual funds, public issues, trusts, securities and international funds. It involves dealing with the corporate clients and advising them on various issues like- mergers, acquisitions, public issues, etc.
- The need of corporate advisory service is increasing at a rapid gait. There are many corporate advisors providing an advisory service that includes corporate strategies and restructuring advices to the companies which are not well settled or facing problem in business growth.
- Regulatory framework the merchant banking activity in India is governed by SEBI (Merchant Bankers) Regulations, 1992. Registration with SEBI is mandatory to carry out the business of merchant banking in India.
- Karvy is well networked with 200 full-fledged branches and 350 Investor Service Centres with a workforce of over 3500 personnel drawn from various disciplines.

QUESTIONS

(I) **Multiple Choice Questions (MCQs):**

(a) Category 1 merchant bankers can act as __________. *(March 18)*

(i) Only as advisor (ii) Underwriter (iii) Consultant (iv) All issue management functions

(b) Merchant bankers are __________.

(i) Merchants (ii) Banks (iii) Neither merchants nor banks (iv) None of these

(c) Merchant banker shall not associate with any business other than that of the securities market.

(i) False (ii) True (iii) None of these (iv) All of these

(d) All type of activities which are of a financial nature is called __________. *(Oct. 17)*

(i) Financial market (ii) Primary market (iii) Capital market (iv) Financial services

(e) Find out odd one.

(i) Fund based activity (ii) Fee based activity (iii) Modern activities (iv) Purchase of raw materials

(f) A merchant bank can help an organization specifically in promotional functions, __________.

(i) Sponsoring the issue (ii) Marketing (iii) None of these (iv) All of these

(g) Role of merchant bankers __________.

(i) Mobilization of funds (ii) Promotional function (iii) Innovation (iv) All of these

(h) __________ is a financial intermediary who helps to mobilize and transfer capital from those who possess it to those who need it.

(i) Lease finance (ii) Venture capital (iii) Merchant banker (iv) Hire purchaser

[Ans.: (a – iv), (b – iv), (c – ii), (d – iv), (e – iv), (f – iv), (g – iv), (h – iii)]

(2) Fill in the blanks:

(a) __________ refer to services provided by the finance industry.

(b) Merchant banking is a kind of financial service which implies __________.

(c) __________ act as intermediaries between the issuers of capital and the investors who purchase these securities.

(d) Registration with __________ is mandatory to carry out the business of merchant banking in India.

(e) The merchant banking activity in India is governed by __________. *(Oct. 17)*

(f) __________, a SEBI registered Merchant Banker is a 100% subsidiary of Karvy Consultants Limited and is among the top 10 merchant Bankers in India.

(g) __________ is the financial intermediation that matches the entities that need capital and those that have capital for investment.

[Ans.: (a) Financial services, (b) investment management, (c) Merchant bankers, (d) SEBI, (e) SEBI (Merchant Bankers) Regulations, 1992, (f) Karvy Investor Services Limited, (g) Merchant banking]

(3) True or False:

(a) Banking services refer to services provided by the finance industry.

(b) Merchant banking is a kind of financial service which implies loan management.

(c) Lead manager act as intermediaries between the issuers of capital and the investors who purchase these securities.

(d) Registration with RBI is mandatory to carry out the business of merchant banking in India.

(e) The merchant banking activity in India is governed by AMFI. *(Oct. 17)*

(f) CAMS investor services, a SEBI registered Merchant Banker is a 100% subsidiary of Karvy Consultants Limited and is among the top 10 merchant Bankers in India.

(g) Loan syndication is the financial intermediation that matches the entities that need capital and those that have capital for investment.

(h) Financial services are offered by intermediaries.

(i) Financial services are tangible.

(j) Owned and borrowed capital can be raised by issuing various financial instruments.

[Ans.: (a) False, (b) False, (c) True, (d) False, (e) False, (f) False, (g) False, (h) True, (i) False, (j) True]

(4) **Match the column:**

Group "A"	Group "B"
(a) Financial Service	(i) Provides loans
(b) Fund based	(ii) Karvy Consultants Limited
(c) Non fund based	(iii) Financial Re-engineering
(d) Loan syndication	(iv) Credit rating
(e) Merchant banking	(v) Shares, bonds or derivatives
(f) Karvy investor service	(vi) Service offered by merchant banker
(g) Corporate advisory service	(vii) Intangible
(h) Financial instrument	(viii) Non fund based service
(i) Hedging	(ix) Leasing
(j) Commercial banks	(x) Derivatives

[Ans.: (a – vii), (b – ix), (c – iv), (d – vi), (e – viii), (f – ii), (g – iii), (h – v), (i – x), (j – i)]

(5) What do you mean by merchant banking?

(6) How merchant banking is different from commercial banking? ***(Oct. 17)***

(7) What are various services offered by merchant banker?

(8) Explain in detail various SEBI guidelines of merchant banking.

(9) State any example of merchant banker in India? What are services offered by it?

(10) Explain the meaning of Merchant Banking. Discuss various services provided by Merchant Banking. ***(March 19)***

(11) Explain in detail about progress and scope of merchant banking in India. ***(Oct. 18)***

(12) **Write a short notes on:**

(a) Merchant banking.

(b) Corporate advisory services.

(c) Karvy Investors Services Ltd.

(d) Services of Merchant Banks. ***(Oct. 18)***

(e) Problems of Merchant Bank. ***(Oct. 18; March 19)***

Chapter 9

MONEY MARKET

- Meaning of Money Market
- Characteristics of Money Market
- Players or Participants in the Indian Money Market
- Organization Structure of Money Market
- Summary
- Questions

MEANING OF MONEY MARKET:

- The flow of funds around the world may be divided into different segments, depending on the characteristics of financial claims being traded and the needs of different investors. One of the most vital divisions in the financial system is between the money market and the capital market.

- A market where short term funds are borrowed and lend is called money market. It deals in short term monetary assets with a maturity period of one year or less. Liquid funds as well as highly liquid securities are traded in the money market.

- Examples of money market are Treasury bill market, call money market, commercial bill market etc. The main players in this market are banks, financial institutions and government. In simple words, money market is a place where the demand for and supply of short term funds are met.

- According to Crowther, "*Money market is a collective name given to various firms and institutions that deal in the various grades of near money*". Money market is not a place. It is an activity. It comprises all organizations and institutions that deal in short term financial instruments. Though, sometimes geographical names are given to the money market according to the location, e.g. Mumbai Money Market.

CHARACTERISTICS OF MONEY MARKET:

The entire money market in India can be divided into two parts. It is classified into: the organized sector (comprising private, public and foreign owned commercial banks and cooperative banks, together known as scheduled banks); and the unorganized sector (comprising individual or family owned indigenous bankers or money lenders and non-banking financial companies (NBFCs)). The unorganized sector and microcredit are still preferred over traditional banks in rural and sub-urban areas, especially for non-productive purposes, like ceremonies and short duration loans.

The following are the characteristics of money market:

(1) It is a market for short term financial assets that are close substitutes of money.

(2) It is fundamentally an over the phone market.

(3) It is a wholesale market for short term debt instruments.

(4) It is not a solo market but a collection of markets for several instruments.

(5) It eases effective implementation of monetary policy of a central bank of a country.

(6) Transactions are completed without the help of brokers.

(7) It creates the link between the RBI and banks.

(8) The players in the money market are RBI, commercial banks, and companies.

(9) It is difficult for RBI to integrate the Organised and Unorganised Money Markets. Several segments are loosely connected. Thus there is dichotomy in Indian Money Market.

(10) There is lack of integration between various sub-markets as well as various institutions and agencies. There is less co-ordination between co-operative and commercial banks as well as State and Foreign banks. The indigenous bankers have their unique way of doing business.

(11) Differentials in interest rates on various instruments offered by organized and unorganized sector.

(12) In Indian Money Market demand for funds exceeds the supply. There is scarcity of funds in Indian Money Market an account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy etc.

PLAYERS OR PARTICIPANTS IN THE INDIAN MONEY MARKET:

The following are the players in the Indian money market:

(1) Government.

(2) RBI.

(3) Commercial banks.

(4) FIs like IFCI, IDBI, ICICI, SIDBI, UTI, LIC etc.

(5) Discount and Finance House of India.

(6) Brokers.

(7) Mutual funds.

(8) Public sector undertakings.

(9) Corporate units.

(10)

RGANIZATION STRUCTURE OF MONEY ARKET:

The following chart will help you in understanding the ganizational structure of the Indian money market.

Structure of Indian Money Market.

Indian Money Market

- **Organized Money Market**
  - Reserve Bank of India
  - Scheduled Commercial Banks
  - Lenders
  - Development Banks
  - Investment Institutions
  - Regional Rural Banks
  - Foreign Banks
  - State Finance Corporation, etc.
  - DFHI
- **Unorganized Money Market**
  - Indigenous Bankers
  - Domestic Money
  - Nidhis and Chit Funds
  - Traders and Friends
  - Brokers and Dealers
- **Sub Markets**
  - Call Money Market
  - Bill Market
    - Commercial Bills
    - Treasury Bills
  - 364 day Bill Market
  - CDs
  - CPs

xplanation:

) Call Money Market:

It an important sub market of the Indian money market. It is also called as money at call and money at short notice. It is also called inter bank loan market.

In this market money is demanded for extremely short period. The period of such transactions is from few hours to 14 days. It is basically situated in the industrial and commercial locations such as Mumbai, Delhi, Calcutta, etc.

These transactions help stock brokers and dealers to fulfil their financial requirements. The rate at which cash is made available is called as a call rate. Thus rate is determined by the market forces such as the demand for and supply of money.

Participants or Players in the Call Money Market:

(1) Scheduled commercial banks and RBI.

(2) Non-Scheduled commercial banks.

(3) Co-operative banks.

(4) Foreign banks.

(5) Discount and Finance House of India.

(6) Primary dealers.

(2) Commercial Bill Market:

- It is a market for the short term, self-liquidating and negotiable money market instrument. Commercial bills are used to fund the movement and storage of agriculture and industrial goods in domestic and foreign markets.
- The commercial bill market in India is still underdeveloped.
- There are specialized institutions known as discount houses for discounting commercial bills accepted by reputed acceptance houses. RBI has permitted the financial institutions, mutual funds, commercial banks and co-operative banks to enter in the commercial bill market.

(3) Treasury Bill Market:

- This is a market for sale and purchase of short term government securities. These securities are known as Treasury Bills which are promissory notes or financial bills issued by the RBI on behalf of the Government of India.
- There are two types of treasury bills. (i) Ordinary or Regular Treasury Bills and (ii) Ad Hoc Treasury Bills. The maturity period of these securities range from as low as 14 days to as high as 364 days. They have become very famous recently due to high level of safety involved in them.
- Treasury bill is used by the Govt. to raise short term funds for meeting temporary Government deficits. Thus it represents short term borrowings of the Government.
- T-Bills are issued through a bidding process at auctions. The bid can be prepared whichever competitively or non-competitively. In the second type of bidding, return required is not specified and the one determined at the auction is expected on maturity. However, in case of competitive bidding, the return required on maturity is indicated in the bid. In case the return specified is too high then the T-Bill might not be issued to the bidder.

Treasury bills are available for a minimum amount of Rs. 25K and in its multiples. While 91-day T-bills are auctioned every week on Wednesdays, 182-day and 364-day T-bills are auctioned every alternate week on Wednesdays.

NDS is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. RBI issues these instruments to curb out the liquidity from market by contracting the money supply.

Repo (Repurchase) Transaction:

Repo or Reverse Repo are transactions or short term loans in which two parties agree to sell and repurchase the same security. They are usually used for overnight borrowing.

Repo/Reverse Repo transactions can be done only between the parties approved by RBI and in RBI approved securities viz. Central and State Government Securities, T-Bills, PSU Bonds, FI Bonds, Corporate Bonds etc.

Under repurchase agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer buys the securities with an agreement to resell the same to the seller on an agreed date at a predetermined price. Such a transaction is known as Repo when observed from the perspective of the seller of the securities and Reverse Repo when viewed from the perspective of the buyer of the securities.

Certificate of Deposits (CDs):

CDs are short term deposit instruments to raise large sums of money. These are short term deposits which are transferable from one party to another. Banks and financial institutions are major issuers of CD. These are short term negotiable instruments.

It is again an important segment of the Indian money market. The certificate of deposits is issued by the commercial banks. They are worth the value of Rs. 25 lakh and in multiple of Rs. 25 lakh. The minimum subscription of CD should be worth Rs. 1 Crore.

The maturity period of CD is as low as 3 months and as high as 1 year. These are the transferable investment instrument in a money market. The government originated a market of CDs in order to broaden the range of instruments in the money market and to provide a higher flexibility to investors for investing their short term money.

- The certificates of deposits are considered much safe as returns are not known by any party.
- It enables the depositors to earn higher return on their short term surplus.
- This market provides maximum liquidity and the bank can raise money in times of need. This will improve their lending capacity.
- The market provides an opportunity for banks to invest surplus funds.
- The transaction cost of CDs is lower.
- Simply stated, it is a time deposit of specific maturity and is easily transferable. It is a document of title to a time deposit. It is issued as a bearer instrument and is negotiable in the market.
- It is payable on a fixed date. It has a maturity period ranging from three to twelve months. It is issued at a discount rate varying between 13% to 18%. The discount rate is determined by the issuing bank and the market.
- All scheduled banks except Regional Rural Banks and scheduled co-operative banks are eligible to issue CDs to the extent of 7% of deposits. It can be allotted to individuals, corporations, companies, trusts, funds and associations.
- CDs are issued by banks during period of tight liquidity, at relatively high interest rate. Banks depend on this source when the deposit growth is low but credit demand is high. They can be allotted to individuals, companies, trusts, funds, associates, and others.
- The main difference between fixed deposit and CD is that CDs are easily transferable from one party to another, whereas FDs are non-transferable.

(6) Commercial Papers (CPs):

- Commercial papers are unsecured short term promissory notes issued by reputed, well established and big companies having high credit rating.

These are issued at a discount. Commercial papers can currently be issued by primary dealers and all India financial institutions. They can be bought by individuals, banks, companies and other registered Indian corporate bodies. (Investors in CP).

Commercial paper (CP) is an investment instrument which can be issued by a listed company having working capital more than or equal to Rs. 5 cr.

There are various guidelines issued by RBI for CP: CP should be issued to investors directly or through bankers. The CP issuing company must have a net worth of not less than Rs. 5 crores. The issuing company's shares must be listed in the stock exchange. The interest on CP shall be a market determined. The issuing companies should get certification of credit rating for every six months and 'A' grading enterprises may be permitted to enter the market.

7) Inter-Corporate Deposits:

An Inter-Corporate Deposit (ICD) is an unsecured borrowing by corporates and FIs from other corporate entities registered under the Companies Act 1956. The corporate having surplus funds would advance to another corporate in need of funds.

This lending would be an uncollateralized basis and hence a higher rate of interest would be demanded by the lender. The short term credit rating of the corporate would determine the rate at which the corporate would be able to borrow funds.

Further the credit spreads demanded even for the top rated corporates would be higher than similar rated banks and the rates on ICDs would higher than those in the Certificate of Deposit (CD) market. The tenor of ICD might range from 1 day to 1 year, but the most common tenor of borrowing is for 90 days.

Primary Dealers are only permitted to borrow in the ICD market. The borrowing under ICD is restricted to 50% of the Net Owned Funds and the minimum tenor of borrowing is for 7 days.

8) Inter-Bank Participation Certificates:

Inter-Bank Participation Certificates are instruments issued by scheduled commercial banks only to raise funds or to deploy short term surplus. This instrument is issued as per RBI guidelines for two purposes:

(a) on risk sharing basis **(b)** without risk sharing

- Inter-Bank Participation without risk sharing can have tenure of 90 days only where, the issuing bank as borrowing and the participating bank advances to the banks.
- In case of risk sharing basis, the lender bank shares losses with the borrowing banks by mutually determining the interest rate.
- The tenure may be for 90 to 180 days.

(9) Bankers' Acceptance:

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

SUMMARY

- A market where short term funds are borrowed and lend is called money market. It deals in short term monetary assets with a maturity period of one year or less. Liquid funds as well as highly liquid securities are traded in the money market.
- The entire money market in India can be divided into two parts. It is classified into: the organized sector (comprising private, public and foreign owned commercial banks and cooperative banks, together known as scheduled banks); and the unorganized sector (comprising individual or family owned indigenous bankers or money lenders and non-banking financial companies (NBFCs)). The unorganized sector and microcredit are still preferred over traditional banks in rural and sub-urban areas, especially for non-productive purposes, like ceremonies and short duration loans.
- Repo or Reverse Repo are transactions or short term loans in which two parties agree to sell and repurchase the same security. They are usually used for overnight borrowing.
- CDs are short term deposit instruments to raise large sums of money. These are short term deposits which are transferable from one party to another. Banks and financial institutions are major issuers of CD. These are short term negotiable instruments.

Commercial papers are unsecured short term promissory notes issued by reputed, well established and big companies having high credit rating. These are issued at a discount. Commercial papers can now be issued by primary dealers and all India financial institutions.

QUESTIONS

Multiple Choice Questions (MCQs):

(a) Which of the following is an example of a non-banking financial institution?
(i) Commercial Bank **(ii)** RBI **(iii)** Co-operative Bank **(iv)** LIC

(b) Market for borrowing and lending of short term funds is called. ***(March 19)***
(i) Capital market **(ii)** Money market **(iii)** Gilt-edged market **(iv)** derivative market

(c) Which of the following is not a money market instrument?
(i) Commercial Paper **(ii)** Treasury Bill **(iii)** Debenture **(iv)** Commercial Bill

(d) Financial instruments are useful for
(i) Creating benefits for government **(ii)** Providing credit creation **(iii)** Mobilisation of savings **(iv)** For creating direct securities

(e) Who controls the money market? ***(March 18)***
(i) RBI **(ii)** SBI **(iii)** DFHI **(iv)** IDBI

(f) A market for borrowing and lending of funds for a very short period is ________.
(i) Cash Loan **(ii)** Call Loan **(iii)** Certificate of Deposits **(iv)** Debenture

(g) A security used by RBI to adjust liquidity in the financial system.
(i) T-Bills **(ii)** Repo **(iii)** CDs **(iv)** CPs

(h) Treasury Bills are ________ securities and pay no interest. ***(Oct. 18)***
(i) Zero coupon **(ii)** Payment coupon

[Ans.: (a – iv), (b – ii), (c – iii), (d – iii), (e – i), (f – ii), (g – ii), (h – i)]

Fill in the blanks:

(a) ________ is a place where the demand for and supply of short term funds are met.

(b) The rate at which money is made available in call money market is called as ________.

(c) Under ________ agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price.

(d) ________ are worth the value of ₹25 lakh & in multiple of ₹25 lakh.

(e) ________ are available for a minimum amount of Rs. 25K and in its multiples.

(f) ________ are transactions or short term loans in which two parties agree to sell and repurchase the same security.

(g) ________ are issued by banks during period of tight liquidity, at relatively high interest rate.

(h) All scheduled banks except ________ and scheduled co-operative banks are eligible to issue CDs to the extent of 7% of deposits.

(i) Treasury Bills which are promissory notes or financial bills issued by the ___________ on behalf of the Government of India.

(j) ___________ is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments.

*[Ans.: **(a)** Money market, **(b)** Call rate, **(c)** repurchase, **(d)** Certificate of Deposits, **(e)** Treasury bills, **(f)** REPO, **(g)** Certificate of Deposits, **(h)** Regional Rural Banks, **(i)** RBI, **(j)** NDS (Negotiated Dealing system)]*

(3) True or False:

(a) Money market is a place where the demand for and supply of short term funds are met. ***(Oct. 17)***

(b) The rate at which money is made available in call money market is called as a call rate.

(c) Treasury bills are used to finance the movement and storage of agriculture and industrial goods in domestic and foreign markets.

(d) There are specialized institutions known as discount houses for discounting commercial bills accepted by reputed acceptance houses.

(e) Treasury Bills which are promissory notes or financial bills issued by the RBI on behalf of the Government of India. ***(March 19)***

(f) Treasury bill is used by the Govt. to raise short term funds for meeting temporary Government revenues.

(g) Call money are transactions or short term loans in which two parties agree to sell and repurchase the same security.

(h) All scheduled banks except Regional Rural Banks and scheduled co-operative banks are eligible to issue CDs to the extent of 7% of deposits.

(i) Certificate of deposits is an investment instrument which can be issued by a listed company having working capital more than or equal to Rs. 5 cr.

(j) Commercial papers are short term deposits which are transferable from one party to another.

*[Ans.: **(a)** True, **(b)** True, **(c)** False, **(d)** True, **(e)** True), **(f)** False, **(g)** False, **(h)** True, **(i)** False, **(j)** False]*

(4) Match the Columns:

	Group "A"		Group "B"
(a)	Money Market	(i)	90 to 180 days
(b)	Commercial Paper	(ii)	Short term fund
(c)	Certificate of Deposits	(iii)	International Trade
(d)	Call Money Market	(iv)	RBI
(e)	Commercial Bill Market	(v)	Uncollateralized basis
(f)	Inter Corporate Deposits	(vi)	91, 182 & 364-day
(g)	REPO	(vii)	Negotiable money market instrument
(h)	T-Bill	(viii)	Short term deposit instruments
(i)	Interbank Participation Certificates	(ix)	Inter-bank loan market
(j)	Banker's Acceptance	(x)	Unsecured short term promissory notes

[Ans.: (a – ii), (b – x), (c – viii), (d – ix), (e – vii), (f – v), (g – iv), (h – vi), (i – i), (j – iii)]

(5) Explain in detail role of money market along with its characteristics.

(6) Elaborate in detail the structure of money market.

(7) Who are the various participants in money market?

What is money Markets and Explain the Instruments of Money market? *(Oct. 17)*

Write short notes on:

(a) Treasury Bills.
(b) Certificate of Deposits.
(c) REPO Transactions. ***(Oct. 17)***
(d) Call Money. ***(March 18)***
(e) Commercial Bills.
(f) Inter-corporate Deposits.
(g) Inter-bank Participation Certificates.
(h) Bankers' Acceptance. ***(March 18)***
(i) Commercial Paper. ***(Oct. 17; March 18)***

Chapter 10

OTHER FINANCIAL SERVICES

- Intermediaries Involved in Financial Markets
- Introduction to Venture Capital
- Features of Venture Capital Financing
- Various Stages of Venture Capital Financing
- How to Prepare Business Plan for getting Venture Capital Financing?
- Methods of Venture Capital Financing
- Plastic Money
- Introduction to Credit Cards
- Feature of Credit Cards
- Advantages and Disadvantages of Credit Cards
- Debit Card
- Debit Cards v/s Credit Cards: Similarities and Differences
- Parties Involved in Credit Cards
- Non Banking Financial Companies (NBFCs)
- Hire Purchase
- Mutual Funds
- Factors Influencing the Selection of Mutual Funds
- Advantages and Disadvantages/Limitations of Mutual Funds
- E-Wallet – Advantages and Disadvantages
- Consumer Finance – Advantages, Disadvantages and Types
- Summary
- Questions

INTERMEDIARIES INVOLVED IN FINANCIAL MARKETS:

There are many intermediaries in the primary market or capital market. Important players are as follows:

(1) **Merchant bankers:** Merchant bankers play a vital role in attracting public money to capital issues. They act as issue managers, lead managers or co-managers.

(2) **Registrars to the issue:** Registrars are intermediaries who undertake all activities connected with new issue management. They are selected by the company in a discussion with the merchant bankers to the issue.

(3) **Bankers:** Some commercial banks act as accumulating agents and some act as coordinating bankers. Some bankers perform as merchant bankers and some are brokers. They play a vital role in transfer, transmission and safe custody of funds.

(4) **Brokers:** They act as intermediaries in buying and selling of securities in the primary and secondary markets. They have a network of sub brokers spread throughout the length and breadth of the country.

(5) **Underwriters:** Generally investment bankers act as underwriters. They agreed to take a specified number of shares or debentures offered to the public if the issue is not fully subscribed by the public. Underwriters may be financial institutions, banks, mutual funds, brokers etc.

INTRODUCTION TO VENTURE CAPITAL:

Venture Capital is a form of "risk capital". In other words, capital that is invested in a project (in this case a business) where there is a considerable element of risk relating to the future creation of profits and cash flows. Risk capital is capitalized as shares (equity) rather than as a loan and the investor needs a higher "rate of return" to compensate him for his risk.

Venture capital offers long-term, committed share capital, to help unquoted companies grow and succeed. If an entrepreneur is looking to start-up, expand, buy-into a business, buy-out a business in which he operates, turnaround or rejuvenate a company, ventūre capital could help do this. Obtaining venture capital is considerably different from raising debt or a loan from a lender. Lenders have a legal right to interest on a loan and repayment of the capital, regardless of the success or failure of a business. Venture capital is invested in exchange for an equity stake in the business. As a shareholder, the venture capitalist's return is reliant on the growth and profitability of the business. This return is usually earned when the venture capitalist "exits" by selling its shareholding when the business is sold to another owner.

FEATURES OF VENTURE CAPITAL FINANCING:

Starting and growing a business always require capital. There are a number of alternative methods to fund growth. These comprises of the owner or proprietor's own capital, arranging debt finance, or seeking an equity partner, as is the instance with private equity and venture capital.

Private Equity: Private equity is a broad term that states to any type of non-public ownership equity securities that are not listed on a public exchange. Private equity encompasses both early stage (venture capital) and later stage (buy-out, expansion) investing. In the broadest sense, it can also include mezzanine, fund of funds and secondary investing.

Equity financing: Venture capital is a means of equity financing for rapidly-growing private companies. Finance may be essential for the start-up, development/expansion or purchase of a company. Venture Capital firms invest funds on a professional basis, regularly focusing on a limited sector of specialization.

With venture capital financing, the venture capitalist purchases an agreed proportion of the equity of the company in return for the funding. Equity finance offers the substantial advantage of having no interest charges. It is "patient" capital that seeks a return through long-term capital gain rather than instant and regular interest payments, as in the case of debt financing. Given the nature of equity financing, venture capital investors are therefore exposed to the risk of the company failing. As a result the venture capitalist must look to invest in companies which have the ability to grow very positively and provide higher than average returns to compensate for the risk.

VARIOUS STAGES OF VENTURE CAPITAL FINANCING:

Investment Process: The investment process initiates with the venture capitalist conducting an initial review of the proposal to determine if it fits with the firm's investment criteria. Further a meeting will be arranged with the entrepreneur/management team to discuss the business plan.

Preliminary Screening: The initial meeting provides a chance for the venture capitalist to meet with the entrepreneur and key members of the management team to review the business plan and conduct initial due diligence on the project. It is a significant time for the management team to demonstrate their understanding of their business and capability to achieve the strategies sketched in the plan. The venture capitalist will look prudently at the team's functional skills and backgrounds.

Negotiating Investment: This includes an agreement between the venture capitalist and management of the terms of the term sheet, often called Memorandum of Understanding (MoU). The venture capitalist will then continue to study the feasibility of the market to estimate its potential. Often they use market forecasts which have been independently arranged by industry experts who specialise in estimating the size and growth rates of markets and market segments. The venture capitalist also studies the industry carefully to obtain information about competitors, entry barriers and potential to exploit substantial niches, product life cycles, and distribution channels. The due diligence may continue with reports from other consultants.

Approvals and Investment Completed: The process includes due diligence and disclosure of all related business information. Final terms can then be negotiated and an investment proposal is classically submitted to the venture capital fund's board of directors. If accepted, legal documents are prepared.

The investment process can take up to two months, and occasionally longer. It is vital therefore not to expect a speedy response. It is advisable to plan the business financial needs early on to allow appropriate time to protect the required funding.

Venture capital has a number of advantages over other forms of finance, such as:

- It inserts long term equity finance which delivers a solid capital base for future growth.
- The venture capitalist is a business partner, allocating both the risks and rewards. Venture capitalists are contented by business success and the capital gain.
- The venture capitalist is able to deal with practical advice and assistance to the company based on past experience with other companies which were in similar situations.
- The venture capitalist also has a link of contacts in many areas adding value to the company, like in areas of recruiting key personnel, providing contacts in international markets, introductions to strategic partners, and if needed co-investments with other venture capital firms when additional rounds of financing are required.
- The venture capitalist may be accomplished of providing additional rounds of funding should it be required to finance growth.

Venture capital firms usually source the majority of their funding from large investment institutions such as fund of funds, financial institutions, endowments, pension funds and banks. These institutions classically invest in a venture capital fund for a period of up to ten years.

To compensate for the long term commitment and lack of both security and liquidity, investment institutions presume to receive very high returns on their investment. Consequently venture capitalists invest in either companies with high growth potential where they are able to exit through either an IPO or a merger/acquisition. Though the venture capitalist may receive some return through dividends, their primary return on investment comes from capital gains when they ultimately sell their shares in the company, normally between three to five years after the investment.

Venture capitalists are thus in the business of promoting growth in the companies they invest in and managing the connected risk to protect and enhance their investors' capital.

HOW TO PREPARE BUSINESS/INVESTMENT PLAN FOR GETTING VENTURE CAPITAL FINANCING?

Venture capitalist examines hundreds of business plans every year. The business plan must consequently convince the venture capitalist that the company and the management team have the ability to achieve the goals of the company within the specified time.

The business plan should explain the nature of the company's business, what it wants to achieve and how it is going to do it. The company's management should prepare the plan and they should set challenging but achievable goals. The length of the business plan depends on the particular circumstances but, as a general rule, it should be no longer than 25-30 pages. The Plan should evade jargon and general position statements. It should be simple to understand in layman's terminology.

Essential areas to cover in your business plan:

Executive Summary:

This is the most important section and is often best written last. It summarises your business plan and is placed at the front of the document. It is vital to give this summary significant thought and time, as it may well determine the amount of consideration the venture capital investor will give to your detailed proposal.

It should be clearly written and powerfully persuasive, yet balance "sales talk" with realism in order to be convincing. It should be limited to no more than two pages and include the key elements of the business plan.

(1) **Background on the company:** It offers a summary of the fundamental nature of the company and its activities, a brief history of the company and an outline of the company's objectives.

(2) **The product or service:** This concentrates on explaining the company's product or service. Such description is extremely important if the product or service is technically orientated. A non-specialist must be able to understand the plan.

- Highlight the product or service's competitive edge or unique selling point.
- Describe the stage of development of the product or service (seed, early stage, expansion). Is there an opportunity to

develop a second-generation product in due course? Is the product or service open to technological termination?

- If applicable, explain what legal protection you have on the product, such as patents attained, pending or required. Assess the impact of legal protection on the marketability of the product.

(3) Market analysis: The entrepreneur needs to persuade the venture capital firm that there is a real commercial opportunity for the business and its products and services. Provide the reader a combination of clear explanation and analysis, including a realistic "SWOT" (strengths, weaknesses, opportunities and threats) analysis.

- Define your market and explain in what industry sector your company operates. What is the size of the whole market? What are the future prospects for this market? At which stage of business cycle currently your business is?
- How does your company fit within this market? Who are your competitors? For what percentage of the market do they account? What is their strategic positioning? What are their strengths and weaknesses? What are the hindrances faced by new entrants?
- Describe the distribution channels. Who are your customers? How many are there? What is their value to the company now? Mention the price sensitivity of the market.
- Explain the significant problems faced by the business and its products or services in the market. Have these problems been overcome, and if so, how? Address the current issues, concerns and risks affecting your business and the industry in which it operates. What are your forecasts for the company and the market? Assess future potential problems and how they will be tackled, minimised or avoided.

(4) Marketing: Having defined the relevant market and its opportunities, it is necessary to address how the forthcoming business will exploit these opportunities.

- Plan your sales and distribution strategy. What is your planned sales force? What are your strategies for different markets? Which distribution channels are you planning to use and how do these compare with your competitors? Identify overseas market access issues and how these will be resolved.

- What is your pricing strategy? How does this compare with your competitors?
- What are your advertising, public relations and promotion plans?

5) **The management team:** Validate that the company has the quality of management to be able to turn the business plan into reality.

- The senior management team preferably should be experienced in complementary areas, such as management strategy, finance and marketing, and their roles should be well determined and communicated as well. The special abilities each member brings to the venture should be explained. A summarizing curriculum vitae should be included for each team member, highlighting the individual's previous track record in running, or being involved with, successful businesses.
- Recognize the current and potential skills gaps and explain how you target to fill them. Venture capital firms will sometimes assist in locating experienced managers where an important post is unfilled - provided they are persuaded about the other aspects of your plan.
- List your advisers and board members.
- Take in an organisation chart.

6) **Financial projections:** The following should be considered in the financial aspect to your business plan:

- Genuinely assess sales, costs (both fixed and variable), cash flow and working capital. Produce a profit and loss statement and balance sheet. Ensure these are easy to update and adjust. Assess your present and prospective future margins in detail, keeping in mind the potential impact of competition.
- Explain the research commenced to support these assumptions.
- Validate the company's growth prospects over, for example, a three to five year period.

- What are the costs associated with the business? What are the sale prices or fee charging structures?
- What are your budgets for each area of your company's activities?
- Showcase different scenarios for the financial projections of sales, costs and cash flow for both the short and long term. Ask "what if?" questions to ensure that key factors and their impact on the financings required are carefully and realistically assessed. For example, what if sales decline by 30%, or supplier costs increase by 40% or both? How does this effect on the profit and cash flow projections?
- If it is intended that more than one round of financing will be required (often the case with technology-based businesses in particular), identify the likely timing and any associated progress "milestones" or goals that need to be accomplished.
- Keep the plan feasible. Avoid being too optimistic. Highlight challenges and show how they will be met.

Appropriate historical financial performance should also be presented. The company's historical achievements can help give meaning, context and credibility to future projections.

(7) **Amount and use of finance required and exit opportunities:** Determine how much finance is required by your business and from what sources (i.e. management, venture capital, banks and others) and explain the purpose for which it will be applied.

Reflect how the venture capital investors will exit the investment and make a return. Possible exit strategies for the investors may include floating the company on a stock exchange or selling the company to a trade buyer.

Although it is not mandatory that every new venture would submit business plan in this format. Sequence may vary from project to project, but the content lies same.

Aditya Birla PE Advisors Private Limited (ABPE) – Well known Venture Capitalist:

Aditya Birla PE Advisors is a wholly owned subsidiary of ABCL. It provides financial advisory and management services with focus on managing venture capital funds and alternate investment funds. ABPE is presently appointed as an investment manager to two SEBI registered domestic venture capital funds, namely, Aditya Birla Private Equity - Fund I and Aditya Birla Private Equity – Sunrise Fund, where it currently manages a gross AUM of Rs. 11.63 billion under these two funds.

In addition, ABPE offers investment management and advisory services to domestic and global investors and partners with its portfolio companies to provide them strategic direction for their operations and growth. ABPE focuses on growth investments in mid-market companies based in India. ABPE seeks to tap the broader alternative funds market through a variety of products such as buyout funds and mezzanine funds in the future.

Sectors Preferred:

Birla Private Equity adopts a sector agnostic investment style. Within the sector agnostic investment style, they have identified and prefer certain sectors as they perceive these to be better positioned to take advantage of the current stage of India's exponential growth potential.

- Consumption Led Growth sector which will rise per capita income and credit expansion such as financial services, FMCG and retail & other services speciality chemicals, niche engineering & companies within the large scale manufacturing eco-system
- Niche Emerging Sectors such as Education, Healthcare, Logistics, Digital Media and Entertainment.
- Skilled Ancillary Businesses.

Method of Investment:

The strategy of Aditya Birla Private Equity is to take significant minority stakes through equity, quasi-equity or equity linked instruments in companies.

***(Source:** https://privateequity.adityabirlacapital.com)*

METHODS OF VENTURE CAPITAL FINANCING:

The investment process, from reviewing the business plan to investing in a proposal, can take a venture capitalist anything from one month to one year but typically it takes between 3 and 6 months.

There are always exclusions to the rule and deals can be done in extremely short time frames depending on the quality of information been provided and made available.

The key stage of the investment process is the initial assessment of a business plan. Most approaches to venture capitalists are rejected at this stage. In considering the business plan, the venture capitalist will consider several primary aspects:

- Is the product or service commercially viable?
- Does the company have potential for sustained growth?
- Does management have the ability to exploit this potential and control the company through the growth phases?
- Does the possible reward justify the risk?
- Does the potential financial return on the investment meet their investment criteria?

In structuring its investment, the venture capitalist may use one or more of the following types of share capital:

Ordinary shares: These are equity shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been fulfilled. Ordinary shares have votes. In a venture capital deal these are the shares typically held by the management and family shareholders reasonably than the venture capital firm.

Preferred ordinary shares: These are equity shares with extra-ordinary rights. For example, they may be eligible to a fixed dividend or share of the profits. Preferred ordinary shares have votes.

Preference shares: These are non-equity shares. They rank forward of all classes of ordinary shares for both income and capital. Their income rights are clear and they are usually entitled to a fixed dividend (e.g. 10% fixed). The shares may be redeemable on fixed dates or they may be irredeemable. Sometimes they may be redeemable at a fixed premium (e.g. at 120% of cost). They may be convertible into a class of ordinary shares.

Loan capital: Venture capital loans characteristically are entitled to interest and are typically not repayable. Loans may be secured on the company's assets or may be unsecured. A secured loan will rank forward of unsecured loans and certain other creditors of the company. A loan may be convertible into equity shares. Otherwise, it may have a warrant attached which gives the loan holder the option to promise for new equity shares on terms fixed in the warrant. They usually carry a higher rate of interest than bank term loans and rank behind the bank for payment of interest and repayment of capital.

Venture capital investments are often associated with additional financing at the point of investment. This is approximately always the case where the business in which the investment is being made is relatively mature or well-established. In this case, it is appropriate for a business to have a financing structure that includes both equity and debt.

Other forms of finance provided in addition to venture capitalist equity include:

- **Clearing banks: These banks usually** provide overdrafts and short to medium-term loans at fixed or, more variable rates of interest.
- **Merchant banks: Merchant banks help in** organising the provision of medium to longer-term loans, usually for larger amounts than clearing banks. Later they can play an important role in the process of "going public" by recommending on the terms and price of public issues and by arranging to underwrite if required.
- **Finance houses: Finance houses offers** various forms of installment credit, ranging from hire purchase to leasing, regularly asset based and usually for a fixed term and at fixed interest rates.
- **Factoring companies:** Factoring works towards providing finance by buying trade debts at a discount, either on a recourse basis, whereby the owner retain the credit risk on the debts or on a non-recourse basis where factoring company takes over the credit risk.
- **Government and European Commission sources:** Provide financial aid to UK companies, fluctuating from project grants related to jobs created and safeguarded to enterprise loans in selective areas.
- **Mezzanine firms:** These firms usually provide loan finance that is midway between equity and secured debt. These facilities require one or the other a second charge on the company's

assets or are unsecured. Because the risk is subsequently higher than senior debt, the interest charged by the mezzanine debt provider will be higher than that from the principal lenders and sometimes a modest equity "up-side" will be required through options or warrants. It is usually most suitable for larger transactions.

INTRODUCTION TO CREDIT CARDS:

A credit card is mainly a plastic card with a magnetic strip invented to simplify the complicated banking process for an individual in case he/she is short of cash, for any kind of transaction whether usual or critical in nature.

A credit card generally works by giving its holder an immediate authority to purchase services and goods such as travel and hotel reservations as well as shopping for merchandise within and outside the resident's country.

All the credit card comes with a credit limit, a predetermined amount of money which its lender is offering as credit to a credit card holder to spend wherever he wants to. Before issuing a credit card to an individual, the bank or the financial institution has a look at his/her credit rating alongside verifying his/her credit history. After receiving the needful information about the applicant, the lender company issues the credit card to him. Now if the credit card holder goes shopping with his credit card, he pays the vendor through the card which is actually reimbursed to the vendor through the bank or the lender company and finally, the cardholder then repays the bank for the entire credit amount that he has used, by paying it back through regular monthly payments.

In case the cardholder fails to payback the entire balance, the bank can lawfully charge him with an interest fee on the unpaid amount.

In Indian credit card market there are 12 major types of credit cards being provided by banks and financial institutions, providing various financial benefits to holders.

Major India Credit Card Types:

Following are various types of credit cards available in India:

- Premium Credit Cards
- Gold Credit Card
- Cash Back Credit Cards
- Airline Credit Cards

- Silver Credit Card
- Balance Transfer Credit Card
- Low Interest Credit Card
- Rewards.
- Business Credit Cards
- Co-branded Credit Card
- Lifetime Free Credit Cards

Standard Credit Cards: These are the most common type of credit card allowing an individual to have a revolving balance up to a certain credit limit. Credit is used up when one makes a purchase with the use of this card and this limit is made available again once a payment is been made. A finance charge is applied to outstanding balances at the end of each month. Credit cards have a minimum payment that must be paid by a certain due date to avoid late-payment penalties.

Premium Credit Cards: These cards offer incentives and benefits further than that of a regular credit card. Examples of premium credit cards are Gold and Platinum cards that offer cash back, reward points, travel upgrades, and other rewards to cardholders. Premium cards usually charge higher fees and have minimum income and credit score requirements.

Both standard credit cards and premium credit cards have specific types of credit cards. Student credit cards, zero percent interest cards, and travel cards are just a few types available in the market.

Charge Cards: Charge cards do not have a credit limit. The balance on a charge card must be paid in full at the end of each month. Charge cards typically do not have a finance charge or minimum payment since the balance is to be paid in full. Late payments are subject to a fee, charge restrictions, or card cancellation depending on the individual's card agreement.

Limited Purpose Cards: Limited purpose credit cards, as name suggest it could be used only for some specific purposes at specific locations. Limited purpose cards are used like credit cards with a minimum payment and finance charge. Store credit cards and gas credit cards are examples of limited purpose credit cards.

Secured Credit Cards: Secured credit cards act as an opportunity for those without a credit history or those with imperfect credit. Secured cards require a security deposit to be placed on the card. The credit limit on a secured credit card is equal to the amount of the deposit made. Secured credit cards have rotating balances depending on the purchases and payments made.

Prepaid Credit Cards: Prepaid credit cards require the cardholder to load money onto the card before the card can be used. Purchases are withdrawn from the card's balance. The credit limit does not renew itself till more money is loaded onto the card. Prepaid cards do not have finance charges or minimum payments since the balance is withdrawn from the deposit. Prepaid cards are similar to debit cards, except the feature of checking account balance.

Business Credit Cards: Business credit cards are designed explicitly for business use. They offer business owners with an easy method of keeping business and personal transactions separate. There are standard business credit and charge cards available in the financial market

ADVANTAGES AND DISADVANTAGES OF CREDIT CARD:

Like most things, there are advantages and disadvantages to credit cards. Knowing some of these can help in deciding whether to use or not these cards:

Advantages:

- **Increase in Purchasing Power and Ease in transactions:** Credit cards can make it affordable for an individual to purchase any product or service which is not available on cash or is costly than the current cash available with him.
- **Protection of Purchases:** Credit cards may also offer you additional protection if something you have bought is lost, damaged, or stolen. Both your credit card statement (and the credit card company) can assure for the fact that you have made a purchase if the original receipt is lost or stolen. In addition, some credit card companies also offer insurance on large purchases.
- **Building a Credit Line:** Having a good credit score with CIBIL is often important, not only in case of credit cards, but also when applying for loans, rental applications, or even some jobs. Possessing a credit card and using it wisely (making payments on time and in full each month) will help to build a good credit history.

- **Emergencies:** Credit cards can also be useful at the times of emergency. Although credit cards enable lager buying capacity, it also acts as a device to be used in case of emergencies. One can afford better treatment with the help of credit facility available in the form of credit cards.
- **Credit Card Benefits:** Apart from the above mentioned benefits, some credit cards offer additional benefits, such as discounts from particular stores or companies, bonuses such as free airline miles or travel discounts, and special insurances (like travel or life insurance.) While most of these benefits are meant to inspire an individual so as to charge more money on the credit card, the benefits of cards are real and can be helpful as long as one sticks up to its spending limits.

Disadvantages:

- **Blowing one's financial Budget:** The biggest disadvantage of credit cards is that they inspire people to spend money that they don't have. Most credit cards do not require to pay off balance each month, so even if one has Rs. 10,000 in his account, he will be able to spend Rs. 30,000 or even more depending on his credit card. While this may seem like 'free money' for some time, still one has to pay this amount back to the bank within a limited period. Credit card companies charges a good amount of interest rate on the amount borrowed.
- **High Interest Rates and Increased Debt:** Credit card companies charges a considerable amount of interest on each balance that an individual is incapable of paying at the end of each month. This is how these companies make their money whereby most individuals are insufficient to pay and are declared bankrupt. For example: Mr. A has Rs. 50,000 in his saving account, he is liable to earn an average interest of 5-6%. This means he earned interest amount on the funds used by bank. Most credit cards charges up to 10 times that amount of interest on balances. If Mr. A is using credit card, he can use saving account amount to pay off for credit card charges, rather than increasing his debt burden. In other words, credit card is expensive method to borrow money. If we compare interest earned from a bank and that to be paid for using credit card, Savings accounts may pay him around 5% interest; if you have a

loan from a bank you may pay them around 9% interest if you owe money to a credit card company, you may pay them around 20% interest.

- **Credit Card Fraud:** Unlike cash, sometimes credit cards can be stolen. They may be physically stolen whereby one can lose his wallet or someone may steal credit card number from a receipt, over the phone, or from a Web site and use your card to support debts. The biggest advantage of card over cash is, in case of loss, one can report immediately to credit card companies for blocking it. There are several precautions that one can take to prevent credit card fraud:
  - If you lose your card or wallet, report it to your credit card company immediately.
  - Don't lend your credit card to anyone and disclose your credit card information only to trusted companies or Web sites.
  - Check your statement closely at the end of each month to make sure all charges are yours.

DEBIT CARD:

A debit card is a plastic card issued by banks to customers, allowing instant purchase, removing the correct balance from the user's attached bank account. Debit cards are different from credit cards in that they allow purchase based on available funds in the account to be deducted immediately, instead of by using a line of credit that can be repaid at a later time.

Maximum debit cards have two main features: the ability to purchase items at stores that have automated debit or credit card machines, and the ability to withdraw cash from bank account at an Automatic Transaction Machine (ATM). They are available in most countries of the world, and have nearly displaced the use of cheques in the United States. However, the cards possess many dangers to the user, both in terms of possible identity theft and unexpected bank fees.

Utmost forms of debit card require a Personal Identification Number (PIN) as a security feature. When withdrawing money from an ATM or using an automatic purchasing machine at a store, the user will have to enter their PIN for verification. In online purchases, the PIN is usually not required, but users will often need to enter the three or four digit security code listed on the back of the card. Additional safety measures common for debit cards include a photograph of the card's owner on the front, or an electronically reproduced customer signature imprinted on the card.

Although the security features hold up well for in-person transactions, they authorize debit card users vulnerable for online theft. If theft occurs, the thief will likely to have all of the information they need to use debit card for Internet transactions. If an individual has a dual credit/debit card, they may also be able to use it in stores that do not require a PIN for credit use.

DEBIT CARDS v/s CREDIT CARDS: SIMILARITIES AND DIFFERENCES:

Nowadays all financial institutions offer both debit cards and credit cards. Both these cards offer special rewards, such as points and cash back on purchases made through the card. These cards can be used to make online payments with the help of the PIN (Personal Identification Number) assigned to them, whereby they can be used to withdraw money from ATMs, depending on the cash limit available on these cards.

Debit cards and Credit cards differ in some substantial ways. In the case of a credit card, the issuer offers credit and overdraft facilities. This facility is not available with a debit card, which will only debit payments from existing and available funds within the cardholders account. A credit cardholder therefore has a monthly bill to pay in every month that the card is used. If a bill is not paid high interest charges are applied. A debit card holder is free from the hassle of paying those bills and from the risk of building up large debts to credit card companies.

Debit Cards: Types:

Debit cards are offered by banks in the following forms:

- Online Card.
- Prepaid Card.
- Offline Card.
- Electronic Purse Debit Card.
- Debit Cards for telephone, mail and internet transactions.

Debit Cards: Benefits:

Debit cards offer the following benefits:

- They aid people to be disciplined financially, since one cannot display with the limited amount of funds deposited for the card.
- A person with poor credit can obtain a debit card without too much distress.
- Debit cards can be used to make online purchases and payments.
- This card provide freedom from carrying cash and cheques while travelling, thereby offering more safety.
- Debit cards do not control high interest rates or fees on card transactions.

Disadvantages of Debit Cards:

Debit cards, however, do entail certain limitations, such as:

- More fraudulent practices are possible in case of Debit cards than Credit cards.
- Certain transactions like renting a car in a foreign country cannot be carried out with a debit card.
- One can only use only those funds which are available in the account. So, in case of an emergency where credit is urgently needed beyond your account balance, a debit card will not be sufficient to meet financial needs.

PARTIES INVOLVED IN CREDIT CARDS:

➢ **Cardholder:** The holder of the card used to build a purchase; the consumer.

➢ **Card-issuing bank:** The financial institution or organization that issue the credit card to the cardholder. This bank bills the customer for refund and bears the risk that the card is used falsely.

➢ **Merchant:** A person or business accepting credit card payments for products or services sell to the cardholder.

➢ **Acquiring bank:** The financial institution accepting **payment** for the products or services on behalf of the trade.

- **Independent sales organization:** Resellers (to merchants) of the services of the acquiring bank.
- **Merchant account:** This could refer to the acquire bank or the independent sales organization, but general is the organization that the merchant deals with.
- **Credit Card association:** An association of card-issuing banks such as Visa, MasterCard, Discover, American express, etc.
- **Transaction network:** The system that implements the mechanics of the electronic transactions. May be operated by an independent company, and one company may operate multiple networks.

NON-BANKING FINANCIAL COMPANIES (NBFCs):

Liberalization of the economy has witnessed the proliferation of many Non Banking Financial Companies in the country providing financial service of varying descriptions Indeed, the activity of entering into the financial sector had been so very alluring so much so that each and every business house took plunge into financial service. After all, no additional infrastructural facility was required to set up a finance company. As a matter of fact, that entire one required to set up a finance company comprised of basic infrastructural facilities such as telephones, some office space and of course, not to forget-an overfriendly banker and gullible depositors.

Though banks have traditionally provided most financial services, they typically excel in providing payment and liquidity related services (which includes loans) and usually selecting a portfolio mix commensurate to a certain desired return. The RBI is examining the issue of smooth flow of bank finance to NBFCs in order to develop NBFCs into a financially strong sector with improved skill and technology for the SME sector. The NBFCs can play a critical role as an instrument of credit delivery in providing support finance to SME sector. The strategy will have full support from SIDBI and the NABARD which have agreed to evolve viable credit dispensation arrangements to provide resource support to NBFCs (through viable refinance arrangements) for on-lending to the SME sector. These refinancing institutions would be evolving appropriate mechanisms, in consultation with NBFCs, to address their needs and provide support in terms of their capacity building to develop expertise for financing these sectors.

Finance comes from some of the NBFCs in the shape of Venture Capital Funds that aim to provide long term equity capital to SME players. The NBFCs are also aggressively looking into providing ancillary services through their subsidiary and associate companies. The fact that they are able to offer all needs related to infrastructure, capital markets, insurance, forex, venture capital etc. under one umbrella, makes them excellent referral point for SME clients who have limited market knowledge and contacts.

Though banks have also got access to low-cost deposits, due to widespread operations in the form of retail deposits and thus can lend at competitive rates, NBFCs enjoy an advantage over banks in terms of expert domain knowledge, project structuring skills and proved experience. At times NBFCs find favour with the SME sector due to their localized knowledge base and flavour.

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

List of NBFC's in India:

- Bajaj Finance Ltd.
- Shriram Transport Finance Company Limited
- Muthoot Finance Limited
- Mahindra & Mahindra Financial Services Limited
- Sundaram Finance Limited

HIRE PURCHASE:

Credit is defined as a system under which term loans for purchases 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 producer goods or they may be simply services such as air travel etc. Normally the 2 terms-hire purchase credit and instalment credit are used synonymously. The 2 however differ technically, in that in the case of the former the ownership of the good in question is not transferred to the buyer till his ownership is immediately transferred to the buyer.

Hire purchase credit may be provided by the seller himself or by any financial institution. When the seller provides such credit his sources of funds may be his on capital or borrowings from certain financial institutions. Different types of financial institutions such as banks and sales finance companies have now entered in the business hire purchase finance. They may provide instalment loans against the stocks of goods of wholesale traders. Such loans are clean unsecured advances and therefore tend to have a very high cost for the borrower. This method of financing sellers is not very popular.

Alternatively financial institutions may discount or purchase instalment receivables on an outright basis. This rendered possible because instalment contacts are transferable and negotiable. In addition to financing sellers, financial institutions may finance the buyers directly. This may take either of 2 forms: available to the buyer.

Cash instalment credit under which cash is made directly available to the buyer who repays it in the form of instalments over a given period;

Commodity instalment credit under which the buyer is allowed to purchase goods of his choice and a financial institution opens an account in his name and collects cash over a period of time.

Apparently, hire purchase credit is available in India for a wide range of products and services. Products like automobiles, sewing machines refrigerators, TV sets, machinery and equipment, other capital goods, industrial sheds and services like educational fees and medical fees are now financed with the of such credit. However unlike in other countries, the emphasis in India is on provision of instalment credit for productive goods and services rather than for purely consumer goods.

A large part of instalment credit in India is given for the purchase of commercial vehicles. The borrowers in this market are transport operators who may be individuals, trading concerns or a firm owning a fleet of vehicles; belonging to middle and higher-income group, small scale industrial units, new entrepreneurs, self-employed persons, etc. the sources of the hire purchase finance are apparently many.

First there are hire purchase finance companies. They either public or private limited companies or partnership firms engaged in giving credit for purpose of acquiring durable goods. Other suppliers of the hire purchase finance are retail and wholesale trader, commercial banks, IDBI, ICICI, NSIC, SFCs, SIDCs, AICS.

Traditionally, consumer loans are available in India from moneylenders as well as indigenous bankers. Most of the automobile manufacturers have floated their own subsidiaries or associate concerns to look after the financing of sales of their vehicles on a hire purchase basis. There are some private hire purchase finance companies and partnership firms who also specialize in financing hire purchase business of different goods, particularly cars and trucks. The volume of hire purchase credit and the facilities to advance it have increased significantly in the recent past, but there is still a vast scope for increase in hire purchase credit in India. The official attitude is to encourage the extension of such credit particularly for procuring productive assets.

MUTUAL FUNDS:

- A Mutual Fund is a collective investment vehicle. It is a pool of investor's money invested according to pre-specified investment objectives. The benefits from the investment of the pooled money accrue to those that contribute to the pool. There is thus mutuality in the contribution and the benefit. Hence the name 'mutual fund'.
- A 'mutual fund' is an investment vehicle that allows several investors to pool their resources in order to purchase stocks, bonds and other securities. These collective funds (referred to as Assets under Management or AUM) are then invested by an expert fund manager appointed by a mutual fund company (called Asset Management Company or AMC).
- The combined underlying holding of the fund is known as the 'portfolio', and each investor owns a portion of this portfolio in the form of units.
- A mutual fund is a pool of investor's money, invested in a portfolio of securities as per the stated objective.

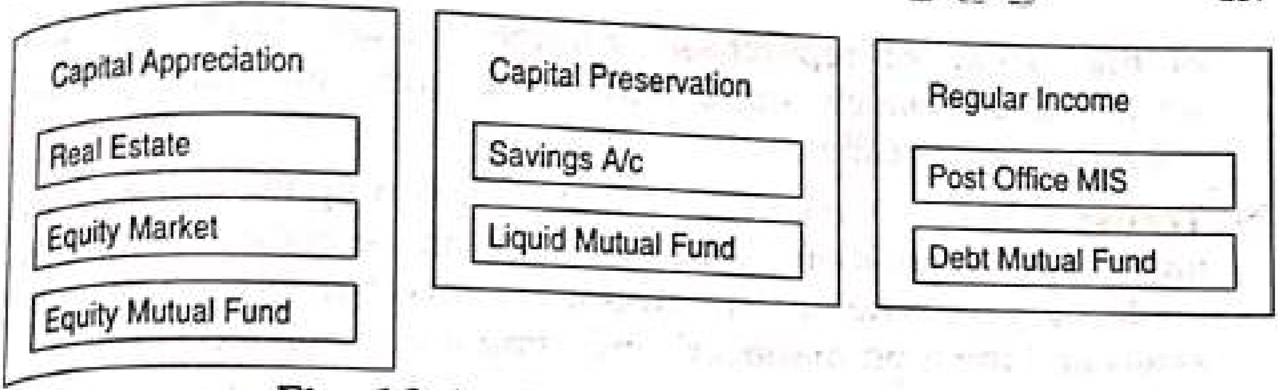


Fig. 10.1 – Investment Objectives

ADVANTAGES OF MUTUAL FUND:

(1) **Professional Management:** An investor avail of the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme as compare to individual investment.

(2) **Diversification:** Mutual Funds invest in a number of companies across a broad cross section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. Investors achieve this diversification through a Mutual Fund with far less money as compare to individual investment.

(3) **Convenient Administration:** Investing in a Mutual Fund reduces paperwork and helps avoiding many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies. Mutual Funds save time and make investing easy and convenient.

(4) **Return Potential:** Over a medium to long term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

(5) **Low Costs:** Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

(6) **Liquidity:** In open-ended schemes, one can get money back promptly at Net Asset Value (NAV) related prices from the Mutual Fund itself. With close-ended schemes, one can sell your units on a stock exchange at the prevailing market price or avail

of the facility of repurchase through Mutual Funds at NAV related prices which some close-ended and interval schemes offer you periodically.

(7) **Transparency:** One can regular information on the value of his investment in addition to disclosure on the specific investments made by your scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.

(8) **Flexibility:** Through features such as Systematic Investment Plans (SIP), Systematic Withdrawal Plans (SWP) and dividend reinvestment plans, one can systematically invest or withdraw funds according to his needs and convenience.

(9) **Choice of Schemes:** Mutual Funds offer a variety of schemes to suit your varying needs over a lifetime.

(10) **Well Regulated:** All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI.

(11) **Attract Foreign Capital:** The functioning of mutual funds is not limited to domestic sphere only. In addition to attracting domestic savings, some funds offer their units abroad and attract foreign capital.

(12) **Advantages to Industrial Concern:** Through mutual funds, needy industrial concerns avail a relatively bigger lot of capital. Therefore, it reduces their burden for raising finance directly from individual savers.

DISADVANTAGES/LIMITATIONS OF MUTUAL FUNDS:

(1) **No Guarantees:** No investment is risk free. Even, if the whole stock market declines in value, the value of mutual fund shares will go down as well, no matter how balanced the portfolio. Investors come across fewer risks when they invest in mutual funds than when they buy and sell stocks on their own. Nevertheless, anyone who invests through a mutual fund runs the risk of losing money.

(2) **Fees and commissions:** All funds charge administrative fees to accommodate their day-to-day expenses. Some funds also

charge sales commissions or "loads" to compensate brokers, financial consultants, or financial planners. Even if an investor uses a broker or other financial adviser, investor has to pay sales commission in form of Load.

(3) **Taxes:** During a typical year, most actively managed mutual funds sell anywhere from 20 to 70 percent of the securities in their portfolios. If fund in which an investment is made earns a profit on its sales, investor has to pay taxes on income earned by fund even if it gives reinvestment option.

(4) **Management risk:** When you invest in a mutual fund, investor depends on the fund's manager to make the right decisions regarding the fund's portfolio. If the manager does not perform well investor has to suffer.

FACTORS INFLUENCING THE SELECTION OF MUTUAL FUNDS:

(1) **Past Performance:** The Net Asset Value is the yardstick for evaluating a Mutual Fund. The higher the NAV, the better it is. Performance is based on the growth of NAV during the referral period after taking into consideration Dividend paid.

$$\text{Growth} = (NAV_1 - NAV_0) + \frac{D_1}{NAV_0}$$

(2) **Timing:** The timing when the mutual fund is raising money from the market is vital. In a bullish market, investment in mutual fund falls significantly in value whereas in a bearish market, it is the other way round where it registers growth. The turns in the market need to be observed.

(3) **Size of Fund:** Managing a small sized fund and managing a large sized fund is not the same as it is not dependent on the product of numbers. Purchase through large sized fund may by itself push prices up while sale may push prices down, as large funds get squeezed both ways. So it is better to remain with medium sized funds.

(4) **Age of Fund:** Longevity of the fund in business needs to be determined and its performance in rising, falling and steady markets have to be checked. Pedigree does not always matter as also success strategies in foreign markets.

(5) **Largest Holding:** It is important to note where the largest holdings in mutual fund have been invested.

(6) **Fund Manager:** One should have an idea of the person handling the fund management. A person of repute gives confidence to the investors.

(7) **Expense Ratio:** SEBI has laid down the upper ceiling for Expense Ratio. A lower Expense Ratio will give a higher return which is better for an investor.

(8) **PE Ratio:** The ratio indicates the weighted average PE Ratio of the stocks that constitute the fund portfolio with weights being given to the market value of holdings. It helps to identify the risk levels in which the mutual fund operates.

(9) **Portfolio Turnover:** The fund manager decides as to when he should enter or quit the market. A very low portfolio turnover indicates that he is neither entering nor quitting the market very frequently. A high ratio, on the other hand, may suggest that too frequent moves have leaded the fund manager to miss out on the next big wave of investments. A simple average of the portfolio turnover ratio of peer group updated by mutual fund tracking agencies may serve as a benchmark. The ratio is lower of annual purchase plus annual sale to average value of the portfolio.

E-WALLET:

In the Virtual era of online transactions, E-Wallet is the latest concept. E-wallet is a type of pre-paid account in which a user can store his/her money for any future online transaction, encrypted with a password. With the help of an E-wallet, one can make payments for groceries, online purchases, flight tickets, mobile recharges and many such others. It is also called as "Digital Wallet"

Economic Times has defined it as: "E-wallet is a type of electronic card which is used for transactions made online through a computer or a smartphone. Its utility is same as a credit or debit card. An E-wallet needs to be linked with the individual's bank account to make payments."

KYC (Know Your Customer) norms need to be met to use this wallet. These wallets operate different as compared to the credit cards and Debit cards. The payment process of an e-Wallet is considerably different to that of card payments; during the payment process the customer is authenticated, he/she then has access to the full features and functions of the E-wallet account. This account may include currency conversions, top-ups, and access to other payment service providers. Wallet users may also have the option to create an unverified E-wallet account during the payments process.

Usage of Online mode of payment increases during Covid-19 pandemic. Since the beginning of the year 2020, most businesses, individuals, wholesale and retail transactions were being carried on remotely with online money transfers being the safest and most convenient way. Most Commonly used E-wallets were PayPal, Paytm, Google pay, Amazon Pay, Mobikwik, BHIM, PayZapp, PhonePe etc.

ADVANTAGES OF E-WALLET:

(1) It eases buying and selling transactions with smooth and efficient payment.

(2) It is useful in case of emergencies. The freedom to transact whenever and wherever one wish to.

(3) With online transactions, one can render exact amount.

(4) These wallets keep a record of all transactions done within a stipulated period ensuring budget awareness for the user.

DISADVANTAGES OF E-WALLET:

(1) E-wallet may get lost therefore it becomes necessary for a wallet provider to know its customer carefully before offering such service.

(2) Chances of fraud are higher in online transactions

(3) To use E-Wallet customer and merchant, both require a smart phone with active internet connection.

(4) It becomes difficult for non-tech savvy individual

(5) In case if mobile is lost or its battery gets exhausted, one can become cashless.

CONSUMER FINANCE:

Consumer finance talks about the saving, borrowing, and asset choices that households make for some time to meet either personal expenditure or for the acquirement of any consumer goods. In other words, it is an emerging concept in the category of 'assets based financial service' to provide finance on stress-free terms and at the place of the consumer. As per the current survey, it is been observed that nowadays many consumers have started borrowing for their everyday use activities, like education, purchase of cars, spending on home décor, etc.

Under the consumer finance scheme, the consumer or buyer pays a share of the purchase price in cash at the time of the delivery of the asset, the balance with interest over a predetermined period.

Consumer Finance plays an important role in the financial inclusion of the economy. Most of these credit given are unsecured without any collateral for safekeeping to the lending institution and are mainly used to fund personal consumption like vehicles, consumer durables, etc. The market is recklessly intensifying with both scheduled commercial banks and NBFC's hostilely growing their portfolios.

ADVANTAGES OF CONSUMER FINANCE:

(1) **Obligatory Investments:** Consumer finance encourages obligatory savings practices among the people. To ensure that there is no default in installment payments, provisions need to be maintained by consumers, enabling them to indulge in various forms of investment and savings. These savings eventually realize them, the ownership of an asset in a period.

(2) **Accessibility:** Accessibility and reasonable consideration of need and usage of finance are determined as per the nature and type of customers. Obtaining consumer financing is easier for creditworthiness consumers, but considering today's environment, qualifying for credit seems to be very easy.

(3) **Emergencies:** The consumer finance facility is available to meet personal requirements like the purchase of durables, education, marriage, family requirements, festival necessities, emergencies, etc. The credit facility is not strictly confined to any particular need alone. In times of emergencies, consumer finance turns out to be a better option.

(4) **Augments Standard of living:** Consumer finance availability enhances the standard of living by making consumers capable of demanding durables and other necessities, by which they can upgrade their lifestyle.

(5) **Promotes Industrial growth:** Easy accessibility of consumer finance accelerated the demand for consumer durables, thus enhancing and promoting innovation in industrial production. More supply of innovative products encourages the industries to produce more and supply more, thus creating employment opportunities. It not only creates employment but also helps in the smooth flow of the working capital cycle by cash movements from consumer to producer.

(6) **Economic Development:** Industrial growth becomes an integral part of economic development. Increase in demand and supply, Money circulation, high standard of living, increased employment opportunities, rise in incomes help to accelerate the economic development of the country.

DISADVANTAGES OF CONSUMER FINANCE:

(1) **Aggressive purchasing:** Easy availability of finance, accelerate more buying habits. Overspending inculcates a habit of stocking goods without any use or priority many times. Thus also leading to creating scarcity and thus increasing inflation rate.

(2) **Insolvency:** Overbuying of goods results in several people declaring themselves insolvent/bankrupt within a shorter period. Thus eventually ruining their lives in the long term.

(3) **Damaged credit rating:** Although these days it is very easy to obtain consumer finance, in several cases, it is been observed that improper usage or due to lack of planning in execution of these funds, affects the creditability of consumers when they are unable to repay.

(4) **Accumulation of Interest rate and Extra Fees:** Consumer finance is mostly collateral-free loans thus charging a higher amount of interest rates. Mismanagement of funds by consumers results in their lack of financial planning which forces them to postpone their interest rates payments. Accumulation of such rates carries the additional financial burden on consumers in the form of paying lump bills.

(5) **Economic Instability:** Artificial boom and depression hints to economic volatility and causes turmoil in the financial system. It becomes difficult to understand the economy whether it is reflecting a true picture or a simulated one.

TYPES OF CONSUMER FINANCE:

(1) **Open-end (Revolving) Credit:** It is an ongoing open-end credit arrangement like an overdraft facility with a pre-arranged loan amount that can be used anytime. The repayment of the used credit amount is being paid in installments over a period.

(2) **Charge Cards:** Charge cards do not have a credit limit. The balance on a charge card must be paid in full at the end of each month. Charge cards typically do not have a finance charge or minimum payment since the balance is to be paid in full. Late payments are subject to a fee, charge restrictions, or card cancellation depending on the individual's card agreement.

(3) **Secured Credit Cards:** Secured credit cards act as an opportunity for those without credit history or those with imperfect credit. Secured cards require a security deposit to be placed on the card. The credit limit on a secured credit card is equal to the amount of the deposit made. Secured credit cards have rotating balances depending on the purchases and payments made.

(4) **Cash Loan:** This type of financing works for the buyer whereby the consumer gets loan amounts in the form of cash from bank or non- banking financial institutions for buying the required goods. This is a risky form of lending credit

(5) **Installment loans:** Installment loans against the stocks of goods of wholesale traders. Such loans are clean unsecured advances and therefore tend to have a very high cost for the borrower.

There are still several types of consumer finance available to consumers for their financial needs and ease. Credit cards and Debit cards are also instruments of consumer credit.

SUMMARY

- Venture Capital is a form of "risk capital". In other words, capital that is invested in a project (in this case - a business) where there is a substantial element of risk relating to the future creation of profits and cash flows.
- Venture capitalists view hundreds of business plans every year. The business plan must therefore convince the venture capitalist that the company and the management team have the ability to achieve the goals of the company within the specified time.

- Aditya Birla Capital Advisors Private Limited (ABCAP)–Well known venture capitalist: Aditya Birla Capital Advisors Private Limited (ABCAP) offers investment management and advisory services as Aditya Birla Private Equity to domestic and global investors.
- The investment process, from reviewing the business plan to investing in a proposition, can take a venture capitalist anything from one month to one year but typically it takes between 3 and 6 months.
- A credit card is a plastic card with a magnetic strip invented to simplify the complicated banking process for an individual in case he/she is short of cash, be it something casual like shopping or something severe like an emergency.
- A debit card is a plastic card issued by banks to customers. The card allows instant purchase, removing the correct balance from the user's attached bank account. Debit cards are distinct from credit cards in that they allow purchase based on available funds in the account to be deducted immediately, instead of by using a line of credit that can be repaid at a later time.
- A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

QUESTIONS

(1) **Multiple Choice Questions (MCQs):**

(a) NBFC stands for ___________. ***(March 18)***

(i) Non banking finance companies (ii) Non banking financial corporation (iii) Non bulk finance companies (iv) None of these

(b) The term ___________ refers financial investment in a highly risky and growth oriented venture with the objective of earning a high rate of return.

(i) Venture capital (ii) Merchant banking (iii) Leasing (iv) None of these

(c) ___________ is a road towards a high growth economy. ***(Oct. 17)***

(i) Venture capital (ii) Merchant banking (iii) Leasing (iv) None of these

(d) ___________ act as an intermediary to link up the sources of ideas and the sources of fund.

(i) Venture capital (ii) Merchant banking (iii) Leasing (iv) None of these

(e) ___________ is needed for developing a product in the initial stages.

(i) Seed capital (ii) Startup capital (iii) Second round financing (iv) None of these

(f) The purpose of valuation is to assess the ___________ and viability of the venture and to divide of the percentage of the VCF ownership in the new venture.

(i) Profitability (ii) Feasibility (iii) Availability (iv) None of these

(g) In the case of a ___________, the issuer offers credit and overdraft facilities.

(i) ATM Card (ii) Credit card (iii) Debit card (iv) Cash Credit

(h) A ___________ is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares / stock / bonds / debentures / securities.

(i) NBFC (ii) Loan Capital (iii) Merchant Banking (iv) Leasing

(i) __________ under which cash is made directly available to the buyer who repays it in the form of instalments over a given period.

(i) Cash instalment credit (ii) Commodity instalment credit (iii) Credit financing (iv) Cash credit

(j) A __________ is an investment vehicle that allows several investors to pool their resources in order to purchase stocks, bonds and other securities.

(i) Equity shares (ii) Mutual fund (iii) Insurance (iv) Derivatives

(k) A __________ is an investment vehicle that allows resources in order to purchases stocks, bonds and other securities.

(i) Mutual funds (ii) Derivation

(l) __________ is not a feature of mutual fund.

(i) Professional Management (ii) Portfolio Diversification (iii) Huge Capital Appreciation

(m) __________ was scheme under the mutual fund which gives tax benefit. *(March 19)*

(i) ELSS (ii) Growth Scheme (iii) Debt Scheme

(n) __________ is a mutual fund having lock in period. ***(March 19)***

(i) Open ended scheme (ii) Close ended scheme (iii) Debt scheme

(o) __________ is a limitations of mutual fund. ***(March 19)***

(i) Economies of scale (ii) Tax Efficiencies (iii) Overload of Choices

[Ans.: (a – i), (b – i), (c – i), (d – i), (e – i), (f – i), (g – ii), (h – i), (i – i), (j – ii), (k – i), (l – iii), (m – i), (n – ii), (o – ii)]

(2) Fill in the blanks:

(a) __________ act as intermediaries in purchase and sale of securities in the primary and secondary markets.

(b) __________ agreed to take a specified number of shares or debentures offered to the public, if the issue is not fully subscribed by the public.

(c) __________ is a broad term that refers to any type of non-public ownership equity securities that are not listed on a public exchange.

(d) Preference ordinary shares are __________ with special rights.

(e) The biggest advantage to mutual funds is __________.

(f) The fund is set up as a trust, with an independent trustee, who keeps custody over the assets of the trust. Each share of the trust is called __________.

(g) A __________ is basically a plastic card with a magnetic strip invented with the intention to simplify the complicated banking process for an individual in case he/she is short of cash.

(h) __________ are distinct from credit cards in that they allow purchase based on available funds in the account to be deducted immediately, instead of by using a line of credit that can be repaid at a later time.

[Ans.: (a) Brokers, (b) Underwriters, (c) Private equity, (d) equity shares, (e) Diversification, (f) Unit, (g) credit card, (h) Debit cards]

(3) True or False:

(a) Underwriters act as intermediaries in purchase and sale of securities in the primary and secondary markets.

(b) Brokers agreed to take a specified number of shares or debentures offered to the public, if the issue is not fully subscribed by the public.

(c) Credit is defined as a system under which term loans for purchases of goods and services are advanced to be fractionally liquidated through a contractual obligation.

(d) Debit cards and credit cards differ in some significant ways. ***(Oct. 17)***

(e) Debit cards allow overdraft facility.

(f) Venture Capital is a form of "risk capital".

(g) Venture Capital firms invest funds on a professional basis, often focusing on a limited sector of specialization.

(h) An open-ended mutual fund is the one whose units can be freely sold and repurchased by the investors.

(i) Closed-ended mutual funds do not have a fixed number of units, and a fixed tenure.

(j) The role of a custodian is to act as the Investment Manager of the Trust.

[Ans.: (a) False, (b) False, (c) True, (d) True, (e) False, (f) True, (g) True, (h) False, (i) False, (j) False]

(4) **Match the columns:**

Group "A"	Group "B"
(a) Ordinary Shares ***(March 18)***	(i) Venture Capital
(b) Preference Ordinary Shares	(ii) Finance between Debt & Equity
(c) Preference Shares	(iii) AMFI
(d) Loan Capital	(iv) Lead Manager
(e) Merchant Banker	(v) Non-Banking Finance Companies
(f) Mezzanine Firm	(vi) Equity Shares
(g) Mutual Fund	(vii) Amount Deduction from Account
(h) NBFC	(viii) Credit Limit
(i) Credit Card	(ix) Equity Shares with Special Rights
(j) Debit Card	(x) Fixed Rate of Dividend

[Ans.: (a – vi), (b – ix), (c – x), (d – i), (e – iv), (f – ii), (g – iii), (h – v), (i – viii), (j – vii)]

(5) Explain in detail the role of venture capital financing in corporate finance.

(6) What is Venture Capital Finance? State its features.

(7) What is the role of NBFC in the corporate sectpr?

(8) What do you mean by credit cards? What are the various types of cards offered?

(9) What do you mean by debit cards? How credit cards are different as compared to debit cards?

(10) Explain the role of NBFC in the corporate sector. ***(Oct. 17)***

(11) What is a mutual fund? Explain its features. ***(March 19)***

(12) What are the various types of consumer finance?

(13) State various advantages and disadvantages of consumer finance?

(14) **Write short notes on:**

(a) Venture capital. ***(Oct. 17)***

(b) Credit cards. ***(March 18)***

(c) Features of mutual funds. ***(Oct. 17; March 18)***

(d) Limitations of mutual funds. ***(Oct. 18)***

(e) Factors affecting the selection of mutual funds. ***(Oct. 18)***

(f) Merits of credit cards. ***(March 19)***

(g) E-Wallet. ***(Oct. 18, March 19)***

(h) Investment plan. ***(March 19)***

(i) Consumer finance.

Abbreviations

ACH	Automated Clearing Houses
ADR	American Depository Receipts
ALM	Assets Liabilities Management
AMC	Asset Management Company
ARC	Asset Reconstruction Company
ARF	Asset Reconstruction Fund
ASBA	Application Supported by Blocked Amount
BCBS	Basel Committee on Banking Supervision
BFS	Board for Financial Supervision
BIFR	Board For Industrial and Financial Reconstruction
BIS	Bank For International Settlements
BSC	Banking Supervision Committee
BSE	Bombay Stock Exchange
CAC	Capital Account Convertibility
CAS	Credit Authorisation Scheme
CBLO	Collateralised Borrowing and Lending Obligation
CCI	Controller of Capital Issue
CCIL	Clearing Corporation of India Ltd.
CD	Certificates of Deposit
CDR	Corporate Debt Restructuring
CDSL	Central Depository Securities Limited
CFMS	Centralised Funds Management System
CGCI	Credit Guarantee Corporation of India
CMA	Credit Monitoring Arrangement
CP	Commercial Paper
CRR	Cash Reserve Ratio
DBOD	Department of Banking Operations & Development
DBS	Department of Banking Supervision
DCCB	District Central Cooperative Banks
DFHI	Discount and Finance House of India
DFI	Development Finance Institution
DIGS	Deposit Insurance Guarantee Scheme
DIT	Department of Information Technology
DPSS	Department of Payment & Settlement System
DRT	Debt Recovery Tribunal
DTL	Demand and Time Liability
ECS	Electronic Clearing System

EFT	Electronic Funds Transfer
EME	Emerging Market Economy
FCCB	Foreign Currency Convertible Bonds
FPO	Follow on Public Offer
GDP	Gross Domestic Production
GDR	Global Depository Receipts
ICAAP	Internal Capital Assessment Process
ICICI	Industrial Credit and Investment Corporation of India
ICRA	Information and Credit Rating Agency
IDBI	Industrial Development Bank of India
IDFC	Infrastructure Development Finance Company
IDL	Intra-Day Liquidity
IDRBT	Institute for Development and Research in Banking Technology
IFCI	Industrial Finance Corporation of India
IFSC	Indian Financial System Code
IMD	India Millennium Deposit
IMF	International Monetary Fund
INFINET	Indian Financial Network
IOSCO	International Organisation of Securities Commission
IRBI	Industrial Reconstruction Bank of India
IRCI	Industrial Reconstruction Corporation of India
IRDA	Insurance Regulatory and Development Authority
IRDP	Integrated Rural Development Programme
ISIN	International Securities Identification Number
KYC	Know Your Customer
LAF	Liquidity Adjustment Facility
LIC	Life Insurance Corporation
MBFC	Mutual Benefit Finance Companies
MEI	Macro-Economic Indicator
MFP	Monetary and Financial Policy
MIA	Multiple Indicator Approach
MICR	Magnetic Ink Character Recognition
MPC	Monetary Policy Committee
NABARD	National Bank of Agriculture and Rural Development
NBFC	Non-Banking Financial Companies
NDS	Negotiated Dealing System
NDTL	Net Demand and Time Liabilities
NEAT	National Exchange for Automated Trading
NEFT	National Electronic Funds Transfer
NHB	National Housing Bank

NOF	Net Owned Fund
NPA	Non Performing Assets
NSDL	National Securities Depository Limited
NSE	National Stock Exchange
OMO	Open Market Operation
OTC	Over The Counter
OTCEI	Over The Counter Exchange of India
PACS	Primary Agricultural Credit Society
PCA	Prompt Corrective Action
PD	Primary Dealer
PDO	Public Debt Office
PLR	Prime Lending Rate
QIBs	Qualified institutional Buyers
REIT	Real Estate Investment Trust
RBI	Reserve Bank of India
RBS	Risk Based Supervision
RCTC	Risk Capital and Technology Corporation
RRBs	Regional Rural Banks
RTGS	Real Time Gross Settlement
SAA	Service Area Approach
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest
SBI	State Bank of India
SBTS	Screen Based Trading System
SCB	State Cooperative Banks
SEBI	Securities and Exchange Board of India
SFDA	Small Farmer's Development Agencies
SGSY	Swarnajayanti Gram Swarojgar Yojana
SIDBI	Small Industries Development Bank of India
SLR	Statutory Liquidity Ratio
SLMA	Secondary Loan Market Association
SSS	Securities Settlement System
STCI	Securities Trading Corporation of India
TDICI	Technology Development and Information Company of India Ltd.
TFCI	Tourism Finance Corporation of India Ltd.
UTI	Unit Trust of India
VSAT	Very Small Aperture Terminal
WMA	Ways and Means Advances

Useful Books for BAF
Second Year : Semester IV

(1) **Special Accounting Areas (FA – IV)**
Kishnadwala & Others

(2) **Introduction to Management Accounting (MA – I)**
Arvind A. Dhond

(3) **Indirect Taxes – II (Taxation – II)**
A. V. Wandrekar: H. M. Thakkar

(4) **Financial Markets Operations (Commerce – II)**
Jia Makhija

(5) **Company Law (Business Law – III)**
Kalaivani Venkataraman

(6) **Applications in Business (IT – II)**
D. G. Doshi

(7) **Value Education and Soft Skill (FC - II)**
Riya Rupani