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DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

M.B.A III Semester

COURSE - 16 A

FINANCIAL MARKETS AND INSTISTUTIONS

BLOCK

1

OVERVIEW OF INDIAN FINANCIAL SYSTSEM

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BLOCK -1 : OVERVIEW OF INDIAN FINANCIAL SYSTEMS

The financial system of a country is an important tool for economic development of the country, as it helps in creation of wealth by linking savings with investments. It facilitates the flow of funds from the households (savers) to business firms (investors) to aid in wealth creation and development of both the parties. A financial system consists of various financial institutions, financial market, financial transactions, rules and regulations, liabilities and climes etc.

The first block of this course overview of Indian financial system comprises of 04 units (01-04). Unit 01 discuss reserve bank of India introduction, historical background, evolution, purpose of establishment, role in Indian financial system, the functions and minority policy. Unit 02 explains commercial banks in India introduction, functions, structure of scheduled and non-scheduled banks, resources and need for nationalization. Unit 03 elucidates non-banking financial companies(NBFCs) Introduction growth, functions, types of services rendered, features and regulation. Unit 04 exhibits regulatory framework of banking sector introduction, role in credit control, and regulations over commercial banks.

UNIT - 1 : RESERVE BANK OF INDIA

Structure :

1.0 OBJECTIVES

After reading this unit, you will be able to;

- The concept of Reserve Bank of India
- Historical background of Reserve Bank of India.
- The Functions of Reserve Bank of India
- The role of Reserve Bank of India in financial system.
- The Reserve Bank of India and monetary policy.

1.1 INTRODUCTION

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. 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. It became the public sector bank from 1st January, 1949. Thus, Reserve Bank of India was established as per the Act 1935 and empowerment took place in Banking Regulation Act 1949.

Reserve Bank of India is the queen bee of the Indian financial system which influences the commercial banks' management in more than one way. The Reserve Bank of India regulates and monitors the functioning of commercial banks through its various policies, directions and regulations. Its role in bank management is quite unique. In fact, the Reserve Bank of India performs the four basic functions of management, viz., planning, organizing, directing and controlling in laying a strong foundation for the functioning of commercial banks. Reserve Bank of India has four local boards in North, South, East and West – located respectively in four metro cities viz Delhi, Chennai, Calcutta, and Mumbai.

1.2 HISTORICAL BACKGROUND AND OF CENTRAL BANK IN INDIA

The genesis of Reserve Bank of India (RBI) started in 1926 when the Hilton-Young Commission or the Royal Commission on Indian Currency and Finance made recommendation to the British Government of India for creation of a central bank. The chief objectives of such recommendations were twofold:

- To separate the control of currency and credit from the government
- To augment banking facilities throughout the country.

To give effect to above recommendations, a bill was introduced in Legislative Assembly in 1927 but this bill was withdrawn because various sections of the people were not in agreement.

The recommendation to create a reserve bank was made by White Paper on Indian Constitutional Reforms. Thus, a fresh bill was introduced and was enacted in 1935.

Thus, Reserve Bank of India was established via the RBI Act of 1934 as the banker to the central government. RBI launched its operations from April 1, 1935. Its headquarters were in Kolkata in the beginning, but it was shifted to ShahidBhagat Singh Marg, Mumbai in 1937.

Prior to establishment of RBI, the functions of a central bank were virtually being done by the Imperial Bank of India, which was established in 1921 by merging three Presidency banks. It was mainly a commercial bank but also served as banker to the government to some extent.

It's worth note that RBI started as a privately owned bank. It started with a Share Capital of Rs.5 Crore, divided into shares of Rs.100 each fully paid up. In the beginning, this entire capital was owned by private shareholders. Out of this Rs.5 Crore, the amount of Rs.4,97,8000 was subscribed by the private shareholders while Rs.2 20,000 was subscribed by central government.

After independence, the government passed Reserve Bank (Transfer to Public Ownership) Act, 1948 and took over RBI from private shareholders after paying appropriate compensation. Thus, nationalization of RBI took place in 1949 and from January 1, 1949, RBI started working as a government owned Central Bank of India.

Key Landmarks in the journey of RBI:

In 1926, the Royal Commission on Indian Currency and Finance recommended creation of a centralbank for India. In 1927, a bill to give effect to the above recommendation was introduced in the Legislative Assembly, but was later withdrawn due to lack of agreement among various sections of people.

In 1933, the White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.

In 1934, the Bill was passed and received the Governor General's assent In 1935, Reserve Bank commenced operations as India's central bank on April 1 as a private shareholders' bank with a paid up capital of rupees five crore. In 1942 Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar).

In 1947, Reserve Bank stopped acting as banker to the Government of Burma.

In 1948, Reserve Bank stopped rendering central banking services to Pakistan.

In 1949, the Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.

In 1949, Banking Regulation Act was enacted. In 1951, India embarked in the Planning Era. In 1966, the Cooperative Banks came within the regulations of the RBI. Rupee was devaluated for the first time.

In 1969, Nationalization of 14 Banks was a Turning point in the history of Indian Banking. In 1973, the Foreign Exchange Regulation act was amended and exchange control was strengthened.

In 1974, the Priority Sector Advance Targets started getting fixed.

In 1975, Regional Rural Banks started In 1985, the Sukhamoy Chakravarty and Vaghul Committee reports embarked the era of Financial Market Reforms in India.

In 1991, India came under the Balance of Payment crisis and RBI pledged Gold to shore up reserves. Rupee was devaluated. In 1991-92, Economic Reforms started in India. In 1993, Exchange Rate became Market determined.

In 1994, Board for Financial Supervision was set up.

In 1997, the regulation of the Non-Banking Financial Companies (NBFC) got strengthened.

In 1998, Multiple Indicator Approach for monetary policy was adopted for the first time. In 2000, the Foreign Exchange Management Act (FEMA) replaced the erstwhile FERA.

In 2002, the Clearing Corporation of India Ltd started operation.

In 2003, Fiscal Responsibility and Budget Management Act (FRBMA) enacted.

In 2004, Liquidity Adjustment Facility (LAF) started working fully. In 2004, Market Stabilization Scheme (MSS) was launched.

In 2004 Real Time Gross Settlement (RTGS) started working. In 2006, Reserve Bank of India was empowered to regulate the money, forex, G-Sec and Gold related security markets.

In 2007, Reserve bank of India was empowered to regulate the Payment systems.

1.3 PURPOSE OF ESTABLISHMENT OF RESERVE BANK OF INDIA

The Preamble to the Reserve Bank of India Act, 1934 spells out the objectives of the Reserve Bank as: “to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.”

Prior to the establishment of the Reserve Bank, the Indian financial system was totally inadequate on account of the inherent weakness of the dual control of currency by the Central Government and of credit by the Imperial Bank of India. The Hilton-Young Commission, therefore, recommended that the dichotomy of functions and division of responsibility for control of currency and credit and the divergent policies in this respect must be ended by setting-up of a central bank – called the Reserve Bank of India – which would regulate the financial policy and develop banking facilities throughout the country. Hence, the Bank was established with this primary object in view.

Another objective of the Reserve Bank has been to remain free from political influence and be in successful operation for maintaining financial stability and credit. 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 government, and to promote 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.

A significant object of the Reserve -Bank of India has also been to assist the planned process of development of the Indian economy. Besides the traditional central banking functions, with the launching of the five-year plans in the country, the Reserve Bank of India has been moving ahead in performing a host of developmental and promotional functions, which are normally beyond the purview of a traditional Central Bank.

1.4 ROLE OF RESERVE BANK OF INDIA IN INDIAN FINANCIAL SYSTEM

In every country there is one organization which works as the central bank. The function of the central bank of a country is to control and monitor the banking and financial system of the country. In India, the Reserve Bank of India (RBI) is the Central Bank.

The RBI was established in 1935. It was nationalized in 1949. The RBI plays role of regulator of the banking system in India. The Banking Regulation Act 1949 and the RBI Act 1953 has given the RBI the power to regulate the banking system.The RBI has different functions in different roles. Below, we share and discuss some of the functions of the RBI.

♦ **RBI is the Regulator of Financial System**

The RBI regulates the Indian banking and financial system by issuing broad guidelines and instructions. The objectives of these regulations include:

- Controlling money supply in the system,

- Monitoring different key indicators like GDP and inflation,
- Maintaining people's confidence in the banking and financial system, and
- Providing different tools for customers' help, such as acting as the "Banking Ombudsman."

♦ **RBI is the Issuer of Monetary Policy**

The RBI formulates monetary policy twice a year. It reviews the policy every quarter as well. The main objectives of monitoring monetary policy are:

- Inflation control
- Control on bank credit
- Interest rate control

The tools used for implementation of the objectives of monetary policy are:

- Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR),
- Open market operations,
- Different Rates such as repo rate, reverse repo rate, and bank rate.

♦ **RBI is the Issuer of Currency**

Section 22 of the RBI Act gives authority to the RBI to issue currency notes. The RBI also takes action to control circulation of fake currency.

♦ **RBI is the Controller and Supervisor of Banking Systems**

The RBI has been assigned the role of controlling and supervising the bank system in India. The RBI is responsible for controlling the overall operations of all banks in India. These banks may be:

- Public sector banks
- Private sector banks
- Foreign banks
- Co-operative banks, or
- Regional rural banks

The control and supervisory roles of the Reserve Bank of India is done through the following:

- **Issue of License:** Under the Banking Regulation Act 1949, the RBI has been given powers to grant licenses to commence new banking operations. The RBI also grants licenses to open new branches for existing banks. Under the licensing policy, the RBI provides banking services in areas that do not have this facility.

- **Prudential Norms**: The RBI issues guidelines for credit control and management. The RBI is a member of the Banking Committee on Banking Supervision (BCBS). As such, they are responsible for implementation of international standards of capital adequacy norms and asset classification.
- **Corporate Governance:** The RBI has power to control the appointment of the chairman and directors of banks in India. The RBI has powers to appoint additional directors in banks as well.
- **KYC Norms:** To curb money laundering and prevent the use of the banking system for financial crimes, The RBI has issued "Know Your Customer" guidelines. Every bank has to ensure KYC norms are applied before allowing someone to open an account.
- **Transparency Norms:** This means that every bank has to disclose their charges for providing services and customers have the right to know these charges.
- **Risk Management:** The RBI provides guidelines to banks for taking the steps that are necessary to mitigate risk. They do this through risk management in Basel norms.
- **Audit and Inspection:** The procedure of audit and inspection is controlled by the RBI through off-site and on-site monitoring system. On-site inspection is done by the RBI on the basis of "CAMELS". Capital adequacy; Asset quality; Management; Earning; Liquidity; System and control.
- **Foreign Exchange Control:** The RBI plays a crucial role in foreign exchange transactions. It does due diligence on every foreign transaction, including the inflow and outflow of foreign exchange. It takes steps to stop the fall in value of the Indian Rupee. The RBI also takes necessary steps to control the current account deficit. They also give support to promote export and the RBI provides a variety of options for NRIs.
- **Development**: Being the banker of the Government of India, the RBI is responsible for implementation of the government's policies related to agriculture and rural development. The RBI also ensures the flow of credit to other priority sectors as well. Section 54 of the RBI gives stress on giving specialized support for rural development. Priority sector lending is also in key focus area of the RBI.

Apart from the above, the RBI publishes periodical review and data related to banking. The role and functions of the RBI cannot be described in a brief write up. The RBI plays a very important role in every aspect related to banking and finance. Finally the control of NBFCs and others in the financial world is also assigned with RBI.

1.5 FUNCTIONS OF THE RESERVE BANK OF INDIA

The Reserve Bank of India performs all the typical functions of a good Central Bank. In addition, it carries out a variety of developmental and promotional functions which are tuned to the course of economic planning in the country:

i) Issuing currency notes, i.e. to act as a currency authority.

ii) Serving as banker to the Government.

iii) Acting as bankers' bank and supervisor.

iv) Regulatory and Supervisor Functions.

V) Controller of Credit.

Important functions of Reserve Bank of India are briefed below:

i) Monopoly in Note Issue: - Reserve Bank of India enjoys monopoly of Notes issue since its establishment. The bank issues the currency notes of all denominations. Except coins which are issued by the ministry of finance in the government of India. But these coins are put into circulation only through the RBI. The Bank (RBI) issue currencies to a minimum reserve system under which Rs 200\- crores worth of Gold and foreign exchange reserve should be kept out of these 200 crores, 115 crores values should be in the form of Gold only. To undertake this function RBI established two departments i.e.

a) Issue Department

b) Banking department

Issue department is involved in issue of currencies and manages currencies circulation.

ii) Banker to the Government: - Reserve Bank of India acts as a banker to the central and state Government. As a banker it provides all the services like a commercial bank to these Governments. It accepts deposits of the Government and allows them to withdrawal of cheques. It makes payments and collect receipts on behalf of the government. It also provides temporary advances for maximum period of 3 months to these governments. It is known as "Ways" and "Means advances". It is also the financial advisor to the central and states. It also helps them in formulation of financial policies.

iii) Bankers bank: - Reserve Bank of India is the apex financial institution acts as banker to other bank. RBI accepts deposits, maintains cash reserves and lends loans to all the banks operating under its preview. It is a banker's bank in the following grounds: It provides short-term loans to the banks for 3 months against (security) i.e. eligible securities.

It is known as lenders of last resort in the times of financial emergency. It also gives loans at concessional rate of Interest for a specific purpose. It also offers refinance facilities to all the eligible banks.

iv) Regulatory and Supervisor Functions: -The most significant provision of the Banking regulation act is supervision and regulation of banks. Section 35 of the act say's that RBI can inspect any branch of Indian Bank located in or 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.

v) Controller of Credit: - Reserve Bank of India is an important controller of credit in our credit. The credit created by bank leads to inflation or depression and disturbs the smooth functioning of the economy. Therefore, to regulate credit Reserve Bank of India uses qualitative as well as Quantitative credit control measures.

1.6 THE RBI AND MONETARY POLICY

The RBI formulates monetary policy twice a year. It reviews the policy every quarter as well. The main objectives of monitoring monetary policy are:

- Inflation control
- Control on bank credit
- Interest rate control

The tools used for implementation of the objectives of monetary policy are:

- Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR),
- Open market operations,
- Different Rates such as repo rate, reverse repo rate, and bank rate.

1.7 NOTES

1.8 SUMMARY

In this unit historical background of Reserve Bank of India, Functions and Objectives of Reserve Bank of India are discussed. The Reserve Bank of India is India's central banking institution, which controls the monetary policy of the Indian rupee. It was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act; 1934.The central office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. The Central Office is where the Governor sits and where policies are formulated. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India. The central bank performs the functions of issuing of notes, as bankers bank, as banker to the government, credit control etc. it uses qualitative and quantitative measures to control the credit.

1.9 SELF-ASSESSMENT QUESTIONS

1. What do you mean by "Central Banking". Explain in detail.

2. Discuss the organization of Reserve Bank of India?

3. What are the various functions of Reserve Bank of India?

4. Write short note on following:

(i) Ways and means advances

(ii) Banker's Bank

5. Discuss various objectives of Reserve Bank of India?

6. "Central Bank is an apex financial institution of the country". Elaborate

7. Examine the role played by Reserve Bank of India in our economy.

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UNIT-II : COMMERCIAL BANKS IN INDIA

Structure :

2.0 OBJECTIVES

After reading this Unit, you will be able to;

- The structure of working of Commercial Banks in India,
- The functions of Commercial Banks
- The sources of funds for Commercial Banks and their utilization,
- The problem of non-performing assets of banks and its impact on banks functioning.

2.1 INTRODUCTION

Commercial Banks are the oldest and the largest banking institutions in India. Some of them are more than hundred years old. Their branches are spread all over the country and have penetrated in the countryside as well. Commercial Banking has passed through three distinct phases in India since Independence. The period 1955- 1970 witnessed the genesis of public sector banking in India Commencing with the setting up of the State Bank of India in 1955 and ending with the nationalization 0f 14 major banks in 1969.

The two decades after nationalization of banks i.e. the seventies and eighties witnessed the conversion of class banking into mass banking. During this Period branch expansion took place on a large-scale, followed by recruitment of -large number of bank employees, expansion in priority sector advances, especially for the poor and neglected sectors.

Loan Melas were the main features of this period. On the other hand, the Reserve Bank of India's regulatory control intensified over various facets of banking operations. The post-nationalization era was not without its resultant problems. With poor training, employee efficiency and productivity went down, problem of non-recovery of loans cropped up, and pre-emption of funds in meeting statutory requirement went up, resulting in reduced profitability of banks. It was such a situation in 1991 when the new economic policies were launched by the Government.

A Committee on financial sector under the Chairmanship of Shri M, Narashimham was appointed which suggested measures of far-reaching significance to improve efficiency, productivity and profitability of banks. These measures have been largely implemented.

2.2 FUNCTIONS OF COMMERCIAL BANKS

A Bank is a financial Institution whose main business is accepting deposits and lending loans. A Banker is a dealer of money and credit. Banking is an evolutionary concept i.e. expanding its network of operations. According to banking regulations act 1949, the word Banking has been defined as "Accepting for the purpose of lending and investment of deposits of money from the public repayable on demand or otherwise".

The important functions of commercial banks are explained below:

I. Primary Functions

These are further classified into 2 categories

i) Accepting Deposits: -

Deposits are the capital of banker. Therefore, it is first Primary function of the banker. He accepts deposits from those who can save and lend it to the needy borrowers. The size of operation of every bank is determined by size and nature of Deposits. To attract the saving from all sort (categories) of individuals, Commercial banks accepts various types of deposits account they are:

a) Fixed Deposits

b) Current Deposits

c) Saving Bank account

d) Recurring Deposits

ii) Lending Loans: -

The 2nd important function of the commercial bank is advancing loans. Bank accepts deposits to lend it at higher rate of interest. Every Commercial Bank keep the rate of interest on its deposit at lower level or less that what he charges on its loans which is as NIM (Net Interest Margin). The banker advances different types of loans to the individual and firms. They are: -

a) Overdraft

b) Cash Credit

c) Term Loan

d) Discounting Bill

II) Secondary Functions

i) Agency functions:

Bankers act as an agent to the customers it means he performs certain function son behalf of the customers such services are called Agency Services. Example:

a) Bank pay electricity bill, water bill, Insurance Premium etc.

b) They guide the customer in Task Planning.

c) Bank provides safety locker facility.

d) Pay salaries of customer's employees.

ii) General Utility Services: -

Bankers are the past of society. They offer: several services to general public they are:-

a) It provides cheap remittance (transfer) facilities.

b) The banks issue traveler cheque for safe travelling to its customers.

c) Banks accepts and collects foreign Bills of Exchanges.

d) Other than these services the bankers also provide ATM services, Internet Banking, Electronic fund transfer (EFT), E-Banking to provide quick and proper services to its customers.

III) Credit Creation: -

It is a unique function of Commercial Banks. When a bank advances loan to its customer if doesn't lend cash but opens an account in the borrowers name and credits the amount of loan to that account. Thus, whenever a bank grants loan, it creates an equal amount of bank deposits. Creation of deposits is called Credit Creation. In simple words we can define Credit creation as multiple expansions of deposits. Creation of such deposits will results an increase in the stock deposits. Creation of such deposits will results an increase in the stock of money in an economy.

2.3 STRUCTURE OF COMMERCIAL BANKS

Commercial banks are basically of two types.

2.3.1. Scheduled banks

2.3.2. Non- scheduled banks.

2.3.1 Scheduled Banks are those which have been in II schedule of Reserve Banks of India act, 1934 and following criteria should be satisfied.

1. Minimum paid up capital Rs. 5 lakh.
2. It must be a corporation as co-operative society.
3. Any activity of bank will not adversely affect the interest of depositors

Scheduled banks consists public sector banks, private sector banks, foreign banks, and regional rural banks.

2.3.1.1 Public Sector Banks:

Public banks are those in which 50% of their capital is provided by central government, 15% by concerned state government and 35% by sponsored commercial banks. In India, there are 27 public sector banks. They includes the state bank of India and its 6 associated banks such as state bank of Hyderabad, state bank of Mysore etc. and 19 nationalized banks and IDBI banks Ltd. Public sector banks mostly situated in rural area than urban area.

2.3.1.2 Private Sector Banks:

Private Banks are those in which majority of share capital kept by business house and individual. After the nationalization, entry of private sector banks is restricted. But some of private banks continued to operate such as Jammu & Kashmir bank Ltd. To increase the competition spirit and improve the working of public sector banks, RBI permitted the entry of private sector banks in July, 1993.

2.3.1.3 Foreign Banks:

Foreign banks are those which incorporated outside India and open their branches in India. Foreign banks performed all the function like other commercial banks in India. Foreign banks are superior in technology and management than India banks. They offer different types of products and services such as offshore banking, online banking, personal banks etc. They provide loans for automobiles, small and large businesses. Foreign banks also providespecial types of credit card which are nationally and internationally accepted. These banks earn lots of profit and create new ways of investments in the country.

2.3.1.4 Regional Rural Banks

Regional rural banks established 1975 with mandate to ensure sufficient credit for agriculture and rural sector. RRB's are jointly owned by government of India, concerned state government and sponsor bank, the capital share being 50 %, 15% and 35% respectively. Now these Days, there are 14,475 regional rural banks in India. NABARD control and prepare the policies for Regional Rural Banks. The basic objective of establishing RRB's in India was to provide the credit to rural sector especially the small and medium farmers, artisans, agricultural labour and even small entrepreneurs.

2.3.2 Non Scheduled Banks:

Non Scheduled banks in India define in clause (C) of section 5 of Banks regulation Act 1949. Non Scheduled banks are those which are not a schedule bank and their paid up capital and reserves less than Rs.5 lakh and are not included in the 2nd schedule of the Reserve Bank of India Act, 1934.

2.4 RESOURCES OF COMMERCIAL BANKS

Banking business essentially lies in the acceptable of deposits for the purpose of lending and investment. Acceptance of deposits thus, constitutes the main source of funds for them. Their own funds constitute a small percentage of their total resources. As we shall see later, efforts are being made during recent years to increase the owned funds of the banks also.

2.4.1 Paid Up Capital and Reserves

The authorized capital of nationalized banks is Rs. 1500 crore each. The Central Government has subscribed to the 100% paid-up capital in case of some banks, while in other cases; its percentage holding has declined with the issuance of shares to the public. Banks transfer 20% (now 25%) of their net profits to a Statutory Reserve Fund every year. Besides, they also maintain other Reserve Funds, e.g. Capital Reserves, Share premium, revenue and other reserves and Investment Fluctuation Reserve.

2.4.2 Deposits

Deposits from the public, institutions, and organizations constitute the bulk of the resources of commercial banks. They accept deposits under three types of deposit accounts:

i) Fixed Deposits: the minimum period of such deposits is 15 days

ii) Savings Deposits

iii) Current Deposits

No interest is payable on current deposits, while interest on savings bank accounts is prescribed by Reserve Bank of India. Currently it is payable @ 4% p.a. Interest is calculated on the minimum balance held in the savings accounts from 11^{th} day of the month till the last day of the month. Interest rates on fixed deposits were prescribed by Reserve Bank of India till a few years ago. Now, such interest rates are completely deregulated. Banks are permitted to prescribe their own interest rates for fixed deposits of different maturities. At the stance of the Reserve Bank of India, banks pay slightly higher rates on bulk deposits of Rs. 15 lakh and above and on deposits held in the names of senior citizens (i.e. persons of age 60 years and above).

Deposits with Commercial banks, as well as with Regional Rural Banks and Co-operative banks are insured by Deposit Insurance and Credit Guarantee COMPANY of India up to an amount of Rs. 1 lakh in each account. These banks pay the insurance premium @ 5 paise percent to the COMPANY for this insurance. Scheduled Commercial Banks also solicit large deposits through certificates of deposits. The outstanding amount of CDs issued by them stood at Rs. 1695 crore as on October 20, 2000, but declined to Rs. 823 crore as on October 5, ‘ 2001.

2.4.3 Borrowings

Banks augment their resources by borrowings also. Sources of such borrowings are:

i) Reserve Bank of India

ii) Other Banks

iii) Other Institutions and Agencies.

Reserve Bank of India provides refinance for export credit and also provides short-term funds under its Liquidity Adjustment Facility Moreover; banks get refinance from other Apex Banks like Exim Bank, IDBI etc.

2.5 EMPLOYMENT OF RESOURCES

As you have keen, bulk of banks’ funds are raised in the form of deposits, which are repayable on demand or after a specified period. Banks, therefore, employ these funds partly in liquid assets like cash balances with themselves and other banks and money at call and short notice and the rest of the amount is either invested in securities or given in the form of loans and advances.

i) Cash and balance with other Banks

These are the most liquid assets of a bank and are called the first line of defence, because banks can immediately repay the claims of the depositors with these balances. Banks keep a reasonable amount of cash; say 10% or so of, deposits, in such balances.

ii) Money at Call and Short Notice

The surplus money with the banks is lent to other banks which are in need of funds for a day or a few days. Banks earn interest on-such amount lent to other banks. The interest rate varies from day to ‘day on the basis of demand for and supply of funds.

iii) . Cash Reserves with Reserve Bank of India

Under Section 42 of the Reserve Bank of India Act, 1934, scheduled commercial banks are required to maintain at least 3 % of their net demand and time liabilities with the Reserve Bank of India. This is the statutory minimum limit; Reserve Bank of India is empowered to raise it to a higher percentage of upto 20%.

With effect from June 1, 2002, the Cash Reserve Ratio ICRR) is required to be maintained @ 5% (reduced from 5.5%). In recent years, Reserve Bank of India has gradually reduced this rate. With every reduction in CRR, Commercial Banks' balances with Reserve Bank of India are released to them, thereby increasing their liquidity. Reserve Bank of India pays interest at bank rate on eligible balances i.e. balances held in excess of statutory 3% limit.

iv). Investments

Banks invest substantial portion of their deposit liabilities in investments. Primarily, banks are under compulsion to invest in Government and other approved securities to meet the Statutory Liquidity requirement under section 24 of the Banking regulation act, 1949. Besides, Reserve Bank of India has also permitted the' banks to invest in corporate securities, i.e. equity shares, convertible bonds and debentures within the ceiling of 5% of their total outstanding advances as on March 31 of the previous year. Thus, commercial banks do invest in corporate securities, predominantly, bonds and debentures.

Investments of banks are shown under the following head in their Balance Sheets:

1) Government Securities

2) Other approved securities

3) Shares

4) Debentures and Bonds

5) Subsidiaries and Joint Ventures

6) Others (Commercial Paper, Indira Vikas Patras, Units of UTI and Mutual Funds)

Though the Statutory Liquidity Requirement at present is 25% of net demand and time liabilities, banks do invest more than this percentage, which is mainly due to their investments in corporate bonds and debentures. The investment-deposit ratio of Scheduled Commercial banks (on an outstanding basis) was 38.5% as on March 23, 2001.

v) Loans and Advances

Granting loans and advances is the principal business of commercial banks. There are three forms in which such loans are granted:

a) Bills purchased and discounted,

b) Cash credits, overdrafts and loans repayable on demand, and

c) Term loans.

a) Bill of exchange arises out of genuine trade transactions. When the bills are payable at sight or presentment, banks purchase them from customers (i.e. drawers' of the bills). In case of time bills or usance bills banks discount them.

b) Cash Credit is a running account wherein a cash credit limit is prescribed for a customer. He is permitted to withdraw the amount any time he likes and may return the money whenever he is able to do so. Interest is charged on the actual amount lent and for the period of loan.

Overdraft is a temporary facility which is granted to account holders. They are permitted to draw more than their deposits for some exigency or urgent work. Short-term loans are granted- to the customers, which are repayable on demand.

c) Term loans are loans for medium to long periods. Such loans are granted by banks either singly or jointly with term lending institutions. These loans are meant for investment in futed assets or for expansion, modernization, etc.

2.6 NEED FOR NATIONALIZATION OF COMMERCIAL BANKS

Nationalization of Commercial Banks

The role of public sector banks increased after nationalization of commercial banks. On I July 1955, the government of India took over imperial Bank of India and converted it into the state Bank of India. In India, the major nationalization of commercial banks was done in July 1969 by Prime Minister Mrs Indira Gandhi. 14 Commercial banks were nationalized in July 1969. In April 1980, 7 more bank were nationalized.

Need for Nationalization of Commercial Banks

The needs for nationalization of Commercial Banks are given below.

1. Commercial Banks were provide loans to large scale Industries and neglected priority sectors.

2. Before the nationalization financially strong Bank ignored RBI Directives which adversely effected RBI monetary policy.

3. To remove the fear of bank failures from the minds of people.

4. To keep means of generating wealth in public control.

5. To remove regional imbalances and ensure even distribution of banking facilities.

6. To prevent unfair credit distribution by commercial banks

Advantages of Nationalization of Commercial Banks

Some of the advantages of Nationalization of Commercial Banks are as follows:

1. To Check on Creation of Industrial Monopoly:

Before nationalization of commercial banks credit was concentrated to few hands and this formed Industrial Monopoly. No person except big Industrialist could get loan and advances. This neglected the other smaller industrialist. So, commercial banks were nationalized to curb the monopolizing tendencies.

2. Credit Facility to Priority Sector:

Agriculture sector is backbone of India. This sector was neglected at that time. There was no credit facility available to agriculture sector before nationalization.

3. Reduction of Regional Imbalance:

Regional imbalances had existed in India for a long time in area of banking facilities. After nationalization, branches opened in backward states like Assam, Bihar, and Uttar Pradesh than in developed states like Gujarat, Tamil Nadu etc. These banks reduced the Regional Imbalances.

4. Collection of Saving:

Before the Nationalization, the banks did not attract more saving from public, because people did not trust banking system. But After nationalization of commercial Banks, the deposits were increased. Because public believed in public sector Banks then private sector Banks.

5. To check on Black Money:

In order to avoid income tax, people kept money with banks. For the solution of this problem the banks were nationalized.

6. Economic Growth:

Before nationalization of banks, economy of country was not growing due to antisocial practices, speculation and hoarding. The country's economy suffered badly. In order to solve this problem banks were nationalized.

7. Export Promotion:

Commercial Banks also promotes export. Because there is need to promote export for earn Foreign exchange. So, Banks give Finance to Exporter at concessional rates.

8. Credit Card Facility:

Credit card facility is provided by these Banks which has made our life easy. People can buy necessary things through credit card make payment later on.

9. Promote Small Scale Industry:

Nationalized commercial Banks encouraged small scale Industry by granting Loans. These banks grant short term and long term loan to purchase machinery and equipment.

Disadvantages of Nationalization of Commercial Banks

1. Low performance:

The biggest problem of nationalized banks has been their low performance. Banks are required to keep minimum capital to risk asset ratio which known as capital adequacy ratio. It should be 9%.Most of public sector banks had negative ratio. Only four banks maintained ratio during 1999-2000.

2. Favoritism:

Another limitation of commercial banks was favoritism in granting loan. They harass certain small industrialist and same time banks grant loan to big industrialist on easy terms and conditions. They follow the policy of partiality which affected the trust of client in banks working.

3. Unbalanced Distribution of Credit:

In initial years, Agriculture sector got priority and other sector were neglected. Bank do not advance loan to weaker section such as laborers, worker and small trader due to lack of security.

4. Financial Crisis:

After nationalization, some banks were operating under losses .This is because banks advance loan without adequate security. Banks grant non-performing loans which interest has not been received for 180 days. The recovery of loan was poor which lead to losses. This is main reason for failure of banks.

5. Political Interference:

Another limitation of nationalized commercial banks was increasing the political interference in granting loans, appointment of banks personnel, opening of new branches etc.

6. Inadequate Facilities:

Nationalized commercial banks have failed to provide adequate facilities and services to population living in rural and sub urban area. Banks failed to mobilize rural deposit.

2.7 NOTES

2.8 SUMMARY

Major portion of commercial banking in 1ndia is undertaken in the public sector. Within the public sector, the State Bank of India and its subsidiaries constitute State Bank Group on the basis of their ownership pattern. New private sector bank, include ICICI Bank Ltd, which is the second biggest bank after State Bank of India. Banks get the status of Scheduled Banks on the fulfilment of prescribed conditions.

The main sources of banks' funds are deposits. Interest Rates on deposits are now completely deregulated (except savings). Borrowings from Reserve Bank and other institutions also augment their funds.

Commercial Banks employ their funds in liquid assets, semi liquid assets and profit earning assets like loans and advances. They are required to maintain a prescribed percentage of deposits with Reserve Bank of India as CRR and also to maintain Statutory Liquidity Ratio of 25%.

Funds are lent for diversified purposes-priority sector advances constitute over 40% of total advances. They also lend for housing, consumer durables, real estate financing and other personal purposes also.

2.9 SELF ASSESSMENT QUESTIONS

1. What do you mean by Commercial banks? Explain the functions of Commercial banks.

2. Discuss the structure of commercial banks in India.

3. Critically examines the need of nationalization of commercial banks.

2.10 REFERENCES

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UNIT –III : NON-BANKING FINANCIAL COMPANIES (NBFCs)

Structure :

3.0 Objectives

3.1 Introduction

3.2 Growth Of Non-Banking Financial Companies

3.3 Functions Of Non-Banking Financial Companies

3.4 Types Of Non-Banking Financial Companies (NBFCs)

3.5 Types Of Services Rendered By Non-Banking Finance Companies

3.6 Features Of Non-Banking Financial Companies

3.7 Regulations of (NBFCs)

3.8 Notes

3.9 Summary

3.10 Self Assessment Questions

3.11 Some Useful Books

3.0 OBJECTIVES

After reading this unit, you will be able to;

- The concept of Non-Banking Financial Companies
- The difference between NBFCs and Banks
- The Functions of Non-Banking Financial Companies (NBFCs)
- The different kinds of services rendered by Non-Banking Finance Companies (NBFCs)

3.1 INTRODUCTION

Financial intermediaries are that institution which link lenders and borrows. The process of transferring saving from savers to investors is known as financial intermediation. Commercial banks and cooperative credit societies are called “finance Companies”, or “finance companies”. These finance companies with very little capital have been mobilizing deposits by offering attractive interest rates and incentives and advance loans to wholesale and retail traders, small industries and self-employed persons. They grant unsecured loans at very rates of interest. These are non-banking companies performing the functions of financial intermediaries. They cannot be called banks. 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.

Number of Non-Banking Financial Companies

The number of Non-Banking Financial Companies continued to grow year after year in the nineties. During 1996-97, the aggregate deposits of 13,970 Non- Banking Financial Companies totalled up to Rs.3,57,150crores. As on March 31, 2012 the total number of Non-Banking Financial Companies registered with RBI stood at 12,385 compared with 12,409 in 2011. The number of deposit taking Non-Banking Financial COMPANY’s (NBFC-D), including residuary NBFCs (RNBC), also reduced from 297 at end-March 2011 to 271 as on end March 2012. The size of total assets of Non-Banking Financial Companies grew from Rs 1,169 billion to Rs 1,244 billion as at end March 2012. Net owned funds of NBFCs too grew 25% from Rs 180 billion in 2011 to Rs 225 billion at end- March 2012.The large finance companies numbering 2,376 accounted for 63 per cent of deposits.

3.2 GROWTH OF NON-BANKING FINANCIAL COMPANIES

NBFCs in India have existed since long. They came into limelight in the second half of the 1980s and in the first half of the 1990s.

NBFCs flourished during the stock market boom of the early 1990s. In the initial years of liberalization, they not only became prominent in a wide range of activities but they outpaced banks in deposit raising owing to their customized services. They have backed many small entrepreneurs. They have also lent small-ticket personal loans of size of Rs 25,000 to customers and thereby fuelled the consumption boom.

Total assets/liabilities of NBFCs grew at an average annual rate of 36.7 percent during the 1990s (1991-98) as compared to 20.9 percent during the 1980s (1981-91). The growing importance of this segment and the surfacing of some scams compelled the RBI to increase regulatory attention.

Almost all corporate houses have set up their own NBFCs. Big banks also floated NBFCs to tap certain segments on which restrictions were imposed by the regulator. Banks through the NBFCs could generously lend funds to promoters to raise his holdings through a creeping acquisition. Citi Financial is one of the oldest foreign bank-owned NBFC and a pioneer in this segment. There has been an increase in the number of NBFCs, especially those floated by foreign banks as there are strictures on branch licensing. Reserve Bank of tightened NBFC norms in November 2006 to reduce regulatory arbitrage between different financial sector players. According to the new guidelines, non-deposit taking NBFCs which have assets of over Rs. 100 crore will be subject to exposure and capital adequacy norms. Banks will not be able to lend indiscriminately to them. Nor will they be allowed to hold more than 10 percent equity stake in deposit taking NBFCs. Moreover, foreign banks with NBFC subsidiaries will be required to include the activities of their NBFC arms in their reporting to the Reserve Bank.

3.3 FUNCTIONS OF NON-BANKING FINANCIAL COMPANIES

The functions performed by Non-Banking Financial Companies may be described as under:

- They are able to attract deposits of huge amounts by offering attractive rates of interest and other incentives. Half of the deposits are below two years time period.
- They provide loans to wholesale and retail merchants' small industries, self employment schemes.
- They provide loans without security also. Hence they are able to charge 24 to 36 per cent interest rate.

- They run Chit Funds, discount hundies, provide hire-purchase, leasing finance, merchant banking activities.
- They ventures to provide loans to enterprises with high risks. So they are able to charge high rate of interest. They renew short period loans from time to time. They therefore become long period loans.
- They are able to attract deposits by offering very high rate of interest. In the process many companies sustained losses and went into liquidation. The bankruptcy of many companies adversely affected middle-class and lower income people. There is no insurance protection for deposits as in the case of bank deposits.
- The finance companies are able to fill credit gaps by providing lease finance, hire purchase and instalment buying. They provide loans to buy scooter, cars, TVs and other consumer durables. Such extension of functions makes them almost commercial banks. The only difference is that Non-Banking Financial Companies cannot introduce cheque system. This is the difference b/w the two

♦ **Difference between banks & Non-Banking Financial Companies:**

Non-Banking Financial Companies are doing functions similar to that of banks; however there are a few differences:

1) A Non-Banking Financial Companies cannot accept demand deposits,
2) It is not a part of the payment and settlement system and as such cannot issue cheques to its customers,
3) Deposit insurance facility of DICGC is not available for Non-Banking Financial Companies depositors unlike in case of banks

3.4 TYPES OF NBFCs

There are different categories of Non-Banking Financial Companies' operating in India under the supervisory control of RBI. They are:

1. Non-Banking Financial Companies (NBFCs)
2. Residuary Non-banking Finance companies (RNBCs).
3. Miscellaneous Non-Banking Finance Companies (MNBCs)

Residuary Non-Banking Company is a class of Non-Banking Financial Companies, which is a company and has as its principal business the receiving of deposits, under any scheme of arrangement or in any other manner and not being Investment, Leasing, Hire-Purchase, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds. Peerless Financial Company is the example of RNBCs.

Miscellaneous Non-Banking Financial Companies are another type of Non- Banking Financial Companies and MNBC means a company carrying on all or any of the types of business as collecting, managing, conducting or supervising as a promoter or in any other capacity, conducting any other form of chit or kuri which is different from the type of business mentioned above and any other business similar to the business as referred above. Type of Services provided by Non-Banking Financial Companies: Non-Banking Financial Companies provide range of financial services to their clients.

3.5 TYPES OF SERVICES PROVIDED BY NON-BANKING FINANCE COMPANIES

Non-Banking Financial Companies provide range of financial services to their clients. Types of services under non-banking finance services include the following:

1. Hire Purchase Services
2. Leasing Services
3. Housing Finance Services
4. Asset Management Services
5. Venture Capital Services
6. Mutual Benefit Finance Services (Nidhi) banks.

The above type of companies may be further classified into those accepting deposits or those not accepting deposits.

Hire Purchase Services

Hire purchase is the legal term for a conditional sale contract with an intention to finance consumers towards vehicles, white goods etc. If a buyer cannot afford to pay the price as a lump sum but can afford to pay a percentage as a deposit, the contract allows the buyer to hire the goods for a monthly rent. If the buyer defaults in paying the installments, the owner can repossess the goods. Hire purchase is a different form of credit system among other unsecured consumer credit systems and benefits. Hero Honda Motor Finance Co., Bajaj Auto Finance Company is some of the Hire purchase financing companies.

Leasing Services

A lease or tenancy is a contract that transfers the right to possess specific property. Leasing service includes the leasing of assets to other companies either on operating lease or finance lease. An NBFC may obtain license to commence leasing services subject to, they shall not hold, deal or trade in real estate business and shall not fix the period of lease for less than 3 years in the case of any finance lease agreement except in case of computers and other IT accessories. First Century Leasing Company Ltd., Sundaram Finance Ltd. is some of the Leasing companies in India.

Housing Finance Services

Housing Finance Services means financial services related to development and construction of residential and commercial properties. An Housing Finance Company approved by the National Housing Bank may undertake the services /activities such as Providing long term finance for the purpose of constructing, purchasing or renovating any property, Managing public or private sector projects in the housing and urban development sector and Financing against existing property by way of mortgage. ICICI Home Finance Ltd., LIC Housing Finance Co. Ltd., HDFC is some of the housing finance companies in our country.

Asset Management Company

Asset Management Company is managing and investing the pooled funds of retail investors in securities in line with the stated investment objectives and provides more diversification, liquidity, and professional management service to the individual investors. Mutual Funds are comes under this category. Most of the financial institutions having their subsidiaries as Asset Management Company like SBI, BOB, UTI and many others.

Venture Capital Companies

Venture capital Finance is a unique form of financing activity that is undertaken on the belief of high-risk-high-return. Venture capitalists invest in those risky projects or companies (ventures) that have success potential and could promise sufficient return to justify such gamble. Venture capitalist not only provides finance but also often provides managerial or technical expertise to venture projects. In India, venture capitals concentrate on seed capital finance for high technology and for research & development.

Industrial Credit and Investment company ventures and Gujarat Venture are one of the first venture capital organizations in India and SIDBI, Industrial development bank of India and others also promoting venture capital finance activities.

Mutual Benefit Finance Companies (MBFCs)

A mutual fund is a financial intermediary that allows a group of investors to pool their money together with a predetermined investment objective. The mutual fund will have a fund manager who is responsible for investing the pooled money into specific securities/bonds. Mutual funds are one of the best investments ever created because they are very cost efficient and very easy to invest in. By pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading costs than if they tried to do it on their own. But the biggest advantage to mutual funds is diversification.

There are two main types of such funds, open-ended fund and close-ended mutual funds. In case of open-ended fund, the fund manager continuously allows investors to join or leave the fund. 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 a Unit and the fund itself is called a Mutual Fund. The portfolio of investments of the Mutual Fund is normally evaluated daily by the fund manager on the basis of prevailing market prices of the securities in the portfolio and this will be divided by the number of units issued to determine the Net Asset Value (NAV) per unit. An investor can join or leave the fund on the basis of the NAV per unit.

In contrast, a close-end fund is similar to a listed company with respect to its share capital. These shares are not redeemable and are traded in the stock exchange like any other listed securities. Value of units of close-end funds is determined by market forces and is available at 20-30% discount to their NAV.

3.6 FEATURES OF NON-BANKING FINANCIAL COMPANIES

1) **Small size:** NBFCs are small entities in terms of their size and scope. Some NBFCs are larger in size like Provident Fund, Pension Fund etc., but mostly these are small size institutions. Their structure is easy and simple and management cost is low.

2) **Less Capital intensive:** These entities have very low amount of owned capital. The attractive returns offered help them to collect larger sum of money from the people. If they do not offer attractive returns to the people, their existence will bein danger, as they will find it difficult to collect deposits.

3) **Easy availability of loans:** Borrowers turned down by the commercial banks and development banks, go to these NBFCs. Loans from NBFCs are easily available as very little documentation is required. Handicraft and small industries, small businessmen, sundry traders, often turn to NBFCs for loans.

4) **Unsafe loans:** The loans offered by NBFCs involve more risk as the sear offered without or with inadequate mortgage. The recovery of loans, therefore, becomes difficult.

5) **Rescheduling of loans:** Many a times, the loans offered for short and medium term are not recovered and, therefore, converted into long term loans. As result, amount of loan, term and rate of interest increase.

6) **Lack of co-ordination:** The number of NBFCs has increased rapidly. Up to 1996, there were 39,450 NBFCs working in India. Most of the NBFCs were smallsize entities with very few large ones. These smaller size NBFCs do not have anyco-ordination among them. They act independently and focus on short-term profit and therefore, do not survive in the long run.

7) **Annual report and balance sheet:** Except few, most NBFCs ignore auditing of their accounts, publication of balance sheet and other relevant information. This is not good from the point of view of depositors.

8) **Fulfilment of several needs of the economy :** People need loan assistance in several activities like agriculture, industry, trade, service sector, and also for consumption, education, home construction, purchase of vehicle, healthetc. NBFCs come forward to provide loan assistance in all the areas where it is possible to earn maximum rate of interest.

9) **Independent Policy:** NBFCs are required to follow the rules and orders of RBI. They are registered under Company Act, but capital limitation, profit provisioning maintaining reserves, auditing of accounts and publication of balance sheet etc., are not binding on them. As a result, many NBFCs emerge and conduct their business independently.

10) **Perfection in work:** Some NBFCs conduct their business very efficiently. They always strive for perfection in their work, which in turn benefits both the depositors and borrowers. Other NBFCs either get into the problems or don't survive.

3.7 REGULATIONS OVER NON-BANKING FINANCE COMPANIES

The Non-Banking Finance Companies perform very important financial inter mediation function in India. They supplement the role of the banking institutions, as they cater to the needs of those borrowers who remain beyond the purview of the banking institutions and mobilize the savings from the depositors. Hire purchase finance and leasing companies, loans and investment companies and housing finance companies are the important categories of such Non-Banking Finance Companies (NBFCs).

In the 1960s, the RBI made an attempt to regulate NBFCs by issuing directions relating to the relating to the maximum amount of deposits, the period of deposits, and rate of interest they could offer on the deposits accepted. Norms were laid down regarding maintenance of certain percentage of liquid assets, creation of reserve funds, and transfer there to every year a certain percentage of profit, and so on. These directions and norms were revised and amended from time to time. And In view of the significant role played by NBFCs, regulatory framework has been devised, particularly to safeguard the interests of the depositors. Chapter III(B) of the Reserve Bank of India Act, 1934 provides for such regulatory framework over NBFCs. Significant amendments to this Chapter were made in January, 1997, vesting more powers in the Reserve Bank of India to regulate the activities of such companies. We shall first deal with the provisions of Chapter 111 B, following by the important provisions of the directives issued by the Reserve Bank of India in this regard.

1) Reserve Bank of India Act, 1834

The powers vested in the Reserve Bank of India Act under Chapter I11 B of Reserve Bank of India Act, 1934 are as follows:

i) **To regulate or prohibit issue of prospectus**

In the public interest, the Reserve Bank of India may regulate or prohibit the issue by any non-banking company of any prospectus or advertisement soliciting deposits of money from the public. The Bank may also give directions to these companies as to the particulars to be included in such advertisements.

ii) **To collect information as to deposits and to give direction**

The Reserve Bank of India is empowered to direct every non-banking institution to furbish to it information or particulars relating to the deposits received by it. The Bank may also issue directions in the public interest, to such institutions generally, or to any institution in particular, or group of such institutions in particular, on any of the matter sconnected with the receipt of deposits. If any such institution fails to comply with any direction, the Bank may prohibit the acceptance of deposits by such institutions.

iii) **To conduct inspection**

The Reserve Bank of India may, at any time, causes an inspection to be made of any non-banking institution to verify the **correctness/completeness** of the particulars furnished to the Bank or to obtain any such particulars, if not submitted.

iv)The Reserve Bank of India (Amendment) Act, 1997, has conferred explicit powers on the Reserve Bank of India as follows:

a) A new NBFC cannot operate unless it is registered with Reserve Bank of India and has a minimum owned fund of Rs. 25 lakhs. Reserve Bank has been vested with the power of enhancing the minimum Net Owned Funds (NOF) of NBFCs to Rs. 2 crore in case of companies which are incorporated on or after April 20, 1999, and which seek registration with Reserve Bank of India.

b) Every NBFC is required to create a Reserve Fund and transfer not less than 20% of its net profit each year to such fund before declaring any dividend.

c) Reserve Bank of India is given the power to prescribe the minimum level of liquid assets, as a percentage of the deposits, to be maintained in unencumbered approved securities (i.e. government securities or guaranteed bonds).

d) The Company Law Board has been empowered to direct NBFCs to repay deposits that have matured, if it finds that the company is unable or unwilling to repay the depositors.

e) Powers have been conferred upon the Reserve Bank of India to:

- give directions to the NBFCs regarding prudential norms,
- give directions to the NBFCs and their auditors on matters relating to balance sheets and cause special audit as well as to impose penalty on erring auditors,
- prohibit NBFCs from accepting deposits for violation of the provisions of the RBI Act and to direct NBFCs not to alienate their assets,
- file winding up petition against erring NBFCs,
- Impose penalty directly on the erring NBFCs.

2) NBFCs Acceptance of Public Deposits (Reserve Bank)Directions. In exercise of the powers vested in it under Chapter 111 B, the Reserve Bank of India, issued these directions to NBFC sregarding acceptance of deposits from the public. These directions were substantially revised in January, 1998, to include prudential norms to be followed by NBFCs. The salient features of RBI Directions, as further revised in December, 1998 are as follows:

i) For regulatory purposes, NBFCs have been classified in to three categories:

a) Those accepting public deposits,

b) Those not accepting public deposits, but engaged in financial business,

c) Core investment companies, with 90% of their total assets in investments in the securities of their group/holding/subsidiary companies.

The thrust of RBI regulation is on companies accepting public deposits (category (a) above).

ii) Public deposits have been defined to include field/ recurring deposits received from public, deposits received from relatives and friends, deposits from shareholders by a public limited company and money raised by issue of unsecured debentures and bonds to shareholders and the public. Public Deposits exclude money raised by way of issue of secured debentures and bonds, borrowings from banks and financial institutions (including by way of unsecured debentures), deposits from directors, inter-corporate deposits, deposits from foreign citizens, deposits received by private limited companies from their shareholders, security deposits from employees, advance receipt of lease and hire purchase instalments.

iii) NBFCs with net owned funds (NOF) of less than Rs. 25 *1* lakh (with or without credit rating) are not allowed to accept public deposits.

iv) Ceilings on public deposits for NBFCs, with NOF of Rs. 25lakh and above, have been prescribed as follows. These ceiling limits were enforced in December, 1998. Prior to that, these limits were based on the credit rating (effective January, 1998).

A) Equipment Leasing and Hire Purchase Finance Companies

a) For unrated and under-rated (i.e. rating below the minimum investment grade) NBFCs- 1.5 times of their NOF or Rs. 10 crore, whichever is less (provided their CRAR is 15%, or above, as per their last audited balance sheet).

b) for NBFCs with minimum investment grade creditrating-4 times of their NOF (provided they have CRAR of not less than 10% as on 31.3.1998 and not less than12% as on 3 1.3.1999). They are required to increase CRAR to 15% as early as possible.

B) **Loan and Investment Companies**

a) Unrated and under-rated-not entitled to accept public deposits (irrespective of their NOF and CRAR).

b) With minimum Investment Grade Credit Rating-1.5times of NOF (provided they have CRAR of 15% or above).

Further, it has been stipulated that loan and investment companies which do not have minimum CRAR of 15% as on

Date, but other-wise comply with all the prudential norms and

a) have credit rating of **AAA** may accept or renew public deposits up o the level outstanding as on December 18,1998 or 1.5 times of the NOF whichever is more, subject to the condition that they should attain CRAR or 15%by 31"' March, 2000 and bring down the excess deposits, if any, by December 3 1, 2000, and

b) Have credit rating of **AA/A** may accept or renew public deposits as per the existing provisions of Directions (i.e.0.5 or 1 time of their NOF), but they should attain the minimum CRAR of 15% on or before 31^{st}March, 2000 as per their audited balance sheet, failing which they should regularize their position by repayment or otherwise by December 3 1, 200 1.

The above benefit will not be available to those companies whose CRAR is presently 15% and above but slips down below the minimum level of 15% subsequently.

v) The maximum permissible interest rate on public deposits has been fixed at 16% per annum. NBFCs can pay uniform maximum brokerage of 2% on deposits for 1 year to 5 years. Brokers may also be reimbursed other expenses not exceeding 0.5% of the collected deposits.

vi). only those NBFCs, which are accepting public deposits, are required to submit to Reserve Bank annual statutory returns and financial statements. Other NBFCs are exempted from this requirement.

3) **Prudential Norms for NBFCs**

Reserve Bank of India issued guidelines prescribing the prudential norms for NBFCs in June, 1994. Companies

Accepting public d deposits have to comply with all the guidelines, while leasing, hire purchase finance, loan and investment companies, not accepting public deposits, are required to comply with prudential norms other norms on capital adequacy and credit investment concentration. Similarly, investment companies holding not less than 90% of their assets being securities of their **group/holding/subsidiary** companies and not accepting public deposits are exempted from prudential norms, these guidelines are as follows:

i) **Income Recognition**

NBFCs are required not to take into books income due but not received within a period of six months, till it is actually received.

ii) **Classification of Assets**

NBFCs are required to classify their assets as non-performingas sets if payment of principal /instalment is due but not received within six months. For leasing, hire purchase finance companies such assets are to be treated as NPAs, if lease rentals and hire purchase instalments remain past due for 12 months. Guidelines regarding classification of assets into4 categories and provisioning issued to commercial banks, are applicable to NBFCs also.

iii) **.Capital Adequacy Norm**

In January 1998, the capital adequacy requirement for NBFCs with net owned funds of Rs. 25 lakhs and above and having public deposits had been raised from 8% to 10%(effective 3 1.3.1998), and further to 12% (effective31.3.1999).The composition of capital and risk weights attached to assets and conversion of off Balance Sheet items are the same as applicable to banks.

iv).**Credit/ Investment Concentration Norms**

Registered finance companies are required not to lend more than 15% of their net owned funds to a single borrower and not more than 25% of their owned fund; to a group of borrowers. These limits are also applicable to investment in a single company or a single group of companies. Composite limits of credit to and investment in a single company or a single group of companies have been prescribed at 25% and 40% respectively of its owned funds. NBFCs are not permitted to lend on the security of their own shares. The ceiling on investment in unquoted shares of companies other than their group/subsidiary companies has been fixed at 10% of their owned funds for equipment leasing and hire purchase finance companies and 20% of the owned funds for loan and investment companies. NBFCs are advised not to invest more than 10% of their owned funds in land and building except for their own use. NBFCs are required to dispose off excess of the assets over the indicated ceilings within three years.

v) **Liquid Assets**

NBFCs are required to maintain certain percentage of their deposits in liquid assets to ensure their liquidity and to safeguard the interests of the depositors. With effect from January 2, 1998, the ratio of liquid assets is uniform for all NBFCs accepting public deposits. It has been prescribed at12.5% with effect from April 1, 1998 and at 15% with effect from April 1, 1999. The liquid assets are to be maintained with relation to public deposits only.

NBFCs are required to keep Government securities and Government guaranteed bonds in the custody of a scheduled bank at the place of its head office. These securities are permitted to be withdrawn for repayment to depositors or for replacing them by other securities or in the case of reduction of deposits.

The above account shows that the Reserve Bank of India has instituted a comprehensive regulatory framework for NBFCs. Out .of 8802 applications of NBFCs which were eligible for registration on the basis of Minimum Net Owned Funds of Rs. 25 lakh, registration has been granted to 7555 NBFCs. Out of them only 584 NBFCs have been permitted to accept public deposits. Applications of 1030 companies have been rejected. 28676 companies with

NOF below Rs. 25 lakh have been given time up to January 8, 2000 to achieve the minimum NOF. Thus, an era of consolidating and strengthening the Non-Banking Financial Companies has commenced and better results may be expected in future.

3.8 NOTES

3.9 SUMMARY

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. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme of arrangement or any other manner, or lending in any manner is also an on-banking financial company (Residuary non-banking company).NBFCs are doing functions akin to that of banks; however there are a few differences:

(i) An NBFC cannot accept demand deposits;

(ii) An NBFC is not a part of the payment and settlement system and as such an NBFC cannot issue cheques drawn on itself; and

(iii) Deposit insurance facility of Deposit Insurance and Credit Guarantee Company is not available for NBFC depositors unlike in case of banks.

3.10 SELF ASSESSMENT QUESTIONS

1. What do you mean by NBFCs? Classify them and provide brief information.
2. Distinguish between common bank and NBFC.
3. What are the NBFCs? Explain their features.
4. Highlight the various appropriate regulatory or statutory measures taken by the authorities to oversee the operations of NBFCs.

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UNIT-IV : REGULATORY FRAMEWORK OF BANKING SECTOR

Structure :

4.0 OBJECTIVES

After going through this Unit, you will be able to;

- The principal regulatory authorities regulating banking sector.
- The main provisions of the Banking Regulation Act, 1949, which govern the Commercial Banks.
- The powers vested with Reserve Bank of India under Reserve Bank of India Act, 1934 to regulate Commercial Banks.

4.1 INTRODUCTION

Necessity of regulatory framework for the financial system has been universally felt, primarily to safeguard the interests of a large number of savers/depositors and also to ensure proper and efficient functioning of the institutions that are part and parcel of the financial system. Financial institutions, financial markets, financial instruments and financial services are all regulated by regulators like Ministry of Finance, the Company Law Board, RBI, SEBI, IRDA, Dept. of Economic Affairs, Department of Company Affairs etc. The two major Regulatory and Promotional Institutions in India are Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI).

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

4.2 ROLE OF RESERVE BANK OF INDIA IN CREDIT CONTROL

The Reserve Bank of India adopts two methods to control credit in modern times for regulating bank advances. They are as follows:

4.2.1 Quantitative or General Credit Control

This method aims to regulate the amount of bank advance.

a) Bank rate

It is the rate at which central bank discounts the securities of commercial banks or advance loans to commercial banks. This rate is the minimum and it affects rate is the rate of discount prevailing in the money market among other lending institutions. Generally bank rate is higher than the market rate. If the bank rate is changed all the other rates normally change at the same direction. A central bank control credit by manipulating the bank rate. If the central bank raises the bank rate to control credit, the market discount rate and other lending rates in the money will go up. The cost of credit goes up and demand for credit goes down. As a result, the volume of bank loans and advances is curtailed. Thus raise in bank rate will contract credit.

b) Open Market Operation:

It refers to buying and selling of Government securities by the central bank in the open market. This method of credit control becomes very popular after the 1st World War. During inflation, the banks will securities and during depression, it will purchase securities from the public and financial institutions. The Reserve Bank of India is empowered to buy and sell government securities from the public and financial institutions. The Reserve Bank of India is empowered to buy and sell government securities, treasury bills and other approved securities. The central bank uses the weapon to overcome seasonal stringency in funds during the slack season.

When the central bank sells securities, they are purchased by the commercial banks and private individuals. So money supply is reduced in the economy and there is contraction in credit. When the securities are purchased by the central bank, money goes to the commercial banks and the customers. SO money supply is increased in the economy and there is more demand for credit.

c) Variable Reserve Ratio (VRR):

This is a new method of credit control adopted by central bank. Commercial banks keep cash reserves with the central bank to maintain for the purpose of liquidity and also to provide the means for credit control. The cash reserve is also called minimum legal reserve requirement. The percentage of this ratio can be changed legally by the central bank. The credit creation of commercial banks depends on the value of cash reserves. If the value of reserve ratio increase and other things remain constant, the power of credit creation by the commercial bank is decreased and vice versa. Thus by varying the reserve ratio, the lending capacity of commercial banks can be affected.

4.2.2 Qualitative or Selective Control Method

It is also known as qualitative credit control. This method is used to control the flow of credit to particular sectors of the economy. The direction of credit is regulated by the central bank. This method is used as a complementary to quantitative credit control discourages the flow of credit to unproductive sectors and speculative activities and also to attain price stability. The main instruments used for this purpose are:

4.2.2.1 Varying margin requirements for certain bank

While lending commercial banks accept securities, deduct a certain margin from the market value of the security. This margin is fixed by the central bank and adjusts according to the requirements. This method affects the demand for credit rather than the quantity and cost of credit. This method is very effective to control supply of credit for speculative dealing in the stock exchange market. It also helps for checking inflation when the margin is raised. If the margin is fixed as 30%, the commercial banks can lend up to 70% of the market value of security. This method has been used by RBI since 1956 with suitable modifications from time to time as per the demand and supply of commodities.

4.2.2.2 Regulation of consumer's credit

Apart from trade and industry a great amount of credit is given to the consumers for purchasing durable goods also. Reserve Bank of India seeks to control such credit in the following ways:

(a) By regulating the minimum down payments on specific goods.

(b) By fixing the coverage of selective consumers' durable goods.

(c) By regulating the maximum maturities on all instalment credit and

(d) By fixing exemption costs of instalment purchase of specific goods.

4.2.2.3 Control through Directives

Under this system, the central bank can issue directives for the credit control. There may be a written or oral voluntary agreement between the central bank and commercial banks in this regard. Sometimes the commercial banks do not follow these directives of the Reserve Bank of India.

4.2.2.4 Rationing of credit

The amount of credit to be granted is fixed by the central bank. Credit is rationed by limiting the amount available to each commercial bank. The Reserve Bank of India can also restrict the discounting of bills. Credit can also be rationed by the fixation of ceiling for loans and advances.

4.2.2.5 Direct Action

It is an extreme step taken by the Reserve Bank of India. It involves refusal by Reserve Bank of India to extend credit facilities, denial of permission to open new branches etc.

Reserve Bank of India also gives wide publicity about the erring banks to create awareness amongst the public.

4.2.2.6 Moral suasion

Reserve Bank of India uses persuasion to influence lending activities of banks. It sends letters to banks periodically, advising them to follow sound principles of banking. Discussions are held by the Reserve Bank of India with banks to control the flow of credit to the desired sectors.

4.3 REGULATIONS OVER COMMERCIAL BANKS

Main provisions of the Banking Regulation Act, 1949, which govern the Commercial Banks, are as follows:

4.3.1 Establishment

It is essential for every banking company-Indian or foreign, to acquire a license from the Reserve Bank of India, before it commences its business in India. Reserve Bank of India issues a license, if it is satisfied that the company fulfils the following conditions:

i) The company is/or will be in a position to pay its present or future depositors in full as their claims accrue,

ii) The affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors,

iii) The general character of the proposed management of the company will not be prejudicial to the public interest, or the interests, of its depositors,

iv). The company has adequate capital structure and earning prospects,

v) Public interest will be served by the grant of a license to the company to carry on banking business in India,

vi) Any other condition to ensure that the carrying on of the banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors.

A foreign bank must, in addition, satisfy the following conditions:

i) The carrying on of banking business by such company in India will be in the public interest,

ii) The Government or the law of the country in which it is incorporated does not discriminate in any way against banking companies in India, and

iii) The company complies with all the provisions of the Act applicable to such companies.

4.3.2 Opening of Branches

Every banking company (Indian as well as foreign) is required to take Reserve Bank's prior permission for opening a new place of business in India or outside India, or to change the location of an existing place of business in India or outside.

Reserve Bank, before granting its permission, takes into account -

i) The financial condition and history of the company,

ii) The general character of its management,

iii) The adequacy of its capital structure and earning prospects, and

iv) Whether public interest will be served by the opening/ change of location of the place of business.

4.3.3 Business Permitted and Prohibited

Section 6 contains a list of businesses which may be undertaken by a banking company. Under Clause 'O', any other business may also be specified by the Central Government as the lawful business of a banking company. But, a banking company is prohibited from undertaking, directly or indirectly, trading activities and trading risks (except for the realization of the amount lent or in connection with the realization of bills for collection/ negotiations).

4.3.4 Subsidiary Company

A banking company may establish a subsidiary company for undertaking any business permitted under Section 6, or for carrying on the business of banking exclusively outside India, or for undertaking any other business, which in the opinion of Reserve Bank, would be conducive to the spread of banking in India or to be useful in public interest.

4.3.5 Paid-up Capital

The Act stipulates the minimum aggregate value of its paid-up capital and reserves for banks established before 1962. Minimum amount of capital was raised to Rs. 5 Lakhs for banks set up after 1962. The revised guidelines issued by Reserve Bank for establishing new private sector banks prescribed minimum paid-up capital for such bank: at Rs. 200 crore, which shall be increased to Rs. 300 crore in the next three years, out of which promoter's contribution will be 25% (or 20% in case paid-up capital exceeds Rs. 100 crore). Non-Resident .Indians may participate in the equity of a new bank to the extent of 40%. The authorized capital of a nationalized bank is Rs. 1580 crore, which may be raised to Rs. 3000 crores. These banks are allowed to reduce the capital also but nor below Rs. 1500 crore. These banks are permitted to issue shares to the public also, but the share of the Central Government is not allowed to be less than 51% of the paid-up capital. The paid-up capital may be reduced at any time so as to render it below 25% of the paid-up capital as on 1995.

4.3.6 Maintenance of Liquid Assets

Section 24 required every banking company to maintain in India in cash, gold or unencumbered approved securities an amount which shall not, at the close of business on any day, be less than 25% of the total of its net demand and time liabilities in India. Reserve Bank of India is empowered to step up this ratio, called **Statutory Liquid Ratio (SLR),** upto 40% of the net demand and time liabilities. When this ratio is raised, banks are compelled to keep larger proportion of their deposits in these specified liquid assets.

SLR is to be maintained on a daily basis. The amount of SLR is calculated on the basis of net demand and time liabilities as on the last Friday of the second preceding fortnight. Reserve Bank also possesses the power to decide the mode of valuation of the securities held by banks, i.e. valuation may be with reference to cost price, market price, and book value or face value as may be decided by Reserve Bank of India from time to time.

Approved securities mean the securities in which the trustees may invest trust funds under **Section** 20 of the Indian Trusts Act 1882. The securities should be unencumbered i.e. free of charge in favour of any creditor. The Act also provides for penalties for default in maintaining the liquid assets under **Section** 24. At present SLR is to be maintained @ **25%** of net demand and time liabilities (which excludes net interbank liabilities).

4.3.7 Maintenance of Assets in India

Section **25** requires that the assets of every banking company in India at the close of business on the last Friday of every quarter shall not be less than 75% of its demand and time liabilities.

4.3.8 Inspection by Reserve Bank

Under Section 35, the Reserve Bank may, either at its own initiative or at the instance of the Central Government, cause an inspection to be made by one or more of the officers, of any banking company and its books and accounts. If, on the basis of the inspection report submitted by the Reserve Bank, the Central Government is of the opinion that the affairs of the banking company are conducted to detriment the interests of its depositors, it may prohibit the banking company from receiving fresh deposits or direct the Reserve Bank to apply for the winding up of banking company.

4.3.9 Reserve Bank's Power to Issue Directions

Reserve Bank of India is vested with wide powers under **Section** 35 A to issue direction to banking companies generally, or to any banking company, in particular:

i) in the public interest or in the interest or banking policy, or

ii) To prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or

iii) To secure proper management of ally banking company generally. The banking company shall be bound to comply with such direction.

Section 36 empowers the Reserve Rank to caution or prohibit banking companies against entering into any particular transaction or class of transactions and generally give advice to the banking company. Reserve Bank also possesses the powers to ask the banking company to call a meeting of Board of Directors, to depute its officers, to watch the proceedings-of the meetings of the Board, to appoint its officers as observers and requires: the banking company to make changes in the management on suggested lines.

4.3.10 Management of Banks

The constitution of the Board of Directors of the private sector commercial banks must be in accordance with the provisions of the Banking Regulation Act, 1949. Section 10 (A)lays down the Board of Directors be constituted in such ri way that not less than 51% of the total number of members shall consist of persons who satisfy the following two conditions:

i) They have special knowledge or practical experience in respect of accountancy, agriculture, rural economy, banking, co-operation, economics, finance, law, small scale industry, or any other related matter.

ii) They do not have substantial interest in, or be connected with any company or firm which carries on any trading, commercial or industrial concern (this excludes those connected with small-scale industries or companies registered under Section 25 of the Companies Act).

Reserve Bank of India has conferred the power to direct a banking company to reconstitute the Board, if it is not constituted as above. It may remove a Director and appoint a suitable director also. A person cannot be a Director of two banking companies or a Director of a banking company, if he is . A Director of companies which are entitled to exercises voting rights in excess of 25% of the total voting rights of all shareholders of the banking company.

The Act also requires that the Chairman of a banking company shall be a person who has special knowledge and practical experience of the working of a bank or financial institution, or that of financial, economic or business administration. But he shall not be a Director of a company, partner in a firm or have substantial interest in any company. Firm If, the Reserve Bank of India is of the opinion that a person appointed as Chairman is not a fit/proper person hold such office, it may request the bank to elect another person. If it fails to do so, the Reserve Bank of India is authorized to remove the said person and to appoint a suitable person in his place.

Reserve Bank's approval is also required to appoint, re-appoint, or terminate the appointment of a Chairman, Director, or Chief Executive Officer. Reserve Bank has the power to remove top managerial personnel of the banking companies, if the Bank feels it necessary in the public interest, or for preventing the affairs of a banking company being conducted in a manner detrimental to the interests of the depositors. Reserve Bank may appoint a suitable person in place of the person so removed. Moreover, Reserve Bank is also empowered to appoint Additional Directors not exceeding five or one third of the maximum strength of the Board, whichever is less.

The Board of Directors of the nationalized banks are to be constituted in accordance with the provisions of Section 9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or 1980. It provides for appointment as Directors or officials of RBI, Central Government, other financial institutions and from amongst the officers and workmen of the bank concerned. Moreover, six Directors are to be nominated by the Central Government, and two to six directors are to be elected by shareholders other than Central Government. These Directors are required to be experts in, or have practical experience in the subjects enumerated above in case of private banks' Directors. If the Reserve Bank is of the opinion that any Director elected by the shareholders (other than Government) does not fulfil the aforesaid requirement, it can remove such Director, and the Board of Directors shall co-opt another person in his place.

The nationalized banks are under an obligation to comply with the guidance given by the Central Government. According to **Section** 8 of the (Nationalization) Act, "every nationalized bank shall, in the discharge of its functions, be guided by such directions in regard to matters of policy, involving public interest as the Central Government may, after consultation with the Governor of the Reserve Bank,give".

4.3.11 Control over Advances

Section 21 confers wide powers on the Reserve Bank of India to issue directive to the banking companies with regard to the advances to be granted by the banking companies either generally or by any of them in particular. These directions may relate to any or all of the following:

a) The purposes for which advances may, or may not be, granted,

b) The margins to be maintained in respect of secured advances,

c) The maximum amount of advance to any one company, firm, individual or association of persons,

d) The maximum amount up to which guarantees may be given by the banking company on behalf of any company or firm, and

e) The rate of interest and other terms and conditions, on which advances may be made or guarantees may be given.

The directive issued under this Section is called Selective Credit Control Directives, if they relate to advances on the security of selected commodities. Banks are bound to comply with these directives.

4.3.12 Restrictions on Loans and Advances

A banking company is prohibited from sanctioning loans and advances on the security of its own shares. Restrictions are also imposed under Section 20 on the loans granted by banks to the persons interested in the management of banks.

4.3.13 Maintenance of Cash Reserve with Reserve Bank Section 42 of the Reserve Bank Act, 1934 requires every scheduled bank to maintain with the Reserve Bank of India an average daily balance, the amount of which shall not be less than 3% of the net demand and time liabilities of the bank in India. Reserve Bank of India is empowered to increase this rate up to 20% of the net demand and time liabilities. If a bank fails to maintain the cash balance as required by the Reserve Bank, penalty may be imposed as prescribed in the Act. This provision applies to all scheduled banks, commercial banks, state co-operative banks, and Regional Rural Banks. With effect from December 29, 2001, commercial banks are required to maintain Cash Reserve Ratio @ 5.5% of their net demand and time liabilities of the second preceding fortnight. It was reduced by 2 percentage points from 7.5% to 5.5% with effect from that date and further to 5% w.e.f. June 1, 2002. Reserve Bank of India pays interest on eligible cash reserves as per the Bank Rate (6.5%).

4.4 NOTES

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4.5 SUMMARY

In this unit we have studied the regulatory framework under which the banks in India function. There are two regulatory authorities in this field, viz. the Reserve Bank of India and the Securities and Exchange Board of India. They have been entrusted with the responsibilities of development and regulation of the money market and capital market respectively.

The Reserve Bank of India is the regulatory authority over the commercial banks, co-operative banks, non-banking finance companies and the financial institutions. It derives its powers from the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949, exercising its discretionary powers, the Reserve Bank of India issues directives to these institutions from time to time. In this Unit, we have studied institution-wise regulatory framework.

Reserve Bank exercises control over the commercial banks through the provisions of the Banking Regulation Act, 1949,relating to licensing of banks, opening of branches, establishment of subsidiaries, paid-up capital, and maintenance of liquid assets. Reserve Bank of India has the power to inspect the banks, to issue the directives, to exercise control over the top management and advances granted by them. Cash Reserves are maintained by banks with the Reserve Bank of India under Section 42 of the Reserve Bank of India Act, 1934. Reserve Bank of India has also issued directives regarding priority sector advanced, capital adequacy ratio, exposure norms, assets classification, provisioning, etc.

4.6 SELF ASSESSMENT QUESTIONS

1. What do you mean by NBFCs? Classify them and provide brief information.
2. Distinguish between commercial bank and NBFC.
3. Explain the role of NBFCs in Indian financial system.

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DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

M.B.A III Semester

COURSE - 16 A

FINANCIAL MARKETS AND INSTISTUTIONS

BLOCK

2

CAPITAL MARKETS

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BLOCK -2 : CAPITAL MARKETS

Capital markets are markets for buying and selling equity and debt instruments in which money is provided for periods longer than one year. A new era in capital market in India was ushered in July, 1991, with starting of a process of financial and economic deregulation.

Block 02 capital markets contain 04 units (05-08) Unit 05 specifies capital market introduction, importance, primary and secondary market, listing of securities , issue mechanism, functions of new issue primary and secondary market, and relationship between new issue market and stock exchanges. Unit 06 on stock exchange introduction, functions, BSE,NSE, functions and services, OTC need and objectives, features, benefits and securities traded, reasons for the down fall of stock market. Unit 07 explains FDI and Foreign Portfolio Investment(FPI). Introduction, meaning and definitions, advantages and disadvantages of foreign direct investment. Meaning, introduction and definitions of PFI, difference between FDI and FPI, and introduction, meaning and definitions of private equity. Last unit of this block investors protection and SEBI guidelines introduction, need, factors affecting investor, SEBI guidelines of primary market, secondary market, Foreign Institution Investors (FIIs), types of issues, types of debentures, guidelines for the protection of debenture holders.

UNIT-5 : OVERVIEW OF CAPITAL MARKET

Structure:

5.0 OBJECTIVES

After studying this unit, you will be able to;

- Give the meaning of capital market
- Explain the issue mechanism
- Describe the functions of stock market
- Bring out the importance of the capital market
- Identify the functions of primary market
- Highlight the primary and secondary market

5.1 INTRODUCTION

Capital Market It is a market for long-term funds. Its focus is on financing of fixed investment in contrast to money market which is the institutional source of working capital finance. The main participants in the capital market are mutual funds, insurance organisations, foreign institutional investors, corporate and individuals. The capita/securities market has two segments: (i) Primary new issue market and (ii) Secondary market/stock exchange(s)market(s).

New Issue Market (NIM) Primary Market: The NIM deals in new securities, that is, securities which were not previously available and are offered to the investors for the first time. Capital formation occurs in the NIM as it supplies additional funds to the corporate directly. It does not have any organisational setup located in any particular place and is recognised only by the specialist institutional services that it tenders to the lenders/borrowers (buyers/sellers) of capital funds at the time of any particular operation. It performs **triple-service/function,** namely: (i) **origination,** that is, investigation and analysis and processing of new issue proposals; (ji) **underwriting** in terms of guarantee that the issue would be sold irrespective of public response and (iii) **distribution** of securities to the **investors.**

Secondary Stack Market/Exchange (SE) The SE is a market for old/existing securities, that is, those already issued and granted SE quotation/listing. It plays only an indirect role in industrial financing by providing liquidity to investments already made. It has a physical existence and is located in a particular geographical area. The SE discharges three vital functions in the orderly growth of capital formation: (i) Nexus between savings and investments; (ii) Liquidity to investors by offering a place of transaction in securities and (iii) Continuous price formation.

The behaviour of SEs as reflected in the prices of listed securities has a Significant bearing on the level of activity in the NIM in terms of its response to issues of capital. Similarly, the prices of new issues are generally influenced by the price movements in the stock markets.

5.2 IMPORTANCE OF CAPITAL MARKET

Absence of capital market acts as a deterrent factor to capital formation and economic growth. Resources would remain idle if finances are not funnelled through the capital market. The importance of capital market can be briefly summarised as follows:

(i) The capital market serves as an important source for the productive use of the economy's savings. It mobilizes the savings of the people for further investment and thus, avoids their wastage in unproductive uses.

(ii) It provides incentives to saving and facilitates capital formation by offering suitable rates of interest as the price of capital.

(iii) It provides an avenue for investors, particularly the household sector to invest in financial assets which are more productive than physical assets.

(iv) It facilitates increase in production and productivity in the economy and thus, enhances the economic welfare of the society. Thus, it facilitates 'the movement of stream of command over capital to the point of highest yield ' towards those who can apply them productively and profitably to enhance the national income in the aggregate.

(v) The operations of different institutions in the capital market induce economic growth. They give quantitative and qualitative directions to the flow of funds and bring about rational allocation of scarce resources.

(vi) A healthy capital market consisting of expert intermediaries promotes stability in values of securities representing capital funds.

(vii) Moreover, it serves as an important source for technological up gradation in the industrial sector by utilizing the funds invested by the public.

Thus, a capital market serves as an important link between those who save and those who aspire to invest their savings.

5.3 PRIMARY AND SECONDARY MARKETS

A **primary market** is a financial market in which new issues of a security, such as a bond or a stock, are sold to initial buyers by the corporation or government agency borrowing the funds. A **secondary market** is a financial market in which securities that have been previously issued (and are thus second-hand) can be resold.

The primary markets for securities are not well known to the public because the selling of securities to initial buyers often takes place behind closed doors. An important financial institution that assists in the initial sale of securities in the primary market is the investment bank. It does this by underwriting securities: It guarantees a price for a corporation's securities and then sells them to the public.

The New York and American stock exchanges, in which previously issued stocks are traded, are the best-known examples of secondary markets, although the bond markets, in which previously issued bonds of major corporations and the U.S. government are bought and sold, actually have a larger trading volume. Other examples of secondary markets are foreign exchange markets, futures markets, and options markets. Securities brokers and dealers are crucial to a well-functioning secondary market. Brokers are agents of investors who match buyers with sellers of securities; dealer's link buyers and sellers by buying and selling securities at stated prices.

When an individual buys a security in the secondary market, the person who has sold the security receives money in exchange for the security, but the corporation that issued the security acquires no new funds. A corporation acquires new funds only when its securities are first sold in the primary market. Nonetheless, secondary markets serve two important functions. First, they make it easier to sell these financial instruments to raise cash; that is, they make the financial instruments more liquid. The increased liquidity of these instruments then makes them more desirable and thus easier for the issuing firm to sell in the primary market. Second, they determine the price of the security that the issuing firm sells in the primary market. The firms that buy securities in the primary market will pay the issuing corporation no more than the price that they think the secondary market will set for this security. The higher the security's price in the secondary market, the higher will be the price that the issuing firm will receive for a new security in the primary market and hence the greater the amount of capital it can raise. Conditions in the secondary market are therefore the most relevant to corporations issuing securities. It is for this reason that books like this one, which deal with financial markets, focus on the behaviour of secondary markets rather than that of primary markets.

5.4 LISTING OF SECURITIES

Listing of securities mean the securities are admitted for trading on a recognised stock exchange. Transactions in the securities of any company cannot be conducted on stock exchanges unless they are listed by them. Hence, listing is the basis of stock exchange operations. It is the green signal given to selected securities to get the trading privileges of the stock exchange concerned. Securities become eligible for trading only through listing.

Listing is compulsory for those companies which intend to offer shares/ debentures to the public for subscription by means of issuing a prospectus. Moreover, the SEBI insists on listing for granting permission to a new issue by a public limited company. Again, financial institutions do insist on listing for underwriting new issues. Thus, listing becomes an unavoidable one today.

The companies which have got their shares/debentures listed in one or more recognised stock exchanges must submit themselves to the various regulatory measures of the stock exchange concerned as well as the SEBI. They must maintain necessary books, documents, etc., and disclose any information which the stock exchange may call for.

Group A. group S and group C shares (BSE)

The listed shares are generally divided into two categories namely:

i. Group A shares (Specified shares or cleared securities).

ii. Group B shares (Non-specified shares or non-cleared securities).

Group A shares represent large and well established companies having a broad investor base. These shares are actively traded. Naturally, these shares attract a lot of speculative multiples. These facilities are not available to Group B shares. However, shares can be moved from Group B to Group A and vice versa depending upon the criteria for shifting. For instance, the Bombay Stock Exchange has laid down several criteria for shifting shares from Group B to Group A, such as, an equity base of Rs 10 crore, a market capitalisation of Rs. 25-30 crore, a public holding of 35 to 40 per cent, a shareholding population of 15,000 to 20,000, good dividend paying status etc. Group B2 shares are again divided into B1 and B shares on the Bombay Stock Exchange. B1 shares represent well traded scrip's among the B Group and they have weekly settlement.

Apart from the above, there is another group called Group C shares. Under Group C, only odd lots and permitted securities are included. A number of shares that are less than the market lot are known as odd lots. Market lot refers to the minimum number of shares of a particular security that must be transacted on a stock exchange. Odd lots have settlement once in a fortnight or once on Saturdays. Permitted securities are those that are not listed on a stock exchange but are listed on other stock exchanges in India. So, they are permitted to be traded on this stock exchange. Odd lots cannot be easily transacted on the stock exchange and so they are not liquid in. nature.

The market where existing securities are traded is referred to as the secondary market or stock market. In a stock market, purchases and sales of securities whether of Government or Semi-Government bodies or other public bodies and also shares and debentures issued by joint-stock companies are affected. The securities of Government are traded in the stock market as a separate component, called gilt-edged market. Government securities are traded outside the trading wing in the form of over-the-counter sales or purchases. Another component of the stock market deals with trading in shares and debentures of limited companies.

Stock exchanges are the important ingredient of the capital market. They are the citadel of capital and fortress of finance. They are the theatres of trading in securities and as such they assist and control the buying and selling of securities. Thus, according to Husband and Dockeray, 'Securities or stock exchanges are privately organised markets which are used to facilitate trading in securities'. However, at present, stock exchanges need not necessarily be privately organised ones.

As per the Securities Contracts Regulation Act, 1956, a stock exchange has been defined as follows: 'It is an association, organisation or body of individuals whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities'. In brief, stock exchanges constitute a market where securities issued by the Central and State Governments, public bodies and joint-stock companies are traded.

5.5 ISSUE MECHANISM

The success of an issue depends, partly, on the issue mechanism. The methods by which new issues are made are: (i) Public issue through prospectus, (ii) Tender/Book building, (iii) Offer for sale (iv) Placement and (v) Rights issue.

Public Issue through Prospectus

A common method followed by corporate enterprises to raise capital through the issue of securities is by means of a prospectus inviting subscription from the investing public. Under this method, the issuing companies themselves offer directly to the general public a fixed number of shares at a stated price, which in the case of new companies is invariably the face value of the securities, and in the **case** of existing companies it may sometimes include a premium amount, if any. Another feature of public issue method is that generally the issues are underwritten to ensure success arising out of unsatisfactory public response.

The foundation of the public issue method is a prospectus, the minimum contents of which are prescribed by the Companies Act, 1956. It also provides both civil and criminal liability for any misstatement in the prospectus. Additional disclosure requirements are also mandated by the SEBI. The contents of the prospectus, inter alia, include: (i) Name and registered office of the issuing company; (ii) Existing and proposed activities; (iii) Board of directors; (iv) Location of the industry; (v) Authorised, subscribed and proposed issue of capital to public; (vi) Dates of opening and closing of subscription list; (vii) Name of broker, underwriters, and others, from whom application forms along with copies of prospectus can be obtained; (viii) Minimum subscription; (ix) Names of underwriters, if any, along with a statement that in the opinion of the directors, the resources of the underwriters are sufficient to meet the underwriting obligations; and (x) A statement that the company will make an application to stock exchange(s) for the permission to deal in or for a quotation of its shares and so on.

The public issue method through prospectus has the advantage that the transaction is carried on in the full light of publicity coupled with approach to the entire investing public. Moreover, a fixed quantity of stock has to be allotted among applicants on a non-discriminatory basis. The issues are, thus, widely distributed and the danger of an artificial restriction on the quantity of shares available is avoided. It would ensure that the share ownership is widely-diffused, thereby contributing to the prevention of concentration of wealth and economic power.

A serious drawback of public issue, as a method to raise capital through the sale of securities, is that it is a highly expensive method. The cost of flotation involves underwriting expenses, brokerage, and other administrative expenses. The administrative cost includes printing charges of prospectus, advertisement/publicity charges, accountancy charges, legal charges, bank charges, stamp duty, listing fee, registration charges, travelling expenses, filling of document charges, mortgage deed registration fee and postage and so on. In view of the high cost involved in raising capital, the public issue method is suitable for large issues and it cannot be availed of in case of small issues.

Tender/Book Building Method

The essence of the tender/book building method is that the pricing of the issues is left to the investors. The issuing company incorporates all the details of the issue proposal in the offer document on the lines of the public issue method including the reserve/ minimum price. The investors are required to quote the number of securities and the price at which they wish to acquire.

Offer for Sale

Another method by which securities can be issued is by means of an offer for sale. Under this method, instead of the issuing company itself offering its shares directly to the public, it offers through the intermediary of issue houses/merchant banks/ investment banks or firms of stockbrokers. The modus operandi of the offer of sale is akin to the public issue method in that the prospectus with strictly prescribed minimum contents which constitutes the foundation for the sale of securities, and a known quantity of shares are distributed to the applicants in a non-discriminatory manner. Moreover, the issues are underwritten to avoid the possibility of the issue being left largely in the hands of the issuing houses. But the mechanism adopted is different. The sale of securities with an offer for sale method is done in two stages.

In the first stage, the issuing company sells the securities enbloc to the issuing houses or stockbrokers at an agreed fixed price and the securities, thus acquired by the sponsoring institutions, are resold, in the second stage, by the issuing houses to the ultimate investors. The securities are offered to the public at a price higher than the price at which they were acquired from the company. The difference between the sale and the purchase price, technically called as turn, represents the remuneration of the issuing houses. In the case of public method, the issuing houses receive a fee based upon the size and the complications involved in supervision as they act as agents of the issuing companies. Although this is theoretically possible, but usually the issuing houses' remuneration in offer for sale is the turn' out of which they also meet subsidiary expenses such as underwriting commission, the cost of advertisement **and prospectus, and so on, whereas these are borne by the** companies themselves in the case of public issue method.

The offer for sale method shares the advantage available to public issue method. One additional advantage of this method is that the issuing company is saved from the cost and trouble of selling the shares to the public. Apart from being expensive, like the public issue method, it suffers from another serious shortcoming. The securities are sold to the investing public usually at a premium. The margin between the amount received by the company and the price paid by the public does not become additional funds, but it is pocketed by the issuing houses or the existing shareholders.

Placement Method

Yet another method to float new issues of capital is the placing method defined by London Stock Exchange as "sale by an issue house or broker to their own clients of securities which have been previously purchased or subscribed·, Under this method, securities are acquired by the issue houses, as in offer for sale method, but instead of being subsequently offered to the public, they are placed with the clients of the issue houses, both individual and institutional investors. Each issue house has a list of large private and institutional investors who are always prepared to subscribe to any securities which are issued in this manner. Thus, the flotation of the securities involves two stages: In the first stage, shares are acquired by the issuing houses and in the second stage; they are made available to their investor-clients. The issue houses usually place the securities at a higher price than the price they pay and the difference, that is, the turn is their remuneration. Alternatively, though rarely, they may arrange the placing in return for a fee and act merely as an agent and not principal.

Another feature of placing is that the placing letter and the other documents, when taken together, constitute a prospectus/offer document and the information concerning the issue has to be published. In this method, no formal underwriting of the issue is required as the placement itself amounts to underwriting since the issue houses agree to place the issue with their clients. They endeavour to ensure the success of the issue by carefully vetting the issuing company concerned and offering generous subscription terms.

Placing of securities that are unquoted is known as private placing. The securities are usually in small companies but these may occasionally be in large companies. When the securities to be placed are newly quoted, the method is officially known as stock exchange placing.

The main advantage of placing, as a method of issuing new securities, is its relative cheapness. This is partly because many of the items of expenses in public issue and offer for sale methods like underwriting commission, expense relating to applications and allotment of shares, and so on are avoided. Moreover, the stock exchange requirements relating to contents of the prospectus and its advertisement are less onerous in the case of placing.

Its weakness arises from the point of view of distribution of securities. As the securities are offered only to a select group of investors, it may lead to the concentration of shares into a few hands who may create artificial scarcity of scrip's in times of hectic dealings in such shares in the market.

The placement method is advantageous to the issuing companies but it is not favourably received by the investing public. The method is suitable in case of small issues which cannot bear the high expenses entailed in a public Issue, and also in such issues which are unlikely to arouse much

Interest among the general investing public. Thus with the placement method, new issues can be floated by small companies, which suffer from a financial disadvantage in the form of prohibitively high cost of capital in the case of other method of flotation as well as at times when conditions in the market may not be favourable a, it doe, not depend for its success on public response. This underscores the relevance of this method from the viewpoint of the market.

Rights Issue

The methods discussed above can be used both by new companies as well as by established companies. In the case of companies whose share, are already listed and widely-held, shares can be offered the existing shareholders. This is called rights issue. Under this method, the existing shareholders are offered the right to subscribe to new shares in proportion 10 the number of shares they already hold. This offer is made by circular to 'existing shareholders only.

In India Section 81 of the Companies Act 1956 provides that where a company increases its subscribed capital by the issue of new shares. Either after two years of its formation or after one year of first issue of shares whichever is earlier, these have to be first offered to the existing shareholders with a right to renounce them in favour of a nominee. A company can, however dispense with this requirement by passing a special resolution to the same effect.

Rights issues are not normally underwritten hut to ensure full subscription and as a measure of abundant precaution. a few companies have resorted to underwriting of rights shares. The experience of these companies has been that underwriters were not called upon to take up shares in terms of their obligations. It is, therefore, observed that such underwriting serves little economically useful purpose in that "it represents insurance against a risk which is (i) readily avoidable and (ii) of extremely rare occurrence even where no special steps are taken to avoid it." The chief merit of rights issue is that it is an inexpensive method. The usual expenses like underwriting commission, brokerage and other administrative expenses are either non-existent or are very small. Advertising expenses have to be incurred only for sending a letter of rights to shareholders. The management of applications and allotment is less cumbersome because the number is limited. As already mentioned, this method can be used only by existing companies and the general investing public has no opportunity to participate in the new companies. The pre-emptive right of existing shareholders may conflict with the broader objective of wider diffusion of share-ownership.

The above discussion shows that the available methods of flotation of new issues are suitable in different circumstances and for different types of enterprises. The issue mechanism would vary from market to market.

5.6 FUNCTIONS OF NEW ISSUES/PRIMARY MARKET

The main function of NIM is to facilitate the transfer of resources from savers to entrepreneurs seeking to establish new enterprise or to expand/diversify existing ones. Such facilities are of crucial importance in the context of the dichotonomy of funds available for capital uses from those in whose hands they accumulate, and those by whom they are applied to productive uses. Conceptually, the NIM should not, however, be conceived as exclusively serving the purpose of raising finance for new capital expenditure. In fact, the organisation and facilities of the market are also utilized for selling concerns to the public as going concerns through the conversion of existing proprietary enterprises or private companies into public companies. The NIM is a complex of institutions through which funds can be obtained directly or indirectly by those who require them from investors who have savings.

New issues can be classified in various ways. The first category of new issues is by new companies and old companies. This classification was first suggested by **R.F. Henderson.** The distinction between new also called initial and old also known as further, does not bear any relation to the age of the company. The securities issued by companies for the first time either after the incorporation or conversion from private to public companies are designated as initial issues, while those issued by companies which already have stock, exchange quotation, either by public issue or by rights to existing shareholders, are referred to as further or old.

The new issues by corporate enterprise can also be classified on the basis of companies seeking quotation, namely, new money issues and no new money issues. The term new money issues refers to the issues of capital involving newly created shares; no new money issues represent the sale of securities already in existence and sold by their holders. The new money issues provide funds to enterprises for additional capital investment. According to **Merrett** and others, new money refers to the sum of money equivalent to the number of newly created shares multiplied by the price per share minus all the administrative cost associated with the issue. This money may not be used for additional capital investment: it may be used wholly or partly to repay debt. Henderson uses the term in a rather limited sense so that it is the net of repayment of long-term debt and sums paid to vendors of existing securities. The differences in the approaches by **Merrett** and others, on the one hand, and Henderson, on the other, arise because of the fact that while the concern of the former is with both flow of funds into the market as well as flow of money, **Henderson** was interested only in the latter.

However, two types of issues are excluded from the category of new issues. First, bonus/capitalization issues which represent only book-keeping entries, and, second, exchange issues by which shares in one company are exchanged for securities of another.

The general function of the NIM, namely, the channelling of investible funds into industrial enterprises, can be split from the operational stand-point, into three services: 7 (i) Origination, (ii) Underwriting, and (iii) Distribution. The institutional setup dealing with these can be said to constitute the NIM organisation. In other words, the NIM facilitates the transfer of resources by providing specialist institutional facilities to perform the triple-service junction.

Origination

The term origination refers to the work of investigation and analysis and processing of new proposals. These two functions are performed by the specialist agencies which act as the sponsors of issues. One aspect is the preliminary investigation which entails a careful study of technical, economic, financial, and legal aspects of the issuing companies. This is to ensure that it warrants the backing of the issue houses in the sense of lending their name to the company and, thus, give the issue the stamp of respectability, to satisfy themselves that the company is strongly-based, has good market prospects, is well-managed and is worthy of stock exchange quotation. In the process of registration the sponsoring institutions render, as a second function, some services of an advisory nature which go to improve the quality of capital issues. These services include advice on such aspects of capital issues as: (i) determination of the class of security to be issued and price of the issues in the light of market conditions, (ii) the timing and magnitude of issues, (iii) methods of flotation, and (iv) Technique of selling, and so on. The importance of the specialised services provided by the NIM organisation in this respect can hardly be overstressed in view of its pivotal position in the process of flotation of capital in the NIM. On the thoroughness of investigation and soundness of judgement of the sponsoring institutions depends, to a large extent, the allocative efficiency of the market.

Underwriting

The origination howsoever thoroughly done, will not, by itself, guarantee the success of an issue. To ensure success of an issue, therefore, the second specialist service—underwriting-provided by the institutional setup of the NIM takes the form of a guarantee that the issues would be sold by eliminating the risk arising from uncertainty of public response. That adequate institutional arrangement for the provision of underwriting is of crucial significance both to the issuing companies as well as the investing public cannot be overstressed.

Distribution

Underwriting, however, is only a stop-gap arrangement to guarantee the success of an issue. The success of an issue, in the ultimate analysis, depends on the issues being acquired by the investing public. The sale of securities to the ultimate investors is referred to as distribution. It is a specialist job which can best be performed by brokers and dealers in securities, who maintain regular and direct contact with the ultimate investors.

Thus, the NIM is a complex of institutions through which funds can be obtained by those who require them from investors who have savings. The ability of the NIM to cope with the growing requirements of the expanding corporate sector would depend on the presence of specialist agencies to perform the triple-service junction, of origination, underwriting and distribution. While the nature of the services provided by an organised NIM is the same in all developed countries, the degree of development and specialisation of market organisation, the type of institutions found and the actual procedures followed differ from country to country, as they are determined partly by history and partly by the particular legal, social, political, and economic environment.

5.7 FUNCTIONS OF STOCK/SECONDARY MARKETS/EXCHANGES

Stock exchanges discharge three vital functions in the orderly growth of capital formation: (i) Nexus between savings and investments, (ii) Market place and (iii) Continuous price formation.

Nexus between Savings and Investment

First and foremost, they are the nexus between the savings and the investments of the community. The savings of the community are mobilised and channelled by stock exchanges for investment into those sectors and units which are favoured by the community at large, on the basis of such criteria as good return, appreciation of capital, and so on. It is the preference of investors for individual units as well as industry groups, which is reflected in the share price, that decides the mode of investment. Stock exchanges render this service by arranging for the preliminary distribution of new issues of capital, offered through prospectus, as also offers for sale of existing securities, in an orderly and systematic manner. They themselves administer the same. by ensuring that the various requisites of listing (such as offering at least the prescribed minimum percentage of capital to the public, keeping the subscription list open for a minimum period of days, making provision for receiving applications at least at the prescribed centres, allotting the shares against applications on a fair and unconditional basis) are duly complied with. Members of stock exchanges also assist in the flotation of new issues by acting (i) as brokers, in which capacity they, inter alia, try to procure subscription from investors spread all over the country, and (ii) as underwriters. This quite often results in their being required to nurse new issues till a time when the new ventures start making profits and reward their shareholders by declaring reasonable dividends when their shares command premiums in the market. Stock companies also provide a forum for trading in rights shares of companies already listed, thereby enabling a new class of investors to take up a part of the rights in the place of existing shareholders who renounce their rights for monetary considerations.

Market Place

The second important function discharged by stock markets/exchanges is that they provide a market place for the purchase and sale of securities, thereby enabling their free transferability through several successive stages from the original subscriber to the never ending stream of buyers, who may be buying them today to sell them at a later date for a variety of considerations like meeting their own needs of liquidity, shuffling their investment portfolios to gear up for the ever changing market situations, and so on. Since the point of aggregate sale and purchase is centralised, with a multiplicity of buyers and sellers at any point of time, by and large, a seller has a ready purchaser and a purchaser has a ready seller at a price which can be said to be competitive. This guarantees sale ability to one who has already invested and surety of purchase to the other who desires to invest.

Continuous Price Formation

The third major function, closely related to the second, discharged by the stock exchanges is the process of continuous price formation. The collective judgement of many people operating simultaneously in the market, resulting in the emergence of a large number of buyers and sellers at any point of time, has the effect of bringing about changes in the levels of security prices in small graduations, thereby evening out wide swings in prices. The ever changing demand and supply conditions result in a continuous revaluation of assets, with today's prices being yesterday's prices, altered, corrected, and adjusted, and tomorrows values being again today's values altered, corrected and adjusted. The process is an unending one. Stock exchanges thus act as a barometer of the stat" of health of the nation's economy, by constantly measuring its progress or otherwise. An investor can always have his eyes turned towards the stock exchanges to know, at any point of time, the value of the investments and plan his personal needs accordingly.

5.8 RELATIONSHIP BETWEEN NEW ISSUE MARKET AND STOCK EXCHANGE

The industrial securities market is divided into two pans, namely, NIM and stock market. The relationship between these pans of the market provides an insight into its organisation. One aspect of their relationship is that they differ from each other organisationally as well as in the nature of functions performed by them. They have some similarities also.

Differences

The differences between NIM and stock exchanges pertain to (i) Types of securities dealt, (ii) Nature of financing, (iii) Organisation and (iv) Functions.

They are depicted in Exhibit (a)

Exhibit (a : Differences Between Stock Exchange and Primary Market

Exhibit (a : Differences Between Stock Exchange and Primary Market

	New Issue Market	Stock Exchange
1. Types of Security	New	Existing / old
2. Nature of Financing	Direct	Indirect
3. Organization	Physical Existence	Specialist Institutional Triple-services
4. Functions	• Nexus between savings and investments	• Organisation
	• Market Place	• Underwriting
	• Continuous price formation	• Distribution

New vs. Old Securities: The NIM deals with new securities, that is, securities which were not previously available and are, therefore, offered to the investing public for the first time. The market. subscription. The stock market, on the other hand, is a market for old securities which may be defined as securities which have been issued already and granted stock exchange quotation. The stock exchanges, therefore, provide a regular and continuous market for buying and selling of securities. The usual procedure is that when an enterprise is in need of funds, it approaches the investing public, both individuals and institutions, to subscribe to its issue of capital. The securities thus floated are subsequently purchased and sold among the individual and institutional investors. There are, in other words, two stages involved in the purchase and sale of securities. In the first stage, the securities are acquired from the issuing com parties themselves and these are, in the second stage, purchased and sold continuously among the investors without any involvement of the companies whose securities constitute the stock-in-trade except in the strictly limited sense of registering tile transfer of ownership of the securities. The section of the industrial securities market dealing with the first stage is referred to as the NIM, while secondary market covers the second stage of the dealings in securities.

Nature of Financing Another aspect related to tile separate functions of these two parts of the **securities market is the nature of their contribution to industrial financing. Since the primary market is** concerned with new securities, it provides additional funds to the issuing companies either for **starting a new enterprise or for the expansion or diversification of the existing one and, therefore, its** contribution to company financing is *direct.* In contrast, the secondary markets can in no circumstance supply additional funds since the company is not involved in the transaction. This, however, **does the stock markets have no relevance in the process of transfer of resources from savers to investors. Their role regarding the supply of capital is indirect. The usual course in the** development of industrial enterprise seems to be that those who bear the initial burden of financing a new enterprise pass it on to others when the enterprise becomes well-established. The existence of secondary markets which provide institutional facilities for the continuous purchase and sale of securities and, to that extent, lend liquidity and marketability, play an important part in the process.

Organisational Differences The two parts of the market have orgartisational differences also. The stock exchanges have orgartisationally speaking, physical existence and are located in a particular geographical area. The NIM is not rooted in any particular spot and has no geographical existence. The NIM has neither any tangible form any administrative organisational setup like that of stock exchanges, nor is it subjected to any centralised control and administration for the consummation of its business. It is recognised only by the services that it renders to the lenders and borrowers of capital funds at the time of any particular operation. The precise nature of the specialised institutional facilities provided by the NIM is described in a subsequent section.

Similarities

Nevertheless, in spite of organisational and functional differences, the NIM and the stock exchanges are inseparably connected.

Stock Exchange Listing One aspect of this inseparable conned ion between them is that the securities issued in the NIM are invariably listed on a recognised stock exchange for dealings in them. In India, for instance, one of the conditions to which a prospectus is to conform is that it should contain a stipulation that the application has been made, or will be made in due course for admitting the securities to dealings on tile stock exchange. The practice of listing of new issues on the stock market is of immense utility to the potential investors who can be sure that should they receive an allotment of new issues, they will subsequently be able to dispose them off any time. The absence of such facilities would act as some sort of psychological barrier to investments in new securities. The facilities provided by the secondary markets, therefore, encourage holdings of new securities and, thus, widen the initial/primary market for them.

Control The stock exchanges exercise considerable control over the organisation of new issues. In terms of regulatory framework related to dealings in securities, the new issues of securities which seek stock quotation/listing have to comply with statutory rules as well as regulations framed by the stock exchanges with the object of ensuring fair dealings in them. If the new issues do not conform to the prescribed stipulations, the stock exchanges would refuse listing facilities to them. This requirement obviously enables the stock exchange to exercise considerable control over the new issues market and is indicative of dose relationship between the two.

Economic Interdependence The markets for new and old securities are, economically, an integral part of a single market-the industrial securities market. Their mutual interdependence from the economic point of view has two dimensions. One, the behaviour of the stock exchanges has a significant bearing on the level of activity in the N1M and, therefore, its responses to capital issues: Activity in the new issues market and the movement in the prices of stock exchange securities are broadly related: new issues increase when share values This is because the two parts of the industrial securities market are susceptible to common influences and they act and react upon each other. The stock exchanges are usually the first to feel a change in the economic outlook and the effect is quickly transmitted to the new issue section of the market.

The second dimension of the mutual interdependence of the two parts of tile market is that the **prices of new issues are influenced by the price movements on the stock market. The securities** market represents an important case where the stock-demand-and-supply curves, as distinguished from flow-demand-and-supply curves, exert a dominant influence on price determination. The quantitative predominance of old securities in the market usually ensures that it is these which set the tone of the market as a whole and govern the prices and acceptability of the new issues. Thus, the flow of new savings into new securities is profoundly influenced by the conditions prevailing in the old securities market-the stock exchange.

5.9 CHECK YOUR PROGRESS

1. The differences between NIM and stock exchanges pertain to

a) Types of securities dealt b) Nature of financing

c) Organisation and Functions d) RBI

2. Primary market and Secondary market is also known as

a) New issue and stock market b) Old issue and debt market

c) New and Old issue market c) Fresh issue and old market

3. Mention the methods by which new issues are made

a) Public issue through prospectus

b) Tender/Book building

c) Offer for sale

d) Rights issue

Answer to check your progress: 1) a, b, c, 2) a 3) a, b, c, d

5.10 NOTES

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5.11 SUMMARY

Capital market consists of primary markets and secondary markets. Primary markets deal with trade of new issues of stocks and other securities, whereas secondary market deals with the exchange of existing or previously-issued securities. Another important division in the capital market is made on the basis of the nature of security traded, i.e. stock market and bond market. An essential characteristic of Indian Capital Market is that it is developing and making rapid strides by allowing the development of new financial institutions to happen. An important one among them include venture capital firms, mutual firms, credit rating agencies, factoring firms, etc. an innovative feature of the capital market in India is the introduction of the new and innovative financial instruments used by firms for raising capital.

5.12 KEY WORDS

Capital Market: Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions.

Capital markets help channelize surplus funds from savers to institutions which then invest them into productive use. Generally, this market trades mostly in long-term securities.

Rights Issue: A rights offering (issue) is an issue of rights to a company's existing shareholders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period.

Underwriter: An underwriter is a company or other entity that administers the public issuance and distribution of securities from a corporation or other issuing body.

An underwriter works closely with the issuing body to determine the offering price of the securities buys them from the issuer and sells them to investors via the underwriter's distribution network.

5.13 SELF ASSESMENT QUESTIONS

1. What do you mean issue mechanism?
2. Define the term capital market.
3. Explain the functions of stock market.
4. Identify the relationship between new issue market and stock exchange.
5. Discuss the importance of capital market.

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UNIT - 6 : THE STOCK EXCHANGE

Structure:

6.0 OBJECTIVES

After studying this unit, you sould be able to;

- Give the meaning of stock exchange
- Explain the various services provided by stock exchange
- Describe the functions of stock market
- Differentiate BSE and NSE
- Identify the services of stock exchange
- Highlight the various reasons for the downfall of stock exchange

6.1 INTRODUCTION

The Securities Contracts (Regulation) Act, 1956 has defined stock exchange as an "association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in Securities."

According to Pyle, "security exchanges are market places where securities that have been listed thereon may be bought and sold for either investment or speculation".

K.L. Garg has described the stock exchange as "an association of persons engaged in the buying and selling of stocks, bonds and shares for the public on commission and guided by certain rules and conditions."

The word "Stock Exchange" is made from two words 'Stock' and Exchange. Stock means part or fraction of the capital of a company, and Exchange means a transferring the ownership; representing a market for purchasing and selling. Thus, we can describe the stock exchange as a market or a place where different types of securities are bought and sold. Securities traded on a stock exchange include shares issued by companies, unit trusts, derivatives, pooled investment products and bonds. As the stock exchange deals in all types of securities, it is known as 'securities market' or 'securities exchange' also. A stock exchange is a secondary market of securities because the trading happens only for the securities that have already been issues to the public and now being allowed to be traded on the floor of a stock exchange after getting listed with the stock exchange. The initial offering of stocks and bonds to investors is by definition done in the primary market and subsequent trading is done in the secondary market.

A stock exchange is a body that deals with stocks shares, bonds and securities. It also includes people who deal with stocks shares, bonds and securities. Those people are known as traders or stock brokers. Their services include issue and also redemption of stocks, securities and any other financial instruments. Stock exchange also facilitates payment of dividend and other income in short the entire stock market is regulated by the stock exchange. These securities and shares are issued by companies. One can however deal with the stocks and shares of those companies that are listed in the stock exchange. All stocks and shares cannot be dealt here. So to deal with a particular company's share or stock it has to be listed. The physical records of the stick exchange are located at a particular place but then trading and other transactions can be done from anywhere. Internet has, to a great extent improved the stock and shares business. Hence the speed of the transactions is increased and the cost is minimized. Also such trading is possible only by the members of the stock exchange.

The stock exchange consists of:

- **Primary market**
- **Secondary market**

In the primary market the initial offering of the stock shares and securities are done. The trading of these securities and bonds is done in the secondary market. In a stock market the vital role is played by the stock exchange. The supply and the demand of the various stocks and securities are however as result of lot of factors.

The stock exchange gives an option to deal with the securities without the stock exchange. Such kind of trading is called as over the counter or off exchange trading. Normally the bonds and derivatives are traded this way. In the global market also the stock exchanges play a vital role.

6.2 FUNCTIONS OF STOCK EXCHANGE

The roles and responsibilities of stock exchange are detailed below:

- **They help to raise the capital for a business for expansion**: Such capital can be raised by selling the stocks and shares. The common ways to raise capital with the help of stock exchange is by going public, venture capital, partnerships and corporate partners.
- **Organize the savings which can be invested:** Stock exchange uses the funds of the people for the best resource. Hence the funds are used effectively which will lead to growth of the general economy and in turn that will lead to more returns for those who are saving as well as investing.

- **They help the companies which want to and also have the potential to grow:** Expansion is possible with the help of capital raising option.
- **The profits are shared by all**. Right from the big investor to a small investor all of them get dividend in relation to the amount that they have invested. So all are entitled for the income and share in the profit.
- **Stock exchange has an overall governance of the companies that deal in the stock market.** To deal in the stock exchange certain standards have to be met by the companies.
- **Even small investors can invest in the stock market.** So it breaks the old rule that only people with lot of money can invest in business. Even small investors have the opportunity to invest.
- **For infrastructure work the government needs funds:** Water treatment, sewage work are all infrastructure projects for which the government need funds. They get these funds by selling security that is called bonds. The members of the stock exchange can raise these funds. Which means people can give loan to the government. So government will pay interest for the loan at regular intervals and also the principal will be paid back at the maturity.

Stock exchange is an indicator of how the economy is performing. The prices of the shares depend vastly on the market. In a stable economy the stock price is also stable and there will also be growth. The prices will come down and the market will crash when the economy is going through depression. Similarly the prices will increase when there is a boom. In India we have the National Stock Exchange and the Bombay Stock exchange.

6.3 BOMBAY STOCK EXCHANGE

Bombay Stock Exchange is also known as BSE. It is one of the oldest stock exchanges that existed in whole of Asia. It was established 135 years ago in year 1875 under the name of "The Native Share & Stock Brokers". It is a podium where various and number of transactions that takes place daily and has provided tremendous growth to various sectors such as corporate sector. Bombay Stock Exchange (BSE).

In order to trade in Bombay Stock exchange one needs to be listed with the Bombay Stock Exchange. As per the records, there are about 4900 companies which are listed with the Bombay Stock Exchange and thus making it supreme through the world in terms of the companies that are listed with any stock exchange. The trading that place in the Bombay stock exchange is not only manual but there is a facility of electronic transaction that can be made in the BSE. If ranked on the terms of the electronic transaction that takes place daily in the Bombay Stock exchange, than the BSE become the fifth largest stock exchange in the world.

When a stock exchange obtains an ISO 9001:2000 certificate, it is regarded as the distinctive asset of that stock exchange. The Bombay Stock Exchange had all the capabilities to acquire that certificate and thus it had become the second most stock exchanges in the world to obtain the certificate. By obtaining the certificate it had become the India first stock exchange to obtain the same.

The Stock exchange also had the facility of BOLT, which is known as BSE Online Trading System. For this system, the stock exchange has received the Information Security Management System Standard BS 7799-2-2002 Certificate and thus making it Second in the world to obtain the same, and it had also become the first stock exchange to obtain the certificate, thus making it a supreme stock exchange amongst all.

BSE Index

SENSEX is the Index on which the BSE works. It is the most distinctive and important bench mark index in India.

Contribution of Bombay stock Exchange

Though every Stock Exchange in the world has its own distinctive features, but the Bombay stock Exchange has contributed under various heads thus making it important. The various contributions that are made by the Bombay Stock Exchange are:

- It has developed its In house technology by purchasing marketplace technology in 2009;

- It had purchased fifteen percentage of stick in the United Stock exchange. The purchase has helped in the enhancement of the currency and the imitative markets for the interest rates;
- BSE Sensex Mobile Streamer was launched by the Stock exchange;
- It has launched its websites in Gujarati, Hindi, Marathi;
- The stock exchange is providing enough support in the field of education, environment by taking the Corporate social Responsibility;
- The exchange has also launched IPO and PSU websites.

Thus, these are some of the contributions which are made by the Bombay Stock exchange. Though the contribution made by every stock exchange is a contribution which can be never be replaced, but the contribution made by the Bombay stock Exchange is something which the world will remember for the time to come.

6.4 NATIONAL STOCK EXCHANGE

Every Stock exchange is located at a particular place. For example, the Stock Exchange which is located in Delhi is known as Delhi Stock exchange. The Stock Exchange which is located in Mumbai (Maharashtra) earlier Bombay is known as Bombay Stock Exchange. But National Stock Exchange is formed to aim whole nation. At the request of the Government of India, the national Stock Exchange is endorsed by various Financial Institutions, Insurance companies, banks etc.

Incorporation and Origin of NSE:

The National Stock Exchange was for the first time incorporated in 1992. It was incorporated as a tax paying company. The Stock Exchange was under the provisions of the Securities Contracts (Regulation) Act, 1956 was accepted as a recognized stock exchange. Since then, the National stock exchange was growing with leaps and pounds. In 1994, the stock exchange started to deal in the Whole Sale Debt Market and has started to operate in the Capital Market. However, it was not until 2000 when the stock exchange has for the first time stated its operations in the derivatives.

The National Stock exchange is highly active in the field of market capitalization and thus aiming it the ninth largest stock exchange in the said field. Similarly, the trading of the stock exchange in equities and derivatives is so high that it has resulted in high turnovers and thus making it the largest stock exchange in India.

National stock Exchange Index:

The Index of the National stock exchange is known as S&P CNX Nifty. It is popularly known as NIFTY. The other indices which are contributed by the National Stock Exchange are CNX Nifty Junior, CNX 100, S&P CNX 500 and CNX Midcap.

Contributions of the National stock Exchange

There are significant numbers of contributions which are provided by the National Stock Exchange. Some of the contributions are listed herein below:

There is hardly ant stock exchange which uses the satellite communication technology for trading. The National stock Exchange is a Stock exchange which was the first stock exchange in the world to use such technology. The technology is basically a client server based technology which is known as NEAT (National Exchange for Automated Trading);

- It is the first stock exchange in India which has started using the NSE model;
- It is the first stock exchange which has provided an innovation to the spot equity market. This is done by the national stock exchange by establishing a NSCCL (National Securities Clearing Corporation Ltd);
- It is the stock exchange which has established the first s\depository system in India by establishing a National Securities Depository system;
- It has launched the S&P CNX Nifty;
- The facility of internet trading was established by the National Stock exchange for the first time in year 2000;
- It has traded in GOLD ETFs and thus making it the first stock exchange in doing such activity;
- A media centre known as NSE-CNBC-TV 18 was launched in co-operation with the CNBC-TV 18;

Thus, these are the some of the achievements which are honored to the National Stock Exchange. The National stock Exchange has contributed mainly in all the fields and thus making it distinctive and unique stock exchange in India.

The national Stock Exchange is dealing in capital market and the main section of the capital market in which the National stock Exchange is dealing in are Equity, stock lending and borrowing, currency futures, wholesale debt market etc.

Working Hours of the national Stock exchange

Every Stock Exchange has a fixed number of duration in a day in which the transaction in that particular stock exchange takes place. The official timing of the national stock exchange is 9:00 AM to 3:30 PM. It is working an all week days except Sundays. It also does not work on all the official holidays that are affirmed by the National Stock exchange. All the official holidays of the National stock Exchange are declared well in advance.

Though the National stock exchange was established in year 1992 but it was recognized as the stock exchange only in year 1993. To safeguard the investors it has launched the Investor Grievance cell in year 1995. Thus, in all it can be regarded that the contribution made by the National stock exchange cannot be regarded and thus makes it a stock exchange which is not only boosting the economy of India but also safeguarding the investor in every aspect.

6.5 FUNCTIONS /SERVICES OF STOCK EXCHANGES

The stock market occupies a pivotal position in the financial system. It performs several economic functions and renders invaluable services to the investors, companies, and to the economy as a whole. They may be summarised as follows:

(i) Liquidity and marketability of securities

Stock exchanges provide liquidity to securities since securities can be converted into cash at any time according to the discretion of the investor by selling them at the listed prices. They facilitate buying and selling of securities at listed prices by providing continuous marketability to the investors in respect of securities they hold or intend to hold. Thus, they create a ready outlet for dealing in securities.

(ii) Safety of funds

Stock exchanges ensure safety of funds invested because they have to function under strict rules and regulations and the bye-laws are meant to ensure safety of investible funds. Overtrading, illegitimate speculation, etc., are prevented through carefully designed set of rules. This would strengthen the investor's confidence and promote larger investment.

(iii) Supply of long-term funds

The securities traded in the stock market are negotiable and transferable in character and as such they can be transferred with minimum of formalities from one hand to another. So, when a security is transacted, one investor is substituted by another, but the company is assured of long-term availability of funds.

(iv) Flow of capital to profitable ventures

The profitability and popularity of companies are reflected in stock prices. The prices quoted indicate the relative profitability and performance of companies. Funds tend to be attracted towards securities of profitable companies and this facilitates the flow of capital into profitable channels. In the words of Husband and Dockeray, 'Stock exchanges function like a traffic signal, indicating a green light when certain fields offer the necessary inducement to attract capital and blazing a red light when the outlook for new investment is not attractive.

(v) Motivation for Improved performance

The performance of a company is reflected on the prices quoted in the stock market. These prices are more visible in the eyes of the public. Stock market provides room for this price quotation for those securities listed by it. This public exposure makes a company conscious of its status in the market and it acts as a motivation to improve its performance further.

(vi) Promotion of Investment

Stock exchanges mobilise the savings of the public and promote investment through capital formation. But for these stock exchanges, surplus funds available with individuals and institutions would not have gone for productive and remunerative ventures.

(vii) Reflection of business cycle

The changing business conditions in the economy are immediately reflected on the stock exchanges. Booms and depressions can be identified through the dealings on the stock exchanges and suitable monetary and fiscal policies can be taken by the government. Thus, a stock market portrays the prevailing economic situation instantly to all concerned so that suitable actions can be taken.

(viii) Marketing of new Issues

If the new issues are listed, they are readily acceptable to the public, since listing presupposes their evaluation by concerned stock exchange authorities. Public response to such new issues would be relatively high. Thus, a stock market helps in the marketing of new issues also.

(ix) Miscellaneous services

Stock exchange supplies securities of different kinds with different maturities and yields. It enables the investors to diversify their risks by a wider portfolio of investment. It also inculcates saving habits among the community and paves the way for capital formation. It guides the investors in choosing securities by supplying the daily quotation of listed securities and by disclosing the trends of dealings on the stock exchange. It enables companies and the Government to raise resources by providing a ready market for their securities.

6.6 OVER-THE-COUNTER

The term over-the-counter is a way of trading securities otherwise than on an organized stock exchange. Trading of securities is carried out by the brokers, dealers scattered over different locations and regions, with the help of a communication network including telephone, telegraphs, tele-typewriters, telex; fax and computers. Communication network links every deafer-broker, helps arrive at the prices and allows investors to select among the competing market-makers. A market-maker is one who offers two-way prices (a buy rate and a sell rate) at which the member-dealer is willing to buy or sell a standard quantity of scrip's that will be continuously quoted for a specified period. Thus, over-the-counter (OTC) market is envisaged as a floorless securities trading system equipped with electronic or computer network through which nationally and internationally scattered buyers and sellers can conduct business more efficiently and economically.

6.6.1 Need and Objectives

The setting up of the OTCEI was conceived as a method by which the ailments facing the working of the traditional stock exchanges at present could be overcome. Stock exchanges function as a single door market in which the securities of companies engaged in different industries and trades of varied sizes are listed with identical qualifying criteria, and are traded simultaneously in the same trading hall. This creates a situation where only the big and in1portant companies receive all the attention, with the large bulk of companies, particularly the new and small companies remaining unnoticed. This creates a situation of unlisted / on-traded companies that greatly jeopardizes liquidity of small scrips.

Small investors allover the country are faced with the problems of access, liquidity, delays in payment and delivery, and uncertainty regarding prices at which their shares are bought or sold. Prohibitive issue costs restricted access to the markets and administered pricing of their shares are the main' problems faced by companies. This meant India lacked a stock market option for small and medium companies given the BSE and NSE entry threshold of Rs.l0 crores-equity base. Similarly small, start-up companies in India had the problems of raising capital through a public issue. at exorbitant costs and delays in realization of proceeds. Moreover. many companies, which are doing well, were unable to grow to their potential because of their inhibition to go public to raise adequate capital. All such mid-cap companies have benefited from the establishment of OTCEI. The OTC Exchange has been set up as an answer to these problems of companies and investors, the two critical players in the cap ital markets.

The OTCEI aims at creating a stock exchange that will:

1. Facilitate small companies to raise funds from the capital market in a cost-effective manner. as it does not involve any flotation costs
2. Provide a convenient and an efficient avenue of capital market investments for small investors
3. Strengthen investors' confidence in the financial market by offering them the two-way best prices to the investors
4. Ensure transparency, redress investors' complaints and unify the country's securities market to cover even those places which do not have a stock exchange.
5. Provide liquidity advantage to the securities traded
6. Promote organized trading in Unlisted Securities
7. Broad base the existing informal market in order to make it more liquid
8. Provide a source of valuation for securities traded and
9. Act as a launch pad to an I PO

6.6.2 Features

The salient features of OTCEI are as follows:

Nation-wide Trading

OTCEI has a nation-wide network. By listing 011 the OTCEI, securities of a company call be traded across the country through centers that are located in different cities. Counters opened at different locations are interlinked by computer-based communication system. A public notice is given as to the availability of counters where trading takes place. Facilities for trading will be available at the counters of the sponsors and the market-makers who are notified by the OTCEI. Companies have an unique benefit of nationwide listing and trading of the scrips by simply listing at only one exchange, the OTC Exchange.

Compulsory Investor Registration

Every investor is expected to obtain 'Invest OTC Card for buying and selling securities on OTCEI by making an application at any of the counters of OTCEI. In fact, the share application form includes the necessary details to be filled in for obtaining 'Invest OTC Card'. The purpose of the investor registration is to facilitate computerized trading. It also provides greater safety of operations to the investors.

Ringless Trading

Trading does not take place on any specific floor of an exchange. The members and dealers open counters at various, places, which offer investors to connect locations for the purchase and sale of the listed securities. OTCEI does not have any trading ring/hall. Dealers quote, query and transact business through a central OTC computer connected with computers that are located at different centres/counters spread across the country.

The network of on-line computers allows market participants to execute trades from their offices and provides all relevant information on their screens, creating a fair market. Trading takes places through a network of computers (screen based) of OTC dealers located at several places within the same city and even across cities. These computers allow dealers to quote, query and transact through a central OTC computer using telecommunication links. Investors can walk into any of the counters of members and dealers, and see the quote display on the screen, decide to deal and conclude the transaction.

Transparent Computerized Trading

The entire trading at OTCEI is done in a transparent and speedy manner through computers. This makes the market more disciplined. The confirmation that the investor receives through the computer, gives the exact date, time, price of the deal and brokerage charged. The system also ensures that transactions are done at the best prevailing quotes in the market. The investors ' interest is fully protected in this regard.

Exclusive Listing

Companies listed at OTCEI are not listed on other stock exchanges. However, of late, following the liberalized approach of the RBI, companies that have been already listed in other stock exchanges are also allowed trading on the OTCEI. The companies sponsored by members of OTCEI are listed.

Closeness to Investors

There are a large number of inter-connected counters throughout the country. Facility for trading is available at the counters of the sponsors. The addresses of Additional Market-makers and dealers are provided in the application attached to the offer for sale. This way, OTCEI is considered to be closer to investors.

Authorized Dealers

Only those members and dealers who are authorized and approved by the OTCEI can deal on it.

Price Display

In a traditional stock exchange, the investor has no means of verifying the price at which the broker effected the transaction. Conversely, the OTCEI continuously displays current security prices on the screens installed at each of the OTC Exchange counters. This enables investors to make on-the-spot decisions on purchase or sale of securities.

Greater Liquidity

Since the sponsor and the Additional Market-maker offer two-way quotes, (i.e. buy and sell quotes) within specified margin, securities can be purchased and sold at any time. The compulsory market-making by the sponsor for every security ensures that buy and sell quotes are available everyday for a period of 3 years after which another market-maker takes over the price quotation. Unlike other stock exchanges, the OTC Exchange, through its nationwide reach, facilitates widely dispersed trading across the country, thus enabling greater liquidity.

Trading for Unlisted Companies

In pursuance of the recommendations of the Dave Committee, the SEBI has allowed trading of equity shares of all unlisted companies on the OTCEI to boost-the business volume of OTCEI. Such trading provides an opportunity to make the stocks liquid and tradable. In addition, it also provides a source of valuation of mutual funds, facilitates inter-institutional trades and enables placement of these shares with. Foreign institutional investors (FIIs) who can now subscribe to the shares of unlisted companies.

Trading in Derivatives

Based on Dave Committee recommendations, instruments like futures and options, forward contracts on stocks, other forms of forward transactions and stock lending are allowed to be traded on OTCEI. This aims at improving OTCEI's liquidity by providing greater depth.

Instant Execution of Orders

The investors' orders are executed immediately. If there are no buyers or sellers on the OTC Exchange, the market-maker deals with the investor. .

Ready Information

The compulsory market-maker carries out research on the scrip sponsored by him and, hence, all vital information pertaining to the company is readily available.

MoU with NASDAQ

OTCEI has signed a Memorandum of Understanding with NASDAQ, USA, the second largest stock exchange in the world. The MoU entails mutual exchange of information, training in various aspects of the capital market, access to the global market, etc **Multi-product Exchange**

A lot of innovation has gone into the working of the OTCEI. For instance, OTCEI introduces new products from time to time for the benefit of the investors, issuers and intermediaries in the capital market and the nation at large. OTCEI has also created a national market in its listed segment to facilitate large corporates to have simultaneous listing on the exchange. It is pertinent to note that OTCEI currently offers trading in the following category of securities viz., Listed Equity, Listed Debentures, GOI Securities. Permitted Equity. Permitted Debentures, Mutual Funds and Bonds of public sector units.

Technology

OTCEI uses computers, telecommunications and other technologies. of the modern information age in order to bring members/dealers together electronically, so as to enable them to trade with one another electronically, rather than on a trading floor in a single location. All the information needed for trading 'is available on the OTCEI's computer screen. To enhance connectivity for its trading systems, OTCEI has shifted to VSATs (Very Small Aperture Terminals). The use of modern technology ensures a more transparent. quick and disciplined trading.

Faster Transfers

The investor has to submit counter receipt at any of the OTCEI counters for transfer of shares. Shares are automatically transferred in the name of the investor. if the consolidated holding of the shares is within the limit of 0.5 percent of the issued capital of the company.

OTC trading provides for transfer of shares by Registrars up to a certain percentage per folio. This results in faster transfers. The concept of immediate settlement makes it better for the investors. Investors will trade, not with share certificates but with a different tradable document called Counter Receipt (CR). However, an investor can always exercise his right of having the share certificate by surrendering the CR and again exchanging the share certific.ate for CR when he wants to trade. A custodian provides this facility along with a settler who will do the signature verification and CR validation (The Counter Receipt is no longer a tradable document from 1st March, 1999).

Trading Services

An investor can buy and sell any listed scrip at any of the OTC exchange counter. The investor can also make an application for services like transfer of shares, splitting and consolidation of shares, nomination and revocation. of nomination, registering power of attorney, transmission of shares and change of holder's name, etc. The parties involved in trading on OTC-are Investor, Counter, Settler, Registrar/Custodian, Company and Bank. The trading documents mainly involved in OTC exchange transactions are: Temporary Counter Receipt (TCR), Permanent Counter Receipt (PCR), Sales Confirmation Slip (SCS), Transfer Deed (TD), Service Application Form (SAF), Application Acknowledgement Slip (AAS), and Deal Form (DF).

6.6.3 Benefits

The OTCEI offers the following benefits:

Benefits to Listed Companies

The benefits that are offered to companies listed with OTCEI are as follows:

1. Negotiability The Company can negotiate the issue price with the sponsors who have to market the issue. It provides an opportunity for fair pricing of an issue through negotiation with the sponsors.

2. Fixation of premium In consultation with the sponsors, the company can fix an optimum level of premium on issue with minimum risk of non-subscription of the issue.

3. Savings in costs Lots of costs associated with public issue of capital are saved through this mode. It provides an opportunity to companies to raise funds through capital market instruments at an extremely low cost as compared to a public issue. The method of sponsors placing the scrip's with members who in turn will offload the scrip's to public will obviate the need for a public issue and its associated costs.

4. No take-over threat OTCE lists scrip's even with 40 percent of the capital offered for public trading, limit has now been brought down to 20 percent in the case of closely held companies and new companies. As a result, the present management of the companies are saved of threats of takeover if they restrict public offer.

5. Large access Accessing a large pool of captive investor base through the OTCEI's computerized network is made possible for companies. Through nationwide network for servicing of investors, companies listed on

OTC Exchange can have a larger investor base.

6. Other benefits

a) Helpful to small companies

b) Shares of all unlisted companies can now be traded on OTCEI

c) Platform for issuers and first-level investors like financial institutions, state level financial corporations, Foreign Institutional Investors, etc.

d) System for defining benchmark for securities

e) Increasing business for the market constituents

f) Easier launch pad for an IPO

6.6.4 Benefits to Investors

The OTCEI offers the following benefits that are otherwise not available for investors dealing in other stock exchanges. These are as follows:

1. Safety OTCEI's ringless and scrip less electronic trading ensures safety of transactions of the investor. For instance, every investor in a OTCEI is given an 'Invest-OTC-Card ' free. This code is allotted on a permanent basis and should be used in all OTC transactions and applications of OTC issues. This card provides for the safety and security of the investors ' investments. The mechanism offers greater security to investors as the sponsors investigate into the company and the projects, before accepting sponsorship thus building up much needed greater investor confidence. .

2. Transparency OTC screens at every OTC counter display the best buy/sell prices. The exact trading prices are printed in the trading documents for confirmations. This protects the investor interest and thereby minimizes disputes.

3. Liquidity A great advantage of the OTC is that the scrip's traded are liquid. This is because there are at least two market-makers who indulge in continuous buying and selling. This enables investors to buy and sell the scrip's any time. .

4. Appraisal OTC member's sponsor each scrip listed in an OTC counter. The sponsor makes an appraisal of the scrip's for investor worthiness. This ensures quality of investments.

5. Access Every OTC counter serves as a single window to the entire OTC exchange throughout the country and throughout the world too. Therefore, buying and selling may be resorted to from any part of the world. It offers the facility of faster deal settlement for investors across the counters spread over the entire country.

6. Transfer: It is important that OTC shares are transferable within 7 days, where the consolidated holdings of the scrip's do not exceed 0.5 percent of the issued capital of the company.

7. Allotment There is not much waiting for the investors when it comes to allotment of scrip's. Allotment is completed in all respects within a matter of 35 days and trading begins immediately thereafter.

8. Other benefits:

a) Derivatives such as futures and options, forward contracts on stocks, and other forms of forward transactions and stock lending are allowed on OTCEI

b) Scrip less trading makes dealings simpler and easier

c) Market-making system in OTC Exchange gives sufficient opportunities for the investor to exit

d) Acts as a benchmark to value securities

e) Creating an exit option for illiquid stocks/venture capitalists

f) Shuffling portfolios for the investors

g) Organizing and broad-basing trading in the existing market

6.6.5 Benefits to Financial System

The OTCEI's role has been laudable in as far as it helps contribute improving the financial system of India in the

Following ways:

1. National network of OTCEI operations facilitates the integration of capital market in the country
2. Boon to closely-held companies as they are encouraged to go public because scrips can be listed even if only 40 percent of capital (now a minimum of 20 percent in case of closely held and new companies) is offered for public trading
3. Facilitates wider dispersal of economic activities by encouraging small companies and small investors
4. Promoting savings and investments by offering easier avenues for raising capital
5. Providing over-all stimulation to venture capital activities thereby promoting entrepreneurship

6. Market-making assistance by the sponsors on the OTCEI that helps in making an appraised future projections in the issue documents which in turn helps prospective investors in determining the

7. usefulness of the issues for investment purposes, promoting investment environment in general

8. Those members of the OTCEI who did not have multiple memberships Can now have an opportunity to trade in some of the large capital index stocks.

9. Encourage venture capital activities and boost entrepreneurship

10. Spread of stock exchange operations geographically all over India

6.6.6 Securities Traded

Following are the securities that are traded on the OTCEI:

1. Listed equity (exclusive) these are equity shares of the companies listed exclusively on the OTCEI. The shares can be bought or so ld at any of the member/dealer's office all over India. The securities, which are listed exclusively on the OTCEI, cannot be traded on other stock exchanges.

2. Listed debt These are the debentures/bonds that are issued through a public issue or a private placement and are listed on OTCEI. Any entity holding the entire series of a particular debt instrument can also offer them for trading on the OTCEI, by appointing an OTCEI member/dealer to carry out compulsory market making in those securities.

3. Gills The securities issued by the Central arid State Governments are called ' gilts'. Government of India Dated Securities, Treasury Bills and special securities are traded in this segment. Banks, Foreign Investors, Foreign Institutional Investors, NBFCs and Provident Funds can trade in these securities through OTCEI designated members/dealers. PSU Bonds, Commercial Paper, and Certificates of Deposit will also be traded in this segment.

4. Permitted securities These are the securities listed on other exchanges, which are permitted for trading on OTCEI. Securities of Blue Chip companies like ACC, Reliance Industries Ltd., State Bank of India, ITC etc are traded in this segment.

5. Listed mutual funds Listed mutual funds are units of mutual funds that are listed on OTECI. Mutual fund units like units of Unit-64, Monthly Income Plan, and IISFUS 97 are also listed under this category.

6.7 REASONS FOR THE DOWNFALL OF STOCK MARKET

We all know about the unpredictable nature of stock market. There are several reasons when the stock market go high and touch the sky, similarly there are reasons which make the stocks market fall. The major fall in the stock market comes when there is an unnecessary hike in prices of stocks in a very short span of time. Stock market falls generally when the stocks listed in large cap index that is the index which has stocks of all the big companies. When stock prices of the top companies which are included in large cap index start falling, stock market as a whole will take the downward trend. It is very important that corrections should take place in stock market at regular intervals because if the market will keep on rising people will lose interest and the downfall is the time which attracts new investors to participate in the investment of stock market.

a) Pressure of inflation always tends to move the stock markets down.

b) There is a fear of hike in prices which also provokes the stock market towards its downfall.

c) Weak growth of industry can also take stock market towards downfall.

d) Scandals and scams like the one done by Harshad Mehta in 1991-1992 can prove to be one of the reasons.

e) Changing policies of government regarding tightening of domestic and foreign trade can prove one of the reasons for the fall of stock process.

f) Introduction of new policies by Reserve Bank of India can also lead stock markets towards its downfall.

g) Sometimes some new announcements made by SEBI i.e. Securities Exchange Board of India make a noise in stock market in such a way that the prices of stock start falling which ultimately lead to the fall of stock market.

h) Stock market tends to fall abruptly when foreign investors start selling their stocks in our market due to political instability or any other new policy intervention.

i) Sometimes wrong news in the Market conveys wrong things to its investors due to which they start selling their stock at a faster rate which lead towards a disastrous fall in the stock market.

j) Sometimes Reserve Bank of India increase the value of Cash Reserve Ratio i.e. CRR which can be responsible for the downfall in stock market.

k) Global economies also affect our Indian stock markets in one way or the other due to which fall in any of the global economy can make our Indian stock market fall too.

l) Interest rates movements can also be one of the reasons for the downfall of the market.

m) Sometimes due to natural disasters like droughts and heavy rain fall also have a bad impact on markets which lead their way to the downfall?

n) In case of situations like wars, markets can fall as people feel insecure about their money and start selling their stocks at a faster rate.

o) Terrorism is also one of the other factors which create fear in mind of people and there is a state of terror in country which stops people in investing in stocks.

p) Increased rate of fraud and high rate of crime also pave the way to the downfall of the stock market in India.

In conclusion we can say that, it is the best time for the investors who want to buy stocks because when the markets are following the downward trend, prices of stocks go down abruptly. At this point of time when the markets are following a downward trend sellers want to sell their stocks at any price which they are getting in order to save themselves from loses while the buyers wait for the lowest prices to buy the stock and they wait the stock to reach its lowest point in order to buy that stock. Whenever there is a fall in stock market, nobody can predict that whether this is due to minor fluctuations or major fluctuations and this is a temporary downfall or going to last for some longer period of time. So an investor should be careful while taking the investment decision when the stock markets are going southward trend.

6.8 CHECK YOUR PROGRESS

1. The full form of OTCEI is

a) Over-the-Counter Exchange of India

b) Over the Counter Exchange of India

c) Over the Stock Exchange of India

d) Over the Stock Exchange of India

2. The index of BSE and NSE is also known as

a) SENSEX and NIFTY b) NYSE and SENSEX

c) LSE and TSE c) NASDAQ and NYSE

3. Mention the functions of stock market

a) Liquidity and marketability of securities

b) Supply of long term funds

c) Safety of funds

d) Promotion of Investment

Answer to check your progress: 1) a 2) a 3) a, b, c, d]

6.9 NOTES

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6.10 SUMMARY

The stock market is the market in which shares of publicly held companies are issued and traded either through exchanges or over-the-counter markets. The stock market lets investors participate in the financial achievements of the companies whose shares they hold. National Stock Exchange of India or in short NSE happens to be India's largest Stock Exchange and World's third largest stock exchange in terms of transactions. It is located in Mumbai and was incorporated in November 1992 as a tax-paying company. It was in April 1993 that NSE was recognized as stock exchange under the Securities Contract Act 1956.BSE or Bombay Stock Exchange is the oldest stock exchange in Asia that was established in 1875. It is also the biggest stock exchange in the world. BSE is located at Dalal Street, Mumbai. Bombay Stock Exchange and National Stock Exchange are both major stock exchange in India. But there is a difference between NSE and BSE. Investors put their money in the stock market in order to reap huge benefits from their investment. But nobody can predict the market. Also any stock market is decided by its country's growth. But you should be aware that it requires a lot of patience. The market tumbles down and this is the reason why investors fear of investing their money.

6.11 KEY WORDS

Bombay Stock Exchange (BSE) and National Stock Exchange (NSE): are the leading stock exchanges of India. BSE is the 4th largest stock exchange in Asia and the 11th largest in the world. NSE is mutually-owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries in India.

The over-the-counter exchange of India (OTCEI) is an electronic stock exchange based in India that is comprised of small- and medium-sized firms looking to gain access to the capital markets.

6.12 SELF ASSESSMENT QUESTIONS

1. What do you mean by OTCEI?

2. Define the term stock exchange.

3. Explain the various reasons for the downfall of stock market.

4. Differentiate between BSE and NSE

5. Explain the various features of OTCEI.

6. Mention the functions and services of stock exchange.

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UNIT - 7 : FOREIGN DIRECT INVESTMENT AND FOREIGN PORTFOLIO INVESTMENT

Structure:

7.0 OBJECTIVES

After studying this unit, you will be able to;

- Give the meaning of foreign direct investment
- Explain the meaning of FPI
- Describe the advantages of foreign direct investment
- Bring out the meaning of private equity
- Identify the difference between FDI and FPI
- Highlight the advantages and disadvantages of FDI

7.1 INTRODUCTION TO FOREIGN DIRECT INVESTMENT (FDC)

A foreign direct investment (FDI) is an investment made by a company or entity based in one country, into a company or entity based in another country. Foreign direct investments differ substantially from indirect investments such as portfolio flows, wherein overseas institutions invest in equities listed on a nation's stock exchange. Entities making direct investments typically have a significant degree of influence and control over the company into which the investment is made. Open economies with skilled workforces and good growth prospects tend to attract larger amounts of foreign direct investment than closed, highly regulated economies.

Foreign Direct Investment, or FDI, is a type of investment that involves the injection of foreign funds into an enterprise that operates in a different country of origin from the investor.

Investors are granted management and voting rights if the level of ownership is greater than or equal to 10% of ordinary shares. Shares ownership amounting to less that the stated amount is termed portfolio investment and is not categorized as FDI.

This does not include foreign investments in stock markets. Instead, FDI refers more specifically to the investment of foreign assets into domestic goods and services. FDIs are generally favoured over equity investments which tend to flow out of an economy at the first sign of trouble which leaves countries more susceptible to shocks in their money markets.

7.2 MEANING AND DEFINITION OF FOREIGN DIRECT INVESTMENT (FDI)

Foreign direct investment (FDI) is an investment in a business by an investor from another country for which the foreign investor has control over the company purchased. The **Organization of Economic Cooperation and Development (OECD)** defines control as owning 10% or more of the business. Businesses that make foreign direct investments are often called **multinational corporations (MNCs)** or **multinational enterprises (MNEs)**. A MNE may make a direct investment by creating a new foreign enterprise, which is called a **Greenfield investment**, or by the acquisition of a foreign firm, either called an **acquisition** or **brown field investment**.

Investment from one country into another (normally by companies rather than governments) that involves establishing operations or acquiring tangible assets, including stakes in other businesses. The purchase or establishment of income-generating assets in a foreign country that entails the control of the operation or organisation.

FDI is distinguished from portfolio foreign investment (the purchase of one country's securities by nationals of another country) by the element of control. Standard definitions of control use the internationally agreed 10 per cent threshold of voting shares, but this is a grey area as often a smaller block of shares will give control in widely held companies. Moreover, control of technology, management, even crucial inputs can confer de facto control.

FDI is not just a transfer of ownership as it usually involves the transfer of factors complementary to capital, including management, technology and organisational skills.

Example:

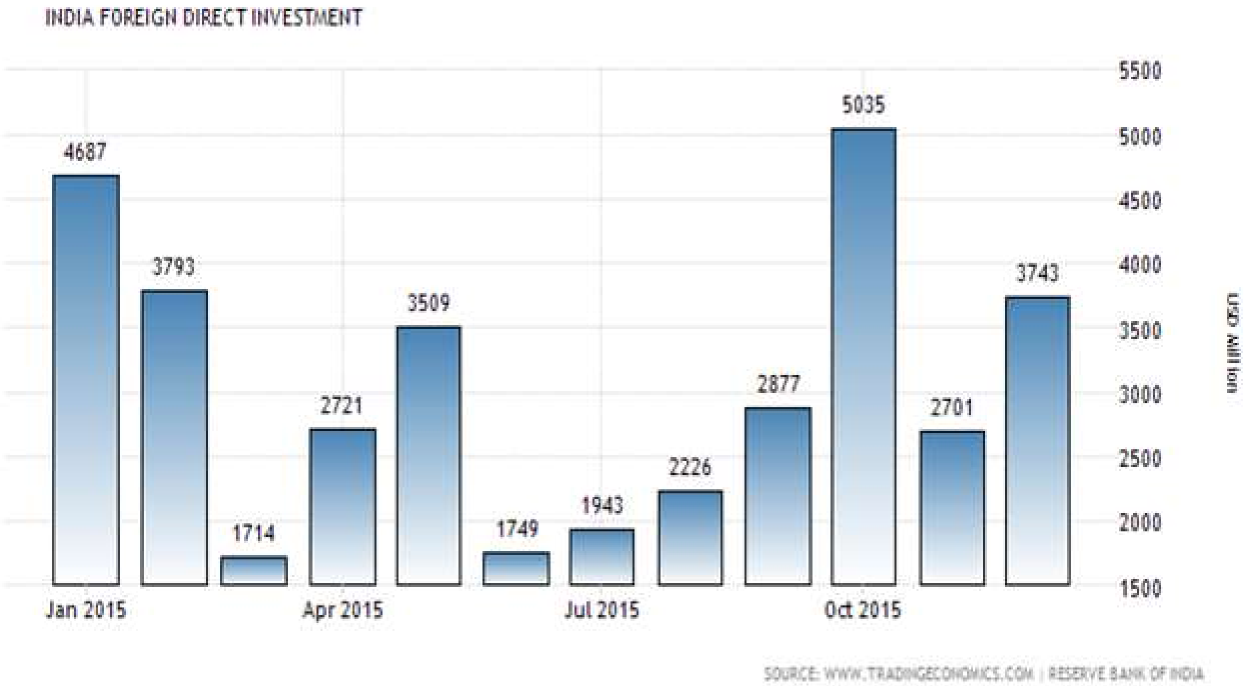
Strategically FDI comes in three types:

Horizontal: where the company carries out the same activities abroad as at home (for example, Toyota assembling cars in both Japan and the UK.

Vertical: when different stages of activities are added abroad. Forward vertical FDI is where the FDI takes the firm nearer to the market (for example, Toyota acquiring a car distributorship in America) and Backward Vertical FDI is where international integration moves back towards raw materials (for example, Toyota acquiring a tyre manufacturer or a rubber plantation).

Conglomerate: where an unrelated business is added abroad. This is the most unusual form of FDI as it involves attempting to overcome two barriers simultaneously - entering a foreign country and a new industry. This leads to the analytical solution that internationalisation and diversification are often alternative strategies, not complements.

In the below given diagram we can observe the foreign direct investment for the year 2015 for various months.



Source: Reserve Bank of India

7.3 ADVANTAGES AND DISADVANTAGES OF FOREIGN DIRECT INVESTMENT

It is true that globalization has rapid expansion through national borders and several industries. The foreign direct investment is considered as one of the most significant economical figures and it is associated with business enterprise and benefits that will greatly help you in attaining your business goals in just a short period of time. Today, most of the countries are opening their borders and doors especially when it comes to foreign investment. Foreign direct investment (FDI) is made into a business or a sector by an individual or a company from another country. It is different from portfolio investment, which is made more indirectly into another country's economy by using financial instruments, such as bonds and stocks.

There are various levels and forms of foreign direct investment, depending on the type of companies involved and the reasons for investment. A foreign direct investor might purchase a company in the target country by means of a merger or acquisition, setting up a new venture or expanding the operations of an existing one. Other forms of FDI include the acquisition of shares in an associated enterprise, the incorporation of a wholly owned company or subsidiary and participation in an equity joint venture across international boundaries. If a business is planning to engage in this kind of venture, you should determine first if it provides you and the society with maximum benefits. One good way to do this is evaluating its advantages and disadvantages.

Various Advantages of Foreign Direct Investment is mentioned below:

1. Economic Development Stimulation.

Foreign direct investment can stimulate the target country's economic development, creating a more conducive environment for you as the investor and benefits for the local industry.

2. Easy International Trade:

Commonly, a country has its own import tariff, and this is one of the reasons why trading with it is quite difficult. Also, there are industries that usually require their presence in the international markets to ensure their sales and goals will be completely met. With FDI, all these will be made easier.

3. Employment and Economic Boost:

Foreign direct investment creates new jobs, as investors build new companies in the target country, create new opportunities. This leads to an increase in income and more buying power to the people, which in turn leads to an economic boost.

4. Development of Human Capital Resources:

One big advantage brought about by FDI is the development of human capital resources, which is also often understated as it is not immediately apparent. Human capital is the competence and knowledge of those able to perform labor, more known to us as the workforce. The attributes gained by training and sharing experience would increase the education and overall human capital of a country. Its resource is not a tangible asset that is owned by companies, but instead something that is on loan. With this in mind, a country with FDI can benefit greatly by developing its human resources while maintaining ownership.

5. Tax Incentives:

Parent enterprises would also provide foreign direct investment to get additional expertise, technology and products. As the foreign investor, you can receive tax incentives that will be highly useful in your selected field of business.

6. Resource Transfer:

Foreign direct investment will allow resource transfer and other exchanges of knowledge, where various countries are given access to new technologies and skills.

7. Reduced Disparity Between Revenues and Costs:

Foreign direct investment can reduce the disparity between revenues and costs. With such, countries will be able to make sure that production costs will be the same and can be sold easily.

8. Increased Productivity:

The facilities and equipment provided by foreign investors can increase a workforce's productivity in the target country.

9. Increment in Income:

Another big advantage of foreign direct investment is the increase of the target country's income. With more jobs and higher wages, the national income normally increases. As a result, economic growth is spurred. Take note that larger corporations would usually offer higher salary levels than what you would normally find in the target country, which can lead to increment in income.

List of Disadvantages of Foreign Direct Investment

1. Hindrance to Domestic Investment.

As it focuses its resources elsewhere other than the investor's home country, foreign direct investment can sometimes hinder domestic investment.

2. Risk from Political Changes.

Because political issues in other countries can instantly change, foreign direct investment is very risky. Plus, most of the risk factors that you are going to experience are extremely high.

3. Negative Influence on Exchange Rates.

Foreign direct investments can occasionally affect exchange rates to the advantage of one country and the detriment of another.

4. Higher Costs.

If you invest in some foreign countries, you might notice that it is more expensive than when you export goods. So, it is very imperative to prepare sufficient money to set up your operations.

5. Economic Non-Viability.

Considering that foreign direct investments may be capital-intensive from the point of view of the investor, it can sometimes be very risky or economically non-viable.

6. Expropriation.

Remember that political changes can also lead to expropriation, which is a scenario where the government will have control over your property and assets.

7. Negative Impact on the Country's Investment.

The rules that govern foreign exchange rates and direct investments might negatively have an impact on the investing country. Investment may be banned in some foreign markets, which means that it is impossible to pursue an inviting opportunity.

8. Modern-Day Economic Colonialism.

Many third-world countries, or at least those with history of colonialism, worry that foreign direct investment would result in some kind of modern day economic colonialism, which exposes host countries and leave them vulnerable to foreign companies' exploitations.

Investing into another country's economy, buying into a foreign company or otherwise expanding your business abroad can be extremely financially rewarding and might provide you with the boost needed to jump to a new level of success. However, foreign direct investment also carries risks, and it is highly important for you to evaluate the economic climate thoroughly before doing it. Also, it is essential to hire a financial expert who is accustomed to working internationally, as he can give you a clear view of the prevailing economic landscape in your target country. He can even help you monitor market stability and predict future growth. Remember that we live in an increasingly globalized economy, so foreign direct investment will become a more accessible option for you when it comes to business. However, you should weigh down its advantages and disadvantages first to know if it is the best road to take.

7.4 INTRODUCTION TO FOREIGN PORTFOLIO INVESTMENT

Foreign portfolio investment (FPI) consists of securities and other financial assets passively held by foreign investors. Foreign portfolio investment (FPI) does not provide the investor with direct ownership of financial assets, and thus no direct management of a company. This type of investment is relatively liquid, depending on the volatility of the market invested in. It is most commonly used by investors who do not want to manage a firm abroad.

Foreign portfolio investment typically involves short-term positions in financial assets of international markets, and is similar to investing in domestic securities. FPI allows investors to take part in the profitability of firms operating abroad without having to directly manage their operations. This is a similar concept to trading domestically: most investors do not have the capital or expertise required to personally run the firms that they invest in.

Foreign portfolio investment differs from foreign direct investment (FDI), in which a domestic company runs a foreign firm. While FDI allows a company to maintain better control over the firm held abroad, it might make it more difficult to later sell the firm at a premium price. This is due to information asymmetry: the company that owns the firm has intimate knowledge of what might be wrong with the firm, while potential investors (especially foreign investors) do not.

The share of FDI in foreign equity flows is greater than FPI in developing countries compared to developed countries, but net FDI inflows tend to be more volatile in developing countries because it is more difficult to sell a directly-owned firm than a passively owned security.

7.5 MEANING AND DEFINITION OF FOREIGN PORTFOLIO INVESTMENT

Foreign Portfolio Investment (FPI) is investment by non-residents in Indian securities including shares, government bonds, corporate bonds, convertible securities, infrastructure securities etc. The class of investors who make investment in these securities are known as Foreign Portfolio Investors. The FPI is induced by differences in equity price scenario, bond yield, growth prospects, interest rate, dividends or rate of return on capital in India's financial assets.

SEBI has recently stipulated the criteria for Foreign Portfolio Investment. According to this, any equity investment by non-residents which is less than 10% of capital in a company is portfolio investment. While above this the investment will be counted as Foreign Direct Investment (FDI). Investment by a foreign portfolio investor cannot exceed 10 per cent of the paid up capital of the Indian company. All FPI taken together cannot acquire more than 24 per cent of the paid up capital of an Indian Company.

Who are Foreign Portfolio Investors?

Foreign Portfolio Investors includes investment groups of Foreign Institutional Investors (FIIs), Qualified Foreign Investors (QFIs) (Qualified Foreign Investors) and subaccounts etc.

After the new SEBI guidelines, the RBI stipulated that Foreign Portfolio Investors include Asset Management Companies, Pension Funds, Mutual Funds, and Investment Trusts as Nominee Companies, Incorporated / Institutional Portfolio Managers or their Power of Attorney holders, University Funds, Endowment Foundations, Charitable Trusts and Charitable Societies.

Who is a Foreign Institutional Investor?

FII is an institution like a mutual fund, insurance company, pension fund etc. According to SEBI, "an FII is an institution established or incorporated outside India which proposes to make investment in India in securities". FII is an institution who is registered under the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995. FIIs comprised of a pension fund, a mutual fund, investment trust, insurance company or a reinsurance company.

Who is a Qualified Foreign Investor?

QFI is an individual, group or association which is a resident in a foreign country. The QFI should compliant with the Financial Action Task Force standard and should be a signatory to the International Organisation of Securities Commission.

The FIIs are big and hence they have the capacity to make large scale investment. On the other hand, small investors and individuals under QFI category can't match FIIs in terms of business volume. So, often when we hear about foreign investment in the share market, it is the FIIs who steal the attention.

7.6 DIFFERENCE BETWEEN FDI AND FPI

FDI is an acronym that stands for Foreign Direct Investment. It refers to the type of investment carried out at international level where an investor will acquire a stake in an enterprise in a foreign country with long term realization of goals in the enterprise. FPI stands for Foreign Portfolio Investment where an international investor acquires stakes in a foreign country in terms of stock, bonds and some other assets but with the investor having an inert role in the management of those financial holdings.

FDI typically involves establishment of some physical entity such as a factory or an enterprise in a foreign country. It may involve a relationship created between a parent company in one country and an affiliate in another country which would together form a multinational company. All kinds of capital contributions are included while calculating FDI, for instance stock acquisitions, reinvestments of business profits by a parent company in its foreign subsidiary or just direct lending by a subsidiary company. It is not easy to withdraw from FDI so it is common to have members with a direct interest in the investment committing to managing the day to day affairs of their foreign interests or at least making major strategic decisions.

FPI usually aims at short term benefits and typical target countries for this type of foreign investment, given its transient nature, are developing countries. It offers easier escape routes compared to FDI, where an investor can easily withdraw from a foreign portfolio either when targets have been realized or when there's an unexpected occurrence affecting the economic standing of that country which may adversely affect foreign investments. Unlike FPI, FDI requires more investment specific capital and so it's harder to adjust this type of investment in short term changing conditions whereas FPI can easily be adjusted as the business conditions fluctuate.

7.7 INTRODUCTION: PRIVATE EQUITY

Private equity is equity capital that is not quoted on a public exchange. Private equity consists of investors and funds that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Capital for private equity is raised from retail and institutional investors, and can be used to fund new technologies, expand working capital within an owned company, make acquisitions, or to strengthen a balance sheet. The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time. Private equity investments often demand long holding periods to allow for a turnaround of a distressed company or a liquidity event such as an IPO or sale to a public company.

Private equity refers to a type of investment aimed at gaining significant, or even complete, control of a company in the hopes of earning a high return. As the name implies, private equity funds invest in assets that either are not owned publicly or that are publicly owned but the private equity buyer plans to take private. Though the money used to fund these investments comes from private markets, private equity firms invest in both privately and publicly held companies. The private equity industry has evolved substantially over the past decade or so. The basic principle has remained constant: a group of investors buy out a company and use that company's earnings to pay themselves back. What has changed are the sheer numbers of recent private equity deals. In the past ten years, the record for the most expensive buyout has been broken and re-broken several times. Private equity firms have been acquiring companies left and right, paying sometimes shockingly high premiums over these companies' market values. As a result, takeover targets are demanding exorbitant prices for their outstanding shares; with the massive buyouts that have made headlines around the world, companies now expect a certain premium over their current value. One example is Free-scale Semiconductor, who turned down a deal that paid a nearly 30% premium over its market value, holding out for a sweeter package, which it received. The sheer number of these high-priced deals that have occurred in recent years have led some to question whether this pace is sustainable in the long run. This could turn out to be a self-fulfilling prophecy; as concerns grow and people become less eager to invest in private equity deals, firms won't be able to raise the money to fund their acquisitions, essentially crippling the industry.

Private Equity is not very well known outside of the finance world, but it is one of the key players in global business. Private Equity firms are part of the fabled 'buy-side' and some of the largest firms (mega funds) are:

- Kohlberg, Kravis & Roberts (KKR)
- Blackstone
- Bain Capital
- Carlyle Group

The definition of private equity is simply money invested into a private company, or the privatization of a company through the investment of outside money. Basically, what private equity firms attempt to do is to invest into a company, take a majority stake, improve the company and then exit their investment at a large profit. In order to magnify returns, PE firms make use of leverage (borrowed money) to conduct Leveraged Buyouts (LBOs).

Private Equity firms can either focus on a specific sector (Energy, Technology, Healthcare etc.) or operate across a broad spectrum. The larger the firm, the more likely it is to cover more sectors.

7.8 MEANING AND DEFINITION OF PRIVATE EQUITY

It's a source of investment capital from high net worth individuals with the goal of investing and acquiring equity ownership in companies. The investment in those companies will generally be made by a private equity firm, but also by a venture capital firm or an angel investor.

In simpler terms, the idea behind private equity is to gather up funds from a number of investors, take those funds and use them to acquire a controlling or substantial minority position in a firm, and then get a return on that investment.

The targeted companies of private equity are not usually publicly traded on the stock market— or if they are, are usually de-listed from the markets in order to make the private deal. The firms can be listed again, usually as a way to make money for the private equity investors, as we'll note in a bit.

A private equity fund typically refers to a general partnership formed by PE firms, which are utilized to invest in private companies. The private equity fund may have general investment criteria (meaning it invests in different industries) or have specific industry criteria. However, private equity funds typically have an investment philosophy that it sticks to throughout its term, which tends to be anywhere between 10 and 13 years. After this time period elapses, the private equity fund is closed by having all funds distributed back to the limited partners. Private equity funds may invest directly in equity securities of the target investment, in the form of mezzanine debt, or in both equity and debt.

In general terms, private equity funds often focus on one of the following investment philosophies:

- Venture capital - used to finance early stage companies that do not have access to financial markets or conventional financing.
- Growth capital - used to fund the expansion of an established private company that is "asset light," and therefore may not be able to use its own assets to secure traditional financing for such growth.
- Leveraged or management buyouts - used in combination with additional leverage placed on a company to allow the existing management to take control of the target. The company's cash flow has to be sufficient to cover the carrying costs of the additional debt.
- Distressed or turnaround situations - used when companies are unable to service their existing debt, and the fund's equity is used to recapitalize the balance sheet along with management conducting a turnaround strategy.

How do private equity investors make money back?

They generally receive a return on their investments through one of the following ways:

An initial public offering (IPO):

Shares of the company are offered to the public, typically providing an immediate return on an investment through the sale of shares in the firm.

A merger or acquisition:

The company is sold for either cash or shares in another company.

A recapitalization:

Cash is distributed to the shareholders — the investors — either from cash flows generated by the company or through raising debt or other securities to fund the distribution.

7.9 CHECK YOUR PROGRESS

1. How is FDI strategically classified?

a) Conglomerate b) Vertical

c) diversified d) Horizontal

2. Mention some private equity firms

a) Bain Capital

b) Blackstone

c) Kohlberg, Kravis & Roberts (KKR)

d) Carlyle Group

3. What is the full form of MNE'S?

a) Multinational Equity

b) Multinational Enterprises

c) Multinational Company

d) Multinational Issue

Answer to check your progress: 1) a, b, d, 2) All options 3) b

7.10 NOTES

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7.11 SUMMARY

FDI tends to yield more returns on investment as a direct result of investors' controlling position in the investment but with FPI, although there's a lot of flexibility to adjust to short term environmental changes, there's generally less returns realized, making this a favorite investment route for smaller firms looking for flexibility and lower investment specific costs other than bigger returns.FDI and FPI investment calculations are determined by the amount of investments made in a single year, which is the 'flow', or as 'stock', which is the amount of investment massed in a year. It is therefore harder to make estimates for FPI portfolio flows especially if a FPI investment is made for one year or less as they contain various instruments, so a definite value is hard to estimate. The difference between FDI and FPI may be hard to establish, especially if it is a relatively big foreign investor considering investing in stock options. The two models coincide in part with each other in this case and it may go down to choosing between flexibility and returns on investment.

7.12 KEY WORDS

Foreign direct investment (FDI): Involves establishing a direct business interest in a foreign country, such as buying or establishing a manufacturing business.

A portfolio investment: is an investment made by an investor who is not involved in the management of a company. This is in contrast to direct investment, which allows an investor to exercise a certain degree of managerial control over a company.

Foreign portfolio investment (FPI) is investing in financial assets, such as stocks or bonds, in a foreign country.

7.13 QUESTIONS FOR SELF STUDY

1. What do you mean FDI and FPI?
2. Define the meaning of private equity.
3. Explain the advantages and disadvantages of FDI.
4. Differentiate between FDI and FPI.
5. Discuss the difference between FDI and FPI.

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UNIT - 8 : INVESTORS PROTECTION AND SEBI GUIDELINES

Structure:

8.0 OBJECTIVES

After studying this unit, you will be able to;

- Give the meaning of Investor Protection
- Explain the factors affecting investors interest
- Describe the need for Investor Protection
- Identify the significance of SEBI Guidelines
- Highlight the guidelines of Investor Protection

8.1 INTRODUCTION

The peculiar nature of the company form of organisation is that there is diversity of ownership and management. Though thousands of shareholders have invested their money in a company, they don't have any direct connection with the day-to-day running of the business. They have invested their small means in the company through the share market to get ample returns and also to get capital appreciation of their invested funds. At the same time, they have to shoulder many risks of different kinds. Apart from the normal risks attached to every business, there may be abnormal risks also in the form of dishonesty and improprietory of all the counterparties with whom they come into contact while investing their funds. Hence, there arises a necessity to protect them from all such risks so that their confidence in the market may be built-up and they may actively participate in the market with boosted confidence. It will go a long way in creating a healthy and vibrant capital market.

8.2 NEED FOR INVESTORS' PROTECTION

The need for investors' protection arises due to the following reasons:

(i) To instil confidence in investors' minds

Investors' confidence is very essential for the smooth and successful functioning of the capital market. When their confidence is shaken or when they lose their confidence in the market, there will be a severe jolt in the market. Many investors are tempted to invest with an expectation of making good fortunes out of their investment. If it does not happen, they come away from the market. Such a situation is not at all desirable. Therefore, it is vital to build-up investors' confidence by creating a conducive atmosphere for investment through investors' protection measure.

(ii) To create a conducive atmosphere for investment

A proper and sound investment climate is very essential for industrial development. The corporate customers would find it easy to raise capital at affordable minimum cost only when there is efficient and secured investment climate. In fact, strong investors' protection measures would create a healthy investment climate.

(iii) To ensure transparency in dealing

The investors would be able to evaluate their prospective investments only when there is transparency of dealings of companies and all the intermediaries connected with the stock market. Investment decisions would be taken on the basis of full disclosures made by companies in various areas. All investors' protection measures aim at bringing the much needed transparency and disclosures in all key areas.

(iv) To create a vibrant capital market

Investors would freely enter into the capital market in large numbers only when their interest is fully protected from all angles. This increased participation would develop the market and once the market gets developed, it would again attract more and more investors. Thus, investors' protection would indirectly promote a vibrant capital market.

(v) To regulate the market on sound lines

Investors' protection measures in the form of regulations would make all market players work within the ambit of regulations. It would lead to a smooth and stable functioning of the market on desired lines.

(vi) To create discipline in the market

All investors' protection measures aim at minimising the unhealthy practices, undue speculation, unnecessary malpractices, etc., in the market. It would go a long way in creating a good discipline among all market players.

(vii) To create accountability among market players

A sense of accountability is created among all players in the market by means of laying down strict disclosure norms and taking stringent investors' protection measures. This accountability makes them comply with all requirements failing which they are answerable to the regulatory bodies.

(viii) To create awareness among Investors

Above all, investors must be aware of their own rights and liabilities, grey areas of frauds, the type of frauds that can take place, etc. Hence, investor protection measures also aim at educating the prospective and present investors on these aspects. This would enable them to protect themselves from all unhealthy and fraudulent practices by becoming saviours of their own protection.

8.3 FACTORS AFFECTING INVESTORS' INTEREST

There are many factors that affect investors' 'interest and thereby cause dissatisfaction among them. The prominent causes are:

(i) Price rigging

Price rigging is nothing but the artificial manipulation of prices of securities by forming cartels by bulls and bears. They don't allow the market forces of demand and supply to play their due role. These artificial prices create a market wind in either direction to which innocent investors fall as victims.

(ii) Insider trading

Insider trading refers to the purchase or sale of securities by persons who hold price-sensitive information about the company due to their fiduciary relationship with that company. In other words, insiders get regular profits at the expense of a majority of uninformed investors.

(iii) Excessive speculation

Speculation, if it exceeds its limit, would affect the interest of investors to a greater extent. If brokers, in order to earn more and more profits due to a probable rise in price, may engage themselves in a buying spree far beyond their capacity. It would result in non-fulfilment of their settlement promises which may lead to market crash. Ultimately, the innocent investors suffer for no fault of theirs.

(iv) Lack of transparency

In order to attract investors, some companies may present a rosy picture of their financial position by manipulating their system of accounting. The accounts are not at all transparent in their disclosures. Again, the stock market dealings are not transparent.

(v) Short selling

Short selling refers to selling of scrip's without owning them by bear cartels with the anticipation that these shares could be purchased at a much lesser price in future when delivery would be actually made. It leads to extreme volatility in the market.

(vi) Restricted trading

One of the serious grievances of the investors is restricted trading in stock exchanges. Though there is an increase in the turnover of stock exchanges, it is restricted to a few shares only with the top 10 shares accounting for about 80 per cent of the turnover and top 100 shares for 99 per cent of the turnover.

(vii) Restricted trading hours and trading days

Another factor arises from the fact that the trading hours of stock exchanges are very small and the market also remains closed on many days a week. This affects the marketability and liquidity of securities.

(viii) Dominance of few stock exchanges

Though many stock exchanges are functioning in India, a lion's share of the dealings are held in BSE and NSE only. The regional stock exchanges are gradually losing their importance.

(ix) Dominance of Institutional and foreign Institutional Investors

The institutional investors, particularly the foreign institutional investors dominate the Indian capital market. They dictate the terms in the market. They account for nearly 80 per cent of the new issues. The ownership of equities by individuals and households is gradually coming down.

(x) Excessive volatility

Due to the impact of IT revolution, LPG policies, introduction of innovative instruments and adoption of flexible interest rate structure, the volatility in the capital market has been greatly increased. The small investors are not able to face such a situation with confidence.

(xi) Grievances against listed companies

Moreover, the investor's complaints against listed companies are manifold.

Some of them are:

i. Non-receipt of share certificates.

ii. Non-receipt of refund orders.

iii. Non-receipt of duplicate securities.

iv. Non-receipt of certificates after consolidation.

v. Non-receipt of certificates after splitting.

vi. Bad delivery of share certificates.

vii. Failure to affect transfers and delay in executing transfers.

viii. Non-receipt of interest on listed debentures.

ix. Non-receipt of redemption proceeds of listed debentures.

x. Non-receipt of allotment advice.

xi. Complaints regarding revalidations.

(xii) Grievances against members of stock exchanges are:

The nature of complaints against the members of the stock exchanges

i. Non-receipt of delivery of shares.

ii. Non-receipt of dividend.

iii. Non-receipt of rights shares.

iv. Non-receipt of bonus shares.

v. Non-receipt of sale proceeds.

vi. Disputes relating to non-settlement of accounts.

vii. Disputes regarding rate differences, etc.

(xiii) Miscellaneous grievances

Miscellaneous grievances arise due to:

i. Non-repayment of fixed deposits in financial companies.

ii. Non-repayment of deposits in manufacturing companies.

iii. Non-redemption of mutual funds and all complaints relating to mutual funds.

iv. Complaints relating to shares and debentures in unlisted companies.

8.4 SEBI GUIDELINES

SEBI has brought out a number of guidelines separately, from time-to-time, for primary market, secondary market, mutual funds, merchant bankers, foreign institutional investors, investor protection, etc. The guidelines are described below.

8.4.1 Guidelines for primary market

New company: A new company is one: (a) Which has not completed 12 months commercial production and does not have audited results and (b) Where the promoters do not have a track record.

These companies will have to issue shares only at par.

New company set up by Existing company: When a new company is being set up by existing companies with a five-year track record of consistent profitability and a contribution of at least 50 per cent in the equity of new company, it will be free to price its issue, i.e., it can issue its share at premium.

Private and closely Held companies: The private and closely held companies having a track record of consistent profitability for at least three years shall be permitted to price their issues freely. The issue price shall be determined only by the issues in consultation with lead managers to the issue.

Existing listed companies: The existing listed companies will be allowed to raise fresh capital by freely pricing expanded capital provided the promoter's contribution is 50 per cent on first Rs. 100 crore of issue, 40 per cent on next Rs. 200 crore, 30 per cent on next Rs.300 crore and 15 per cent on balance issue amount.

Reservation of Issues

Reservations under public subscription for various categories of persons are made in the following manner:

1.	Permanent Employees	-	10%
2.	Indian Mutual Funds	-	20%
3.	Foreign Institutional Investors	-	15%
4.	Development Financial Institutions	-	20%
5.	Shareholders of Group of Companies	-	10%

Composite Issues

In the case of composite issue, i.e., right-cum-public issue by existing listed companies differential pricing shall be allowed. In other words, issue to the public can be priced differentially as compared to issue to rights shareholders. However, justification for the price difference should be given in the offer document.

Lock-In period

Lock-in period is five years for promoter's contribution from the date of allotment or from the commencement of commercial production whichever is late. At present, the lock-in period has been reduced to one year.

Guidelines for public Issue

1. Abridged prospectus has to be attached with every application.
2. A company has to highlight the risk factors in the prospectus.
3. Objective of the issue and cost of project should be mentioned in the prospectus.
4. Company's management, past history and present business of the firm should be highlighted in the prospectus.
5. Particulars with regard to company and other listed companies under the same management which made any capital issues during the last three years are to be stated in the prospectus.
6. Justification for premium, in the case of premium is to be stated.
7. Subscription list for public issues should be kept open for a minimum of three days and a maximum of 10 working days.
8. The collection centers should be at least 30 which include all centers with stock exchanges.
9. Collection agents are not to collect application money in cash.
10. The quantum of issue, whether through a rights or public issue, shall not exceed the amount specified in the prospectus. No retention of oversubscription is permissible under any circumstances.
11. A compliance report in the prescribed form should be submitted to SEBI within 45 days from the date of closure of issue.
12. Minimum number of shares per application has been fixed at 500 shares of face value of Rs. 100.
13. The allotments have to be made in multiples of tradable lot of 100 shares of Rs. 10 each.
14. Issues by way of bonus, rights, etc., to be made in appropriate lots to minimize odd lots.
15. If minimum subscription of 90 per cent has not been received, the entire amount is to be refunded to investors within 120 days.
16. The capital issue should be fully paid-up within 120 days.
17. Underwriting has been made mandatory.
18. Limit of listing of companies issue in the stock exchange has been increased from Rs. 3 crore to Rs. 5 crore.

19. The gap between the closure dates of various issues, *viz.,* rights and public should not exceed 30 days.

20. Issues should make adequate disclosure regarding the terms and conditions of redemption, security conversion and other relevant features of the new instrument so that an investor can make reasonable determination of risks, returns, safety and liquidity of the instrument. The disclosure shall be vetted by SEBI in this regard.

21. SEBI has made grading of all IPO mandatory for which draft documents are filled with it after April 30, 2007.

It shall be mandatory to obtain grading from at least one credit rating agency.

The issues shall be required to disclose all grades obtained by it in the prospectus, abridged prospectus, issue advertisements and others places where the issues is advertising for the IPO.

SEBI has announced on 5th August, 2008 that an alternate payment mode would be launched for public issues that would ensure that the funds of retail investors are not locked until the actual allotment of shares. On 10th September, 2008, five banks have agreed to debit application money only when it was required and not 21 days in advance and the registrar to give instruction to block the amount only when it was required.

8.4.2 Secondary market

Stock exchange

i. Board of Directors of stock exchange has to be reconstituted so as to include non-members, public representatives, and government representatives to the extent of 50 per cent of total number of members.

ii. Capital adequacy norms have been laid down for members of various stock exchanges depending upon their turnover of trade and other factors.

iii. Working hours for all stock exchanges have been fixed uniformly.

iv. All the recognized stock exchanges will have to inform about the transaction within 24 hours.

v. Guidelines have been issued for introducing the system of market making in less liquid scrip's in a phased manner in all stock exchanges.

Brokers

i. Registration of brokers and sub-brokers is made compulsory.

ii. In order to ensure that brokers are professionally qualified and financially solvent, capital adequacy norms for registration of brokers have been evolved.

iii. Compulsory audit of broker's book and filing of audit report with SEBI have been made mandatory.

iv. To bring about greater transparency and accountability in the broker client relationship, SEBI has made it mandatory for brokers to disclose transaction price and brokerage separately in the contract notes issued to client.

v. No broker is allowed to underwrite more than 5 per cent of public issue.

8.4.3 Foreign Institutional Investors (FIIs)

i. Foreign institutional investors have been allowed to invest in all securities traded in primary and secondary markets.

ii. There would be no restriction on the volume of investment for the purpose of entry of FIIs.

iii. The holding of single FIT in a company will not exceed the ceiling of 5 per cent of the equity capital of a company.

iv. Disinvestment will be allowed only through stock exchanges in India.

v. FIIs have to pay a concessional tax rate of 10 per cent on large capital gain (more than one year) and 30 per cent on short-term capital gains. A tax rate of 20 per cent on dividend and interest is prescribed.

8.4.4 Bonus Issue

The guidelines relating to the issue of bonus shares have undergone several changes since 1969. The latest set of guidelines announced by SEBI was made effective from April 13, 1994. At present, there are in all 10 guidelines laid down for bonus shares.

(i) There should be a provision in the Articles of Association of the company for issue of bonus shares. If not, the company should pass a resolution at the General Body Meeting, making provision for capitalization of profits. The proposal for bonus issues is recommended by the Board of Directors and then approved in the General Body Meeting.

(ii) The bonus is made out of free reserves built out of the genuine profits or share premiums collected in cash only.

(iii) Reserves created by revaluation of fixed assets are not permitted to be capitalized.

(iv) The declaration of bonus issue in lieu of dividend is not to be made.

(v) Bonus issues are not permitted unless the partly paid shares existing are fully paid-up.

(vi) No bonus issue will be permitted if there are sufficient reasons to believe that the company has defaulted in respect of payment of statutory dues to the employees such as provident fund, gratuity, bonus, etc. Further, no bonus issue is permitted if the company defaults in payment of principal or interest on fixed deposits or on debentures.

(vii)No bonus issue can be made within 12 months of any public issue/ rights issue.

(viii) A company which announces bonus issue after the approval of the Board of Directors must implement the proposals within a period of six months from the date of such proposal and shall not have the option of changing the decision.

(ix) Consequent to the issue of bonus shares, if the subscribed and paid-up capital exceeds the authorized share capital, a resolution shall be passed by the company at its general body meeting for increasing the authorized capital.

(x) Issue of bonus shares after any public/ rights issue is subject to the condition that no bonus shall be made which will dilute the value or rights of holders of debenture, convertible fully or partly.

The company shall forward a certificate duly signed by the issuer and duly countersigned by its statutory auditor or by a company secretary in practice to the effect that the terms and conditions for the issue of bonus shares as laid down in these guidelines have been complied with.

8.4.5 Rights Issue

Section 81 of the Companies Act specifies the conditions to be satisfied by a public company for issuing rights shares. SEBI has issued the following guidelines for the issue of rights share.

(i) **Composite issue:** A public and rights issue can be made at different prices where these two kinds of issues are made as a composite issue by existing listed companies. There is no restriction in charging lower premium on rights issue than on public issues. The premium must be fixed by the Board of Directors in consultation with lead manager to the issue. Differential pricing in a composite issue is not permitted in the case of existing unlisted companies making public issue for the first time.

(ii) **Appointment of merchant banker:** Appointment of merchant banker is not mandatory, if the size of rights issue by a listed company does not exceed Rs. 50 lakh. For issues of listed companies exceeding Rs. 50 lakh, the issue is to be managed by an authorized merchant banker.

(iii) Minimum subscription: If the company does not receive minimum subscription of 90 per cent of the issue amount including devolvement of underwriters within 120 days from the date of opening of issue, the company has to refund the entire subscriptions within 128 days with interest at 15 per cent p.a. for delay beyond 78 days from the date of closure of the issue.

(iv) Preferential allotment: No preferential allotment shall be made along with the rights issue. If a company wants to make preferential allotment, it should be made independent of rights issue by complying the provisions of the Companies Act, 1956.

(v) Underwriting: Underwriting of rights issue is not mandatory but as per SEBI (Underwriter's) Rules and Regulations, 1993, rights issue can be underwritten.

(vi) Rights of FCD/PCD holders: The proposed rights issue should not dilute the value or rights of fully or partly convertible debenture holders. If the conversion of FCDs/PCDs is due within a period of 12 months from the date of rights issue, reservation of shares out of rights issue is to be made for them in proportion to the convertible part of FCDs/PCDs.

(vii) Oversubscription not to be retained: The quantum rights issue should not exceed as specified in the letter of offer. The companies are not allowed to retain oversubscription under any circumstances through rights issue.

(viii) Promoter's contribution: If the promoter's shareholding in the equity at the time of the rights issue is more than 20 per cent of the issued capital, the promoters have to ensure that their equity holding do not fall below 20 per cent of the expanded capital.

If the promoter's holdings are less than 20 per cent of the issued capital, they shall take up the unsubscribed portion of the rights issue so that their holdings amount to 20 per cent of the expanded capital.

The lock-in period is two years for the share holdings prior to the rights issue from the date of allotment in the rights issue.

(ix) Vetting of letter of offer by SEBI: The letter of offer pertaining to rights issue has to be vetted by SEBI and the concerned lead manager has to obtain SEBI clearance for the draft letter of offer before approaching stock exchange for fixing the record date for the proposed issue. A copy of letter of offer is forwarded to SEBI for information if the rights issue is less than Rs. 5lakh. The responsibility of vetting the rights issue is passed on to merchant bankers in 1995. Rights issue not accompanied by public issue, if made three months prior to or three months after the public issue, will not have to be vetted by SEBI.

(x) **Disclosure in the letter of offer:** The letter of offer like the prospectus should conform to the disclosure prescribed in Form 2A under Section 56(3) of the Companies Act, 1956. Full justification and parameters used for issue price should clearly be mentioned in the letter of offer.

(xi) **Advertisement in newspaper:** All listed companies making rights issue shall invariably issue an advertisement in at least two all India newspapers about the dispatch of letters of offer, opening date, closing date, etc. Such advertisement should be at least one week before the date of opening of the subscription list.

(xii) **Compliance report:** Within 45 days of closure of rights issue, a report in the prescribed form along with the compliance certificate from statutory auditor / practicing chartered accountant/ company secretary should be forwarded to SEBI by lead managers.

(xiii) **Applicability of SEBI guidelines:** The above guidelines with regard to rights issue apply only to rights issue made by existing listed companies.

(xiv) **Revised disclosure norms for listed companies:** To enable the listed companies to raise funds easily from the primary market, the SEBI has amended its Disclosure and Investor Protection Guidelines in March 2006. These guidelines are applicable to those listed companies that are regular in filing periodic returns with stock exchanges and have comprehensive investor grievances mechanism. The following are the important guidelines:

(a) Listed companies going in for a rights issue can now fix and disclose the issue price any time prior to fixing the record date in consultation with the designated stock exchange.

(b) In the case of fixed price route, for public issues of such companies, the price can be fixed before filing of the prospectus with the Registrar of companies. .

(c) Further, companies making rights issues are now permitted to dispatch an abridged letter of offer, containing disclosures as required in the abridged prospectus. However, such companies may provide the detailed letter of offer to any shareholder upon request.

(d) Again, companies that have filed a draft offer document with full disclosures can now come out with further capital issues even before the shares pertaining to the document are listed on the bourses.

These guidelines do not apply to rights issue by existing private companies/ closely held or other unlisted companies. They have to comply with the requirements as laid down in the Companies Act.

SEBI, on 13th August, 2008, reduced the time duration for a rights issue from 109 days to 43 days.

Reduction in timeline approved includes:

1. The number of days for the notice period for a board meeting will be reduced from 7 working days to 2 working days.
2. The notice period for record date will be reduced to 7 working days.
3. The issued period will be reduced from a minimum of 30 days with a minimum of 15 days with a maximum of 30 days.
4. The period for completion of post-issue activity will be reduced from 42 days to 15 days.

8.4.6 Debentures

i. The amount of working capital debenture should not exceed 20 percent of the gross current assets.

ii. The debt-equity ratio should not exceed 2: 1.

iii. The rate of interest can be decided by the company.

iv. Credit rating is compulsory for all debentures except debentures issued by public sector companies, private placement of Non-Convertible Debentures (NCDs) with financial institutions and banks.

v. Debentures are to be redeemed after the expiry of seven years from the date of allotment. NCD is permitted to be redeemed at 5 per cent premium.

vi. Normally, debentures above seven years cannot be issued.

vii. Debentures issued to public have to be secured and registered.

viii. A Debenture Redemption Reserve is to be set up out of profits of the company.

ix. Debenture Trustee and Debenture Trust Deed are to be finalized within six months of the public offer.

8.4.7 Fully Convertible Debenture (FCD). Partly Convertible Debenture (PCD) and Non-Convertible Debentures (NCDs)

(i) FCD/PCD/NCD issued for a period of more than 18 months are to be compulsorily credit rated.

(ii) The debentures converted within 18 months are treated as equity.

(iii) FCDs having conversion period more than 36 months will not be permitted.

(iv) The terms of issue should be predetermined and stated in the prospectus.

(v) The interest rate can be determined by the issuer.

(vi) Conversion after 18 months from the date of allotment but before 36 months will be optional at the hand of the debenture holders.

(vii) Appointment of Debenture Trustees and Creation of Debenture Redemption Reserve are not necessary if the maturity period is 18 months or less.

(viii) The Debenture Trust Deed should be executed within six months of the closure of the issue.

(ix) The offer document should specify existing and future equity, long term debt-equity ratio, servicing of existing debentures, payment of interest on existing loans and debentures.

(x) No objection for second or participation charge.

(xi) In the case of rollover of NCO portion of debentures, the following conditions are ‘to be complied with:

(a) Six months before the date of redemption, fresh credit rating should be obtained and it should be communicated to debenture holders.

(b) The company must have obtained the positive consent of debenture holders.

(c) SEBI should vet the roll over and its terms and conditions.

8.4.7 Guidelines for protection of the debenture holders

(i) Servicing of debentures

A Debenture Redemption Reserve shall be created by companies issuing debentures on the following basis:

Existing companies need not create ORR up to the date of commercial production. ORR shall be created in equal instalments for the remaining period.

For new companies, creation of ORR will commence from the year the company earns profit and it should be created in equal or in one or more instalments for the remaining life of debentures.

In the case of PCOs, ORR should be created only for NCO portion. ORR should be created up to 50 per cent of the amount before redemption commences.

Withdrawal from ORR will be permitted only after 10 per cent of the liability is actually redeemed.

DRR will be treated as a part of general reserve for the purpose of bon US issue.

In the case of new companies, distribution of dividend shall require approval of trustees to the debenture issue and the lead institution, if any.

In the case of existing companies, prior permission of the lead institution for declaring dividend exceeding 20 per cent or as per the loan covenants is necessary if the company does not comply with institutional conditions regarding interest and debt service coverage ratio.

(ii) Protection of Interest of debenture holders

Trustees to the debenture issue shall be vested with the requisite powers for protecting the interest of debenture holders including a right to appoint a nominee director on the Board of the Company in consultation with institutional debenture holders.

Lead institution / investment institutions will monitor the progress in respect of debentures for project finance, modernisation, diversification, etc. The lead bank for the company will monitor debentures raised for working capital funds.

The company shall file with SEBI, a certificate from their bankers that the assets on which security is to be created are free from encumbrances and necessary permissions to mortgage the assets have been obtained or a no objection certificate from the financial institutions or banks for a second or pari passu charge in case where assets are encumbered.

The security should be created within six months from the date of issue of debentures. It can be created within 12 months provided 2 per cent penal interest is paid to debenture holders.

If the security is not created even after 18 months, a meeting of the debenture holders shall be called within 21 days to explain the reasons thereof and the date by which the security would be created.

The trustees to the debenture holders will supervise the implementation of the conditions regarding creation of security for the debenture and debenture redemption reserve.

The trustees and institutional debenture holders should obtain a certificate from the company's auditors in respect of utilisation of funds during the implementation of period of projects and at the end of each accounting year in the case of debentures for working capital.

8.4.8 Underwriters

(i) No person can act as underwriter unless he holds certificate of registration granted by SEBI.

(ii) The certificate of registration is valid for a period of three years from the date of issue.

(iii) The total underwriting obligations should not exceed 20 times of his net worth.

(iv) In the case of devolvement, the underwriter should subscribe to such securities within 30 days of the receipt of the intimation from the company.

(v) The underwriter should furnish within a period of six months from the end of the financial year a copy of the balance sheet, profit and loss account, the statement of capital adequacy requirements ·and such other documents as required by SEBI.

(vi) The books of accounts should be maintained for a period of five years.

10 . Investor protection

Investor protection is the major responsibility of the SEBI. SEBI has taken various measures to protect the interests of investors.

New Issues

The issuing company should provide fair and correct information. Allotment process should be transparent and not tainted by any bias. The draft prospectus of the companies is scrutinised for full and fair disclosure.

- No delay in refunds or despatch of share certificates.
- Underwriting ·obligations is necessary to inspire confidence of investors.
- Risk factors and highlights should be fairly stated without any bias in the prospectus.
- Listing should be timely and transferability is ensured.
- Both stock exchange and companies are responsible for investor protection in respect of free trading and transferability of shares.

The investor protection is to be ensured by not only the Director / Secretary of the company but by all the parties in the new issue process namely merchant bankers, Registrars, collecting banks, stock exchange and SEBI.

Recently, SEBI has instituted the system of appointing its representatives to supervise the allotment process to ensure that no malpractices take place in allotment process.

8.5 CHECK YOUR PROGRESS

1. According to SEBI guidelines debt equity ratio should not exceed

    a) 3:1 b) 2:1

    c) 1:3 d) 1:2

2. Mention the role of merchant banker

    a) Combination of banking and consultancy services b) Underwriter

    c) Stock exchange d) Primary Market

3. Define the need for investor protection

    a) To ensure transparency in dealing

    b) To instil confidence in investors' minds

    c) To create vibrant capital market

    d) To create discipline in the market

Answer to check your progress: 1) b 2) a 3) all options

8.6 NOTES

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8.7 SUMMARY

Investors, especially small investors who constitute an important segment of the Indian stock market need all the support and protection so as to enable them to trade on the stock exchange fearlessly and truthfully. It is interesting to know that several factors were responsible for the loss of confidence of the investor on the activities of stock exchange. The unsuccessful and failing mutual fund is one of the chief reasons for the loss of investor interest on the stock market activities. Investors basically command certain rights such as the right to receive all the benefits/material information declared for the investors by the company, the right to obtain prompt services from the company such as transfers, sub-divisions and consolidation of holdings in the company. The Bombay stock exchange is providing lot of benefits to the investors in order to protect the interest of the investors.

8.8 KEY WORDS

Investor Protection: Actions to encourage honest advertising of financial products, and to prevent fraud to make sure that investors do not lose money if their investments default (are not repaid).

Bonus Issue: A bonus issue is an offer of free additional shares to existing shareholders. A company may decide to distribute further shares as an alternative to increasing the dividend payout. Also known as a “scrip issue” or “capitalization issue”.

Bonus shares are additional shares given to the current shareholders without any additional cost, based upon the number of shares that a shareholder owns.

Rights Issue: A rights offering (issue) is an issue of rights to a company’s existing shareholders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period.

8.9 SELF ASSESMENT QUESTIONS

1. What you mean by investor protection?
2. Define the term rights issue.
3. Explain the need for investor protection.
4. Discuss the guidelines of SEBI pertaining to secondary market and primary market.
5. Discuss the guidelines of SEBI for investor protection.

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KARNATAKA STATE OPEN UNIVERSITY

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DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

M.B.A III Semester

COURSE - 16 A

FINANCIAL MARKETS AND INSTISTUTIONS

BLOCK

3

MONEY MARKET

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BLOCK -3 : MONEY MARKET

Money market is a segment of financial markets where borrowing and lending of the short term funds takes place. The maturity of the money market instruments in one day to one year. In our country money markets are regulated by both RBI and SEBI.

This block money market exhibits 04 units (09-12) . Unit 09 tells about introduction to money market meaning, constituents, functions and government security market. Unit 10 takes you to money market instruments introduction, money market instruments, participants and regulations of the money market in India. Unit 11 explains recent development in money market introduction, MIBOR, recent development and chit funds and their regulations. The last unit 12 of this block elucidates prevention of money laundering introduction, prevention, global money market, integration of domestic and global money market.

BLOCK - 3
MONEY MARKET

UNIT- 9: OVERVIEW OF MONEY MARKET

Structure:

9.0 OBJECTIVES

After studying this unit, you should be able to ;

- Concept of money market
- Difference between money market and capital market
- Call money market and Short-term Deposit market
- Various money market instruments
- Types & features of Government Securities
- Bill Rediscounting
- Money Market Mutual funds
- Concept & features of Treasury bills
- Guidelines for issuance of Commercial Paper.

9.1 INTRODUCTION

Money market is a very important segment of the Indian financial system. It is the market for dealing in monetary assets of short-term nature. Short-term funds up to one year and financial assets that are close substitutes for money are dealt in the money market. Money market instruments have the characteristics of liquidity (quick conversion into money), minimum transaction cost and no loss in value. Excess funds are deployed in the money market, which in turn are availed of to meet temporary shortages of cash and other obligations. Money market provides access to providers and users of short-term funds to fulfill their borrowings and investment requirements at an efficient market clearing price. It performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity and in the process, facilitating the conduct of monetary policy. Short-term surpluses and deficits are evened out. The money market is the major mechanism through which the Reserve Bank influences liquidity and the general level of interest rates. The Bank's interventions to influence liquidity serve as a signaling-device for other segments of the financial system.

The money market is a wholesale debt market for low-risk, highly liquid, short term instruments. Funds are available in this market for periods ranging from a single day up to a year. Mostly government, banks and financial institutions dominate this market. It is a formal financial market that deals with short-term fund management. Though there are a few types of players in money market, the role and the level of participation by each type of player differs greatly. Government is an active player in the money market and in most economies, it constitutes the biggest borrower of this market. Both, Government Securities or G-Secs and Treasury-Bills or T-Bills are securities issued by RBI on behalf of the Government of

India to meet the latter's borrowing for financing fiscal deficit. Apart from functioning as a merchant banker to the government, the central bank also regulates the money market and issues guidelines to govern the money market operations.

Another dominant player in the money market is the banking industry. Banks mobilize deposits and utilize the same for credit accommodation. However, banks are not allowed to use the entire amount for extending credit. In order to promote certain prudential norms for healthy banking practices, most of the developed economies require all banks to maintain minimum liquid and cash reserves. As such, banks are required to ensure that these reserve requirements are met before directing on their credit plans. If banks fall short of these statutory reserve requirements, they can raise the same from the money market since it is a short-term deficit.

Moreover, financial institutions also undertake lending and borrowing of short-term funds. Due to the large volumes these FIs transact in, they do have a significant impact on the money market. Corporates also transact in the money market mostly to raise short-term funds for meeting their working capital requirements.

♦ **Features of Money Market**

The money market is a wholesale market. The volumes are very large and generally transactions are settled on a daily basis. Trading in the money market is conducted over the telephone, followed by written confirmation from both the borrowers and lenders.

There are a large number of participants in the money market: commercial banks, mutual funds, investment institutions, financial institutions and finally the Reserve Bank of India. The bank's operations ensure that the liquidity and short-term interest rates are maintained at levels consistent with the objective of maintaining price and exchange rate stability. The Central bank occupies a strategic position in the money market. The money market can obtain funds from the central bank either by borrowing or through sale of securities. The bank influences liquidity and interest rates by open market operations, REPO transactions changes in Bank Rate, Cash Reserve Requirements and by regulating access to its accommodation. A well-developed money market contributes to an effective implementation of the monetary policy. It provides:

1. A balancing mechanism for short-term surpluses and deficiencies.
2. A focal point of central bank intervention for influencing liquidity in the economy and
3. A reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable price or cost.

- ***Money Market Vs. Capital Market***

The money market possesses different operational features as compared other institutional players like mutual funds (MFs), Foreign institutional investors (FIIs) etc. also transact in money market. However, the level of participation of these players varies largely depending on the regulations. For instance, the level of participation of the FIIs in the Indian money market is restricted to investment in government securities only to capital market. It deals with raising and deployment of funds for short duration while the capital market deals with long-term funding. The money market provides the institutional source for providing working capital to the industry, while the capital market offers long-term capital for financing fixed assets. The money market operates as a wholesale market and has a number of inter-related sub-markets such as the call market, the bill market, the Treasury bill market, the commercial paper market, the certificate of deposits market etc. The volume of transaction in money market is very large and varied and skilled professional operators are required to ensure successful operations. Due to its flexibility, money market trading is mostly done on telephone with written confirmation from both borrowers and lenders being sent immediately thereafter. The transactions are supposed to be on “same day settlement” basis. As stated earlier, commercial banks, financial intermediaries, large corporates and the Reserve Bank of India (RBI) are the major constituents of Indian Money Market. RBI as the residual source of funds in the country plays a key role and holds strategic importance in the money market. RBI is able to expand or contract the liquidity in the market through different instruments such as Statutory Liquidity Ratio (SLR), Current Liquidity Ratio(CLR) etc. Thus RBI policy controls the availability and the cost of credit in the economy.

- ***Growth of Money Market***

The organisation and structure of the money market has undergone a sea change in the last decade in India. This was accompanied by a growth in quantitative terms also.

1. Call Money Market;
2. Inter Bank Term Deposit/Loan Market;
3. The Participation Certificate Market;
4. Commercial Bills Market;
5. Treasury Bills Market; and
6. Inter-corporate Market

The market had 3 main deficiencies:

1. It had a very narrow base with RBI, Banks, LIC and UTI as the only participants lending funds while the borrowers were large in number.
2. There were few money market instruments. The participation certificate became extinct during 1980s;
3. The interest rates were not market determined but were controlled by either RBI or by a voluntary agreement between the participants through the Indian Banks Association (IBA).

To set right these deficiencies the Chakravarthy Committee (1985) and the Vaghul Committee (1987) offered many useful suggestions and their implementation has widened and deepened the market considerably by increasing the number of participants and instruments and introducing market determined rates as compared to the then existing administered interest rates.

An additional feature was the creation of an active secondary market for money market instrument to have greater liquidity. For this purpose the Discount and Finance House of India Limited (DFHI) was formed as an autonomous financial intermediary in April, 1988 to smoothen the short-term liquidity imbalances and to develop an active secondary market for the instruments of the money market. The DFHI plays the role of a market maker in money market instruments. In the relaxation of the regulatory framework and the arrival of the new instruments and the new players, DFHI occupies a key role in ushering in a more active de-regulated money market.

9.2 CONSTITUENTS AND FUNCTIONS

1. Constituents of Money Market:

A money market is a mechanism which makes possible for borrowers and lenders to come together. Essentially it refers to a market of short-term funds. It meets the short-term requirements of the borrowers and provides liquidity of cash to the lenders. In the words of Crowther, money market is the name given to the various firms and institutions that deal with various grade of money.

According to Madden and Nadler, "a money market is a mechanism through which short-term loans are loaned and borrowed and through which a large part of the financial transactions of a particular country or of the world are cleared".

The importance of the money market for the nation does not solely lie on its size; it lies rather in its liquidity in its capacity for furnishing cash to any part of the country at a few hours' notice. What a bank balance is to the individual, the money market is to the country's credit system.

The term "money market" is used at least in three senses to be judged by the context. In its narrowest and most specific sense it appears as "the London Money Market" when it signifies the market in short--term, secured loans, most of them "at call" in which the borrowers are the London Discount Houses and a small number of money brokers and jobbers and the lenders are principally the commercial banks, though they include other financial institutions and some companies.

In London the term money even in narrow sense the money market is to be regarded as embracing the market in bills in which the discount houses are predominant. Secondly, the term is used to denote any market in highly liquid assets which is supported by an identifiable and active set of operators.

In London it embraces the group includes the Inter-bank, Inter-company and Local Authority Markets and the market in Sterling Certificates of deposit. Finally, the term is occasionally met in the literature of Monetary Theory where it may refer simply to the market in loanable funds in the most general and undifferentiated sense.

The term "Money Market" does not refer to any specific place where money is lent or borrowed. Money market is a mechanism through which a large part of the financial transactions of a particular country or of the world are cleared.

Although money market does not refer to any specific place, it may be located in or associated with a particular place or geographical locality where short-term funds from an entire region or country or countries are attracted.

Mumbai Money Market in India, is a typical example. There are also a few money markets which are international in character e.g. London Money Market, New York Money Market etc. These serve not only specific areas or countries but several countries in the world.

A money market is not homogeneous in character. It consists of several sectors or sub-markets such as call loan markets, bills market or discount market, acceptance market, collateral loan market etc. That is why, Crowther describes, "a money market as the various firms and institutions that deal in various grades of near money.

The money market is a wholesale market. The volume of business is very large and generally transactions are settled on a daily basis. There are a large number of participants in the money market commercial banks, mutual funds, investment institutions, financial institutions and finally the central bank.

The central bank occupies a strategic and pivotal position in the money market. The money market can obtain funds from the central banks either by borrowing or through sales of securities.

By varying the liquidity and regulating accession to the accommodation, the central bank influences the cost and availability of credit. A well-developed money market contributes to an effective implementation of monetary policy.

The Constituents of the Money Market:

A money market consists of several sectors or sub- markets; each specialising in a particular type of lending.

The important sectors are:

(a) Call Money Market:

This is a sub-market specialising in call loans which are sometimes referred to as “loans to call and short notice”. Call money refers to funds borrowed by the discount houses from the clearing and other banks and which they employ in holding portfolio assets.

A large portion of the funds are borrowed literally “at call” that is they can be withdrawn, “called” without notice on a day’s basis. Some, however, are lent at seven days’ notice or for even longer periods. For the clearing banks call money represents their most liquid asset after cash and balances at the central bank and is used for the adjustment of day-to-day changes in their total reserves.

In UK such loans are provided by the banks to bill brokers and discount houses. In USA call money is interest-bearing deposits and foreign banks that can be withdrawn within 24 hours’ notice. Many Euro currency take this form. In India this sector provides facilities for inter-bank lending.

(b) Acceptance Market:

This sub-market specialises in the acceptance of bills of exchange on behalf of the customers. Acceptance Houses in the London Money Market provide an example of institutions specialising in this business.

Commercial banks also accept bills of exchange on behalf of their customers. Although both inland and foreign bills are accepted, the service rendered by the acceptance market is especially important in the case of foreign bills. Once the bill is accepted in this manner, it is easier for the same to be discounted.

(c) Bill Market (Discount Market):

This is another sub-market specialising in the discounting of short-term commercial bills and treasury bills. In the London Money Market, the Discount Houses specialise in this field. English commercial banks do not undertake the discounting of commercial bills; instead they get these bills from the discount houses according to their needs.

With the decline in the volume of commercial bills, the Discount Houses turned their attention to the Treasury Bills and short- dated government securities also. In other countries the discounting of commercial bills is considered to be a subsidiary function of the commercial banks. In India, the establishment of Discount and Finance House of India Ltd. in 1988 has been an important step towards the development of an active discount market.

The discount market provides valuable services to the commercial banks by imparting greater flexibility to them in their funds management, to the trading community by facilitating the financing of home and foreign trade and to the government by creating a market in Treasury Bills and short-dated government securities.

(d) Collateral Loan Market:

This sector specialises in the granting of short-term loans against collateral securities. Such loans are usually granted by the commercial banks to stock exchange dealers and brokers. Business houses also avail of short-term loans; against the security of goods, documents of title to goods, stock exchange securities, bullion etc.

2. Functions of Money Market:

Money markets serve five functions—to finance trade, finance industry, invest profitably, enhance commercial banks' self-sufficiency, and lubricate central bank policies.

1. Financing trade:

The money market plays crucial role in financing domestic and international trade. Commercial finance is made available to the traders through bills of exchange, which are discounted by the bill market. The acceptance houses and discount markets help in financing foreign trade.

2. Financing industry:

The money market contributes to the growth of industries in two ways:

- They help industries secure short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.
- Industries generally need long-term loans, which are provided in the capital market. However, the capital market depends upon the nature of and the conditions in the money market. The short-term interest rates of the money market influence the long-term interest rates of the capital market. Thus, money market indirectly helps the industries through its link with and influence on long-term capital market.

3. Profitable investment:

The Money Market enables the commercial banks to use their excess reserves in profitable investment. The main objective of the commercial banks is to earn income from its reserves as well as maintain liquidity to meet the uncertain cash demand of the depositors. In the money market, the excess reserves of the commercial banks are invested in assets (e.g., short-term bills of exchange) which are highly liquid and can be easily converted into cash. Thus, the commercial banks earn profits without sacrificing liquidity.

4. Self-sufficiency of commercial bank:

Developed money markets help the commercial banks to become self-sufficient. In the situation of emergency, when the commercial banks have scarcity of funds, they need not approach the central bank and borrow at a higher interest rate. On the other hand, they can meet their requirements by recalling their old short-run loans from the money market.

5. Help to central bank:

Though the central bank can function and influence the banking system in the absence of a money market, the existence of a developed money market smoothens the functioning and increases the efficiency of the central bank.

Money markets help central banks in two ways:

- Short-run interest rates serve as an indicator of the monetary and banking conditions in the country and, in this way, guide the central bank to adopt an appropriate banking policy,

- Sensitive and integrated money markets help the central bank secure quick and widespread influence on the sub-markets, thus facilitating effective policy implementation.

9.3 GOVERNMENT SECURITY MARKET

A Government security is a tradable security issued by the Central Government or the State Governments, acknowledging the Government's debt obligation. Such securities can be short term (usually called Treasury Bills, with original maturities of less than 1 year) or long term (usually called Government bonds or dated securities with original maturity of one year or more). In India, the 7 Central Government issues both Treasury Bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). Government securities carry practically no risk of default and, hence, are called risk-free instruments. Government of India also issue savings instruments (Savings Bonds, National Saving Certificates (NSCs), etc.) or special securities (Oil bonds, FCI bonds, fertilizer bonds, power bonds, etc.) but they are usually not fully tradable and are not eligible for meeting the SLR requirement.

a. Treasury Bills (T-Bills):

Treasury Bills, which are money market instruments, are short term debt instruments issued by the Government of India and are presently issued in three tenors, viz., 91 day, 182 day and 364 day. Treasury Bills are zero coupon securities and pay no coupon. They are issued at a discount and redeemed at the face value at maturity. For example, a 91 day Treasury Bill of Rs.100/- (face value) may be issued at a discount of say, Rs.1.80, that is Rs.98.20 and redeemed at the face value of Rs.100/-. The return to the investors is, therefore, the difference between the maturity value or face value (i.e., Rs.100) and the issue price (please see answer to Question No. 21 on calculation of yield on Treasury Bills). Treasury Bills are issued through auctions conducted by the Reserve Bank of India usually every Wednesday and payments for the Treasury Bills purchased have to be made on the following Friday. The Treasury Bills of 182 days and 364 days' tenure are issued on alternate Wednesdays, that is, Treasury Bills of 364 day tenure are issued on the Wednesday preceding the reporting Friday while Treasury Bills of 182 days tenure are issued on the Wednesday prior to a non-reporting Friday. Currently, the notified amount for issuance of 91 day and 182 day Treasury Bills is Rs.500 crore each whereas the notified amount for issuance of 364 day Bill is higher at Rs.1000 crore. Government, at its discretion, can also decide to issue additional amounts of the Treasury Bills by giving prior notice. An annual calendar of T-Bill issuances for the following financial year is released by the Reserve Bank 8 of India in the last week of March. The Reserve Bank of India also announces the issue details of Treasury bills by way of press release every week.

b. Dated Government Securities:

Dated Government securities are longer term securities and carry a fixed or floating coupon (interest rate) paid on the face value, payable at fixed time periods (usually half-yearly). The tenor of dated securities can be up to 30 years. The Public Debt Office (PDO) of the RBI acts as the registry / depository of Government securities and deals with the issue, interest payment and repayment of principal at maturity. Most of the dated securities are fixed coupon securities. The nomenclature of a typical dated fixed coupon Government security has the following features - coupon, name of the issuer, maturity and face value. For example, 7.49% GOI 2017 would have the following features. Date of Issue : April 16, 2007 Date of Maturity : April 16, 2017 Coupon : 7.49% paid on face value Coupon Payment Dates : Half-yearly (October16 and April 16) every year Minimum Amount of issue/ sale : Rs.10,000.

The details of all the dated securities issued by the Government of India are made available on the RBI website at http://rbi.org.in/ Scripts/ financialmarketswatch.aspx. Just as in the case of Treasury Bills, dated securities of both Government of India and State Governments are issued by RBI through auctions which are announced by the RBI a week in advance through Press Releases and paid advertisements in major dailies (for dated securities). The investors are thus given adequate time to plan for the purchase of government securities through such auctions. A specimen of a dated security in physical form is given at Annex 1.

Dated securities may be of the following types:

i) **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. For example – 8.24%GS2018 was issued on April 22, 2008 for a tenor of 10 years maturing on April 22, 2018. Coupon on this security will be paid half-yearly at 4.12% (half yearly payment being the half of the annual coupon 8.24%) of the face value on October 22 and April 22 of each year.

ii) Floating Rate Bonds: Floating Rate bonds are securities which do not have a fixed coupon rate and the coupon is re-set at pre-announced intervals based on a specified methodology. The coupon is re-set at predetermined intervals (say, every six months or one year) by adding a spread over a base rate. In the case of most floating rate bonds issued by the Government of India, the base rate is the weighted average cutoff yields of the last three 364 day Treasury Bill auction preceding the coupon re-set date. Floating Rate Bonds were first issued in September 1995 in India. For example, a Floating Rate Bond was issued on July 2, 2002 for a tenor of 15 years, maturing on July 2, 2017. The base rate on the bond for the coupon payments was fixed at 6.50% being the weighted average rate of implicit yield on 364 day Treasury Bills during the preceding six auctions. Further, in the bond auction, a cut-off spread (markup over the benchmark rate) of 34 basis points (0.34%) was decided. Hence the coupon for the first six months was fixed at 6.84%. At the next reset date after six months, assuming that the average cutoff yield in the preceding six auctions of 364 day Treasury Bill is 6.60%, coupon applicable for the next half year would be 6.94%.

iii) Zero Coupon Bonds: Zero coupon bonds are bonds with no coupon payments. Like Treasury Bills, they are issued at a discount to face value. Such securities were issued by the Government of India in the 1990s, but no issue was made thereafter.

iv) 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. A capital indexed bond, with the principal hedged against inflation, was issued in December 1997. These bonds matured in 2002. Steps are now being taken to revive the issuance of the Inflation Indexed Bonds wherein payment of both the coupon and principal payments on the bonds will be linked to an Inflation Index (Wholesale Price Index).

v) Bonds with Call/ Put Options: Bonds can also be issued with features of optionality wherein the issuer can have the option to buyback (call option) or the investor can have the option to sell the bond (put option) to the issuer during the currency of the bond. A bond (viz., 6.72%GS2012) with call / put option was issued in India in the year 2002 which will mature in 2012. 6.72%GS2012 was issued on July 18, 2002 for a maturity of 10 years maturing on July 18, 2012. The optionality on the bond could be exercised after completion of five years tenure from the date of issuance on any coupon date falling thereafter. The Government has the right to buyback 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.

vi) Special Securities: In addition to Treasury Bills and dated securities issued by the Government of India under the market borrowing programme, the Government of India also issues, from time to time, special securities to entities like Oil Marketing Companies, Fertilizer Companies, the Food Corporation of India, etc. as compensation to these companies in lieu of cash subsidies. These securities are usually long dated securities carrying coupon with a spread of about 20-25 basis points over the yield of the dated securities of comparable maturity. These securities are, however, not eligible SLR securities but are approved securities and are eligible as collateral for market repo transactions. The beneficiary oil marketing companies may divest these 11 securities in the secondary market to banks, insurance companies / Primary Dealers, etc., for raising cash.

vii) Steps are being taken to introduce new types of instruments like STRIPS (Separate Trading of Registered Interest and Principal of Securities). STRIPS are instruments wherein each cash flow of the fixed coupon security is converted into a separate tradable Zero Coupon Bond and traded. For example, when Rs.100 of the 8.24%GS2018 is stripped, each cash flow of coupon (Rs.4.12 each half year) will become coupon STRIP and the principal payment (Rs.100 at maturity) will become a principal STRIP. These cash flows are traded separately as independent securities in the secondary market.

C. State Development Loans (SDLs)

State Governments also raise loans from the market. SDLs are dated securities issued through an auction similar to the auctions conducted for dated securities issued by the Central Government (see question 3 below). Interest is serviced at half-yearly intervals and the principal is repaid on the maturity date. Like dated securities issued by the Central Government, SDLs issued by the State Governments qualify for SLR. They are also eligible as collaterals for borrowing through market repo as well as borrowing by eligible entities from the RBI under the Liquidity Adjustment Facility (LAF).

c. How are the Government Securities issued?

Government securities are issued through auctions conducted by the RBI. Auctions are conducted on the electronic platform called the Public Debt Office – Negotiated Dealing System (PDO-NDS). Commercial banks, scheduled urban cooperative banks, Primary Dealers (a list of Primary Dealers with their contact details is given in Annex 2), insurance companies and provident funds, who maintain funds account (current account) and securities accounts (SGL account) with RBI, are members of this electronic platform. All members of PDO-NDS can place their bids in the auction through this electronic platform. All non-NDS 12 members including non-scheduled urban co-operative banks can participate in the primary auction through scheduled commercial banks or Primary Dealers. For this purpose, the urban co-operative banks need to open a securities account with a bank / Primary Dealer – such an account is called a Gilt Account. A Gilt Account is a dematerialized account maintained by a scheduled commercial bank or Primary Dealer for its constituent (e.g., a non-scheduled urban co-operative bank).

The RBI, in consultation with the Government of India, issues an indicative half-yearly auction calendar which contains information about the amount of borrowing, the tenor of security and the likely period during which auctions will be held. A Notification and a Press Communique giving exact particulars of the securities, viz., name, amount, and type of issue and procedure of auction are issued by the Government of India about a week prior to the actual date of auction. RBI places the notification and a Press Release on its website (www.rbi.org.in) and also issues an advertisement in leading English and Hindi newspapers. Information about auctions is also available with the select branches of public and private sector banks and the Primary Dealers.

9.4 NOTES

9.5 SUMMARY

Money market is a very important segment of the Indian financialsystem. It is the market for dealing in monetary assets of short-term nature. There are a large number of participants in the money market: commercial banks, mutual funds, investment institutions, financial institutions and the Regulatory Authority. The money market possesses different operational features as compared to capital market. It deals with raising and deployment of funds for short duration while the capital market deals with long-term funding.

The money market operates as a wholesale market and has a number of inter- related sub-markets such as the call market, the bill market, the Treasury bill market, the commercial paper market, the certificate of deposits market etc. Money market instruments mainly include Government securities, securities issued by banking sector and securities issued by private sector. All funds raised by the government from the money market are through the issue of securities by the RBI.

9.6 KEY WORDS

Money market, Short-term funds, financial institutions, Treasury-Bills or T-Bills, short-term funds, working capital requirements, participants in the money market, REPO transactions, Bank Rate, Cash Reserve Requirements, Statutory Liquidity Ratio, Current Liquidity Ratio, Chakravarthy Committee, Vaghul Committee.

9.7 SELF ASSESSMENT QUESTIONS

1. What is money market?

2. What steps have been taken to develop the Indian money market?

3. What is CRR?

4. Write short notes on:

    a. Certificate of Deposits

    b. Commercial Paper and Treasury bills.

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UNIT - 10 : MONEY MARKET INSTRUMENTS

Structure:

10.0 OBJECTIVES

After studying this lesson, you will be able to;

- State the nature and importance of money market;
- Money Market Instruments;
- Regulations of the Money Market in India.
- Participants in Money Market
- State the advantages of money market from the points of view of companies, investors and society as a whole;

10.1 INTRODUCTION

The Money Market is a market for short term funds with maturity ranging from overnight to one year and includes instruments that are deemed to be close substitutes of money. The Money Market is a key component of the financial system as it is the fulcrum of the monetary operations conducted by the RBI in its pursuit of monetary policy objectives. As the Central Bank, RBI regulates the Money Market in India and injects liquidity in the banking system. Important institutions operating in the money market are central banks, commercial banks, acceptance house, non-banking financial institutions, bill brokers etc. The objective of this lesson is to provide the students with basic understanding of Money Market, its distinct features, various instruments available in the Money Market, .difference between Money Market and Capital Market, instruments used in financing import and export etc.,

10.2 MONEY MARKET INSTRUMENTS

Money market instruments are generally characterized by a high degree of safety of principal and are most commonly issued in units of $1 million or more. Maturities range from one day to one year; the most common are three months or less. Active secondary markets for most of the instruments allow them to be sold prior to maturity. Unlike organized securities or commodities exchanges, the money market has no specific location. Available from financial institutions, money markets give the smaller investor the opportunity to get in on treasury securities. The institution buys a variety of treasury securities with the money you invest. The rate of return changes daily, and services such as check writing may be offered. The major participants in the money market are commercial banks, governments, corporations, government-sponsored enterprises, money market mutual funds; futures market exchanges, brokers and dealers. Some of the money market instruments are:

1. Treasury Bills

These are issued by the Reserve Bank usually a period of 91 days. The Reserve Bank uses these bills to take money out of the market. This will reduce a bank's ability to lend to its clients leading to a contraction of the money supply. The bill consists of an obligation to pay the bearer the face value of the bill upon a given date. A bank buying such a bill will not pay face value for it but would instead buy it at a discount. The bill is tradable so the purchaser does not have to hold it until the due date. If interest rates decrease during the term of the bill, the holder can sell the bill at a profit before the due date.

Advantages of investing in Treasury Bills:

- No Tax Deducted at Source (TDS)
- Zero default risk as these are the liabilities of GOI
- Liquid money Market Instrument
- Active secondary market thereby enabling holder to meet immediate fund requirement.

1. Bankers' Acceptance

Although BA's, as they are known, have their origin in trade bills issued by merchants, today they are an important money market instrument. A banker's acceptance is simply a bill of exchange drawn by a person and accepted by a bank. The person drawing the bill must have a good credit rating otherwise the BA will not be tradable. The drawer promises to make payment of the face value upon a given future date. The most common term for these instruments is 90 days. They can vary from 30 days to180 days. The BA has the advantage of locking the borrower in to a fixed rate over the term of the bill. This can be important if a rise in short-term rates is expected.

2. Negotiable Certificates of Deposit (NCD)

NCD's are like fixed deposits except them are bearer documents. They offer a market related rate of interest and are completely liquid because they can be negotiated during the term of the deposit. Most NCD's have a term of less than one year. They usually offer a rate of return slightly higher than banker's acceptances which makes them extremely popular instruments.

3. Money Market at Call and Short Notice

Next in liquidity after cash, money at call is a loan that is repayable on demand, and money at short notice is repayable within 14 days of serving a notice. The participants are banks & all other Indian Financial Institutions as permitted by RBI.

The market is over the telephone market, non-bank participants act as lender only. Banks borrow for a variety of reasons to maintain their CRR, to meet their heavy payments, to adjust their maturity mismatch etc.

4. Repo/ Reverse Repo

A repo agreement is the sale of a security with a commitment to repurchase the same security as a specified price and on specified date while a reverse repo is purchase of security with a commitment to sell at predetermined price and date. A repo transaction for party would mean reverse repo for the second party. In lieu of the loan, the borrower pays a contracted rate to the lender, which is called the **repo rate**. As against the call money market where the lending is totally unsecured, the lending in the repo is backed by a simultaneous transfer of securities. The main players in this market are all institutional players like banks, primary dealers like PNB Gilts Limited, financial institutions, mutual funds, insurance companies etc. allowed to operate a SGL with the Reserve Bank of India. Further RBI also operates daily repo/ reverse repo auctions to provide a benchmark rates in the markets as well as managing in the liquidity in the system. RBI sucks or injects liquidity in the banking system by daily repo/ reverse operations.

5. Commercial Bills

Commercial bill is a short term, negotiable, and self-liquidating instrument with low risk. It enhances the liability to make payment within a fixed date when goods are bought on credit. Bills of exchange are negotiable instruments drawn by the seller (drawer) on the buyer (drawer) or the value of the goods delivered to him. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills. The bank discount this bill by keeping a certain margin and credits the proceeds. Banks can also get such bills rediscounted by financial institutions such as LIC, UTI, GIC, ICICI and IRBI. The maturity period of the bills varies from 30 days, 60 days or 90 days, depending on the credit extended in the industry.

Commercial bill is an important tool finance credit sales. It may be a demand bill or a nuisance bill; clean bills or documentary bills. Inland bills or foreign bills.

6. Commercial Paper

Commercial Paper is a money-market security issued (sold) by large banks and corporations to get money to meet short term debt obligations , and is only backed by an issuing bank or corporation’s promise to pay the face amount on the maturity date specified on the note. Since it is not backed by collateral, only firms with excellent credit ratings from a recognized rating agency will be able to sell their commercial paper at a reasonable price. Commercial paper is usually sold at a discount from face value, and carries shorter repayment dates than bonds. The longer the maturity on a note, the higher the interest rate the issuing institution must pay. Interest rates fluctuate with market conditions, but are typically lower than banks' rates. Corporate Borrowers, especially the large and financially sound, can diversify their short term borrowing by the issue of Commercial Paper. Commercial Paper is especially attractive for companies with cyclical cash flows and for cash rich companies during periods of greater cash inflows than overdraft or cash credit since monitoring is more convenient. Maturity: 7days -1 year Preconditions for issue of Commercial paper:

- Tangible net worth (paid-up capital plus free reserves) is not less than Rs 4 crores has been sanctioned working capital limit by banks or FIs
- Borrowable account of the company is classified as a Standard Asset by Banks/FIs
- Specified Credit Rating of P2 is obtained from CRISIL, A2 from ICRA and PR2 from CARE Commercial Paper is issued in denominations of Rs. 5 lakhs. But the minimum lot or investment is Rs 25 lakhs (face value) per investor.

The secondary market transactions can be for Rs. 5 lakhs or multiples thereof. Commercial Paper may be issued to any person, bank, company or other registered (in India) corporate body and incorporated body. Issue to NRI can only be on non-repatriable basis and is not transferable. The paper issued to NRI should state that it is non-repatriable and non-endorsable.

Procedure for Issue:

Commercial Paper is issued only through the bankers who have sanctioned working capital limits to the company. It is counted as a part of working capital. Unlike public deposit, commercial paper really cannot augment working capital resources. There is no increase in the overall short term borrowing facilities.

Every company proposing to issue commercial paper should submit the proposal in the form prescribed by the RBI to the bank which provides working capital along with the credit rating of the company. The bank scrutinizes the application and on being satisfied that eligibility criteria are met and conditions stipulated are met will has to be privately place the issue within two weeks by the company or through the good offices of a merchant banker. The initial investor pays the discounted value of the paper to the account of the issuing company with the bank in writing. The working capital limit is correspondingly reduced by the bank. The company must advise RBI, through the bank, of the amount of commercial paper issued within three days.

7. Certificates of Deposit (CD’s)

Money in a CD is tied up from a few months to six years or more depending on the terms of the specific CD you buy. A notice of withdrawal is required and a penalty imposed if you withdraw money before the CD matures. Interest earned is higher than paid on insured savings accounts. The longer you tie up money in a CD, the higher the interest rate earned.

Interest is paid either at time of purchase or at maturity, depending on the policy of the financial institution. In most cases, the more money you invest, the higher the rate of interest earned. All earnings are subject to income tax. CD’s are available from banks, savings and loans and credit unions. No purchase fees are charged.

8. Gilt Edged Government Securities

These are issued by governments such as Central Government, State Government, Semi Government authorities, City Corporations, Municipalities, Port trust, State Electricity Board,

Housing boards etc. The gilt-edged market refers to the market for Government and semi-government securities, backed by the Reserve Bank of India(RBI). Government securities are tradable debt instruments issued by the Government for meeting its financial requirements. The term gilt-edged means ‘of the best quality’. This is because the Government securities do not suffer from risk of default and are highly liquid (as they can be easily sold in the market at their current price). The open market operations of the RBI are also conducted in such securities.

9. Money Market Mutual Funds (MMMFs)

A money market fund is a mutual fund that invests solely in money market instruments. Money market instruments are forms of debt that mature in less than one year and are very liquid. Treasury bills make up the bulk of the money market instruments. Securities in the money market are relatively risk-free. Money market funds are generally the safest and most secure of mutual fund investments. The goal of a money-market fund is to preserve principal while yielding a modest return by investing in safe and stable instruments issued by governments, banks and corporations etc.

10. Tax-Exempt Bonds

Often referred to as municipal bonds, tax-exempt bonds represent state and local government debt. A City, town, or a village and also states, territories, and housing authorities, port authorities, and local government agencies may issue these bonds. Interest earned is exempt from income taxes and from state and local income taxes if bonds issued are from your state or city. Interest rates are determined by the general level of interest rates and by the credit rating of the issuer. The seller of these bonds has tables showing you what the tax-exempt yields of these bonds are equivalent to in taxable yield for your tax bracket. As little as $1,000 may be invested in these bonds, available from a broker or a financial institution.

Type 3 investments include corporate bonds and corporate stocks. Higher investment risk and lower purchasing power risk are represented by these investment alternatives.

10.3 REGULATIONS OF THE MONEY MARKET IN INDIA

Reserve Bank of India is the biggest regulator of the Indian markets. It controls the monetary policy of India. Its control is however limited to the organised part of economy and the unorganised sector which has a significant presence is largely unregulated. RBI frequently introduces many reforms to bolster the Indian economy which is in a state of constant flux and is continuously evolving. The major money market reforms came after the recommendations of S. Chakravarty Committee and Narsimham Committee. These were major changes which helped unfold the banking potential of India and shape our financial institutions to world class standards. It was soundness of these reforms which helped our economy to easily tide over the economic crisis which had gripped the world in 2008. These are discussed below:

1. Deregulation of Interest Rates
2. Reforms in Call and Term money market
3. Introduction of new money market instruments
4. Setting up Discount and Finance House of India
5. Introducing Liquidity Adjustment Facility
6. Refinance by RBI
7. Regulation of Non-Banking Financial Companies
8. Debt Recovery

1. Deregulation of Interest Rates

Interest rates are now subject to market conditions as the ceiling limit on them have been removed by RBI after 1989.The important interest rates in India are-Bank rate, Medium-term lending rate, Prime Lending rate, Bank Deposit rate, Call rate, Certificate of Deposit rate, Commercial paper rate etc. This deregulation got a major push after the economic liberalisation of 1991. Chakravarty Committee was a strong proponent of free and flexible interest rates to promote savings, investments, government financial system and stability.

RBI removed the upper ceiling of 16.5% and instead fixed a minimum of 16% per annum. The rates were further relaxed after the Narasimhan Committee report in 1991.

2. Reforms in Call and Term money market

The reforms in call and term money market were done to infuse more liquidity into the system and enable price discovery. RBI undertook several important steps to check the constraints and remove them systematically. It was in October 1998, RBI announced that non-banking financial institutions should not participate in call/term money market operations and it should purely be an interbank operating segment and encouraged other participants to migrate to collateralised segments to improve stability. Also, reporting of all call/notice money market transactions through negotiated dealing system within 15 minutes of conclusion of transaction was made mandatory. The volume of operations in this segment was not increased much even after the reforms.

3. Introduction of new money market instruments

RBI introduced many new market instruments to diversify the market. These were certificates of deposit in 1989, commercial papers in 1990 and interbank participation certificates with/without risk in 1988.

4. Setting up Discount and Finance House of India

Discount and Finance House of India was set up in 1988 to impart more liquidity and also further develop the secondary market instruments. However, maturities of existing instruments like CDs and CPs were gradually shortened to encourage wider participation. Likewise ad hoc treasury bills were abolished in 1997 to stop automatic monetisation of fiscal deficit.

5. Introducing Liquidity Adjustment Facility

RBI introduced a Liquidity Adjustment Facility in June 2000 which was operated through fixed repo and reverse repo rates. This helped establishment of interest rate as an important monetary instrument and granted greater flexibility to RBI to respond to market needs and suitably adjust liquidity in the market. Repo and Reverse Repo rates were introduced in 1992 and 1996 respectively.

6. Refinance by RBI

This is a potent tool by RBI to meet the any liquidity shortages and for credit control to select sectors. The export credit refinance facility to banks is provided under Section 17(3) of RBI Act 1934. It is available to all scheduled commercial banks who are authorised to deal in foreign exchange and have extended export credit. The SCBs are prvided export credit to the tune of 50% of the outstanding export credit. The concept of directed credit was also changed as the Narasimhan Committee recommended reduction of directed credit from 40 to 10%. It also suggested narrowing of priority sector and realigning focus to small farmers and low income target groups. The refinance rate is linked to bank rate.

7. Regulation of Non-Banking Financial Companies

RBI Act was amended in 1997 to bring the NBFCs under its regulatory framework. A NBFC is a company registered under Companies Act, 1956 and is involved in making loans and advances, acquisition of shares, stocks, bonds, securities issued by government etc. They are similar to banks but are different from the latter as they cannot accept demand deposits and cannot issue cheques. They have to be registered with RBI to operate within India. There are a host of regulations which NBFCs have to follow to smoothly operate within India like accept deposit for a minimum period, cannot accept interest rate beyond the prescribed rate given by RBI.

8. Debt Recovery

RBI has set up special Recovery Tribunals which provide legal assistance to banks for recovery of dues.

10.4 PARTICIPANTS IN MONEY MARKET

The following are the players in the Indian money market:

1. Govt.
2. RBI
3. Commercial banks
4. Financial institutions 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

10.5 NOTES

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10.6 SUMMARY

To sum up, the money market is a key component of the financial system as it is the fulcrum of monetary operations conducted by the central bank in its pursuit of monetary policy objectives. It is a market for short-term funds with maturity ranging from overnight to one year and includes financial instruments that are deemed to be close substitutes of money. The money market performs three broad functions. Firstly, it provides an equilibrating mechanism for demand and supply of short-term funds. Secondly, it enables borrowers and lenders of short-term funds to fulfil their borrowing and investment requirements at an efficient market clearing price. Three, it provides an avenue for central bank intervention in influencing both quantum and cost of liquidity in the financial system, thereby transmitting monetary policy impulses to the real economy. The objective of monetary management by the central bank is to align money market rates with the key policy rate. As excessive money market volatility could deliver confusing signals about the stance of monetary policy, it is critical to ensure orderly market behavior, from the point of view of both monetary and financial stability. Thus, efficient functioning of the money market is important for the effectiveness of monetary policy.

10.7 KEY WORDS

Money Market, Treasury Bills, Bankers' Acceptance, Negotiable Certificates Of Deposit, Money Market, Call and Short Notice, Repo/ Reverse Repo, Commercial Bills, Commercial Paper, Certificates Of Deposit, Gilt Edged Government Securities, Money Market Mutual Funds, Tax-Exempt Bonds, Reserve Bank of India, Deregulation of Interest Rates, Non-Banking Financial Companies, Debt Recovery, Commercial Banks, Brokers, Public Sector Undertakings, Corporate Units.

10.8 SELF ASSESSMENT QUESTIONS

1. Briefly discuss about Call money and Notice Money Market.
2. Explain Treasury Bills as an effective Cash Management product and state how yield of Treasury Bill is calculated.
3. What is Banker's Acceptance? Discuss.
4. Explain briefly about Money Market Mutual funds.
5. How credit transaction takes place in a Letter of Credit? Explain with step wise description.

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UNIT- 11 : RECENT DEVELOPMENTS IN MONEY MARKET

Structure:

11.0 OBJECTIVES

After studying this unit, you should be able to;

- Define the recent development in Money Market
- State the chit bund and that regulations

11.1 INTRODUCTION

Banks and primary dealers in government securities may soon have more flexibility in borrowing and lending in the call money market. The Reserve Bank of India said that banks may be allowed to borrow and lend in the interbank call money market based on their assets and liability match rather than prudential limits.

In the call money market, banks can currently borrow not beyond 100 % of their capital funds on a fortnightly average basis and on daily basis it cannot exceed 125 %they can lend up to 25 % of their capital fund on a fortnightly average basis and 50 % on daily basis. With the rising credit demand, the RBI will also review the Inter-bank participation certificates scheme to improve assets liability management and liquidity management. The debt market would require more investor if the statutory liquidity ratio of banks is cut, the RBI said. With respect to SLR, the central bank said," The investor base needs to be widened in the views of possibilities of reduction in the captive investor base resulting from the scaling down of the SLR from the present level".

11.2 RECENT DEVELOPMENTS IN MONEY MARKET

Indian Government appointed a committee under the chairmanship of Sukhamoy Chakravarty in 1984 to review the Indian monetary system. Later, Narayanan Vaghul working group and Narasimham Committee was also set up. As per the recommendations of these study groups and with the financial sector reforms initiated in the early 1990s, the government has adopted following major reforms in the Indian money market.

Reforms made in the Indian Money Market are:-

1. Deregulation of the Interest Rate :

In recent period the government has adopted an interest rate policy of liberal nature. It lifted the ceiling rates of the call money market, short-term deposits, bills re-discounting, etc. Commercial banks are advised to see the interest rate change that takes place within the limit. There was a further deregulation of interest rates during the economic reforms. Currently interest rates are determined by the working of market forces except for a few regulations.

2. Money Market Mutual Fund (MMMFs):

In order to provide additional short-term investment revenue, the RBI encouraged and established the Money Market Mutual Funds (MMMFs) in April 1992. MMMFs are allowed to sell units to corporate and individuals. The upper limit of 50 crore investments has also been lifted. Financial institutions such as the IDBI and the UTI have set up such funds.

3. Establishment of the DFI :

The Discount and Finance House of India (DFHI) was set up in April 1988 to impart liquidity in the money market. It was set up jointly by the RBI, Public sector Banks and Financial Institutions. DFHI has played an important role in stabilizing the Indian money market.

4. Liquidity Adjustment Facility (LAF):

Through the LAF, the RBI remains in the money market on a continue basis through the repo transaction. LAF adjusts liquidity in the market through absorption and or injection of financial resources.

5. Electronic Transactions:

In order to impart transparency and efficiency in the money market transaction the electronic dealing system has been started. It covers all deals in the money market. Similarly it is useful for the RBI to watchdog the money market.

6. Establishment of the CCIL:

The Clearing Corporation of India limited (CCIL) was set up in April 2001. The CCIL clears all transactions in government securities, and repose reported on the Negotiated Dealing System.

7. Development of New Market Instruments:

The government has consistently tried to introduce new short-term investment instruments. Examples: Treasury Bills of various duration, Commercial papers, Certificates of Deposits, MMMFs, etc. have been introduced in the Indian Money Market.

These are major reforms undertaken in the money market in India. Apart from these, the stamp duty reforms, floating rate bonds, etc. are some other prominent reforms in the money market in India. Thus, at the end we can conclude that the Indian money market is developing at a good speed.

11.3 MIBOR

Mumbai Inter-Bank Offer Rate (MIBOR) and Mumbai Inter-Bank Bid Rate (MIBID) are the benchmark rates at which Indian banks lend and borrow money to each other. The **bid** is the price at which the market would *buy* and the **offer** (or **ask**) is the price at which the market would *sell*. These rates reflect the short term funding costs of major banks. In other words, MIBOR reflects the price at which short term funds are made available to participating banks.

MIBID is the rate at which banks would like to borrow from other banks and MIBOR is the rate at which banks are willing to lend to other banks. Contrary to general perception, MIBID is *not* the rate at which banks attract deposits from other banks.

MIBOR is the Indian version of London Interbank Offer Rate (LIBOR). MIBOR is fixed for overnight to 3 month long funds and these rates are published every day at a designated time. Of the above tenors, the overnight MIBOR is the most widely used one which is used for pricing and settlement of Overnight Index Swaps (OIS). Corporates use the OIS for hedging their interest rate risks[1]. The MIBID/MIBOR rate is also used as a bench mark rate for majority of deals struck for Interest Rate Swaps (IRS), Forward Rate Agreements (FRA), Floating Rate Debentures and Term Deposits. The aggregate amount of outstanding interbank/Primary Dealers (PD) notional principal referenced to MIBOR remained at INR 16,847.6 billion as on October 31, 2013[2].

Financial Benchmarks

MIBOR, MIBID etc. are all financial benchmarks. Financial benchmarks are mainly used for pricing, settlement, and valuation of financial contracts. The IOSCO's Report on Principles for Financial Benchmarks describes financial benchmarks as:

"Prices, estimates, rates, indices or values that are:

- *Made available to users, whether free of charge or for payment;*
- *Calculated periodically, entirely or partially by the application of a formula or another method of calculation to, or an assessment of the value of one or more underlying Interests;*
- *Used for reference for purposes that includes one or more of the following:*
- *Determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments;*
- *Determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument; and/or*
- *Measuring the performance of a financial instrument."*

MIBOR is the interest rate at which banks can borrow funds, in marketable size, from other banks in the Indian interbank market. MIBOR is calculated everyday by the National Stock Exchange of India (NSEIL) as a weighted average of lending rates of a group of banks, on funds lent to first-class borrowers. The MIBOR was launched on June 15, 1998 by the Committee for the Development of the Debt Market, as an overnight rate.

The NSEIL launched the 14-day MIBOR on November 10, 1998, and the one month and three month MIBORs on December 1, 1998. Further, the exchange introduced a 3 Day FIMMDA-NSE MIBID-MIBOR on all Fridays with effect from June 6, 2008 in addition to existing overnight rate. Thus, we can say that MIBOR is is arrived now a days by FIMMDA and NSE, based on inputs from PS Banks, Private Sector Banks, Primary Dealers and Foreign Banks.

Evolution of MIBOR- How MIBOR is fixed?

An Internal Committee at NSE for the Development of the Debt Market had studied and recommended the modalities for the development for a benchmark rate for the call money market. Accordingly,National Stock Exchange (NSE) developed and launched the NSE Mumbai Inter-bank Bid Rate (MIBID) and NSE Mumbai Inter-bank Offer Rate (MIBOR) for the overnight call money market on June 15, 1998. The success of the Overnight NSE MIBID-MIBOR encouraged the Exchange to develop a benchmark rate for the term money market. Thus, NSE launched the 14-day NSE MIBID- MIBOR on November 10, 1998 and the longer term money market benchmark rates for 1 month and 3 months on December 1, 1998. Fixed Income Money Market and Derivative Association of India (FIMMDA) became a partner to NSE in co-branding the dissemination of MIBID-MIBOR rates for the overnight and term segments on March 4, 2002 and the product thereafter was rechristened as FIMMDA-NSE MIBID/MIBOR. Later, NSE introduced a 3 Day FIMMDA-NSE MIBID-MIBOR on all Fridays with effect from June 6, 2008 in addition to existing overnight rate.

FIMMDA-NSE MIBID MIBOR was based on rates polled by NSE from a representative panel of 30 banks/ primary dealers. That is, participating banks are asked at what rate they would be borrowing/lending funds of a reasonable market size at the scheduled time of reference. Extreme values are avoided while calculating the reference rates and the mean or average benchmark rate is calculated with “Bootstrapping” scores (i.e., computing the reference rate from a sample with replacement, as an average of the polled rates after an appropriate amount of trimming to minimize noise (outliers) and then computing a measure of dispersion i.e. the confidence intervals for the trimmed means/average).

Every day the FIMMDA-NSE MIBID MIBOR along with their respective standard deviations (probability that the estimated trimmed mean obtained after avoiding extreme values, lies in a given range) were disseminated to the market at 9.40 (IST) for overnight rates (3 day on all Fridays) and at 11.30 PM for the three term rates, viz. 14-day, 1-month and 3-month. The structure of the reporting is given below.

FIMMDA-NSE MIBID MIBOR for the Day					
Category	**Time**	**MIBOR**	**Standard Deviation of MIBOR**	**MIBID**	**Standard Deviation of MIBID**
OVERNIGHT	9:40 a.m.				
3 DAY	9:40 a.m.				
14 DAY	11:30 a.m.				
1 MONTH	11:30 a.m.				
3 MONTH	11:30 a.m.				

Source: http://www.arthapedia.in/index.php?title=MIBOR_and_MIBID

11.4 CHIT FUNDS AND THEIR REGULATIONS

A Chit fund is a kind of savings scheme practiced in India. A chit fund company is a company that manages, conducts, or supervises such a chit fund, as defined in Section of the Chit Funds Act, 1982.

According to Section 2(b) of the Chit Fund Act, 1982 "Chit means a transaction whether called chit, chit fund, chitty, kuree or by any other name by or under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical installments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount".

Such chit fund schemes may be conducted by organized financial institutions, or may be unorganized schemes conducted between friends or relatives. In some variations of chit funds, the savings are for a specific purpose. Chit funds also played an important role in the financial development of people of south Indian state of Kerala, by providing easier access to credit. In Kerala, chitty (chit fund) is a common phenomenon practiced by all sections of the society. A company named Kerala State Financial Enterprise exists under the Kerala State Government, whose main business activity is the chitty.Chit fund concept came into the eyes of people in 1800's when Raja Rama Varma, ruler of erstwhile Cochin state gave a loan to a Syrian Christian trader, by keeping a certain portion of it to himself for other expenses and later he drew that money for the principle of equity.

How it works: An example

Chit funds operate in different ways, and this may lead to many fraudulent tactics practiced by private firms. The basic necessity of conducting a 'Chitty' is a group needy people called subscribers. The foreman — the company or person conducting the chitty — brings these people together and conducts the chitty. The foreman is also responsible for collecting the money from subscribers, presiding over the auctions, and keeping subscriber records. He is compensated by a fixed amount (generally 5% of gross chitty amount) monthly for his efforts. Other than that, the foreman has no specific privileges, she is just a chitty subscriber. A simple formula depicts the pattern of the chitty:

Monthly Premium × Duration in Months = Gross Amount

E.g., 1000 * 50 = 50,000/- Where 1000 is the maximum monthly contribution needed from a subscriber, 50 is the duration of the chitty in months and 50,000 is the maximum sum assured. The duration also equals the number of subscribers, as there must be (not more or less) one subscriber to receive the prize money every month.

The chitty starts on an announced date, every subscriber come together for the auction/ lot. As per Kerala chit act, the minimum prize money of an auction is limited to 70% of the gross sum assured that is 35,000 in the above example. When there are more than one person willing to take this minimum sum, lots are conducted and the 'Lucky subscriber' gets the prize money for the month. If there is no person willing to take the minimum sum, then a reverse auction is conducted where subscribers open-bid for lower amounts; that is from 50,000 >> 49,000 >> 48,000, and so on. The person bidding the lowest sum will get the bid amount.

In both the cases the auction discount, that is the difference between the gross sum and auction amount, is equally distributed among subscribers or is deducted from their monthly premium. For example, if the auction is settled on a sum of 40,000, then the auction discount of 10,000 (50,000 - 40,000) is divided by 50 (the total number of subscribers) and every one gets a discount of 200. The same practice is repeated every month and every subscriber gets a chance of receiving some money.

Chit funds are considered microfinance organizations.

Contribution of Thrissur:

According to All Kerala Kuri Foremen's Association, Kerala has around 5,000 chit companies, with Thrissur district accounting for the maximum of 3,000. These chit companies provide employment to about 35,000 persons directly and an equal number indirectly.

Acts:

Chit funds in India are governed by various state or central laws. Organised chit fund schemes are required to register with the Registrar or Firms, Societies and Chits.

1. Union Government - Chit Funds Act 1982 (Except the State of Jammu and Kashmir)
2. Kerala: Kerala Chitties Act 1975
3. Tamil Nadu: Tamil Nadu Chit Funds Act, 1961
4. Karnataka: The Chit Funds (Karnataka) Rules, 1983
5. Andhra Pradesh: The Andhra Pradesh Chit Funds Act, 1971
6. New Delhi: The Chit Funds Act,1982 and Delhi Chit Funds Rules, 2007
7. Maharashtra: Maharashtra Chit Fund Act 1975

♦ **Organised chit funds:**

In North India, a common type of chit fund uses small paper slips with each member's name, gathered in a box. When all members are at a monthly or weekly meeting, the one in charge in front of the other members picks a slip from the box. The member so selected gets that day's collection. Afterwards, that person's name slip is discarded. Thereafter, he comes to the meetings and pays his share, but his name isn't selected again.

♦ **Special purpose funds**

Some chit funds are conducted as a savings scheme for a specific purpose. An example is the Deepavali sweets fund, which has a specific end date about a week before Deepavali. Neighborhood ladies pool their savings each week. They use this fund to buy and prepare sweets in bulk just before the Deepavali festival, and they distribute sweets to all members. Preparation of Deepavali sweets may be a time consuming and costly activity for individuals. Such a chit reduces costs, and relieves members from extra work in a busy festival season. Nowadays, such special purpose chits are conducted by jeweler shops, kitchenware shops, etc. to promote their products.

- **Online Chit Funds:**

With the advent of ecommerce in India, Chit funds have also started going online. Online chit funds conduct auctions online and subscribers can pay their monthly dues and receive prize amount online through online transactions including electronic fund transfers. Each member has an online account to manage their chit funds.

Guidelines for Chit Fund Companies:

1. How To Get a Registration Certificate:

Chit fund Companies operating in Delhi (for example) as a practice, first obtain a certificate of incorporation from the Registrar of Companies. The office of the Registrar of Companies (Delhi & Haryana) is at Paryavaran Bhawan, C.G.O. Complex, Lodhi Road, New Delhi.

(A) Requirements for registration of New Co. with Registrar of Chit Fund, New Delhi:

After getting this certificate, you can apply for registration of first Bye-laws of the company with Chit Fund Department., Govt. of N.C.T. of Delhi, 13th floor, Bikri Kar Bhawan, I.P. Estate, New Delhi 110 002 (Tel. No. 331 8992)

a) Memorandum and Articles of Association.

b) Incorporation Certificate.

c) Form No. 2 regarding shares allotment.

d) Form No. 18 regarding registered office.

e) Form No. 32 regarding appointment of Directors.

f) R.O.C. Receipt for filing of form No. 2, 18, 32.

g) Bank certificate for deposit of Rs. 1,00,000/- as paid-up capital.

h) Resolution for appointment of foreman of the company.

I) Affidavits of the Directors regarding:

1. Age, good health and sound mind.
2. Insolvency.,
3. Non-conviction.
4. Membership/Directorship in other chit fund company.

j) Proof of ownership of the office premises.

k) No objection certificate from the landlord.

l) Rent Receipt of premises.

m) Lay out plan of premises.

n) Photo-copies of Ration Cards of the Directors.

o) Photographs of all the Directors duly attested.

p) Papers regarding financial soundness of the Directors.

1. Proof of property, if any.
2. Assessment order, if any.
3. Balance sheet(s) of the company whether partnership or proprietorship.
4. Other financial documents.

q) Form CF-1 in duplicate (application for registration).

r) Bye-laws in duplicate.

s) Cash Voucher for Rs.50/- (Bye-laws fee).

(B) Basic requirements for approval of First Bye-laws:

i) All Directors/Partners should be adults, possess good health and sound mind, should not have been convicted in any case and should be financially sound. Preferably, the Directors should not be related to each other.

ii) The Company should have at least an amount of Rs.1,00,000/- in the bank as paid-up capital.

Documents to be submitted at the time of approval of Bye-laws:

a. Form CF-1.

b. Bye-laws (in duplicate).

c. Form regarding details of company's business and deposit of fee.

d. Certificate of Registration in Form CF-II (in duplicate).

e. Bye-laws fee amounting to Rs. 50/- for each Bye-law to be deposited in cash with the Cashier.

f. Residential proof of Directors/Foreman in the shape of ration card, election I-Card, or passport.

(C) Inspection of the Registered Office:

After all the prescribed requirements are fulfilled, spot inspection of the proposed registered office of the company will be made by the Chit Fund Department through an Inspecting Officer.

For this purpose, the registered office should be:

i) Havingat least 150 square feet of office area.

ii) Well-furnished to conduct chit fund business.

iii) Having an Auction Hall.

iv) A sign board displayed on the front side of the premises.

Preferably, the company should also display the registered groups with it showing tickets and monthly subscription and the chit value. In case any vacancy is likely to come up in a group, this may also be displayed.

(D) Framing of Bye-Laws:

The Bye-Laws submitted for registration shall contain the following particulars:

i) The full name of foreman conducting chit business.

ii) The complete address of the foreman, registered address, in the case of a company being a foreman.

iii) The name under which chit business is done or is proposed to be done.

iv) The full details of the working of the chit.

v) The area of operation of the chit.

vi) The circumstances under which withdrawals of subscriber shall be permitted.

vii) The procedure to be followed for returning the money of the subscribers in case withdrawal, ineligibility or death of the subscriber.

viii) The condition under which the transfer of a chit or the interest of a subscriber shall be permitted.

ix) The full name and designation of the officer entitled to sign documents on behalf of the foreman.

x) The rate of commission to which the foreman is entitled.

xi) The language in which the accounts shall be kept.

xii) The mode of custody and investment of money.

xiii) The settlement of disputes touching or concerning the chit.

On receipt of application, the Registrar shall examine the application and Bye-laws in order to satisfy himself that the bye-laws are:

a) In conformity with the Act and Rules.

b) Suitable for carrying out the object of the chit.

c) Suitable for carrying safe and fair conduct of the business and shall grant a certificate of registration in Form CF-II.

(E) Amendment of Bye-laws:

After the Bye-laws have been registered, the chit fund company can apply for the amendment of these bye-laws, if necessary.

Documents required for amendment of Bye-laws:

i) Application alongwith a Court fee stamp of Rs.5/-.

ii) Approved Bye-laws (in original).

iii) Proposed Bye-laws (in duplicate).

When the proposed amendments in Bye-laws are approved, one copy of Bye-Laws duly endorsed for registration of amendment will be issued to the company. No application for amendment of Bye-laws will be entertained, if the chit group of such Bye-laws has commenced. Under prevailing practice of the department amendment of bye-laws is allowed only once.

(F)After the Registrar, Chit Funds Delhi is satisfied that all the requirements are fulfilled, a certificate for registration of first Bye-laws will be issued to the company.

11.5 NOTES

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11.6 SUMMARY

Deepak Mohanty of RBI gives really good speeches.

In his recent speech, he explains how India's money markets have evolved and developed over the years. It also has some basics about money market and its role in an economy.

He makes three suggestions towards the end:

First, there has been a swift transmission of policy rate at the short-end of money market, partly due to the prevalence of market liquidity in deficit mode. However, ensuring market liquidity in a deficit mode of desired level on a sustained basis is contingent on Reserve Bank's ability to effectively conduct OMOs and the market appetite for such operations. Hence, there is a need to develop the market micro-structure and further enhance secondary market transactions in government securities to facilitate smooth conduct of OMOs.

Second, the LAF is not the appropriate instrument for managing the liquidity of more enduring nature. As the system is expected to be in deficit, there is a need to develop term repo to minimise daily requirement of liquidity.

Third, notwithstanding significant advances in developing the market, the term structure in the money market is incomplete. It is, therefore, desirable to extend the yield curve beyond the overnight rate by developing a term-money market.

Second and third are interlinked..Term repo will help in both the tasks of providing term market liquidity and extending the yield curve beyond the overnight rate..

The first one is more interesting. As my report shows, RBI has been relying extensively on forex assets to create liquidity since 2004-05 onwards. Share of Rupee securities in RBI Balance sheet declined significantly. Since last year, as forex flows slowed and RBI intervened to prevent rupee depreciation, RBI relied more on rupee securities via LAF repo and OMO purchases.

As forex assets are beyond RBI's control, it does not have a choice but to look at Rupee securities to keep liquidity in deficit mode. It will be interesting to see what RBI does in future. Will it announce OMOs as it does now or does more secondary market OMO actions as Fed does.

11. 7 KEY WORDS

Reserve Bank Of India , Recent Development, Sukhamoy Chakravarty , Narayanan Vaghul, Narasimham Committee, Deregulation Of The Interest Rate, Establishment Of The DFI, Electronic Transactions, Establishment Of The CCIL, Mumbai Inter-Bank Offer Rate (MIBOR), Mumbai Inter-Bank Bid Rate (MIBID), Financial Benchmarks, CHIT FUNDS.

11.8 SELF ASSESSMENT QUESTIONS

1. Explain the recent development in money market.
2. Explain briefly chit funds.
3. Briefly explain the amendments and regulations of chit funds in India.

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UNIT- 12 : PREVENTION OF MONEY LAUNDERING

Structure:

12.0 OBJECTIVES

After studying this unit, you should be able to;

- Prevention of money Laundering, its impact on the country
- how global money market is interlinked with the domestic money market.
- extent of various instruments available internationally so as to avail benefits by cross border businesses.

12.1 INTRODUCTION

India is extensively gripped under crime of money laundering. Money laundering is usually used by criminals to hide money made through illegal act. It is the process by which huge amount of money obtained unlawfully, from drug trafficking, terrorist activity or other severe crimes. Money laundering has an unfavorable impact on economy and political steadiness of nation. It is necessary that all nations of the world must jointly device policies and adopt measures to curb act of money laundering by resorting to forceful enforcement of law.

Generally people consider Money laundering is the conversion of black money into white money. This takes one back to cleaning the huge piles of cash. If it is done successfully, it allows the criminals to maintain control over their proceeds and ultimately to provide an authentic cover for their source of income. Money laundering fulfils the ambitions of the drug trafficker, the terrorist, the organized criminal, the insider dealer, the tax evader as well as the many other groups who need to avoid the kind of attention from the authorities that unexpected prosperity comes from illegal acts. These criminal tries to get money and power through criminal activities and then attempt to penetrate the legitimate society, thereby misrepresenting the terms of the compact. They create huge amount of money for the members of the enterprise and permit their associates to live extravagant lifestyles.

12.2 PREVENTION OF MONEY LAUNDERING

1. Concept of Money Laundering :

Money laundering is designated as the source of illegally obtained funds covered through a series of transfers and deals in order that those same funds can eventually be made to appear as legitimate income (Robinson). According to Interpol General Secretariat Assembly in 1995, money laundering is any act or attempted act to conceal or disguise the identity of illegally obtained proceeds so that they appear to have originated from legitimate sources.

Money Laundering is an expression that has recent origin. Money laundering is a cultured crime that is not to be taken seriously by society. When comparing with street crimes, it is a modern crime. Some experts refer to it as a victimless crime but in reality, it is not a crime against a particular individual, but it is a crime against nations, economies government, rule of law and world at large. Money laundering has become a worldwide threat. The objective of a huge number of criminal acts is to get profit for the individual or group that performed the act and then hide either the source or the purpose of cash. Money laundering is the processing of these criminal proceeds to cover their illegal origin. This process is very crucial for government and other responsible authorities as it enables the criminal to enjoy money obtained from illegal source. Some of the crimes such as illegal arms sales, smuggling, corruption, drug trafficking and the activities of organized crime including tax evasion produce huge money.

Insider trading, corruption and computer fraud schemes also generate more profits and create the incentive to legitimize the illegal gains through money laundering. When a criminal activity produces large profits, the individual or group involved must find a way to control the funds without attracting attention to the original activity or the persons involved. Criminals perform this by disguising the sources, changing the form, or transferring money to a place where they are less likely to attract attention. Otherwise, they will not be able to use the money because it would connect them to the criminal action, and law enforcement authorities would grab it. If criminals perform this process successfully, it allows the criminals to maintain control over their proceeds and eventually to provide a legitimate cover for their source of income. Where criminals are allowed to use the proceeds of crime, the ability to launder such proceeds makes crime more attractive.

2. Significance of Money Laundering :

Money laundering is an important criminal issue for policy makers and government authorities that gained increasing significance after the occurrence of heart throbbing indents of 9/11 attack on the twin towers in the U.S. After that all nations has focused its attention on the notion of money laundering and has recognized it as a source of the funding of terrorist actions. The process of globalization and advancements of the communications have made crime increasingly international in scope, and the financial aspects of crime have become more complex due to technology enhancement. The huge expansion of international banks all over the world has facilitated the transmission and the disguising of the origin of funds.

This may have shocking social consequences and poses a threat to the security of any nation at large or small scale. It offers immense facilities for drug dealers, terrorists, illegal arms dealers, corrupt public officials and all types of criminals to operate and increase their criminal activities. Laundering enables criminal activity to continue. Money laundering causes an alteration of resources to less productive areas of the economy which in turn decreases economic development. If security authorities and government ignore this crime, there will be serious consequences on social and political development of nation. The economic and political influence of criminal organizations can deteriorate the social fabric, collective ethical standards, and eventually the democratic institutions of civilization.

3. The Oretical Review of Money Laundering :

It has been demonstrated in academic reports that financial institutions have made efforts to detect and prevent money laundering since last many years, but the main feature of money laundering are its processes in which it is carried out. Many experts have argued that money laundering does not take a singular act but takes a more complex operation, which is completed in three basic steps which include placement, layering and integration (Anon, 2006). The International Monetary Fund (IMF) (2001: 7-8) defined money laundering as being the "transferring (of) illegally obtained money or investments through an outside party to conceal the true source". In South Africa, the Public Accountants and Auditors Board (2003), stated that money laundering is defined in local legislation as being "virtually every act or transaction that involves the proceeds of crimes, including the spending of funds that were obtained illegally". There are variation in views of different authorities to explain the notion of money laundering.

4. Processes of Money Laundering :

i. Placement stage:

First step is the Placement stage in the money laundering cycle. Money laundering activities is usually generated from cash intensive business, large amount of cash or hard currency and grown from illegal activities such as sale of drugs, illegal firearms, prostitution or human trafficking. Currencies gained from this cycle need to be disposed of immediately by the launderer, so they go as far as depositing it back in financial institutions, spending in retail economy, and involvement in a business or acquisition of an expensive property/asset or smuggled out of the country. The launderer's intention in this stage is to eliminate the cash from the place of possession so as to escape any form of detection from the authorities and to transform it to other form of assets such as travellers' cheques.

ii. Layering:

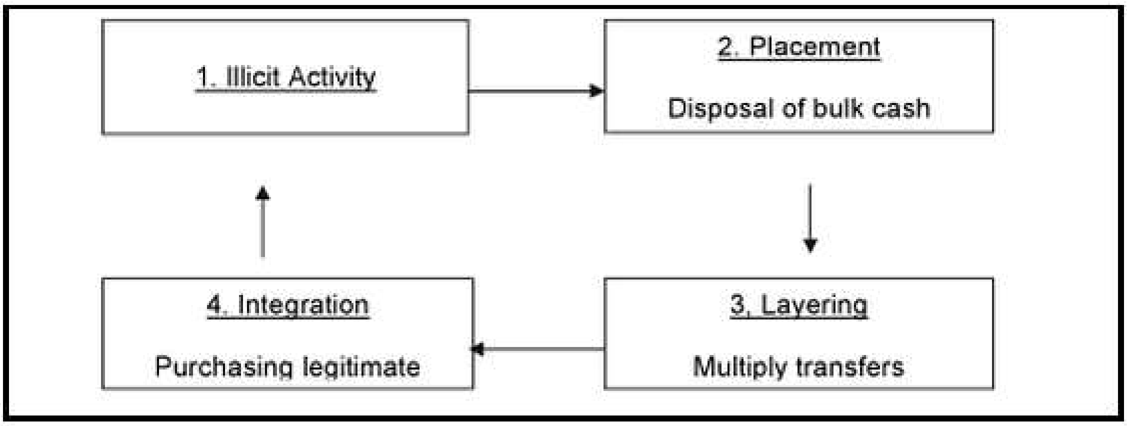
In this stage, the launderer tries to hide or disguise the origin of the funds by creating complicated layers of financial transactions designed to cover the audit trail and conceal it. It stated that layering serves to hide the source and ownership of the funds. Others suggested the methods used to accomplish layering such as the use of offset accounts by dealers, online electronic fund transfers between certain tax havens, and doubtful gold transactions in which large purchases of gold in countries with low VAT rates and then (there is an) exporting (of) the bullion back to the country of origin".

The aim of layering is to separate the illegal duties from the source of the crime, layers upon layers of transactions are created, moving illegal funds between accounts or business, or buying and selling assets on a local and international basis until the original source of the money is undetectable. It has been designated that there are other methods that can be adopted to allow, layering to take place that involve the over-invoicing and false invoicing of imports and exports.

iii. Integration:

After the layering stage, illegal funds are taken back into the financial system as payments for services rendered. Making the launderer feel fulfilled by making the funds appear to be legally earned. Illegal funds is returned to the economy and disguised as genuine income. The techniques adopted to successfully integrate funds from a criminal enterprise would very often be similar to that of practices adopted by legitimate business.

Basic steps of money laundering: (Source: Georgios Boustras, 2012)



5. Impact of Money Laundering on Nation :

There are many dangerous impact of money laundering on country as well as whole world. The following key effects of money laundering are as follows:

i. Undermining of the legitimate private sector:

The use of front companies by money launderers undermines the legitimate private sector, as the motive of money launderers is not necessarily to make a profit out of operations of the front company.

ii. Undermining of the integrity of financial markets:

The succeeding reputational loss by financial institutions results in a loss of confidence by consumers in these affected financial institutions who may be perceived to be involved in fraudulent activities. This could also affect the reputation of a country and force investors to invest in economies that are perceived to be less exposed to the risk of money laundering. Money laundering can deleteriously impact on the truthfulness of financial markets, and also weaken the reputation of a nation.

iii. Loss of control of economic policy:

Reports of IMF (2003) signified that the size of the funds being laundered, and the fact that money launderers would want to launder their funds through developing economies to reduce possible detection of their schemes, can affect the inflow and outflow of funds in these countries.

iv. Economic distortion and instability:

Money laundering may also misrepresent capital flows, and thus destabilise the effective functioning of the world-wide economy. Researchers argued that money launderers would not look at where to best invest their money based on economic principles, but rather at where it would be easier to avoid being caught or based on where the cost of avoidance was lower.

v. Loss of revenue:

Many theorists stated that money laundering decreases the tax funds available for collection in the economy and by implication government's revenues. Consequently, governments may have to levy higher taxes in order to obtain the funds necessary to fulfill their responsibilities towards their citizens.

vi. Security threats to privatization efforts:

Money launderers who are able to obtain previous government entities that are being privatized, can attempt to establish a legitimate front to launder funds. This can weaken economic reforms as money launders are not interested in operating these entities as going concerns, but rather as a channel for laundering money.

vii. Reputation risk:

The nations that are competing as destinations for legitimate investments may face difficulty to do so if there is a perception that the country has a poor track record of dealing with money laundering or is seen to be a centre for money laundering. This is because legitimate investors are wary of being associated with any country that has a negative reputation.

Other impacts of money laundering are as follows:

i. Increased criminality:

The increase in criminality is serious effect and a matter of concern in money laundering. The triumph of money launderers is the distance they create between themselves and the criminal activity producing profit. So that they can live lavish life could through this crime without attracting attention and could also go to the extent of reinvesting their profits to finance other crimes. Therefore, government, legislative act and other enforcing laws must implement policies in legal procedure to curb the crime.

ii. Social effect:

Committing crime of money laundering, transfers the economic power from the right people to the wrong. The good citizens and the government are dispossessed from their right, making the criminals take the benefit to flourish in their criminality. Money laundering damages the financial institution which is an important factor in the economic development of nation.

In developing countries where there is no strict control, the governments have to seek further contribution from good citizens, making people suffer more and continue to be subject to poverty. Companies cannot compete with operators financed by illegal funding, labours then become jobless and the high rate of unemployment result in an increase in criminality, dissatisfaction and insecurity. The burden on the government would then increase with the need to provide security therefore reallocating resources from more productive enterprise to other areas. This reduces productivity in the real sector of the economy by diverting resources from productive areas to social sectors; crime and corruption which are on the increase would then slow down economic growth and decrease human development.

iii. Microeconomics effect:

Money launderers generate and make use of companies that front for them. These companies are not interested in and but pretend to be involved in them. Usually the companies are not doing any serious business. The income generated from the company is not usually from the business but from their criminal activities. Their decisions are not usually based on economic considerations and would offer products at prices below cost price making the front companies have an unjustified competitive advantage. Legitimate businesses lose when competing, as there is no fair competition involved and results in business closures due to crowding out effect of private sector business by criminal organizations.

iv. Macroeconomic effect:

There are numerous impacts of money laundering on the macroeconomic situations. These include volatility in exchange rates and interest rates due to unanticipated transfers of funds; fall in asset price due to the disposition of laundered funds; misallocation of resources in relative asset commodity prices arising from money laundering activities; loss of confidence in markets caused by insider trading, fraud and embezzlement. When businesses make less revenue and pay fewer taxes, people become unemployed and dependent on social assistance which is most times difficult to get in developing countries. When criminals use financial institution for laundering funds, this creates negative promotional and it’s enough to scare banks into striving to keep criminals away from their terrain. Also banks have a risk of performing a balancing act between attracting new business and complying with the regulations and legislations.

The securities markets (especially derivatives) have become the attention of money launderers and are posing an added risk to financial systems. Other indirect economic effects are higher insurance premiums for those who do not make fraudulent claims and higher costs to businesses therefore generating fewer profits which make it difficult to break even. Financial institutions are not the only target the launderers use in their various schemes but they are accountable for financial dealings and for reporting any doubtful transactions.

It has been cleared that the Money laundering has negative consequences on monetary development. Money laundering constitutes a serious risk to national economies and respective governments. The penetration and sometimes saturation of illicit money into legitimate financial sectors and nations accounts can intimidate economic and political constancy. Economic crimes have a disturbing effect on a national economy since potential victims of such crimes are far more numerous than those in other forms of crime. Economic crimes also have the potential of unfavourably affecting people who do not prima-facie, seem to be the victims of the crime. For example, tax evasion results in forfeiture of government income and in turn affecting the potential of the government to spend on development schemes thereby affecting a large section of the population who could have benefited from such government expenditure.

A company fraud not only results in cheating of the people who have invested in that company but may also adversely affects investors’ confidence and eventually the development of the economy. Legislature body has difficulty to quantify the negative economic effects of money laundering on economic development. Such activity damages the financial-sector institutions that are critical to economic growth, reduces productivity in the economy’s real sector by diverting resources and encouraging crime and corruption, which slow economic growth, and can distort the economy's external sector international trade and capital flows to the detriment of long-term economic development.

v. The Financial Sector:

Financial sector may get negative effects of money laundering particularly financial institutions including banking and non-banking financial institutions and equity markets, may directly or indirectly be affected. Basically, these institutions facilitate concentration of capital resources from domestic savings and funds from overseas. These institutions provide impetus to furtherance of investment prospects by providing conducive environment and efficient allocation of these resources to investment projects which contributes substantially to long run economic growth.

Reports signify that Money Laundering weakens the sustainability and development of financial institutions in two ways.

Firstly, the financial institutions are debilitated directly through money laundering as there seems to be an association between money laundering and fraudulent activities undertaken by employees of the institutions. Likewise, with the rise in money laundering acts, major parts of financial institutions of a state are susceptible to crime by criminal elements. This strengthens the criminals of money laundering channels. This may lead to the removal of less equipped competitors and giving rise to domination.

Secondly, customer trust is important to the development of comprehensive financial institutions, and the perceived risk to the growth of sound financial institutions, and the perceived risk to depositors and investors from institutional fraud and corruption. The Real Sector Money laundering harmfully affects economic development through the real sector by diverting resources to less productive activities and by facilitating domestic corruption and crime.

Money laundering also performed through the channels other than financial institutions that include more sterile investments such as real estate, art, antiques, jewellery and luxury automobiles, or investments of the type that gives lower marginal productivity in an economy. These sub optimal allocations of resource give lower level of economic growth which is a serious disadvantage to economic progress for developing countries. Criminals invest their proceeds in companies and real estate in order to make further profits, legal or illegal. Most of these investments are in sectors that are familiar to the criminal, such as bar, restaurant, prostitution.

The real estate sector is the largest and most susceptible sector for money laundering. Real estate is important for money laundering, because it is a non-transparent market where the values of the objects are often difficult for approximation and it is an efficient way to place large amounts of money. The price increase in real estate is lucrative and the annual profits on real business create a legal basis for income. The real estate has the following characteristics for criminal money:

a. A safe investment

b. The objective value is difficult to assess.

c. It allows to realize “white” returns.

vi. The External Sector:

Money laundering activities may weaken the financial growth of any nation through the trade and international capital flows. Excessive illegal capital flight from a state may be facilitated by either domestic financial institutions or by foreign financial institutions. That illicit capital flight drains scarce resources specially from developing economies. In this way, economic growth of corresponding economy is adversely affected. Money laundering negatively affects trust of local citizens in their own domestic financial institutions as well as trust of foreign investors and financial institutions in a state’s financial institution which ultimately contributes to economic growth. Money laundering channels may also be related with distortions of a country’s’ imports and exports.

As with the participation of criminal elements on the import side, they may use illegal proceeds to purchase imported luxury goods, either with laundered funds or as part of the process of laundering such funds. Such imports do not produce domestic economic activity or employment, and in some cases can theatrically reduce domestic prices, thus reducing the productivity of domestic enterprises. The reliability of the banking and financial services market place depends mainly on the perception that it functions within a framework of high legal, professional and ethical standards.

A reputation for integrity is most valuable assets of a financial institution. Dangers for the reputation can happen when a country purposely declares to want to attract ‘criminal money. If funds from criminal activity can be easily processed through a particular institution, either because its employees have been bribed or because the institution do not pay attention to the criminal nature of such funds, the institution could be drawn into active complicity with criminals and become part of the criminal system itself. Such network will damage the attitudes of other financial intermediaries and of regulatory authorities as well as ordinary customers.

Money laundering has other dangerous consequences also. It not only impends the financial system of nation by taking away command of the economic policy from the government, but also declines the moral and social position of the society by exposing it to activities such as drug trafficking, smuggling, corruption and other criminal activities. The Global Sector Money Laundering has become a world-wide problem. Criminals target foreign authority with liberal bank secrecy laws and feeble anti-money laundering regulatory governments as they transfer illegal funds through domestic and international financial institutions often with the speed and internet transactions. This huge penetration of criminal proceeds into world market can destabilize and can have a debasing effect on those who work within the market system. The infiltration of criminals into the genuine markets can also change the balance of economic power from responsible and responsive entities to scoundrel agents who have no political or social responsibility.

6. Prevention and Combat of Money Laundering :

Legislators around the world have realized that concentrated efforts are required to deal with illegal funding and control money laundering. India has different laws to tackle smuggling, narcotics, foreign trade violations, foreign exchange manipulations and also special legal provisions for preventive detention and forfeiture of property, which were enacted over a period of time to deal with such severe crimes. Some of these were considered to be strong measures, but may not now match the post-Sept.11 measures initiated in the US and the EU. In India, there were old age practices for prevention of Money laundering in the sense of seizure and repossession of proceeds of crime. The statutes predominant before the Prevention of Money Laundering Act, 2002 (Money Laundering Act of 2002) are:

i. Criminal Law Amendment Ordinance (XXXVIII of 1944).

ii. The Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976.

iii. Narcotic Drugs and Psychotropic Substances Act, 1985.

i. Criminal Law Amendment Ordinance (XXXVIII of 1944):

Under this law, police can get the proceeds of crime relating to bribe, breach of trust and cheating confiscated by an order of attachment and on completion of the criminal prosecution can get an order from court forfeiting the proceeds. This ordinance was modified in 1946 and responsibility of proof to the accused. In the event of crime under Prevention of Corruption Act, the implementation rests with the CBI. However this law covers proceeds of only certain crimes such corruption, breach of trust and cheating and not all the crimes under the Indian Penal Code.

ii. The Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976:

According to this law, there is a penalty of illegally acquired properties of smugglers and foreign exchange manipulators and for matters connected therewith and incidental thereto. The application of this law is restricted to the persons convicted under the Customs Act, 1962 or Sea Customs Act, 1878 or other foreign exchange laws. Under this Act, no person shall hold any unlawfully acquired property either by himself or through any other person on his behalf. The word 'illegally acquired property' has been well defined under section 3(c) of the act.

There is very broad legislation in India on money laundering which includes all kinds of laundering of money relating to all crimes and offences under laws of India except offences relating to drug trafficking or offences under Indian Penal Code. As far as drug offences are concerned, prevention of money laundering is taken care of by Narcotic and Psychotropic Substances Act, 1985.

iii. Narcotic Drugs and Psychotropic Substances Act, 1985:

Narcotic Drugs and Psychotropic Substances Act, 1985 provide for the penalty of property derived from, or used in illegal traffic in narcotic drugs. Sections 68A to 68Y of Chapter VA of the Act provides for forfeiture of assets derived from or used in unlawful traffic. The provisions are so broad that the authorities administering the law have huge powers including the power to trace the source of drug related money or property and afterward to proceed with freezing of accounts and seizure of property and forfeiting it to the government.

Other analogous statutes:

Besides these legislations, there is a law of Foreign Contribution (Regulation) Act, 1976 under which the Central government regulates flow of funds to various organizations. If the Central government thinks any organization is acting against national interest, it can block its funds. Further to that Reserve Bank of India, which administers Foreign Exchange Management Act, 1999 has powers under section 11 of the Act to give appropriate directions to the authorized dealers to prevent violation of any laws. In addition to above Section 102 and Sections 451to 459 of the Code of Criminal Procedure, 1973 enables seizure and confiscation of the proceeds of crime.

The purpose of the Prevention of Money-laundering Act, 2002 (PMLA) is to combat money laundering in India in order to prevent and control money laundering, to confiscate and seize the property obtained from laundered money, and to deal with any other issue connected with money laundering in India. It came into force from 1st July, 2015. The Act provides that whosoever directly or indirectly attempts to pamper or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property, shall be guilty of offences of money-laundering. For the purpose of money-laundering, the PMLA identifies certain offences under the Indian Penal Code, the Narcotic Drugs and Psychotropic Substances Act, the Arms Act, the Wild Life (Protection) Act, the Immoral Traffic (Prevention) Act and the Prevention of Corruption Act, the proceeds of which would be covered under this Act.

International initiatives are also taken to fight against drug trafficking, terrorism and other organized and serious crimes have concluded that financial institutions including securities market intermediaries must establish procedures of internal control aimed at preventing and impeding money laundering and terrorist financing. In other nations such as US, The US Congress passed the USA Patriot Act of 2001 within 43 days of Sept.11, October 26, 2001. This Act made as many as 52 amendments to the existing Bank Secrecy Act of 1970 (BSA). The range of these new provisions touched every financial institution and business not only in the US, but also in many countries of the world. One of the changes made in the BSA requires every financial institution to establish anti-money laundering programmes.

Moreover, the list of businesses defined as financial institutions is wide ranging and includes banks, brokers and dealers in securities or commodities, currency exchanges, insurance companies, credit card operators, dealers in precious metals, stones and jewels, travel agencies, businesses engaged in the sale of vehicles including automobiles, air planes and boats, casinos and gaming establishments, and even telegraph companies and US postal service. It also adds secretive banking systems, such as 'hawala', to the description of financial institutions. It creates customer documentation and due diligence duties. Simultaneously, it grants immunity to financial institutions and their personnel for sharing reports of doubtful activities with any government agency or with each other. It also makes it a crime to conceal more than US $ 10,000 in money or monetary instruments while entering or leaving the US. Consequently, huge number of financial institutions and businesses, who were not earlier concerned about money laundering, now have to maintain anti-money laundering programmes requiring them to "develop internal policies, procedures and controls", "elect a compliance officer", conduct "ongoing employee training programmes" and perform "independent audit functions".

Currently, the US intelligence agencies can have access to reports and records of financial institutions and businesses including suspicious activity reports filed by them. One of the major changes is ban of correspondent accounts for foreign shell banks, which have no physical presence anywhere. A foreign bank must have a fixed address, employ at least one full-time employee, maintain operating records and be inspected by a banking authority to qualify for a correspondent account. Besides amending the BSA, the USA Patriot Act of 2001 also modified in the Money Laundering Control Act of 1986.

It now acquires extra-territorial jurisdiction to combat terrorist funding and criminal proceeds. The law covered funds representing proceeds of nearly 200 specified unlawful activities such as fraud, kidnapping, gambling, espionage, drug trafficking, etc. It now covers bribing of a foreign public official, embezzlement of public funds, smuggling or export control violations involving items covered by the Arms Export Control Act as well as crimes of violence. The new law requires the financial institutions to provide information regarding customers within 120 days if the account is in the US and within seven days if the records are maintained outside the US in respect of correspondence accounts. The new law also supports forfeiture powers over funds of foreign persons and institutions. The US authorities now have vast power to track and grab laundered money that runs terrorist activities and to penalise the criminals involved. The USA Patriot Act of 2001 has also seen a jump in filing SARs. The US Finance Crimes Enforcement Network reported an increase in SARs by over 40 per cent in the year 2002 compared to the preceding year. The compliance costs for the financial institutions have also gone up but many think that this may be a small price to pay to be able to live in a world with reduced risks of terrorist assaults.

7. Procedures for Anti Money Laundering :

Each registered intermediary must implement written procedures to implement the Anti-Money Laundering provisions as envisaged under the Prevention of Money laundering Act, 2002. Such procedures should include inter alia, the following three specific parameters which are related to the overall ‘Client Due Diligence Process:

i. Policy for acceptance of clients

ii. Procedure for identifying the clients

iii. Transaction monitoring and reporting especially Suspicious

In India, to combat the threat of offences of money laundering, the Government is entrusting the work relating to investigation, attachment of property/proceeds of crime relating to the scheduled offences under the Act and filing of complaints etc. to the Directorate of Enforcement, which currently deals with offences under the Foreign Exchange Management Act.

12.3 GLOBAL MONEY MARKET

The global money market consists of financial institutions and dealers in money or credit who wish to either borrow or lend. Participants borrow and lend for short periods, typically up to thirteen months. Global money market trades in short-term financial instruments commonly called "paper". This contrasts with the capital market for longer-term funding, which is supplied by bonds and equity.

The core of the money market consists of interbank lending banks borrowing and lending to each other using commercial paper, repurchase agreements and similar instruments. These instruments are often benchmarked to (i.e., priced by reference to) the London Interbank Offered Rate (LIBOR) for the appropriate term and currency.

Finance companies typically fund themselves by issuing large amounts of asset-backed commercial paper (ABCP) which is secured by the pledge of eligible assets into an ABCP conduit.

Examples of eligible assets include auto loans, credit card receivables, residential/ commercial mortgage loans, mortgage-backed securities and similar financial assets. Some large corporations with strong credit ratings, such as General Electric, issue commercial paper on their own credit. Other large corporations arrange for banks to issue commercial paper on their behalf.

In the United States, federal, state and local governments all issue paper to meet funding needs. States and local governments issue municipal paper, while theU.S. Treasury issues Treasury bills to fund the U.S. public debt:

1. Trading companies often purchase bankers' acceptances to be tendered for payment to overseas suppliers.

2. Retail and institutional money market funds

3. Banks

4. Central banks

5. Cash management programs

6. Merchant banks

1. Functions of the Global Money Market :

Money markets serve five functions—to finance trade, finance industry, invest profitably, enhance commercial banks' self-sufficiency, and lubricate central bank policies.

i. Financing trade:

The global money market plays crucial role in financing domestic and international trade. Commercial finance is made available to the traders through bills of exchange, which are discounted by the bill market. The acceptance houses and discount markets help in financing foreign trade.

ii. Financing industry:

The global money market contributes to the growth of industries in two ways:

a. They help industries secure short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.

b. Industries generally need long-term loans, which are provided in the capital market. However, the capital market depends upon the nature of and the conditions in the money market. The short-term interest rates of the money market influence the long-term interest rates of the capital market. Thus, money market indirectly helps the industries through its link with and influence on long-term capital market.

iii. Profitable investment:

The Global Money Market enables the commercial banks to use their excess reserves in profitable investment. The main objective of the commercial banks is to earn income from its reserves as well as maintain liquidity to meet the uncertain cash demand of the depositors. In the money market, the excess reserves of the commercial banks are invested in near-money assets (e.g., short-term bills of exchange) which are highly liquid and can be easily converted into cash. Thus, the commercial banks earn profits without sacrificing liquidity.

iv. Self-sufficiency of commercial bank:

Developed money markets help the commercial banks to become self-sufficient. In the situation of emergency, when the commercial banks have scarcity of funds, they need not approach the central bank and borrow at a higher interest rate. On the other hand, they can meet their requirements by recalling their old short-run loans from the money market.

v. Help to central bank:

Though the central bank can function and influence the banking system in the absence of a global money market, the existence of a developed global money market smoothens the functioning and increases the efficiency of the central bank.

Global money markets help central banks in two ways:

a. Short-run interest rates serve as an indicator of the monetary and banking conditions in the country and, in this way, guide the central bank to adopt an appropriate banking policy,

b. Sensitive and integrated money markets help the central bank secure quick and widespread influence on the sub-markets, thus facilitating effective policy implementation.

1. Global Money Market Instruments :

i. Certificate of deposit: Time deposit, commonly offered to consumers by banks, thrift institutions, and credit unions.

ii. Repurchase agreements: Short-term loans normally for less than two weeks and frequently for one day arranged by selling securities to an investor with an agreement to repurchase them at a fixed price on a fixed date.

iii. Commercial paper: Short term usage promissory notes issued by company at discount to face value and redeemed at face value

iv. Eurodollar deposit: Deposits made in U.S. dollars at a bank or bank branch located outside the United States.

v. Federal agency short-term securities: In the U.S., short-term securities issued by government sponsored enterprises such as the Farm Credit System, the Federal Home Loan Banks and the Federal National Mortgage Association.

vi. Federal funds: In the U.S., interest-bearing deposits held by banks and other depository institutions at the Federal Reserve; these are immediately available funds that institutions borrow or lend, usually on an overnight basis. They are lent for the federal funds rate.

vii. Municipal notes: In the U.S., short-term notes issued by municipalities in anticipation of tax receipts or other revenues.

viii. Treasury bills: Short-term debt obligations of a national government that are issued to mature in three to twelve months.

ix. Money funds: Pooled short-maturity, high-quality investments which buy money market securities on behalf of retail or institutional investors.

x. Foreign exchange swaps: Exchanging a set of currencies in spot date and the reversal of the exchange of currencies at a predetermined time in the future.

xi. Short lived mortgage and asset-backed securities

2. Discount and accrual instruments

There are two types of instruments in the fixed income market that pay interest at maturity, instead of as coupons discount instruments and accrual instruments. Discount instruments, like repurchase agreements, are issued at a discount of face value, and their maturity value is the face value. Accrual instruments are issued at face value and mature at face value plus interest short terms investment.

12.4 INTEGARTION OF DOMESTIC AND GLOBAL MONEY MARKET

Global and domestic money market is a phenomenon in which financial markets in neighboring, regional and/or global economies are closely linked together. Various forms of actual global and domestic money market include: Information sharing among financial institutions; sharing of best practices among financial institutions; sharing of cutting edge technologies (through licensing) among financial institutions; firms borrow and raise funds directly in the international capital markets; investors directly invest in the international capital markets; newly engineered financial products are domestically innovated and originated then sold and bought in the international capital markets; rapid adaption/copycat of newly engineered financial products among financial institutions in different economies; cross-border capital flows; and foreign participation in the domestic financial markets.

Because of financial market imperfections, global and domestic money market in neighboring, regional and/or global economies is therefore imperfect. For example, the imperfect global and domestic money market can stem from the inequality of the marginal rate of substitutions of different agents. In addition to financial market imperfections, legal restrictions can also hinder global and domestic money market. Therefore, global and domestic money market can also be achieved from the elimination of restrictions pertaining to cross-border financial operations to allow

i. financial institutions to operate freely,

ii. permit businesses to directly raise funds or borrow and

iii. equity and bond investors to invest across the state line with fewer [or without imposing any restrictions.

However, it is important to note that many of the legal restrictions exist because of the market imperfections that hinder global and domestic money market. Legal restrictions are sometimes second-best devices for dealing with the market imperfections that limit global and domestic money market. Consequently, removing the legal restrictions can make the world economy become worse off. In addition, global and domestic money market of neighboring, regional and/or global economies can take place through a formal international treaty which the governing bodies of these economies agree to cooperate to address regional and/or global financial disturbances through regulatory and policy responses.

The extent to which global and domestic money market is measured includes gross capital flows, stocks of foreign assets and liabilities, degree of co-movement of stock returns, degree of dispersion of world-wide real interest rates, and financial openness.

Benefits:

Benefits of global and domestic money market include efficient capital allocation, better governance, higher investment and growth, and risk-sharing. Global and domestic money market helps strengthen domestic financial sector allowing for more efficient capital allocation and greater investment and growth opportunities. As a result of global and domestic money market, efficiency gains can also be generated among domestics firms because they have to compete directly with foreign rivals; this competition can lead to better corporate governance. If having access to a broader base of capital is a major engine for economic growth, then global and domestic money market is one of the solutions because it facilitates flows of capital from developed economies with rich capital to developing economies with limited capital. These capital inflows can significantly reduce the cost of capital in capital-poor economies leading to higher investment.

Likewise, global and domestic money market can help capital-poor countries diversify away from their production bases that mostly depend on agricultural activities or extractions of natural resources; this diversification should reduce macroeconomic volatility. Global and domestic money market can also help predict consumption volatility because consumers are risk-averse who have a desire to use financial markets as the insurance for their income risk, so the impact of temporary idiosyncratic shocks to income growth on consumption growth can be softened.

Adverse effects:

Global and domestic money market can also have adverse effects. For example, a higher degree of global and domestic money market can generate a severe financial contagion in neighboring, regional and/or global economies. In addition, the capital outflows can journey from capital-poor countries with weak institutions and policies to capital-rich countries with higher institutional quality and sound policies. Consequently, global and domestic money market actually hurts capital-scarce countries with poor institutional quality and lousy policies.

Recent development:

During the past two decades, there has been a significant increase in global and domestic money market; this increased global and domestic money market generates a great deal of cross-border capital flows among industrial nations and between industrial and developing countries. In addition, this increase in global and domestic money market pulls global financial markets closer together and escalates the presence of foreign financial institutions across the globe. With rapid capital flows around the world, the currency and financial crises in the late 1980s and 1990s were inevitable. Consequently, developing countries that welcomed excessive capital flows were more vulnerable to these financial disturbances than industrial nations. It is widely believed that these developing economies were much more adversely impacted as well. Because of these recent financial crises, there has been a heated debate among both academics and practitioners concerning the costs and benefits of global and domestic money market.

12.5 NOTES

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12.6 SUMMARY

To summarize, money Laundering is spreading at speedy rate at global level and it is a serious matter for legislature authorities that must be curbed for smooth functioning of society and economic enhancement of all nations. All nations have to work together to combat such devastating criminal activity. Money Laundering is fundamentally, the process of transforming, through a series of stages, the proceeds of illegal or criminal activity, into apparently legitimately acquired funds. Today, due to technical modernization, the criminals are very clever and cheat the enforcing agencies through deploying a team of experts like chartered accountants, attorneys, banker's mafia, to cover their illicit money and pretence it as legal income. These professionals charge fee between 10 to 15% of the sum involved. The connection between white-collared criminals, politicians, enforcing agencies and gangs are so strong that it is difficult to break.

Bankers also has vital role and without their involvement, the operation cannot be successful. There numerous payment option such wire transfer of funds has further aggravated the difficulties to identify the movement of sludge funds. The international type of money laundering requires international law enforcement cooperation to effectively examine and accuse those that initiate these complex criminal organizations. Money laundering must be combated mainly by penal ways and within the frameworks of international cooperation among judicial and law enforcement authorities. It can be said that simply enactment of Anti-Money Laundering Laws will not resolve such serious crime instead the Law enforcement Community must keep bound with the ever changing dynamics of money Launderers who continually evolves advanced techniques which helps them to implement strict law to curb money laundering.

12.7 KEY WORDS

Money laundering, Insider trading, The International Monetary Fund, Legislators, Central government, Global money market, London Interbank Offered Rate.

12.8 SELF ASSESSMENT QUESTIONS

1. What do you mean by money laundering?
2. Explain the impact of money laundering on nation.
3. Briefly explain the process of money laundering.
4. Strategies to Prevent money laundering in India.

5. What is global money market?

6. Integrate and explain domestic and global money market.

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DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

M.B.A III Semester

COURSE - 16 A

FINANCIAL MARKETS AND INSTISTUTIONS

BLOCK

4

FINANCIAL AND BANKING INSTITUTIONS

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BLOCK -4 : FINANCIAL AND BANKING INSTITUTIONS

A financial institution is an establishment that conducts financial transactions, such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Every thing from depositing money to taking out loans and exchanging currencies must be done through financial institutions.

Block 04 exhibits financial and banking institutions comprises 04 units (13-16). Unit 13 financial institutions explains introduction, Indian financial system, constituent of financial system , financial instruments, financial instruments and institutions , non-banking financial intuitions and economic growth . Unit 14 on fund flow analysis meaning difference between fund flow and income statement and fund flow and balance sheet, benefits, preparation of fund flow statements . Unit 15 clarifies management of commercial banks, Introduction. The banking system, functional and roles of commercial banks, gap analysis, credit rating and methods of lending. Unit 16 explains reforms in banking sector, Narasimhan committee report, NPAS, Asset classification, capital adequacy, provision for substandard assets.

BLOCK – 4
FINANCIAL AND BANKING INSTITUTIONS

UNIT- 13 : FINANCIAL INSTITUTIONS

Structure :

13.0 Objectives

13.1 Introduction

13.2 Indian Financial System

13.3 Constituents of Financial System

13.4 Financial Instruments

13.5 Financial Institutions

13.6 Non – Banking Financial Institutions

13.7 Financial Institutions and Economic Growth

13.8 Important Factors in Building Stable Financial System

13.9 Case Study

13.10 Notes

13.11 Summary

13.12 Key Words

13.13 Questions for Self Assessment

13.14 References

13.0 OBJECTIVES

After studying this unit, you should be able to;

- constituents of financial system
- instruments in financial system
- role of financial system in economic development of India
- important factors in building stable financial system
- capital adequacy, compliance and convergence, co-operation.

13.1 INTRODUCTION

Financial System of any country consists of financial markets, financial intermediaries and financial instruments or financial products. The term “finance” in simple understanding is perceived as equivalent to ‘money’. But finance exactly is not money; it is the source of providing funds for a particular activity. Finance may be classified as personal finance, corporate finance and public finance. Further, the public finance does not mean the money with the Government, but it refers to sources of raising revenue for the activities and functions of a government and use of funds for capital and revenue purposes. Here, some of the definitions of the word ‘finance’, both as a source and as an activity (i.e. as a noun and a verb.) are as follows;

The American Heritage® Dictionary of the English Language, Fourth Edition defines the term (noun) finance as under;

1: The science of the management of money and other assets.

2: The management of money, banking, investments, and credit.

3: Finance monetary resources; Funds, especially those of a government or corporate body.

4: The supplying of funds or capital.

Finance as a function (i.e. verb) is defined by the same dictionary as under;

1: To provide or raise the funds or capital for: financing a new car

2: To supply funds to finance a daughter through law school.

3: To furnish credit to.

Another English Dictionary, "WorldNet ® 1.6, © 1997 Princeton University" defines the term finance as under;

1: the commercial activity of providing funds and capital.

2: the branch of economics that studies the management of money and other assets.

3: the management of money and credit and banking and investments.

All definitions listed above refer to finance as a source of funding an activity. In this respect, providing or securing finance by itself is a distinct activity or function, which results in Financial Management, Financial Services and Financial Institutions. Finance therefore, represents the resources by way of funds needed for a particular activity. We thus speak of 'finance' only in relation to a proposed activity. Finance goes with commerce, business, banking, etc. Finance is also referred as "Funds" or "Capital", when referring to the financial needs of a corporate body. When we study finance as a subject for generalising its profile and attributes, we distinguish between 'personal finance" and "corporate finance" i.e. resources needed personally by an individual for his family and individual needs and resources needed by a business organization to carry on its functions intended for the achievement of its corporate goals.

13.2 INDIAN FINANCIAL SYSTEM

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

FINANCIAL SYSTEM;

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

FINANCIAL MARKET:

A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset. Financial Assets or Financial Instruments represents a claim to the payment of a sum of money sometime in the future and /or periodic payment in the form of interest or dividend.

Money Market; The money market is a wholesale debt market for low-risk, highly liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

Capital Market; The capital market is a market designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.

Forex Market; The Forex market deals with the multicurrency requirements which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe.

Credit Market; Credit market is a place where banks, FIs and NBFCs purvey short, medium and long-term loans to corporate and individuals.

13.3 CONSTITUENTS OF FINANCIAL SYSTEM

Financial Intermediation

Having designed the instrument, the issuer should then ensure that these financial assets should reach the ultimate investors in order to mobilise the requisite amount. When the borrower of funds approaches the financial market to raise funds, mere issue of securities will not suffice. Adequate information of the issue, issuer and the security should be passed on to the borrower. There should be a proper channel within the financial system to ensure such transfer. To serve this purpose, financial intermediaries came into existence. Financial intermediation in the organized sector is conducted by a wide range of institutions functioning under the overall surveillance of the Reserve Bank of India. In the initial stages, the role of the intermediary was mostly related to ensure transfer of funds from the lenders to the borrowers. This service was offered by banks, FIs, brokers, and dealers. However, as the financial system widened along with the developments taking place in the financial markets, the scope of its operations also widened. Some of the important intermediaries operating in the financial markets include; investment bankers, underwriters, stock exchanges, registrars, depositories, custodians, portfolio managers, mutual funds, financial advisers financial consultants, primary dealers, satellite dealers, self regulatory organizations, etc. Though the markets are different, there may be a few intermediaries offering their services in more than one market e.g. underwriter. However, the services offered by them vary from one market to another.

13.4 FINANCIAL INSTRUMENTS

Money Market Instruments

The money market can be defined as a market for short-term money and financial assets that are near substitutes for money. The term short-term means generally a period up to one year and near substitutes to money is used to denote any financial asset which can be quickly converted into money with minimum transaction cost.

Some of the important money market instruments are briefly discussed below;

1. Call/Notice Money

2. Inter Bank Term Money

3. Treasury Bills

4. Term Money

5. Certificate of Deposit

6. Commercial Papers

1. Call /Notice-Money Market

Call/Notice money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is "Call Money". When money is borrowed or lent for more than a day and up to 14 days, it is "Notice Money". No collateral security is required to cover these transactions.

2. Inter-Bank Term Money

Inter-bank market for deposits of maturity beyond 14 days is referred to as inter-bank term money market. The entry restrictions are the same as those for call/notice money except that, as per existing regulations, the specified entities are not allowed to lend beyond 14 days.

3. Treasury Bills

Treasury Bills are short term (up to one year) borrowing instruments of the central government. It is an IOU of the Government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue (14/91/182/364 days i.e. less than one year). They are issued at a discount to the face value, and on maturity, the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

4. Certificate of Deposits

The Certificates of Deposit (CDs) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. The CDs can be issued by (i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by the RBI to raise short-term resources within the umbrella limit fixed by the RBI. Banks have the freedom to issue CDs depending on their requirements. Any FIs may issue CDs within the overall umbrella limit fixed by the RBI(i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and inter corporate deposits) should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

5. Commercial Paper

The CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper, the debt obligation is transformed into an instrument. The CP is thus an unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces. The CP is freely negotiable by endorsement and delivery. A company shall be eligible to issue CP provided; (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore; (b) the working capital (fund-based) limit of the company from the banking system is not less than Rs.4 crore and (c) the borrower account of the company is classified as a Standard Asset by the financing bank/s. The minimum maturity period of CP is 7 days. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies.

Capital Market Instruments

The capital market generally consists of the long term period (i.e., more than one year period) financial instruments. In the equity segment, equity shares, preference shares, convertible preference shares, non-convertible preference shares, etc, and in the debt segment debentures, zero coupon bonds, deep discount bonds, etc.

Hybrid Instruments

Hybrid instruments have both the features of equity and debenture. This kind of instruments is called as hybrid instruments. For example convertible debentures, warrants, etc.

13.5 FINANCIAL INSTITUTIONS

A financial institution is an establishment that conducts financial transactions such as investments, loans and deposits. Almost everyone deals with financial institutions on a regular basis. Everything from depositing money to taking loans and exchanging currencies must be done through financial institutions. The following are the some of the major categories of financial institutions.

13.5.1 Commercial Banks

Commercial banks accept deposits and provide security and convenience to their customers. The original purpose of banks was to offer customers safe keeping for their money. By keeping physical cash at home or in a wallet, there has risk of loss due to theft and accidents, not to mention the loss of possible income from interest. With banks, consumers no longer need to keep large amounts of currency on hand; transactions can be handled with cheques, debit cards or credit cards.

Commercial banks lend loans to individuals and businesses to buy goods or expand business operations, which in turn lead to more deposited funds that make their way to banks. Usually, banks lend money at a higher interest rate than the rate of interest on deposits and operating costs to earn profit for their growth and survival. Banks also serve, often under-appreciated role, as payment agents within a country and between nations. Not only do banks issue debit cards that allow account holders to pay for goods with the swipe and they can also arrange wire transfers with other institutions. Banks essentially underwrite financial transactions by lending their reputation and credibility to the transaction. A cheque is basically just a promissory note between two people, but without a bank's name and information on that note, no merchant would accept it. As payment agents, banks make commercial transactions much more convenient; it is not necessary to carry around large amounts of physical currency when merchants will accept the cheques, debit cards or credit cards of banks.

13.5.2 Investment Banks

The stock market crash of 1929 and Great Depression caused the United States Government to increase financial market regulations. The Glass-Steagall Act of 1933 resulted in the separation of investment banking from commercial banking. Investment banks may also be called "banks," but their operations are far different than deposit-gathering commercial banks. An investment bank is a financial intermediary that performs variety of services for businesses and governments. These service include underwriting debt and equity offerings, acting as an intermediary between an issuer of securities and the investing public, making markets, facilitating mergers and other corporate reorganizations, and acting as a broker for institutional clients. They may also provide research and financial advisory services to companies. As a general rule, investment banks focus on initial public offerings (IPO's) and large public and private share offerings. Traditionally, investment banks do not deal with the general public. However, some of the big names in investment banking, such as JP Morgan Chase, Bank of America and Citigroup, also operate commercial banks. Other past and present investment banks you may have heard of include Morgan Stanley, Goldman Sachs, Lehman Brothers and First Boston.

Generally speaking, investment banks are subject to less regulation than commercial banks. While investment banks operate under the supervision of regulatory bodies, like the Securities and Exchange Commission, FINRA, and the U.S. Treasury, there are typically fewer restrictions when it comes to maintaining capital ratios or introducing new products.

13.5.3 Insurance Companies

Insurance companies pool risk by collecting premiums from a large group of people who want to protect themselves and/or their loved ones against a particular loss, such as a fire, accident, illness, lawsuit, disability or death. Insurance helps individuals and companies manage risk and preserve wealth. By insuring a large number of people, insurance companies operate profitably and at the same time pay claims that may arise. Insurance companies use statistical analysis to project what their actual losses will be within a given class. They know that not all insured individuals will suffer losses at the same time or at all.

13.5.4 Brokerage Company

A brokerage Company acts as an intermediary between buyers and sellers to facilitate securities transactions. Brokerage companies are compensated via commission after the transaction has been successfully completed. For example, when a trade order for a stock is carried out, an individual often pays a transaction fee for the brokerage company's efforts to execute the trade.

A brokerage company can be either full service or discount. A full service brokerage company provides investment advice, portfolio management and trade execution. In exchange for this high level of services, customers pay significant commissions on each trade. Discount brokers allow investors to perform their own investment research and make their own decisions. The brokerage still executes the investor's trades, but since it doesn't provide the other services of a full-service brokerage, its trade commissions are much smaller.

13.5.5 Investment Companies

An investment company is a corporation or a trust through which individuals invest in diversified, professionally managed portfolios of securities by pooling their funds with those of other investors. Rather than purchasing combinations of individual stocks and bonds for a portfolio, an investor can purchase securities indirectly through package products like a mutual fund.

There are three fundamental types of investment companies: unit investment trusts (UITs), face amount certificate companies and managed investment companies. All three types have the following things in common;

- An undivided interest in the fund proportional to the number of shares held
- Diversification in a large number of securities
- Professional management
- Specific investment objectives

Let's take a closer look at each type of Investment Company.

13.5.6 Unit Investment Trusts (UITs)

A unit investment trust, or UIT, is a company established under an indenture or similar agreement. It has the following characteristics;

- The management of the trust is supervised by a trustee.
- Unit investment trusts sell a fixed number of shares to unit holders, who receive a proportionate share of net income from the underlying trust.
- The UIT security is redeemable and represents an undivided interest in a specific portfolio of securities.
- The portfolio is merely supervised, not managed, as it remains fixed for the life of the trust. In other words, there is no day-to-day management of the portfolio.

13.5.7 Face Amount Certificate Company

A face amount certificate company issues debt certificates at a predetermined rate of interest. Additional characteristics include:

- Certificate holders may redeem their certificates for a fixed amount on a specified date, or for a specific surrender value, before maturity.
- Certificates can be purchased either in periodic instalments or all at once with a lump-sum payment.
- Face amount certificate companies are almost nonexistent today.

13.5.8 Management Investment Companies

The most common type of Investment Company is the management investment company, which actively manages a portfolio of securities to achieve its investment objective. There are two types of management investment company, viz, closed-end and open-end. The primary differences between the two come down to where investors buy and sell their shares in the primary or secondary markets and the type of securities the investment company sells.

- Closed-End Investment Companies: A closed-end investment company issues shares in one-time public offering. It does not continually offer new shares, nor does it redeem its shares like an open-end investment company. Once shares are issued, an investor may purchase them on the open market and sell them in the same way. The market value of the closed-end fund's shares will be based on supply and demand, much like other securities. Instead of selling at net asset value, the shares can sell at a premium or at a discount to the net asset value.
- Open-End Investment Companies: Open-end investment companies are also known as mutual funds that issues new shares continuously. These shares are purchased from the investment company and sold back to the investment company.

13.6 NON-BANK FINANCIAL INSTITUTIONS

The following institutions are not technically banks but provide some of the same services as banks.

13.6.1 Savings and Loans Association

Savings and Loan Associations, also known as S&Ls or thrifts, resemble banks in many respects. Most consumers don't know the differences between commercial banks and S&Ls. By law, savings and loan companies must have 65 per cent or more of their lending in residential mortgages, though other types of lending is allowed. S&Ls emerged largely in response to the exclusivity of commercial banks. There was a time when banks would only accept deposits from people of relatively high wealth, with references, and would not lend to ordinary workers. Savings and loans typically offered lower rates than commercial banks and higher interest rates on deposits; the narrower profit margin was a by-product of such S&Ls.

13.6.2 Credit Unions

Credit unions are another alternative to regular commercial banks. Credit unions are almost always organized as not-for-profit cooperatives. Like banks and S&Ls, credit unions can be chartered at the federal or state level. Like S&Ls, credit unions typically offer higher rates on deposits and charge lower rates on loans in comparison to commercial banks. The main problem in credit union is that the membership is not open to the public, but rather restricted to a particular membership group. In the past, this has meant that employees of certain companies, members of certain churches, and so on, were the only allowed joining a credit union. In recent years, though, these restrictions have been eased considerably, there has very much over the objections of banks.

13.6.3 Shadow Banks

The housing bubble and subsequent credit crisis brought attention to what is commonly called “the shadow banking system.” This is a collection of investment banks, hedge funds, insurers and other non-bank financial institutions that replicate some of the activities of regulated banks, but do not operate in the same regulatory environment. The shadow banking system funnelled a great deal of money into the U.S. residential mortgage market during the bubble. Insurance companies would buy mortgage bonds from investment banks, which would then use the proceeds to buy more mortgages, so that they could issue more mortgage bonds. The banks would use the money obtained from selling mortgages to write still more mortgages. Many estimates of the size of the shadow banking system suggest that it had grown to match the size of the traditional U.S. banking system by 2008.

Apart from the absence of regulation and reporting requirements, the nature of the operations within the shadow banking system created several problems. Specifically, many of these institutions “borrowed short” to “lend long.” In other words, they financed long-term commitments with short-term debt. This left these institutions very vulnerable to increase in short-term rates and when those rates rose, it forced many institutions to rush to liquidate investments and make margin calls. Moreover, as these institutions were not a part of the formal banking system, they did not have access to the same emergency funding facilities.

13.7 FINANCIAL INSTITUTIONS AND ECONOMIC GROWTH

A large body of academic research across many countries have demonstrated the important role played by the highly developed banking sector and capital market in facilitating economic growth. Well developed financial system allows economies to reach their potential since they allow firms which have successfully identified profitable opportunities to exploit these opportunities as intermediaries by channelling investment funds from those in the economy who are willing to defer their consumption plans into the future.

In general, economic growth depends on the accumulation of input factors in the production process and on technical progress. Seeing capital and capital accumulation as an important input factor, financial development is linked most clearly to this source of growth. Financial development may also help to realise faster technical progress, embedded in the capital stock, to achieve higher economic growth.

More specifically, financial development can affect growth through three main channels:

i) It can raise the proportion of savings channelled to investment, thereby reducing the costs of financial intermediation

ii) It may improve the allocation of resources across investment projects, thus increasing the social marginal productivity of capital and

iii) It can influence the savings rates of households, for example, if it induces a higher degree of risk sharing and specialisation, which as a result stimulates higher growth.

There is clear evidence of stronger growth in those countries which are characterised by a good legal structure. This may lower both information costs (e.g., through verifying the quality of disclosure of companies' accounts) as well as transaction costs (e.g., through the better legal enforcement of contracts) for a supplier of funds, such as banks. Furthermore, when banks are allowed to be active in a wide range of activities, such as in the securities, insurance, or real estate markets, and when banks can own or control non-financial firms, or vice-versa, credit may be better allocated and/or more credit may be available to entrepreneurs.

In the EU context, the financial structure has seen a remarkable transformation and elements such as the provision of risk capital and the strengthening of market-based elements have become more important in recent years. The clearest transformation of the financial sector has been the tendency towards integration, which is leading to positive scale and scope effects and to increased competitive pressures on financial intermediaries. This is eliminating quasi-rents, improving the allocation of capital, and offering the highest possible returns and the lowest possible cost of capital. Moreover, enhanced competition among intermediaries has provided greater scope for financial innovation. However, considerable differences among Member States do still exist. Even in the EU, there is evidence that differences in the degree of financial sector development and the proportion of activity on financial markets is related to differences in creditor protection and accounting standards.

13.8 IMPORTANT FACTORS IN BUILDING STABLE FINANCIAL SYSTEM

Generally, a stable financial system can be described as a financial system that is able to withstand shocks without giving way to cumulative processes which could impair the allocation of savings to investments and the processing of payments in the economy. How do we get there?

1. Financial system architecture should be carefully planned. Different stages of financial development require adequate institutional processes to be in place. Here, one can refer to the sequencing laid out by IMF in recent years and to the European experience with opening and gradually liberalising the financial sector during 1980s and 1990s.
2. A solid micro supervision of the financial sector and individual institutions should be in place.
3. A close co-operation and exchange of information between the central bank and supervisory authorities is warranted at all times and especially in periods of financial stress. There are several, complementary public policies that are typically needed to sustain or build up confidence in financial institutions.

Let me mention:

- *Fiscal policy*; If fiscal authorities are restricted in their ability to run deficits or accumulate large debts, an important source of financial market stress and financial instability is removed.
- *Monetary policy*; The monetary authorities should try to guarantee price stability while developing monetary policy of the country. Indirectly, this should also be conducive to support financial stability, as the economy will have less macro uncertainties to deal with, when allocating resources. However, it goes without saying that the central bank should take an active interest in monitoring financial sector developments, given the importance of the sector, also from a monetary policy (transmission) perspective, and given its importance in the economic system (intermediation between lenders and borrowers). In some cases, when financial stability is threatened, monetary policy may be used as a tool to support the financial sector. This support may come not only

through interest rate policy, but also and most powerfully through the central bank's role as a lender of last resort, that is, in providing final liquidity when solvent commercial banks suffer liquidity strains.

- *Financial supervision*. An adequate supervisory framework helps to enhance financial stability and maintain overall confidence in the financial system.
- A *financial safety net* is in place in most countries with a view to protect small depositors in case of a bank failure. This system seems to work relatively well in maintaining confidence in financial institutions.

Of course, a stable financial system cannot operate without market discipline of the financial sector. In order to avoid costly bank runs and bank failures, the sector must show some self-discipline, to meet acceptable standards and expectations of shareholders. Banks should be able to show good performance, adopt a sound risk management system and adhere to adequate corporate governance rules. In case of deteriorating results, prompt corrective actions should be taken and announced to the public, in order not to lose its credibility. As an external watchdog, rating agencies provide a valuable service by monitoring the financial sector and designing a rating system, which reflect the institution's capacity to service its debts. This has, at times, proven to be a valuable tool to distinguish sound from unhealthy institutions.

4. Strengthening the supervisory framework; It is a key to enhance financial stability and overall confidence in the financial system. It is essential to ensure that the supervisory structure is effective in safeguarding financial stability. In the EU, given the increased cross-border activity, the infrastructures for large-value payment systems and the use of sophisticated financial instruments, systemic risk is no longer confined to any one Member State but is an EU and euro area-wide concern. In addition, consistent implementation of the common EU regulatory framework and convergence of supervisory practices across Member States are being increasingly pursued, with a view to promoting a level playing field and to favouring the integration of financial markets. Hence, within the EU co-operation among national authorities is increasingly called for to ensure an effective monitoring of risks and to remove regulatory and supervisory obstacles to integrated markets.

Indeed, in open and competitive financial markets a strong supervisory framework can be characterised as encompassing three equally important features: Capital adequacy, Compliance and Convergence, and Co-operation.

13.8.1 Capital Adequacy

It is in simple words, rules and regulations which require banks to hold sufficient capital to cover the risks they undertake. Capital requirements are now generally acknowledged as a major foundation of a stable banking system and have become inherent part of the Financial Sector Assessment Programs conducted by International Financial Institutions. A global benchmark for such rules is the Basel Accord which, although is a product of G-10 Committee, the Basel Committee on Banking Supervision, has undoubtedly achieved a global reach. The New Basel Capital Accord (Basel II) is intended to better align regulatory capital requirements to underlying risks and to provide banks and supervisors with a more flexible capital adequacy framework.

Although Basel II may be seen as a major challenge for both banks and supervisors given its complexity and sophistication, it represents at the same time a 'golden opportunity' for strengthening the quantity and quality of resources devoted to the management and supervision of risks at financial institutions. Specialised training and strengthening of resources, possibly including staff, will be an important component of this process, which will improve the overall quality of the supervisory framework and, ultimately, lead to a more resilient financial system.

13.8.2 Compliance and Convergence

The existence of rules is a necessary but not sufficient condition. In order to enhance credibility and confidence, it is essential that markets perceive the rules to be effectively implemented and enforced in a harmonised manner across countries. This requires convergence in supervisory practices, which is essential in ensuring a level playing field and in limiting compliance costs for financial groups with substantial cross-border business. The activities of large and complex financial groups span across different jurisdictions, significant differences in the implementation and enforcement of prudential rules may drive to allocate business lines to minimise the regulatory burden, then exploiting intra group transactions to ensure an optimal use of funds. But this can create complex dynamics in times of stress. It is essential that competent authorities have full access to the relevant information and are able in good times to fully understand the factors driving the organisation of business within international groups. Towards this aim, enhanced flows of information between banks and their supervisors and frequent exchanges of information between supervisors in different jurisdictions are considered critical to successful implementation.

13.8.3 Co-operation

Co-operation is essential on three main levels. The co-operation (entailing also exchange of information) between supervisory authorities and central bank, irrespective of the function that the latter have in the national supervisory in macro-prudential and structural monitoring of financial market developments, and in the area of financial crisis management. The cross-sector co-operation is important given the increasingly indistinct boundaries between traditional banking, securities and insurance sectors from the integration of financial products, markets and intermediaries across sectors. The cross-border co-operation will be required namely regarding the supervision of large and complex banking groups. In this context, it has been recognised that home-country supervisor may not have the ability to alone gather all relevant information necessary for effective supervision. The principle of "mutual recognition" for internationally active banks is a key basis for international supervisory co-operation. The Basel Committee has published a set of principles to facilitate closer practical co-operation and information exchange among supervisors.

As a specific aspect of international co-operation, it is necessary to stress the relevance of host supervision, namely in light of Basel II. In Argentinean market, indeed many subsidiaries of foreign banks are present and it should be noted that Basel II acknowledges the increased importance of host supervision given the increased complexity of supervising large complex banking groups or conglomerates and given the increased complexity in the regulatory regime. Hence, home supervisors will have to rely more and enhance co-operation with the host supervisors.

Here are some examples of how co-operation was indeed enhanced in the EU. Closer co-operation between central banks and supervisors has been formally addressed through the signing of three Memorandums of Understanding in the first part of 2003 for which the ECB has played a catalytic role. The first addressed co-operation between banking supervisors and payment system overseers, the second on co-operation between central banks and supervisory authorities in crisis situations and the third focused on co-operation between seven EU central banks managing credit registers.

The need to enhance co-operation between regulatory and supervisory authorities in the EU is gaining political momentum. In the banking sector, the European Banking Committee, which is the successor of the Banking Advisory Committee that is responsible for maintaining a robust and flexible EU secondary legislation, which can be easily adapted to fast changing financial markets. Also, a new supervisory committee, the Committee of European Banking Supervisors has set up for providing technical advice and pursuing consistent implementation of the new framework and convergence in supervisory practices. Such committees have been established for all financial sectors. Also, the strengthening of cross-sectoral co-operation has addressed by the newly established Financial Services Committee, which has succeeded the Financial Services Policy Group and is mandated to provide strategic guidance on financial sector policies.

13.9 CASE STUDY

A Commercial Paper (CP) is a short term money market instrument used by Financial Institutions and Corporations to source funds from the public. It is a negotiable instrument transferable by endorsement and delivery. The CP market in India changed tremendously after July 1, 2010. This case presents the salient features of CPs issued in India and abroad, the legal framework related to the issue, the market position after July 1, 2010, the RBI guidelines on the issue of CPs in India, etc. It gives the reader a comprehensive idea of the instrument.

a) Discuss the usefulness of this instrument to the issuing agency.
b) Analyze the Yield to Maturity (YTM) to an investor.
c) Explain the guidelines issued by the RBI.
d) Discuss and debate the pros and cons of this instrument in comparison to other money market instruments.

Case study:

Recently many countries around the globe have under gone financial sector reforms due to global economic crisis such as restructuring or privatizing state owned banks and establishment of capital markets. In Indian economy consists of many rigorous problems in the smooth functioning of the capital markets? It has been made to bring out the phase-wise development in respect of the capital markets in India. While this development was taking place, there may have been some barriers causing hindrance to the development of capital market. These problems or barriers may be political, socio-economic or administrative in nature.

While the capital market playing vital role of developmental activity in the economy, to know the many hindrances involved in their activity and also India is developing country, how it helps to develop?

Find out

a) Problems involved in capital market.

b) Factors affecting to capital market.

13.10 NOTES

13.11 SUMMARY

The term “financial system”, implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. A Financial Market can be defined as the market in which financial assets are created or transferred. The money market is a wholesale debt market for low-risk, highly liquid, short-term instrument. The capital market is a market designed to finance the long-term investments. The Forex market deals with the multicurrency requirements which are met by the exchange of currencies. Credit market is a place where banks, FIs and NBFCs purvey short, medium and long-term loans to corporate and individuals

Important money market instruments are;

1. Call/Notice Money
2. Inter Bank Term Money
3. Treasury Bills
4. Term Money
5. Certificate of Deposit
6. Commercial Papers

Major categories of financial system are; commercial banks, investment banks, investment company, insurance company, unit trust, etc.

Capital adequacy; rules and regulations which require banks to hold sufficient capital to cover the risks they undertake.

13.12 KEY WORDS

Finance

Capital Market

Money Market

Financial Instruments

Financial Institutions

Economic growth

13.13 SELF ASSESSMENT QUESTIONS

1. Distinguish between money market and capital market.
2. Briefly highlight the constituents of financial system.
3. What are the instruments of money market? Explain
4. "Financial system is must for economic growth of India". Discuss
5. Briefly explain the various factors in building stable financial system.

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UNIT- 14 : FUNDS FLOW ANALYSIS

Structure :

14.0 OBJECTIVES

After study in this unit, you should be able to;

- meaning and definition of fund flow analysis,
- sources and application of funds,
- differences between fund flow statement and income statement,
- fund flow statement and balance sheet,
- benefits and drawbacks of funds flow statement,
- the procedure in preparation of funds flow statement,
- interest rate and its determinants, yield curve,
- inflation and risk, types of risk.

14.1 INTRODUCTION

The balance sheet and profit and loss account are the two important financial statements usually prepared by all the companies irrespective of their nature and type to know the operational and financial results at regular intervals. These two statements are also prepared to meet the regulatory and stakeholders requirements. The balance sheet provides information on sources of funds and application of funds. It gives summary of both assets and liabilities on a specified date. The liquidity and solvency position can be examined by analysis of the balance sheet. However, the balance sheet is static statement. In other words, it is just a statement of assets and liabilities. The balance sheet does not disclose the details of assets purchased and funds raised and repayment of liabilities.

The profit and loss account is prepared to know the operational results like gross profit and net profit of a company on a particular date. This statement is also prepared to meet the regulatory requirement. It portrays the summary of incomes realised and expenditures incurred during the operating the period. This statement shows the change in position of the owner on specific date. However, this is also a statement of income and expenditure. This statement involves adjustments which do not have any cash outflow and inflow. However, these two statements do no tell anything about flow of funds. Therefore, there is a need of fund flow analysis.

14.2 MEANING OF FUND

It is essential to understand the concept of fund to provide better understanding the significance of fund flow analysis. The fund has defined by different experts in the field of management accounting differently. In narrow sense, fund refers to cash only. In broader sense, it refers to all financial resources of the company. However, the most acceptable meaning of the term is working capital. The working capital may be defined as the difference between current assets and current liabilities.

14.2.1 Meaning of Flow of Fund

The flow of funds refers to movement of funds involving inflow and outflow in working capital of the company. A flow of fund takes place if there has a transaction between current accounts and non current accounts are involved. In other words, transaction which involves current account and non current account results into flow of funds. The following transactions result into flow of funds;

1. Transaction between current assets and capital.
2. Transaction between current assets and long term liabilities.
3. Transaction between current liabilities and fixed assets.
4. Transaction between current liabilities and capital.
5. Transaction between current liabilities and long term liabilities.
6. Transaction between current assets and fixed assets.

14.2.2 Meaning of Fund Flow Statement

The fund flow statement which is popularly known as "statement of sources and application of funds". The fund flow statement is a report on movement of funds explaining where working capital originates and where working capital goes during an accounting period. It is financial statement which shows the manner in which the financial resources have been generated and used during accounting period. This statement consists of sources and application of funds. The transactions that increase the amount of working capital are known as sources of funds and those that decrease the amount of working capital are known as application of funds. The difference between the sources and application of funds is known as net funds. The statement which depicts the sources of funds and application of funds is known as fund flow statement. This is statement used to assess the change in financial position of a firm between two dates. The fund flow statement is called by variety of names such as;

1. Statement of sources and application of funds.
2. Statement of funds supplied and applied.
3. Statement of where got and where gone.
4. Statement of funds received and disbursed.
5. Statement of fund movement.
6. Statement of inflow of fund and outflow of fund.

14.2.3 Sources of Funds

1. Income from operations
2. Income from investments
3. Sale of fixed assets
4. Sale of long term investments
5. Issue of share capital
6. Issues of debentures
7. Rising of loans.
8. Dividend received
9. Gifts and damages awarded in legal suits.

14.2.4 Application of Funds

1. Operating losses
2. Redemption of preference share capital and debentures
3. Repayment of long term loans
4. Purchase of fixed assets
5. Purchase of long term investments
6. Non trading payments
7. Payment of dividend
8. Payment of taxes

Losses through embezzlements, payments of damages awarded.

14.3 DIFFERENCE BETWEEN FUND FLOW AND INCOME STATEMENT

Fund flow statement	Income statement
Main objective is to ascertain the funds generated and used.	Main objective is to ascertain the operating results from business operations
Prepared based on the financial statements of two consecutive years	Prepared based on the nominal accounts of particular accounting year
Takes into consideration the funds available from business operations and other sources	Takes into consideration income and expenditure transactions relating to business operations of a particular period.
It is not a statutory obligation on the part of management to prepare fund flow statement	It is statutory obligation on the part of management to prepare income statement
Income statement act as a source document in preparation of this statement	Fund flow statement is not necessary in preparation of this statement
It can be prepared at any time at the desire of the management	It is usually prepared at the end of particular period of time
It is prepared on cash basis	It is prepared both on cash and accrual basis
Difficult to manipulate by the management	It is subject to manipulation by the management
It act as an instrument for planning and control	It does not act as an instrument for planning and control

14.4 DIFFERENCE BETWEEN FUND FLOW STATEMENT AND BALANCE SHEET

Fund flow statement	Balance sheet
Main objective is to know the sources and application of funds.	Main objective is to know the financial position of the company on particular date
Prepared based on the balance sheets of two consecutive years	Prepared based on the ledger accounts of particular accounting year
It is a dynamic statement	It is a static statement
It is not a statutory obligation on the part of management to prepare fund flow statement	It is statutory obligation on the part of management to prepare income statement
It shows change in the value of fixed assets and their effect on flow of funds	It is a summary of assets and liabilities on particular date.
It can be prepared at any time at the desire of the management	It is usually prepared at the end of particular period of time
It is prepared for internal purposes	It is prepared to meet both internal and external purposes
Difficult to manipulate by the management	It is subject to manipulation by the management

14.5 BENEFITS OF FUND FLOW ANALYSIS

1. It helps to determine financial consequences of operations.
2. It assists in formulating financial policies of a firm.
3. Optimum utilisation of working capital
4. It depicts the surplus and deficit of working capital
5. Useful to the bankers and lenders while lending the loans

6. It is useful in effective allocation of scarce financial resources among different projects on priority basis
7. It gives the reasons for change in the amount of working capital.
8. It provides the information on financial position of the company.
9. It gives information regarding trends in sources and application of funds
10. It acts as tool for effective planning and control.

14.6.1 Draw backs of Fund Flow Analysis

1. It is prepared based on the data appearing in account books and therefore it a rearrangement of data of account books.
2. It is historical nature.
3. A study of cash flow is more relevant.
4. All the drawbacks of income statement and balance sheet are the draw backs
5. It is useful only when there has transaction between current and non current accounts
6. It does not deal with various changes that are taking place continuously.
7. It ignores the non fund transactions
8. It deals with only external transactions.

14.7 PREPARATION OF FUND FLOW STATEMENT

The funds flow analysis requires preparation of two statements. They are;

1. Statement of changes in working capital
2. Funds flow statement

1. Statement of changes in working capital;

Working capital is the difference between total of current assets and current liabilities. Current assets are those assets which are converted into cash within a period of one year. Similarly, current liabilities are those liabilities which are converted into cash in one year. The amount of working capital does not remain constant and it goes on changing from one period to another. In other words, working capital at two periods is not same. In order to know the change in working capital, it is necessary to prepare a statement of change in working capital. This statement is prepared based on the amount of current assets and current liabilities appearing in the balance sheets. This statement shows change in current assets and current liabilities and their effect on working capital. Total increase and decrease at the end of the period is compared to calculate net increase and decrease in working capital. The statement of change in working capital is also known as schedule of change in working capital. The basic rules in preparation of schedule of working capital are;

1. Increase in current assets results in increase in working capital.

2. Decrease in current assets results in decrease in working capital.

3. Increase in current liabilities results in decrease in working capital.

4. Decrease in current liabilities results in increase in working capital.

14.7.1 Steps in preparation of schedule/statement of change in working capital

1. The amount of each item of current asset of the current year is compared with the amount of the same of corresponding previous year. If the amount of current assets of current year is more than its amount of previous year, the excess is recorded as increase in working capital otherwise decrease in working capital.

2. The amount of each item of current liabilities of the current year is compared with the amount of the same of corresponding previous year. If the amount of current liabilities of current year is more than its amount of previous year, the excess is recorded as decrease in working capital otherwise increase in working capital.

3. Make sure that all items of current assets and current liabilities appearing in the two balance sheets are gone through and the difference is properly recorded.

4. Find the total of all increased and decreased amount.

5. Make comparison between the total of increased and decreased amount to find out the difference in both to ascertain the increase and or decrease in the amount of working capital.

14.8 FUNDS FLOW STATEMENT

The statement of change in working capital covers only current account items only. This statement takes into consideration the change in working capital area. There are other items in the balance sheet which are not covered in the statement of change in working capital. Therefore, it is necessary to prepare fund flow statement to cover the items of balance sheet which have no place in schedule of change in working capital to know the sources and application of working capital. The fund flow statement covers all non current assets and all non current liabilities of the balance sheets of two periods and additional information relating to balance sheets. The preparation of fund flow statement involves ascertainment of increase or decrease in the various items of non current assets and non current liabilities and share capital. The items those increase the amount of working capital are considered as sources of funds and those decrease the amount of working capital are considered as application of funds. The transactions that do not affect the amount of working capital are not in the purview of fund flow statement. It is necessary to calculate the funds from operation to prepare fund flow statement. The fund from operation is calculated by preparing funds from operation or by preparing adjusted profit and loss account. The fund from operation is the difference between the revenues generated from sales proceeds and cost paid. However, the fund from business operation is quite different than fund from trading operations. To ascertain the funds from operations, it is necessary to add non fund items debited to profit and loss account and deduct non fund items credited to profit and loss account to the closing balance of profit/ retained earnings and deduct the opening balance of profit or retained earning and vice versa.

14.9 INTEREST RATE ANALYSIS

Rate of interest prevailing in any economy occupy an important place in the modern world. All investors are interested in knowing the rate of return expected to receive from investment whether it is from bank deposits, equity shares or debentures. The rate of interest motivates the people to save money from their incomes and provide the same for productive purposes.

14.9.1 Meaning of interest

Interest is the payment made for borrowed funds or the price paid for the use of money. Interest is always expressed as a rate percent per annum or per month. i.e. 10% p.a, 5 % p.a.

In the words of Marshall, interest is the price paid for the use of capital in any market. Keynes defined it as premium offered to induce people to hold their savings in some form other than hoarded money. Interest is the cost paid by the borrower for the use of money as well as for the risk involved in lending. The interest may be classified as gross interest and net interest. Gross interest includes not only the payment made for use of capital but also for the risk undertaken by the lender. Net interest includes the payment made exclusively for the use of money.

14.9.2 Determinants of interest rates

The rate of interest is determined by the forces of demand and supply in financial market. But the problem is to identify the demand and supply for what? Numbers of theories have been developed to answer this question differently. They are as follows;

1. Classical theory
2. Loanable fund theory
3. Liquidity preference theory
4. Modern theory

1. Classical theory;

This theory was given by classical economists such as Marshall, Ricardo, Pigiou, Fisher and others. According to them, interest is a real phenomenon and is therefore determined by supply of and demand for capital under condition of perfect competition. The supply of savings depends on the willingness to save and ability to save. The demand for investment depends on cost of investment.

Assumptions of this theory are;

1. Perfect competition.
2. Constant income and price level.
3. Rate of interest is flexible.
4. Full employment of resources
5. Rational behaviour of investors.

2. Loanable fund theory;

This theory is given Wickshell, Myrdal and Robertson. According to them, the rate of interest is determined by demand for and supply of loanable funds; interest is the reward for the use of loanable funds.

Assumptions of this theory are;

1. Perfect competition.
2. Funds are perfectly movable and market is fully integrated.
3. Rate of interest is flexible.
4. Full employment of resources

Supply of loanable funds comes from savings, dishoarded money, credit advanced by banks and money from disinvestment. Demand from loanable funds comes from investment, consumption and hoarding purpose.

3. Liquidity preference theory

This theory is given by Keynes, a renowned economist. According to him, rate of interest is determined by the intersection between the supply of and demand for money. He defined interest as the reward for parting with liquidity for specified period. Interest is the reward offered to people to induce them to hold securities or income yielding assets instead of cash. According to this theory, people's desire for liquidity can be reduced by offering them high rate of interest. Thus, interest is the reward for inducing people to part with liquidity and hold the same in the form of securities. Demand to hold money is called the liquidity preference. The people have the following three motives to hold money as liquid asset. They are transaction motive, precautionary motive and speculative motive. The supply of money is determined and controlled by the monetary authorities.

4 Modern theory;

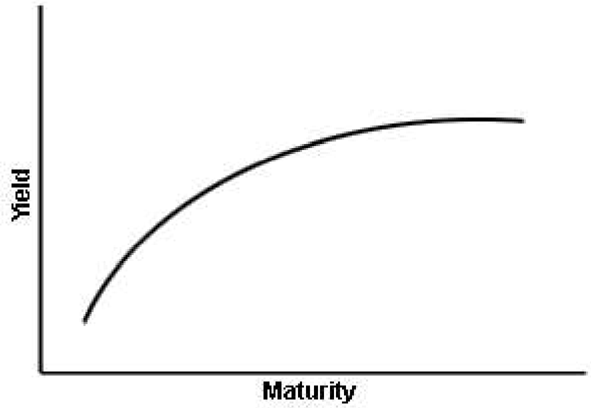
This theory suggests for consideration of both real and monetary factors to determine the rate of interest. The theory suggests four determinants of rate of interest;

1. Saving function
2. Investment function
3. Liquidity preference function and quantum of money

5 Yield Curves;

The term yield is synonymous with interest rate. The structure of interest rate when present graphically, takes the form of yield curve. Yield curve may be defined as curve depicting relation between yield and term to maturity. Yield curve is a name given to the functional relation between yield and the term to maturity. Yield to maturity includes nominal coupon interest payment plus the capital gain or loss arising from sale of security.

A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-years and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.



BREAKING DOWN 'YIELD CURVE'

The shape of the yield curve is closely scrutinized because it helps to give an idea of future interest rate change and economic activity. There are three main types of yield curve shapes: normal, inverted and flat (or humped). A normal yield curve (pictured here) is one in which longer maturity bonds have a higher yield compared to short-term bonds due to the risks associated with time. An inverted yield curve is one in which the short-term yields are higher than the long-term yields, which can be a sign of upcoming recession. A flat (or humped) yield curve is one in which the short and long-term yields are very close to each other, which is also a predictor of an economic transition. The slope of the yield curve is also seen as important: the greater the slope, the greater the gap between short and long-term rates.

14.10 INFLATION AND RISK

Inflation is a fairly new phenomenon for world economic market during pre-twentieth century. There had little upward pressure on prices due to gold and other metallic standards. At the end of the gold standard, strong political pressures often caused governments to issue more money caused increased supply of money supply and therefore the price level.

Inflation reflects a situation where the demand for goods and services exceeds their supply in the economy. Its causes could be triggered by the private sector and the government spending more than their revenues, or by shortfalls in output. Price increases could also be triggered by increases in costs of production. For instance, increase in prices of imported raw materials will cause inflation if not managed. Whatever the initial cause, inflation will not persist unless accompanied by sustained increase in money supply. In this sense, inflation is a monetary phenomenon

But what effect does inflation have on the economy and on investment in particular? Inflation causes many distortions in the economy. It hurts people who are retired and living on a fixed income. When prices rise these consumers cannot buy as much as they could previously. This discourages savings due to the fact that the money is worth more presently than in the future. This expectation reduces economic growth because the economy needs a certain level of savings to finance investments which boosts economic growth. Also, inflation makes it harder for businesses to plan for the future. It is very difficult to decide how much to produce, because businesses cannot predict the demand for their product at the higher prices they will have to charge in order to cover their costs. High inflation not only disrupts the operation of a nation's financial institutions and markets, it also discourages their integration with the rest of the worlds markets. Inflation causes uncertainty about future prices, interest rates, and exchange rates, and this in turn increases the risks among potential trade partners, discouraging trade. As far as commercial banking is concerned, it erodes the value of the depositor's savings as well as that of the bank's loans. The uncertainty associated with inflation increases the risk associated with the investment and production activity of firms and markets.

The impact of inflation has on a portfolio depends on the type of securities held there. Investing only in stocks one may not have to worry about inflation. In the long run, a company's revenue and earnings should increase at the same pace as inflation. But inflation can discourage investors by reducing their confidence in investments that take a long time to mature. The main problem with stocks and inflation is that a company's returns can be overstated. When there is high inflation, a company may look like it's doing a great job, when really inflation is the reason behind the growth. In addition to this, when analysing the earnings of a firm, inflation can be problematic depending on what technique, the company uses to value its inventory.

The effect of inflation on investment occurs directly and indirectly. Inflation increases transactions and information costs, which directly inhibits economic development. For example, when inflation makes nominal values uncertain, investment planning becomes difficult. Individuals may be reluctant to enter into contracts when inflation cannot be predicted making relative prices uncertain. This reluctance to enter into contracts over time will inhibit investment which will affect economic growth.

1. Credit Risk:

Credit risk is arguably the most obvious risk to a bank. A bank's business model is basically predicated on the idea that the large majority of lenders will repay their loans on time, but a certain percentage will not. So long as the bank's estimates of repayment rates are accurate, or conservative, there are few problems. When a bank fails to adequately estimate and price the rate of losses, or when economic conditions change significantly, banks may face higher levels of bad loans which can shrink the bank's capital reserves to an unacceptable level. Taken to the extreme, if a bank underestimates the amount of credit losses it will incur, the bank can fail altogether.

2. Concentration risk;

The risk of having too much money lent out to certain categories of borrowers. If all of a bank's mortgage lending was confined to a particular neighbourhood of a city, or a particular company's employees, there would be major risks to the bank's capital if some sort of disaster where to hit that neighbourhood, or if that company ran into financial difficulties and laid-off many of those employees. More practically, concentration risk for most commercial banks is measured by the type of lending (residential mortgage, multifamily residential, construction, etc.) and the region of the borrowers.

3. Liquidity Risk:

Banks lend out the vast majority of the funds they receive as deposits, therefore, there is always a risk that the bank will face a sudden rush of withdrawals that it cannot meet, with the cash it has on hand. Banks cannot call in loans on demand and cannot legally forbid depositors from withdrawing funds. Banks can call upon lending facilities with other banks or the Federal Reserve. While capital is usually available for healthy banks, a sudden simultaneous rush from multiple banks can increase short-term borrowing costs significantly. The failure of a bank to properly administer its liquidity needs can significantly harm its profitability.

4. Market Risk:

As banks frequently hold investment securities on their balance sheet, they are vulnerable to changes in the market value of those investments. As many banks hold significant percentages of their reserves in debt instruments widely thought of as "safe," (including U.S. government bonds), a sudden market decline in those securities could force banks to raise capital or spare back on lending, to say nothing of the loss in shareholder equity from the investment losses.

5. Operating Risk:

Banks are also vulnerable to the same sort of operating risk as any competitive enterprise. Management may make mistakes regarding acquisitions, expansion, marketing or other policies, and lose ground to rivals. In the case of banking, operating risk can have a longer tail than in other industries. Banks may be tempted to underprice loans to garner market share, but underpriced mortgage loans can hurt a bank for many years, and over-aggressive lending (lending to poor credit risks) can threaten the survival of the bank itself.

6. Interest Rate Risk;

The profitability of banks is determined by the interest rates they charge and pay out and they are highly exposed to changes in interest rates. Banks must always be making predictions and estimates of future interest rate movements and positioning their balance sheet accordingly. Unexpected rate changes can significantly impair profitability, as the bank repositions its balance sheet.

7. Legal Risk:

The banking industry also faces certain legal risks that are not very common outside the financial services industries. In addition to the aforementioned laws concerning fair and honest lending, banks are also compelled to play a role in monitoring potential illegal activities on the part of customers. In particular, banks are required to be on the lookout for signs of money laundering. There are strict "know your customer" rules in place and banks are compelled to maintain customers profile as per the directions of the RBI.

Banks are also subject to legal risks pertaining to their lending activities. Banks are required to be fair and unbiased in their lending, and are also required to disclose a range of information to prospective borrowers, including the annual percentage rates, terms and total cost to the borrowers. Likewise, banks are subject to laws on usury and predatory lending. While the definitions of usury and predatory lending arguably seem fairly clear, in practice they can be subjective; what banks may consider a fair rate to compensate for the elevated risk of default, regulators or citizens groups may deem excessive and predatory.

14.11 CASE STUDY

As a partner in the asset management practice of Mumbai based law firm Malhotra and Rathod has advised around 40 fund managers and trust companies on the creation of products including equity funds, bond funds, monetary market funds and ETFs. With a client base evenly split between foreign joint ventures and domestic companies, their role includes advising on and drafting contractual arrangements for the establishment of new funds, helping in negotiations in the formation of new JVs, and assistance in obtaining regulatory approvals.

Mr.Rathod has also advised a number of international investment banks which are acting as advisors to domestic funds with FDI quotas to invest in international markets. "The international institutions have a useful role to play here, because there are so many funds globally for Indian funds to choose from. It can be daunting trying to decide which will be the most suitable to invest in," he says.

One unique feature of the Indian market is that an institution may have to deal with one of three possible regulatory bodies. "The asset management market in India is still highly regulated, so foreign firms need to understand the restrictions, guidelines and legal risks," he explains. "It is a bit more complicated than in Hong Kong or the US, where you would only have one regulator to deal."

A related point is that with the relaxation of approval processes, a greater number of products are now on the market and Mr.Rathod believes this has stimulated competition and also helped the market evolve. "In the past, marketing was very important to attract investors. But now, the products speak for themselves. With more products available, people can see clearly which have superior performance and that means the marketing element has become less important."

Questions;

1. Discuss the advice made by the various fund managers.
2. Explain the role of regulatory bodies in fund management.

14.12 NOTES

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14.13 SUMMARY

In narrow sense, fund refers to cash only. In broader sense, it refers to all financial resources of the company.

The flow of funds refers to movement of funds involving inflow and outflow in working capital of the company.

The following transactions result into flow of funds; Transaction between current assets and capital, Transaction between current assets and long term liabilities, Transaction between current liabilities and fixed assets, Transaction between current liabilities and capital, Transaction between current liabilities and long term liabilities and Transaction between current assets and fixed assets.

The fund flow statement which is popularly known as "statement of sources and application of funds".

Sources of Funds; Income from operations, Income from investments, Sale of fixed assets, Sale of long term investments, Issue of share capital, Issues of debentures, Rising of loans, Dividend received, Gifts and damages awarded in legal suits.

Application of Funds; Operating losses, Redemption of preference share capital and debentures, Repayment of long term loans, Purchase of fixed assets, Purchase of long term investments, Non trading payments, Payment of dividend, Payment of taxes.

Working capital is the difference between total of current assets and current liabilities.

The statement showing change in current assets and current liabilities is known as schedule of change in working capital

Interest is the payment made for borrowed funds or the price paid for the use of money.

Theories of interest are; Classical theory, Loanable fund theory, Liquidity preference theory and Modern theory.

Yield curve may be defined as curve depicting relation between yield and term to maturity.

Inflation reflects a situation where the demand for goods and services exceeds their supply in the economy.

Risk is the amount of variability in actuals as compared with the estimates.

The main types risk are; credit risk, market risk, concentration risk, liquidity risk, operating risk, interest rate risk, legal risk, etc.

14.14 SELF ASSESSMENT QUESTIONS

1. What is flow of fund? Explain with example the type transactions that results in flow of funds.
2. What do you mean by fund flow statement? Explain the sources and application of funds.
3. Differentiate fund flow and income statement and fund flow statement and balance sheet.
4. What are the merits and demerits of fund flow statement? Explain.
5. Elucidate the statement required to prepare funds flow statement.
6. Define interest rate. What are the determinants of interest rate?
7. Explain the various types of risk in financial market.
8. What is yield curve? Discuss its significance in interest rate determination.

14.15 KEYWORDS

Funds

Fund flow statements

Income statements

Balance sheet

Interest rate

Inflation and risk

14.16 REFERENCES

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UNIT- 15 : MANAGEMENT OF COMMERCIAL BANKS

Structure :

15.0 OBJECTIVES

After studying this unit, you should be able to;

- indian banking system, functions of commercial banks
- types of deposits in banks, agency services
- role of commercial banks in Indian economy
- credit gap analysis, consortium lending
- role of lead bank in consortium
- role of consortium, credit rating
- methods of lending.

15.1 INTRODUCTION

Commercial banks are considered not merely as dealers in money but also the leaders in economic development. They are not only the store houses of the country's wealth but also the reservoirs of resources necessary for economic development.

Many of us share fairly basic views of banks. They are places to store money, make basic investments like term deposits, sign up for a credit card or get a loan. Behind this mundane view, however, is a highly regulated system that ties our day-to-day banking back into the wider financial system.

A **Commercial Bank** is a type of bank/financial institution that provides services such as accepting deposits, making business loans, and offering basic investment products.

"Commercial bank" can also refer to a bank, or a division of a large bank, which more specifically deals with deposits and loan services provided to corporations or large/middle-sized business as opposed to individual members of the public/small business.

A financial institution that provides services, such as accepting deposits, giving business loans and auto loans, mortgage lending, and basic investment products like savings account and certificate of deposits. The traditional commercial bank is a brick and mortar system with tellers, safe deposit boxes, vaults and ATMs. However, some commercial banks do not have any physical branches and require consumers to complete all transactions by phone or Internet. In exchange, they generally pay higher interest rates on investments and deposits, and charge lower fees.

15.2 THE BANKING SYSTEM

A commercial bank is basically a collection of investment capital in search of a good return. The bank, the building, people, processes and services is a mechanism for drawing in more capital and allocating in a way that the management and board believe will offer the best return. By allocating capital efficiently, the bank will be more profitable and the share price will increase. From this view, a bank provides a service to the consumers. But it also provides a service to investors by rendering investment services. Banks that do both jobs will be on successes. Banks that don't do one or either of these jobs may eventually fail. In case of failure, the FDIC swoops in, protects depositors and sees that the bank's assets end up in the hands of a more successful bank.

15.3 FUNCTIONS OF COMMERCIAL BANKS IN INDIA

Commercial banks provide banking services to businesses and consumers through a network of branches. These banks are in business to make a profit for their owners and they are usually public limited companies managed by shareholders. In India, however, most of the top commercial banks are owned by the government. But many private commercial banks have been established in recent years. Commercial banks are all-purpose banks that perform wide range of functions such as accepting demand deposits, issuing cheques against saving and fixed deposits, making short-term business and consumer loans, providing brokerage services, buying and selling foreign exchange and so on.

The primary functions of commercial bank are accepting deposits from the public and granting credit to all sectors of the economy after making provisions for reserves as per the RBI regulations. Apart from receiving and lending functions, commercial banks undertake various secondary or incidental functions such as agency services and general utility services.

The functions of commercial banks are mainly classified in to two types and they are-

1. Primary functions
2. Secondary functions

15.3.1 Primary functions

Collection of deposits, Making loans and advances

Collection of Deposits: The Collection of deposits from the public is a primary function of commercial banks. There are mainly three types of deposits: current, savings and fixed.

Current account is usually opened by the business community to make business related receipts and payments. A customer can deposit and withdraw money from the current account subject to a minimum required balance. If the customer overdraws the account, he/she may be required to pay interest to the bank. Cash credit facility is allowed in the current account.

Savings account is an interest yielding account. Deposits in savings account are used for saving money. Savings bank account-holder is required to maintain a minimum balance in his account to avail cheque facilities.

Fixed or term deposits are used by the customers to save money for a specific period of time, ranging from 7 days to 3 years or more. The rate of interest is related to the period of deposit. For example, a fixed deposit with a maturity period of 3 years will give a higher rate of return than a deposit with a maturity period of 1 year. But money cannot be usually withdrawn before the due date. Some banks also impose penalty if the fixed deposits are withdrawn before the due date. However, the customer can obtain a loan from the bank against the fixed deposit receipt.

Loans and Advances: Commercial banks have to keep a certain portion of their deposits as legal reserves. The balance is used to make loans and advances to the borrowers. Individuals and firms can borrow this money and banks make profits by charging interest on these loans. Commercial banks make various types of loans such as: Loan to a person or to a firm against some collateral security; Cash credit (loan in instalments against certain security); Overdraft facilities (i.e. allowing the customers to withdraw more money than what their deposits permit); and Loan by discounting bills of exchange.

15.3.2 Secondary functions

Agency services and General utility service

Agency Services; The customers may give standing instructions to the banks to accept or make payments on their behalf. The relationship between the banker and customer is that of principal and agent. The following agency services are provided by the bankers:

1. Payment of rent, insurance premium, telephone bills, instalments on hire purchase, etc. The payments are obviously made from the customer's account. The banks may also collect such receipts on behalf of the customer.
2. The bank collects cheques, drafts, and bills on behalf of the customer.
3. The banks can exchange domestic currency for foreign currencies as per the regulations.

3. The banks can act as trustees / executors to their customers. For example, banks can execute the will after the death of their clients, if so instructed by the latter.

4. General Utility Services

General Utility Services: The commercial banks also provide various general utility services to their customers. Some of these services are discussed below:

1. **Safeguarding money and valuables:** People feel safe and secured by depositing their money and valuables in the safe custody of commercial banks. Many banks look after valuable documents like house deeds and property, and jewellery items.
2. **Transferring money:** Money can be transferred from one place to another. In the same way, banks collect funds of their customers from other banks and credit the same in the customer's account.
3. **Merchant banking:** Many commercial banks provide merchant banking services to the investors and the firms. The merchant banking activity covers project advisory services and loan syndication, corporate advisory services such as advice on mergers and acquisitions, equity valuation, disinvestment, identification of joint venture partners and so on.
4. **Automatic Teller Machines (ATM):** The ATMs are machines for quick withdrawal of cash. In the last 10 years, most banks have introduced ATM facilities in metropolitan and semi-urban areas. The account holders as well as credit card holders can withdraw cash from ATMs.
5. **Traveller's cheque:** A traveller's cheque is a printed cheque of a specific denomination. The cheque may be purchased by a person from the bank after making the necessary payments. The customer may carry the traveller's cheque while travelling. The traveller's cheques are accepted in banks, hotels and other establishments.
6. **Credit Cards:** Credit cards are another important means of making payments. The Visa and Master Cards are operated by the commercial banks. A person can use a credit card to withdraw cash from ATMs as well as make payments to trade establishments.

In developing countries like India commercial banks perform certain promotional (developmental) activities. For example, nationalized banks in India provide credit to the top priority sectors of the economy such as agriculture, and small-scale and cottage industries. In this way commercial banks help to promote the socio-economic development of the country.

15.4 ROLE OF COMMERCIAL BANKS

Besides performing the usual commercial banking functions, banks in developing countries play an effective role in their economic development. The majority of people in such countries are poor, unemployed and engaged in traditional agriculture. There is acute shortage of capital. People lack initiative and enterprise. Means of transport are undeveloped. Industry is depressed. The commercial banks help in overcoming these obstacles and promoting economic development. The role of a commercial bank in a developing country is discussed as under;.

1. Mobilising Saving for Capital Formation:

The commercial banks help in mobilising savings through network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilise idle savings of the few rich. By mobilising savings, the bank channelizes them into productive investments. Thus they help in the capital formation of a developing country.

2. Financing Industry:

The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry. In India, they provide short-term loans. Income of the Latin American countries like Guatemala, they advance medium-term loans for one to three years. But in Korea, the commercial banks also advance long-term loans to industry. In India, the commercial banks undertake short-term and medium-term financing to small scale industries and also provide hire purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is undeveloped in such countries.

3. Financing Trade:

The commercial banks help in financing both internal and external trade. The banks provide loans to retailers and wholesalers to stock goods in which they deal. They also help in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. Moreover, they finance both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

4. Financing Agriculture:

The commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for modernisation and mechanisation of their farms, for providing irrigation facilities, for developing land, etc. They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming, and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people.

5. Financing Consumer Activities:

People in underdeveloped countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities.

6. Financing Employment Generating Activities:

The commercial banks finance employment generating activities in developing countries. They provide loans for the education of young person’s studying in engineering, medical and other vocational institutes of higher learning. They advance loans to young entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in India. Thus the banks not only help in human capital formation but also in increasing entrepreneurial activities in developing countries.

7. Help in Monetary Policy:

The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy. Thus the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.

8. Credit Gap Analysis

Gap analysis is one of the traditional methodologies in asset/liability management for credit unions. It should not be confused with GAAP, the acronym for "Generally Accepted Accounting Principles." Instead, it will focus on how interest rate risk can be managed using gap analysis and also describe the limitations of this risk management technique.

People have very different views about the usefulness of gap analysis. At a recent financial institutions' conference, one speaker commented that gap analysis was a valuable foundation but the other participant from a credit union said "gap is crap!".

15.5 GAP ANALYSIS

Gap measurements can be obtained by calculating the difference between rate-sensitive assets and rate-sensitive liabilities at different time periods (or "time buckets"). If there are more rate-sensitive assets than rate sensitive liabilities, the financial institution has a "positive gap" position. If there are more rate-sensitive liabilities than rate-sensitive assets, it has a "negative gap."

In a rising interest rate environment, the financial institution with the negative gap would suffer from lower net interest income. This is because there are more rate sensitive liabilities being re-priced at a rising rate than the assets being re-priced. This would lead to a squeeze in net interest margin as the increase in interest expense from the re-priced liabilities (share accounts and borrowings) would be higher than the increase in interest income derived from the re-priced assets (loans and investments) in that time bucket.

OR

Credit gap analysis is a method of asset-liability management that can be used to assess interest rate risk or liquidity excluding credit risk. Gap analysis is a simple IRR measurement method that conveys the difference between rate sensitive assets and rate sensitive liabilities over a given period of time. This type of analysis works well if assets and liabilities are compromised of fixed cash flows. Because of this a significant shortcoming of gap analysis is that it cannot handle options, as options have uncertain cash flows.

Breaking Down 'Gap Analysis'

1) Conducting a gap analysis can help a company re-examine its goals to determine whether it is on the right path to be able to accomplish them. A company will list the factors that define its current state, outline the factors that are required to reach the target state, and then determine how to fill the "gaps" between the two states.

2) Gap analysis was widely used in the 1980's typically in tandem with duration analysis. It was found to be harder to use and less widely implemented than duration analysis but it can still be used to assess exposure to a variety of term structure

The maturity gap shows the maturity mismatch by comparing assets and liabilities based on the contractual maturity time period. Very often this maturity gap does not reflect true interest rate risks. Some assets and liabilities in a credit union's balance sheet are re-priced very differently from the contractual maturity date.

For example, a one-year floating rate CD can have a maturity term at the end of one year. While the CD maturity is one year, the interest rate can be floating and re-priced every month based on an index such as LIBOR, federal funds, prime, or U.S. treasury bills.ýÿ The contractual maturity term is 1-year but the re-pricing term is monthly.

If a "5/1" Adjustable Rate Mortgage (the interest rate is fixed for the first five years and then the interest rate is subject to adjustment annually afterwards) with a contractual maturity of 10 years originated in 2001, after five years, the final maturity would be five more years later. But the interest rate is re-priced every year starting 2006.

When interest rates rise by 1 percent, the net effect on interest income is negative when the financial institution is negatively gapped. The opposite occurs for a positive gap period.

Traditional advocates for gap analysis think that by matching the re-pricing gap between rate-sensitive assets with rate-sensitive liabilities, interest rate risk can be minimized. The cumulative gap at the one-year level is often used to determine the amount of net interest income at risk.

15.6 WHAT IS CONSORTIUM

Consortium is a group of Independent Companies participating in a Joint Venture for mutual benefits. Companies in a Consortium co-operate with one another, often sharing technology as needed. A Consortium allows the Companies to conduct operations that they would not be able to do individually. It is important to note, however, that a Consortium is not a merger and the Companies remain independent. Further, it is a group of organizations that participate in a Joint Venture. Airbus Industries, a European Airplane manufacturer, is a Consortium of four Public and Private Corporations in Britain, France, Spain and Germany. A group of organizations, sharing the same goals, which combines their resources and risks, are known as consortium banking. Consortium Banking was popular in the late 1970s, when a number of major banks would combine to form a Merchant Banking or Finance Company offshoot. Many of Australia's Merchant Banks were formed as consortia with European, Asian and US Banks teaming with Australian Banks. Consortium is a coalition of organizations, such as Banks and Corporations, set up to fund ventures requiring large capital resources. A Consortium is an association of two or more Individuals, Companies, Organizations or Governments (or any combination of these entities) with the objective of participating in a common activity or pooling their resources for achieving a common goal. Consortium is a Latin word, meaning 'partnership, association or society'.

15.6.1 Consortium of Bank

A Subsidiary Bank owned by several different banks. Each Owner Bank has an equal share so that no bank is the majority shareholder. The owner banks are often in different countries. A Consortium Bank is created to finance a specific project; once the project is completed, the Consortium Bank dissolves itself. While they are not as common as they once were, they are useful when a project involves multiple currencies.

15.6.2 Definition of 'Consortium Bank

A subsidiary bank created by numerous banks. A consortium bank is created to fund a specific project (such as providing affordable homeownership for low- and moderate-income home buyers) or to execute a specific deal (such as selling loans in the loan syndication market).

The consortium leverages individual banks' assets to achieve its objectives. All member banks have equal ownership shares – no one member has a controlling interest. After the bank's objective is met the consortium typically dissolves.

15.6.3 Definition

A Banking Syndicate formed by multiple banks, often from different countries, for the single purpose of financing a specific project that is too large for any individual bank to finance on its own. Under this arrangement participating banks on completion of the project, the Consortium Bank is disbanded. That means Consortium Bank itself is a community of interest and member brings resources in certain percentage in common pool. And therefore, it shares the security interest in common.

Consortium banks originated in early 1960s and are predominantly found in Europe. They were originally created to enable smaller banks to participate in international banking activities. Consortium banks are not as active as in the past; however, examples can still be found both in U.S. and overseas. Member banks can be headquartered in different countries.

15.6.4 Rbi's Role In Consortium Finance:-

Large Lending is usually done under Consortiums as per the guidelines issued by DBOD of RBI. That DBOD of RBI as such issues circulars and guidelines from time to time including documentation. Consortium Bank itself is a community of interest and member brings resources in certain percentage in the common pool formed under statutory directives and documents are obtained as per the IBA formats strictly devised as per directions of RBI. Those in terms of the guidelines which have statutory force, the Consortium of Banks have a force of community of interest.

Now the question springs up for my opinion whether a deed of hypothecation or mortgage created by a borrower in consortium lending shall be treated as one instrument or separate instruments for the purpose of section 5, 6 of Bombay Stamp Act. Whether it is a multifarious instrument covering several distinct matters? We will have to refer the provisions of Bombay Stamp Act. Where several distinct matters and transactions are embodied in a single Instrument, the Instrument is called the multifarious instrument.

15.6.5 What is the difference between loan syndication and a consortium?

In a very general sense, a consortium is any group of individuals or entities that decides to pool resources towards a given objective. A consortium is usually governed by a legal contract that delegates responsibilities among its members. In the financial world, a consortium refers to several lending institutions that group together to jointly finance a single borrower. These multiple banking arrangements are very similar to loan syndication, although there are structural and operational differences between the two.

15.6.6 Loan Syndication

While loan syndication also involves multiple lenders and a single borrower, the term is generally reserved for loans that involve international transactions, different currencies and a necessary banking cooperation to guarantee payments and reduce exposure. Loan syndication is headed by a managing bank that is approached by the borrower to arrange credit. The managing bank is generally responsible for negotiating conditions and arranging the syndicate. In return, the borrower generally pays the bank a fee.

The managing bank in loan syndication is not necessarily the majority lender, or "lead" bank. Any of the participating banks may act as lead or assume the responsibilities of the managing bank depending on how the credit agreement is drawn up.

Consortium

Like loan syndication, consortium financing occurs for transactions that might not take place with a single lender. Several banks may agree to jointly supervise a single borrower with a common appraisal, documentation and follow-up. Consortiums are not built to handle international transactions such as a syndication loan; instead, a consortium may arise because the size of the project at hand is simply too large or too risky for any single lender to assume. Sometimes the participating banks form a new consortium bank that functions by leveraging assets from each institution and disbands after the project is complete.

15.6.7 Role of Lead Bank in Consortium

The lead bank performs the following functions in consortium;

1. Convening of consortium meetings
2. Obtaining of necessary documents, clarification etc. from the borrowing unit.
3. Making arrangements for joint appraisal of loan proposal by all member banks.

Preparation of joint appraisal report and sending the same to all member banks and finalization of decision after discussions.

4. Fixation of loan limit.
5. Finalization of loan documents to be obtained from borrower
6. Convening of Consortium meeting for execution of documents and registration of charge on the assets of the loanee.
7. Custody of documents, securities etc., on behalf of itself and consortium banks.
8. Verification of documents/securities pledged by itself or jointly with consortium banks.
9. To maintain mutual interest between consortium banks and term loan lending institutions, making correspondence with National/State level Financial Institutions.
10. Obtaining stock statement every month and ensuring maintenance of adequate stock for the loan.
11. Obtaining insurance coverage for the entire stock and ensuring renewal of insurance coverage from time to time.

12. Passing on recoveries on pro rata basis to the entire consortium banks.
13. Ensuring of all transactions by borrower through Cash Credit A/c maintained with the Lead Bank.
14. Ensuring of utilisation of working capital sanctioned limit only for production activities.

15.6.8 Role of Consortium Banks

1. Participating in consortium meetings and using their expertise in the general interest of consortium.
2. The consortium members should authorize the Lead Bank to take decision in the interest of consortium Banks.
3. Consortium Banks should give firm decision regarding their share in the consortium.
4. The Consortium Banks are not supposed to change their lending share without obtaining prior approval from the consortium members.
5. The consortium Banks should not demand the refund of loans by taking own decision.
6. Verification of stock pledged and submitting of verification report to lead bank and other consortium banks.
7. If any adverse points observed in respect of the loanee, the same should be brought to the notice of Lead Bank and other consortium members.
8. Annual or ad hoc share should be taken on the basis of original ratio in consortium.
9. A Senior Officer, who is authorized to take spot decision, in the event of necessity, should be deputed to the consortium meeting.

15.6.9 Role of Loanee under Consortium;

1. Furnishing of necessary documents, financial statements to the entire member banks so as to enable them to make quick processing of loan proposals.

2. Assisting Lead Bank in conducting consortium meetings and preparation of proceedings and ensuring the delivery of the same to all consortium banks.
3. Ensuring registration of charge on the assets mortgaged before Registrar of Companies/competent authority.
4. Sending of prescribed stock statement, quarterly statements etc. to all the Consortium Banks within stipulated time.
5. Assisting the Consortium Banks/Lead Bank in the verification of stocks and securities pledged for availing loan.
6. Should deposit the entire sale proceeds to Loan Account maintained at Lead Bank and all the transactions should be routed through Account maintained at Lead Bank.
7. Should submit the working capital renewal proposal well in advance i.e. 2 months earlier to the date of expiry of the limit.
8. If there are any adverse developments in the transactions of the borrower, the same should be informed all the consortium Banks and borrower should abide by the decision taken in the Consortium Banks.

15.7 CREDIT RATING

After 1990, Indian capital market lot of companies entering the capital market with the intention of raising the funds by issuing the shares and/or debentures. It expected that before an investor makes the investment in the instruments issued by the company, he should satisfy himself about the financial credentials of the company. While investing in the equity shares of a company, the investor is assumed to know about the risk involved with the investment. However, in case of the debt instruments, the investor are expected to make the investment in the instruments after making the study of the various factors relating to the investment. However, a small investor is not sufficiently equipped to make such a study. As such, the financial service in the form of credit rating has emerged as a tool to help the investors to evaluate their investment portfolio.

15.7.1 Meaning of credit rating

The credit rating is the expression of opinion, with the help of symbols, given by an independent credit rating agency, about the ability of the issuer of a debt instruments to make timely payments of principal and interest at the specified dates.

The credit ratings are an important tool for borrowers to gain access to loans and debt. Good credit ratings allow borrowers to easily borrow money from financial institutions or public debt markets. At the consumer level, banks will usually base the terms of a loan as a function of your credit rating, so the better your credit rating, the better the terms of the loan typically are. If your credit rating is poor, the bank may even reject you for a loan.

The above description of credit rating reveals the following features;

a) Credit ratings with respect to a particular instruments issued by the company.

   In other words, credit rating indicates the safety associated with the particular instrument issued by the company. It does not indicate the financial health of the company as a whole.

b) Credit rating is not a recommendation for buying, selling or holding a security.

   Actual investment made by the investor depends upon the other important factors like expectation of returns, risk taking capacity of the investor, etc.

c) For the purpose of deciding the rating about the particular instruments, the rating agency may use of various types of information. This information may be made available to the rating agency either by company itself or it may be available to the agency from any other source. However, the rating agency does not perform audit function. In the sense, the rating agency does not certify that the information available to it is true and correct.

d) Credit rating does not create any legal relationship between the rating agency and investor. If an investor invests in particular security on the basis of high credit rating given by rating agency and the investment turns out to be bad investment subsequently, the investor cannot hold rating agency responsible for the bad investment.

e) The credit rating once given is not a one-time phenomenon applicable during the entire tenure of the security. With the changing risk characteristics of the company, the credit rating should be reviewed and upgraded or downgraded accordingly.

15.7.2 Is Credit Rating Obligation?

In the Indian circumstances, credit rating is not obligatory in case of the equity shares. It is obligatory only in case of the debt instruments. To be more precise, credit rating is obligatory in case of the following debt instruments:

a) Convertible or Non-convertible Debentures/ Bonds irrespective of the period of maturity or redemption.

b) Fixed deposit issued by non-banking financial companies.

c) Commercial paper.

Recently amended SEBI guidelines provide that if the size of the issue is more than Rs. 100 crores, the issue is required to be rated by at least two credit rating agencies.

It should be noted that the requirements of credit rating in respect of the above instrument is not a part of any particular law of statute. It is included in the various guidelines applicable for the issue of above instruments.

15.7.3 Who can do the Credit Rating?

Presently, there are four approved credit rating agencies that can do the credit rating of the various instruments. These agencies are:

a) Credit Rating and Information Services of India Ltd. (CRISIL)

b) Investment Information and Credit Rating Agency (IICRA)

c) Credit Analysis and Research Limited (CARL)

d) Fitch Rating India Private Ltd.

15.7.4 Advantages of Credit Rating;

I. Advantages to Investors

1. **Safeguards against bankruptcy:**

Credit rating of an instrument done by credit rating agency, gives an idea to the investors about degree of financial strength of the issuer company which enables him to decide about the investment. Highly rated instrument of a company gives an assurance to the investors of safety of instrument and minimum risk of bankruptcy.

2. **Recognition of risk:**

Credit rating provides investors with rating symbols which carry information in easily recognisable manner for the benefit of investors to perceive risk involved in investments. It becomes easier for the investors by looking at the symbol to understand the worth of the issuer company because the instrument is backed by the financial strength of the company which in detail cannot be provided at the minimum cost to each and every one and at the same time they cannot also analyse or understand such information for taking any investment decisions. Rating symbol gives them the idea about the risk involved or the expected advantages from the investment.

3. **Credibility of issuer:**

Rating gives a clue to the credibility of the issuer company. The rating agency is quite independent of the issuer company and has no "business connections or otherwise any relationship with it or its Board of Directors, etc. Absence of business links between the rater and the rated firm establishes ground for credibility and attract investors.

4. **Easy understand of investment proposal:**

Rating symbol can be understood by an investor which needs no analytical knowledge on his part. Investor can take quick decisions about the investments to be made in any particular rated security of a company.

5. **Saving of resources:**

Investors rely upon credit rating. This relieves investors from knowing about the fundamentals of a company, its actual strength, financial standing, management details, etc. The quality of credit rating done by professional experts of the credit rating agency, reposes confidence in him to rely upon the rating for taking investment decisions.

6. **Independence of investment decisions:**

For making investment decisions, investors have to seek advice of financial intermediaries, the stock brokers, merchant bankers, the portfolio managers, etc. about the good investment proposal, but for rated instruments, investors need not depend upon the advice of these financial intermediaries as the rating symbol assigned to a particular instrument suggests the credit worthiness of the instrument and indicates the degree of risk involved in it.

7. Choice of investments:

Several alternative credit rating instruments are available at a particular point of time for making investment in the capital market and the investors can make choice depending upon their own risk profile and diversification plan. In addition to above, investors have other advantages like, Quick understanding of the credit instruments and weigh the ratings with advantages from instruments; quick decision making for investment and also selling or buying securities to take advantages of market conditions, or perceiving of default risk by the company.

II. Advantages to Company

1. Improves Corporate Image :

Credit rating helps to improve the corporate image of a company. High credit rating creates confidence and trust in the minds of the investors about the company. Therefore, the company enjoys a good corporate image in the market.

2. Lowers Cost of Borrowing :

Companies that have high credit rating for their debt instruments will get funds at lower costs from the market. High rating will enable the company to offer low interest rates on fixed deposits, debentures and other debt securities. The investors will accept low interest rates because they prefer low risk instruments. A company with high rating for its instruments can reduce the cost of public issue to raise funds, because it need not spend heavily on advertising for attracting investors.

3. Wider Audience for Borrowing :

A company with high rating for its instruments can get a wider audience for borrowing. It can approach financial institutions, banks, investing companies. This is because the credit ratings are easily understood not only by the financial institutions and banks, but also by the general public.

4. **Good for Non-Popular Companies :**

Credit rating is beneficial to the non-popular companies, such as closely held companies. If the credit rating is good, the public will invest in these companies, even if they do not know these companies.

5. Act as a Marketing Tool :

Credit rating not only helps to develop a good image of the company among the investors, but also among the customers, dealers, suppliers, etc. High credit rating can act as a marketing tool to develop confidence in the minds of customers, dealers, suppliers, etc.

6. Helps in Growth and Expansion :

Rating provides motivation to the company for growth as the promoters feel confident in their own efforts and encouraged to undertake expansion of their operations or new projects. With better image created though higher credit rating, the company can mobilise funds from public and investors or banks from self assessment of its own status which is subject to self-discipline and self-improvement, it can perceive and avoid sickness.

7. Reduction of cost in public issues:

A company with higher rated instrument is able to attract the investors and with least efforts can raise funds. Thus, the rated company can economise and minimise cost of public issues by controlling expenses on media coverage, conferences and other publicity stunts and gimmicks. Rating facilitates best pricing and timing of issues.

8. Unknown issuer:

Credit rating provides recognition to a relatively unknown issuer while entering into the market through wider investor base who rely on rating grade rather than on 'name recognition'.

9. Benefits to brokers and financial intermediaries:

Highly rated instruments put the brokers at an advantage to make fewer efforts in studying the company's credit position to convince their clients to select an investment proposal. This enables brokers and other financial intermediaries to save time, energy, costs and manpower in convincing their clients about investments in any particular instrument.

15.7.5 Methodology of Credit Rating

For this purpose we will take into consideration the rating methodology followed by CRISIL.

The Rating procedure followed by CRISIL may be based upon the information available either directly from company or any other sources. During this process, CRISIL consider the following aspects about the company.

A) Business Analysing

1) Industry Risk:

This indicates the overall demand/supply position in the industry as a whole, the exiting as well as the potential competitors in the industry, various government policies affecting the industry, etc.

2) Market Position:

This indicates the market position of the company vis-à-vis that of the competitors in the industry in terms of the market share, competitive advantages and disadvantages, selling and distribution arrangements etc.

3) Operating Efficiency:

This involves the consideration of manufacturing process and operating efficiency of the company in relation to those of the competitors, availability of various infrastructural facilities, modernisation/expansion/diversification plans etc.

B) Financial Analysis

This involves the consideration of the various factors like accounting polices followed by the company, analysis of the financial statement, adequacy of cash flows for fixed capital needs, ability to raise funds from the market etc.

C) Management Evaluation

This involves the consideration of the various factors like track record of the management, capacity to overcome the adverse business conditions, management targets/ objectives/strategies, etc.

Credit Rating Symbols

Long term (Debentures/ bonds)			
	CRISIL	IICRA	CARE
Highest safety	AAA	LAAA	CARE AAA
High safety	AA	LAA	CARE AA
Adequate safety	A	LA	CARE A
Moderate safety	BBB	LBBB	CARE BBB
Inadequate safety	BB	LBB	CARE BB
High risk	B	LB	CARE B
Substantial risk	C	LC	CARE C
Default	D	LD	CARE D
Medium term (fixed deposits)			
Highest safety	FAAA	MAAA	CARE AAA (FD)
High safety	FAA	MAA	CARE AA (FD)
Adequate safety	FA	MA	CARE A (FD)
Inadequate safety	FB	MB	CARE B (FD)
High risk	FC	MC	CARE C (FD)
Default	FD	MD	CARE D (FD)
Short term (commercial paper)			
Highest safety	P1	A1	PR1
High safety	P2	A2	PR2
Adequate safety	P3	A3	PR3
Inadequate safety	P4	A4	PR4
Default	P5	A5	PR5

Note:

a) The above table indicates the comparison between the symbols used by the various rating agencies. The basic description for the use of symbols is used by CRISIL. The exact description used by the remaining true rating agencies varies slightly from the description used by CRISIL.

b) The rating agencies may add + or – signs to indicate the degree of variation.

The credit rating symbols used by Fitch Rating India Pvt. Ltd., are as below:

For long term (12 months and more)	
AAA (ind)	High credit quality
AA+(ind), AA (ind), AA-(ind)	High credit quality
A+(ind), A (ind), A-(ind)	Adequate credit quality
BBB+(ind), BBB (ind), BBB-(ind)	Moderate credit quality
BB+(ind), BB (ind), BB-(ind)	Speculative
B+(ind), B (ind), B-(ind)	Highly Speculative
C (ind)	High default risk
D (ind)	Default
Public deposits	
tAAA (ind)	High credit quality
tAA+(ind), tAA (ind), tAA-(ind)	High credit quality
tA+(ind), tA (ind), tA-(ind)	Adequate credit quality
tBBB+(ind), tBBB (ind), tBBB-(ind)	Moderate credit quality
tBB+(ind), tBB (ind), tBB-(ind)	Speculative
tB+(ind), tB (ind), tB-(ind)	Highly Speculative
tC (ind)	High default risk
tD (ind)	Default
For short term (less than12 months)	
F1+(ind), F1(ind)	Highest credit quality
F2+(ind), F2(ind)	Good credit quality
F3 (ind)	Fair credit quality
F4 (ind)	Speculative
F5 (ind)	Default

15.7.6 Limitations of Credit Rating

a) Credit rating is based upon the evaluation made by the agencies which is essentially a subjective evaluation which may vary depending upon the experience, knowledge and the individual opinion of the raters which may be biased in some cases.

b) The various guidelines issued for regulating the various types of instruments for which credit rating is required to the companies to get the credit rating done. However, these guidelines do not require the companies to publish these ratings. As such, in certain cases the companies may not publish the ratings, particularly when the rating is not favourable to the companies. This defeats the basic purpose of credit rating.

c) The approved credit rating agencies prevailing in the country are promoted by the government controlled organisations. This may involves its own consequences.

d) It is usually observed that the rating given by the credit rating agencies is primarily based upon the past performance of the companies. Whereas the future prospective of the companies should be given more importance while deciding credit rating. Moreover, if a particular company or a particular industry is passing though the temporary adverse conditions, it may get a low credit rating if judged on temporary basis.

e) Multiplicity of the rating agencies can be considered to be the limitations of the credit rating. If a company is not satisfied with the rating given by one agency, the company can approach another rating agency with the hope to get better rating form that agency. The recently introduced guidelines issued by the SEBI provide that if the company has approached more than one rating agency, it is required that the ratings given by all agencies are made known to the investors. If there is a vast difference between the ratings awarded by the different agencies, it may be a point of concern for the investors.

f) In the recent past, some cases were observed that rating given by the agencies were either upgraded or downgraded within comparatively a very short span of time. The question arises what went wrong to such an extent that the rating were required to be upgraded or downgraded to such an extract. In the whole process, the basic rating given by the agencies gets challenged effectively, the credibility of the agencies become at stake.

Maximum Permissible Banking Finance (Tandon Committee)

MPBF stands for Maximum Permissible Banking Finance in Indian Banking Sector. As per the recommendations of Tandon Committee, the corporate are discouraged from accumulating too much of stocks of current assets and are recommended to move towards very lean inventories and receivable levels. Depending on the size of credit required, two methods are in practice to fund the working capital needs of the corporate.

15.8 TANDON COMMITTEE

Till mid-1970, the principle of commercial bank lending in India was predominantly security oriented. It was more or less net worth based, collateralized financing. Major Banks were nationalized in 1969 and with that the approach to lending is also changed. In 1974, a study group under the chairmanship of P.L.Tandon was formed to examine the existing methods of lending and suggest changes. The group submitted its report in August 1975, which came to be popularly known as Tandon Committee Report. It was a landmark in the history of bank lending in India. With the acceptance of major recommendations by the Reserve Bank of India, a new era of lending began in India.

15.8.1 Tandon Committee's Recommendations

Breaking away from the traditional methods of security oriented lending, the committee enjoined upon the banks to move towards need-based lending. The committee pointed out that the best security of bank loan is a well functioning of the committee which are as follows;

1. Assessment of the need-based credit of the borrower on a rational basis of their business plans.
2. Bank credit would only supplementary to the borrower's resources and not a replacement of them (i.e. bank would not finance cent percent) of borrower's working capital requirement.
3. Bank should ensure proper end-use of bank credit by keeping a closer watch on the borrower's business, and impose financial discipline on them.
4. Working capital finance would be available to borrower on the basis of industry wise norms (prescribed first by the Tandon Committee and Reserve bank of India) for holding different current assets, viz.
5. Raw material including stores and other items used in the manufacturing process, Stocks- in –process, Finished goods, Accounts receivable and Spares
6. Credit would be made available to the borrower in different components like cash credit; bills purchased and discounted working capital term loan, etc. depending upon the nature of holding of various current assets.

7. In order to facilitate a close watch on the operation of the borrowers, bank would require them to submit, at regular intervals, data regarding their business and financial operations, for both the past and future periods.

15.8.2 Norms of Tandon Committee

Tandon Committee had initially suggested norms for holding various current assets for fifteen different industries. Many of these norms were revised and the list extended to cover almost all major industries of the country. The norms for holding different current assets were expressed as follows:

1. Raw materials, as so many months' consumption. They include stores and other items used in the process of the manufacture.
2. Stocks-in-process of manufacture.
3. Finished goods and accounts receivable, as so many months' cost of sales and sales respectively.
4. Stocks of spares were not included in the norms. In financial terms, these were considered to be small part of total operation expenditure and hence, did not merit the development of general norms for them. Banks were expected to ascertain the requirement of spares on case-by-case basis. However, they should keep a watchful eye if spares exceed 5 per cent of total inventories.

The norms were based on average level of holding of a particular current asset, not on the individual items of the group. For example, if the receivables holding norms of an industry was two months and an unit has satisfied this norm, calculated by dividing annual sales with the average receivables, then the unit would not be asked to delete some of the accounts receivable, which were being held for more than two months. Tandon Committee while laying down the norms for holding various current assets made it very clear that it was against any rigidity and straight-jacking. On the other hand, the committee said that norms were to be regarded as the outer limits for holding different current assets but these were not to be considered as entitlement to hold current assets up to this level. If borrower had managed with less in the past, he should continue to do so. On the other hand, the committee held that allowance must be made for some flexibility under circumstances justifying a need for re-examination. The committee itself visualized that there might be deviation from norms in the following circumstances.

1. Bunched receipt of raw materials included imports.
2. Interruption of production due to power-cuts, strikes or other unavoidable circumstances.

3. Transport delay or bottlenecks.

4. Accumulation of finished goods due to non-availability of shipping space for exports, or other disruptions in sales.

5. Building up of stocks of finished goods, such as machinery, due to failure on the part of the purchasers for whom these were specifically designed and manufactured.

6. Need to cover full or substantial requirements of raw materials for specific export contract of short duration.

While allowing the above exception, the committee observed that the deviation should be for known and specific circumstances and situations, and allowed only for a limited period to tide over the temporary difficulty of a borrowing unit. Return to norms would be automatic when condition returned to normal.

15.9 METHODS OF LENDING

Like many other activities of the banks, method and quantum of short-term finance that can be granted to a corporate was mandated by the Reserve Bank of India till 1994. This control was exercised on the lines suggested by the recommendations of a study group headed by Shri Prakash Tandon.

The study group headed by Shri Prakash Tandon, the then Chairman of Punjab National Bank, was constituted by the RBI in July 1974 with eminent personalities drawn from leading banks, financial institutions and a wide cross-section of the Industry with a view to study the entire gamut of banks finance for working capital and suggest ways for optimum utilisation of bank credit. This was the first elaborate attempt by the central bank to organise the bank credit. The report of this group is widely known as Tandon Committee report. Most banks in India even today continue to look at the needs of the corporate in the light of methodology recommended by the group.

As per the recommendations of Tandon Committee, the corporate should be discouraged from accumulating too much of stocks of current assets and should move towards very lean inventories and receivable levels. The committee even suggested the maximum levels of raw material, stock-in-process and finished goods which a corporate operating in an industry should be allowed to accumulate. These levels were termed as inventory and receivable norms. Depending on the size of credit required, the funding of these current assets (working capital needs) of the corporate could be met by one of the following methods;

- **First Method of Lending:**

Banks can work out the working capital gap, i.e. total current assets less current liabilities other than bank borrowings (called Maximum Permissible Bank Finance or MPBF) and finance a maximum of 75 per cent of the gap; the balance come out of long-term funds, i.e., owned funds and term borrowings. This approach was considered suitable only for very small borrowers i.e. where the requirements of credit were less than Rs.10 lakhs

- **Second Method of Lending:**

Under this method, it was thought that the borrower should provide for a minimum of 25% of total current assets out of long-term funds i.e., owned funds plus term borrowings. A certain level of credit for purchases and other current liabilities will be available to fund the build up of current assets and the bank will provide the balance (MPBF). Consequently, total current liabilities inclusive of bank borrowings could not exceed 75% of current assets. The RBI stipulated that the working capital needs of all borrowers enjoying fund based credit facilities of more than Rs. 10 lakhs should be appraised (calculated) under this method.

- **Third Method of Lending:**

Under this method, the borrower's contribution from long term funds will be to the extent of the entire CORE CURRENT ASSETS, which has been defined by the Study Group as representing the absolute minimum level of raw materials, process stock, finished goods and stores which are in the pipeline to ensure continuity of production and a minimum of 25% of the balance current assets should be financed out of the long term funds plus term borrowings.

For the purpose of calculating MPBF of a borrowing unit, all the three methods adopted equation 2 as the basis, which is translated arithmetically as follows:

Gross current assets	Rs………………
Less: Current liabilities	
Other than bank borrowings	Rs………………
	___________________
Working capital gap	Rs………………..

Under the first Method, 75 percent of this working capital gap (WCG) would be financed by the bank, and the remaining 25 percent would be financed by the borrowing unit from its long-term sources. Under the second method, 25 percent of gross current assets (GCA), the borrowing unit would require to finance from its long-term sources. In third method, permissible bank finance would be calculated in the same manner as in the second method, but-only after deducting core current asset (CCA) from the gross current assets. It was envisaged that CCA would be financed by the borrower from long-term sources.

Action Taken by the RBI:

According to the notification of the RBI dated 21^{st} August, 1975, it accepted some of the main recommendation of the committee and they are as follows;

a. **Norms for inventories and receivables**: Norms suggested by the committee were accepted and banks were instructed to apply them in case of existing and new borrowers. If the level of inventories and receivables are found to be excessive than the suggested norms, the matters should be discussed with the borrower. If excessive levels continue without justification, after giving reasonable notice to the borrowers, banks may charge excess interest on that position which is considered as excessive.

b. **Coverage** : Initially, all the industrial borrowers including small scale industries having aggregate banking limits of more than Rs.10 lakhs should be covered, but it should be extended to all borrowers progressively.

c. **Methods of Borrowing**: The RBI instructed the banks that all covered borrowers should be placed in method I as recommended by the committee. However, all those borrowers who are already complying with requirements of method II should not slip back to method I. As for as method III is concerned, the RBI has not taken any view. However, in case of the borrowers already in method II, matter of application of method III may be decided on use to use basis.

d. **Style of Credit:** As suggested by the committee, instead of granting entire facility by way of cash credit, banks may divide the limit as term loan to take care of permanent requirement and fluctuating cash credit within the overall limit, bill limits may also be considered.

e. **Information system:** Suggestions added by the committee regarding the information system were accepted by the RBI and were made applicable to all the borrowers having the overall banking limits of more than Rs.1crore.

15.10 CASE STUDY

Assume that you manage the interest rate risk position for your bank. Your bank currently has a positive cumulative GAP for all time intervals through 1 year. You expect that interest rates will fall sharply during the year and want to reduce your banks risk position. The current yield curve is inverted with long term rates below short term rates.

a) To reduce risk would you recommend issuing a 3 months' time deposit and investing the proceeds in 1 year T-bills? Will you profit if rate fall during the year?

b) To reduce risk would you recommend issuing a 3 months' time deposit and making a 2 year commercial loan priced at prime plus 1 per cent?

15.11 NOTES

15.12 SUMMARY

A Commercial Bank is a type of bank/financial institution that provides services such as accepting deposits, making business loans, and offering basic investment products.

The functions of commercial banks are ;-

1. Primary functions; Collection of deposits, Making loans and advances
2. Secondary functions; Agency services and General utility service

Bank finance for the growth all sectors of Indian economy.

Gap analysis is one of the traditional methodologies in asset/liability management for credit unions.

Gap measurements can be obtained by calculating the difference between rate-sensitive assets and rate-sensitive liabilities at different time periods.

Consortium is a group of Independent Companies participating in a Joint Venture for mutual benefits.

Consortium Bank itself is a community of interest and member brings resources in certain percentage in common pool.

The credit rating is the expression of opinion, with the help of symbols, given by an independent credit rating agency, about the ability of the issuer of a debt instruments to make timely payments of principal and interest at the specified dates.

15.13 SELF ASSESSMENT QUESTIONS

1. What are the functions of commercial banks? Explain
2. Elucidate the role of commercial banks in development of Indian economy.
3. What is credit gap analysis? Explain the uses of credit gap analysis.
4. Explain the role of RBI in consortium lending.
5. What is credit rating? What are its merits and demerits of credit rating?
6. Explain the recommendations of Tandon Committee on maximum permissible finance

15.14 KEY WORDS

Commercial Banks

Credit Gap Analysis

Consortium

Credit Rating

Lending

Tandon Committee

15.15 REFERENCES

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UNIT - 16 : REFORMS IN BANKING SECTOR

Structure :

16.0 OBJECTIVES

After studying this unit, you should be able to;

- banking sector,
- Narasimham Committee
- NPA, causes, asset classification
- assets classification, measures to solve NPA,
- capital adequacy, provisioning norms,
- disinvestment

16.1 NARASIMHAM COMMITTEE REPORT

India has accepted the policy of LPG from 1991 as a part of WTO agreement and thereafter its economy has been growing significantly. There has lot of progress in banking sector. During this period, recognizing the evolving needs of the banking sector, the Ministry of Finance, Government of India (GOI) set up various Committees with the task of analysing India's banking sector and recommending legislation and regulations to make it more effective, competitive and efficient. Two such expert Committees were set up under the Chairmanship of M.Narasimham. The Committee submitted its report in 1990s which is widely known as the Narasimham Committee-I (1991) Report and the Narasimham Committee-II (1998) Report. These recommendations not only helped unleash the potentials of banking in India but also recognized as a factor towards minimizing the impact of global financial crisis starting from 2007. Unlike the socialist-democratic era of the 1960s to 1980s, India is no longer insulated from the global economy and yet its banks survived the 2008 financial crisis relatively unscathed, a feat due in part to these Narasimham Committees.

Background

The Government of India nationalized 14 commercial banks in 1969 and 6 more Commercial banks in 1980. Many other developments have taken in banking sector during pre liberalization period. However, India faced great set back in its economy resulting to the balance of payment crisis that necessitates transfer of gold reserve from the RBI to International Monetary Fund (IMF) to borrow loan to meet its short term financial obligations. This event called into question the previous banking policies and triggered the era of economic liberalization in India in 1991. These rigidities and weaknesses had made serious inroads into the Indian banking system by late 1980s, the Government of India (GOI), during post economic crisis, took several steps to remodel the country's financial system. (Some claims that these reforms were influenced by the IMF and the World Bank as a part of their loan conditions to India in 1991). The banking sector, handling 80% of the flow of money in the economy, needed serious reforms to make it internationally reputable, accelerate the pace of reforms and develop it into a constructive usher of an efficient, vibrant and competitive economy by adequately supporting the country's financial needs. In the light of these requirements, two expert Committees were set up in 1990s under the Chairmanship of M. Narasimham (an ex- Governor, Reserve Bank of India,) which are widely credited for spearheading the financial sector reforms in India. The first Narasimhan Committee (Committee on the Financial System–CFS) was appointed by Dr.Manmohan Singh, then Finance Minister, Government of India on 14th August 1991, and the second Committee on Banking Sector Reforms was appointed by P.Chidambaram as Finance Minister in December 1997. Subsequently, the first one widely came to be known as Narasimham Committee-I (1991) and the second one is known as Narasimham Committee -II (1998). The purpose of Narasimham-I Committee was to study all aspects relating to the structure, organization, functions and procedures of the financial systems and to recommend improvements in their efficiency and productivity. The Committee submitted its report to the Finance Minister in November 1991 which was tabled in Parliament on 17th December, 1991.

The Narasimham-II Committee was asked to review the progress of implementation of the banking reforms since 1992 with the aim of further strengthening the financial institutions of India. It focused on issues like size of banks and capital adequacy ratio among other things. M. Narasimham, Chairman, submitted the report of the Committee on Banking Sector Reforms (Committee-II) to, Yashwant Sinha, the Finance Minister, Government of India in April 1998.

.**Narasimham Committee Report I - 1991**

The Narasimham Committee was set up in order to study the problems of the Indian financial system and to suggest some recommendations for improvement in the efficiency and productivity of the financial institutions.

The Committee has made the following major recommendations;

1. Reduction in SLR and CRR: The committee recommended the reduction of the higher proportion of the Statutory Liquidity Ratio (SLR) and the Cash Reserve Ratio (CRR). Both of these ratios were very high at that time. The SLR then was 38.5 per cent and CRR was 15 per cent. This high amount of SLR and CRR meant locking the bank resources for government uses. It was hindrance in the productivity of the bank thus the committee recommended their gradual reduction. The Committee recommended reducing SLR from 38.5 per cent to 25 per cent and CRR from 15 per cent to 3 per cent to 5 per cent.

2. **Phasing out Directed Credit Programme**: In India, since nationalization, directed credit programmes were adopted by the government. The committee recommended phasing out of this programme. This programme compelled banks to earmark their financial resources for the needy and poor sectors at concession rate of interest. It was reducing the profitability of banks and accordingly the committee recommended phasing out directed credit programme.

3. **Interest Rate Determination**: The committee felt that the interest rates in India are regulated and controlled by the authorities. The determination of interest rate should be on the grounds of market forces such as the demand for and supply of fund. Hence, the committee recommended eliminating government controls on interest rate and phasing out the concession interest rates for the priority sector.

4. **Structural Reorganizations of the Banking Sector**: The committee recommended that the actual numbers of public sector banks need to be reduced. Three to four big banks including SBI should be developed as international banks. Eight to Ten Banks having nationwide presence should concentrate on the national and universal banking services. Local banks should concentrate on region specific banking. Regarding the RRBs (Regional Rural Banks), it recommended that they should focus on agriculture and rural financing. They recommended that the government should assure that henceforth there won't be any nationalization and private and foreign banks should be allowed liberal entry in India.

5. **Establishment of the ARF Tribunal**: The proportion of bad debts and Non-performing asset (NPA) of the Public Sector Banks and Development Financial Institutions was very alarming in those days. The committee recommended the establishment of an Asset Reconstruction Fund (ARF). This fund will take over the proportion of bad and doubtful debts from the banks and financial institutions. It would help banks to get rid of bad debts.

6. **Removal of Dual Control**: The banks were under the dual control of the Reserve Bank of India (RBI) and the Banking Division of the Ministry of Finance, the Government of India. The committee recommended for removal of dual control system on banking sector. It considered and recommended to the RBI to regulate banking sector as a regulating authority in India.

7. **Banking Autonomy**: The committee recommended that the public sector banks should be free and autonomous. In order to pursue competitiveness and efficiency, banks must enjoy autonomy so that they can reform the work culture and banking technology up gradation.

Some of these recommendations were later accepted by the Government of India and became banking reforms.

Narasimham Committee Report II - 1998

In 1998, the Government of India, appointed another Committee under the Chairmanship of Mr. Narasimham. It is better known as the Banking Sector Committee. It was asked to review the progress of banking reforms and design a programme for further strengthening the financial system of India. The Committee focused on various areas of banking sector reforms such as capital adequacy, bank mergers, bank legislation, etc.

It submitted its report to the Government in April 1998 with the following recommendations.

1. **Strengthening Banks in India**: The committee considered the stronger banking system in the context of the Current Account Convertibility (CAC). It thought that Indian banks must be capable of handling problems regarding domestic liquidity and exchange rate management in the light of CAC. Thus, it recommended the merger of strong banks which will have 'multiplier effect' on the industry.

2. **Narrow Banking**: Many public sector banks were facing a problem of Non-performing assets (NPAs). Some of them had high NPA about 20 per cent of their assets. Thus for successful rehabilitation of these banks, it recommended 'Narrow Banking Concept' where weak banks will be allowed to place their funds only in short term and risk free assets.

3. **Capital Adequacy Ratio**: In order to improve the inherent strength of the Indian banking system, the Committee recommended that the Government should raise the prescribed capital adequacy norms. This will further improve their absorption capacity also. Currently, the capital adequacy ratio for Indian banks is at 9 per cent.

4. **Bank Ownership**: The banks need freedom in their working and autonomy, and accordingly, it felt that the government control over the banks in the form of management and ownership and bank autonomy does not go hand in hand. The Committee recommended reviewing the functions of boards and enabling them to adopt professional corporate strategy.

5. **Review of Banking Laws**: The Committee considered that there was an urgent need for reviewing and amending main laws governing Indian Banking Industry like RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalization Act, etc. This up gradation will bring them in line with the present needs of the banking sector in India.

6. **Autonomy in Banking:** Greater autonomy was proposed for the public sector banks in order to function with equivalent professionalism as their international counterparts. For this, the panel recommended that recruitment procedures, training and remuneration policies of public sector banks be brought in line with the best-market-practices of professional bank

management. The committee recommended GOI equity in nationalized banks is reduced to 33 per cent for increased autonomy. It also recommended to the RBI to relinquish its seats on the board of directors of these banks. The committee further added that the government nominees to the board of banks are often members of parliament, politicians, bureaucrats, etc. They often interfere in the day-to-day operations of the bank in the form of behest-lending. As such, the committee recommended a review of functions of banks boards with a view to make them responsible for enhancing shareholders value through formulation of corporate strategy and reduction of government equity. To implement this, criteria for autonomous status was identified by March 1999 (among other implementation measures) and 17 banks were considered eligible for autonomy. But some recommendations like reduction in Government's equity to 33 per cent, the issue of greater professionalism and independence of the board of directors of public sector banks is still awaiting.

7. **Entry of Foreign Banks:** The committee suggested that the foreign banks seeking to set up business in India should have a minimum start-up capital of $25 million as against the existing requirement of $10 million. It said that foreign banks can be allowed to set up subsidiaries and joint ventures that should be treated on par with private banks.

8. **Reform in the Role of RBI:** The committee recommended that the RBI withdraw from the 91-day treasury bills market and interbank call money and term money markets and be restricted to banks and primary dealers. Further, the Committee proposed a segregation of the roles of RBI as a regulator of banks and owner of bank. It observed that the Reserve Bank as a regulator of the monetary system should not be the owner of a bank in view of a possible conflict of interest. As such, it highlighted that RBI's role of effective supervision was not adequate and wanted it to divest its holdings in banks and financial institutions. Pursuant to the recommendations, the RBI introduced a Liquidity Adjustment Facility (LAF) operated through repo and reverse repos to set a corridor for money market interest rates. To begin with, in April 1999, an Interim Liquidity Adjustment Facility (ILAF) was introduced pending further up gradation in technology and legal/procedural changes to facilitate electronic transfer. As per the second recommendation, the RBI decided to transfer its respective shareholdings of public sector banks like State Bank of India (SBI), National Housing Bank (NHB) and National Bank for Agriculture and Rural Development (NABARD) to GOI. Subsequently, in 2007–08, GOI decided to acquire entire stake of RBI in SBI, NHB and NABARD. Of these, the terms of sale for SBI were finalized in 2007–08.

9. **Stronger Banking System:** The Committee recommended for merger of large Indian banks to make them strong enough for supporting international trade. It recommended a three tier banking structure in India through establishment of three large banks with

international presence, eight to ten national banks and a large number of regional and local banks. This proposal had been severely criticized by the RBI employees union. The Committee recommended the use of mergers to build the size and strength of operations for each bank. However, it cautioned that large banks should merge only with banks of equivalent size and not with weaker banks, which should be closed down if unable to revitalize themselves. Given the large percentage of non-performing assets for weaker banks, some as high as 20 per cent of their total assets, the concept of "narrow banking" was proposed to assist in their rehabilitation. There were a string of mergers in banks of India during late 90s and early 2000s, encouraged strongly by the Government of India|GOI in line with the Committee's recommendations. However, the recommended degree of consolidation is still awaiting sufficient government impetus. Apart from these major recommendations, the committee has also recommended faster computerization, technology up gradation, training of staff, depoliticizing of banks, professionalism in banking, reviewing bank recruitment, etc.

As per recommendations made by the committee, on the Financial System, the Reserve Bank of India has introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the banks. These norms were in line with the international practices, to move towards greater consistency and transparency in the published accounts.

16.1.1 Actions on Recommendations of Narasimham Committee:

To implement the recommendations made by Narasimham Committee, the RBI in October 1998, initiated the second phase of financial sector reforms by raising the banks' capital adequacy ratio by 1 per cent and tightening the prudential norms for provisioning and asset classification in a phased manner on lines of Narasimham Committee-II report. The RBI targeted to bring the capital adequacy ratio to 9 per cent by March 2001. The mid-term Review of the Monetary and Credit Policy, the RBI announced another series of reforms, in line with the recommendations of the Committee, in October 1999. In 1998, the RBI's Governor, Bimal Jalan informed the banks that the RBI had a three to four-year perspective on the implementation of the Committee recommendations. Based on other recommendations of the committee, the concept of a universal bank was discussed by the RBI and finally ICICI bank became the first universal bank of India. The RBI published an Actions Taken on the Recommendations report on 31st October 2001 on its own website.

Many of the recommendations of the committee were accepted by the government. The SLR, which was around 38.5 per cent in 1991-92, was brought down to some 28 per cent in five years. The CRR was also brought down from 14 per cent to 10 per cent by 1997.

The RBI introduced the CRAR or Capital to Risk Weighted Asset ratio in 1992 for the soundness of the banking industry. The RBI also included new prudential reforms for classification of assets and provisioning of non-performing assets.

Some strong banks (such as SBI) were allowed to seek access to capital markets. The banks which were relatively weaker were recapitalized by the government via budgetary support. More private banks were allowed and more freedom was given to banks to open branches. The RBIs supervision system was strengthened. Rapid computerization of the banks was adopted. The RBI started helping the commercial banks to improve the quality of their performance.

16.2 NON-PERFORMING ASSETS

Non-performing assets had been the single largest cause of irritation of the banking sector of India. Earlier, the Narasimham Committee-I had broadly concluded that the main reason for the reduced profitability of the commercial banks in India was the priority sector lending. The committee had highlighted that 'priority sector lending' was leading to the build-up of non-performing assets of the banks and thus it recommended it to be phased out. Subsequently, the Narasimham Committee-II also highlighted the need for 'zero' non-performing assets for all Indian banks with International presence. The 1998 report further blamed poor credit decisions, behest-lending and cyclical economic factors among other reasons for the build-up of non-performing assets of these banks to uncomfortably high levels. The Committee recommended creation of Asset Reconstruction Funds or Asset Reconstruction Companies to take over the bad debts of banks, allowing them to start on a clean-slate. The option of recapitalization through budgetary provisions was ruled out. Overall, the committee wanted a proper system to identify and classify NPAs and NPAs to be brought down to 3 per cent by 2002 and for an independent loan review mechanism for improved management of loan portfolios. The committee's recommendations leads to the introduction of a new legislation which was subsequently implemented as the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and the same came into force with effect from 21st June, 2002.

16.2.1 Definition

A non-performing asset (NPA) is a loan or advance for which the principal or interest payment remained overdue for a period of 90 days.

Thus, a Non- Performing Asset (NPA) is a loan or an advance where:

1. Interest and /or installment of principal remain overdue for a period of more than 90 days in respect of term loan

2. The account remains 'out of order' below, in respect of an overdraft/cash credit

3. The bill remains overdue for a period more than 90 days in case of bills purchase or discounted

4. The installment of principal or interest thereon remains overdue for two crop seasons for short duration crops.

16.2.2 Causes of NPA

- **Speculation:** Investing in high risk assets to earn high income.
- **Default:** Willful default by the borrowers.
- **Fraudulent practices:** Fraudulent practices like advancing loans to ineligible persons, advances without security or reference, etc.
- **Diversion of funds:** Most of the funds are diverted for unnecessary expansion and diversion of business.
- **Internal reasons:** Many international reasons like inefficient management, inappropriate technology, labour problems, marketing failure, etc. resulting in poor performance of the bank.
- **External reasons:** External reasons like a recession in the economy, infrastructural problem, delay in release of sanctioned limits by banks, delays in settlement of payments by government, natural calamities, etc.

16.3 ASSETS CLASSIFICATIONS

Banks are required to classify non-performing assets into the following three categories based on the period for which the asset remained non- performing and the reliability of the dues:

1. Substandard Assets
2. Doubtful Assets
3. Loss Assets

1. Substandard Assets: With effect from March 31, 2005, sub standard asset would be one, which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

2. **Doubtful Assets**: With effect from March 31, 2005, asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub standard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values highly questionable and improbable.

3. **Loss Assets**: A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

16.3.1 Guidelines for Classification of Assets

Take into account the degree of well-defined credit weakness and the extent of dependence on collateral security for realization of dues.

Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts the classification of asset as NPA should be based on the record of recovery.

Banks should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporarily in nature such as non-availability of adequate drawing power based on the latest available stock statement.

16.3.2 Up gradation of Loan Accounts Classified as NPAs

If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should be treated as performing and may be classified as standard account.

16.3.3 Asset Classification to be borrower-wise and not facility-wise

All the facilities granted by a bank to a borrower and investment in all the securities issued by the borrower will have to be treated as NPA/NPI and not the particular facility/ investment or part thereof which has become irregular.

16.3.4 Accounts where there is erosion in the value of security/frauds committed by borrowers:

In respect of accounts where there are potential threats for recovery, such accounts should go through various stages of asset classification.

In case of such serious credit impairment the asset should be straightway classified as doubtful or loss asset as appropriate.

The realizable value of the security is less than 50 per cent of outstanding in the borrowed accounts such NPAs may be straightway classified under doubtful category.

The realizable value of the security, as assessed by the bank is less than 10 per cent of the outstanding in the borrowed accounts; the asset should be straightway classified as loss asset

16.3.4 Advances against Term Deposits, NSC, KVP/IVP, etc

Advances against term Deposits, NSCs eligible for surrender, IVPs, KVPs and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.

Loans with moratorium for payment of interest:

In the case of bank finance given for industrial projects or for agricultural plantations etc. where moratorium is available for payment of interest, payment of interest becomes due only after the moratorium or gestation period is over.

In case of loans granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates.

16.3.5 Government Guaranteed Advances

The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates the guarantee when invoked.

Projects under Implementation:

For all projects financed by the FIs/banks, the ‘Date of Completion’ and the ‘Date of Commencement of Commercial Operations’ (DCCO), of the project should be clearly spelt out at the time of financial closure of the project and the same should be formally documented. These should also be documented in the appraisal note by the bank during sanction of loan.

16.3.6 Measures to Solve Problems of NPA

1. **Debt Recovery Tribunals (DRTs):** Narasimham Committee Report I (1991) recommended the setting up of Special Tribunals to reduce the time required for settling cases. Accepting the recommendations, Debt Recovery Tribunals (DRTs) were established. There are 22 DRTs and 5 Debt Recovery Appellate Tribunals. This is insufficient to solve the problem all over the country (India).

2. **Securitization Act, 2002**: Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, popularly known as Securitization Act, enables the banks to issue notices to defaulters who have to pay the debts within 60 days. Once the notice is issued, the borrower cannot sell or dispose the assets without the consent of the lender. The Securitization Act further empowers the banks to take over the possession of the assets and management of the company. The lenders can recover the dues by selling the assets or changing the management of the firm. The Act also enables the establishment of Asset Reconstruction Company for acquiring NPA. According to the provisions of the Act, Asset Reconstruction Company of India Ltd. with eight shareholders and an initial capital of Rs.10 crores has been set up. The eight shareholders are HDFC, HDFC Bank, IDBI, IDBI Bank, SBI, ICICI, Federal Bank and South Indian Bank.

3. **Lok Adalats:** Lok Adalats have been found suitable for the recovery of small loans. According to RBI guidelines issued in 2001, they cover NPA up to Rs.5 lakhs, both suit filed and non-suit filed are covered. Lok Adalats avoid the legal process. The Public Sector Banks have recovered Rs.40 crores at the end of September 2001.

4. **Compromise Settlement:** Compromise Settlement Scheme provides a simple mechanism for recovery of NPA. Compromise Settlement Scheme is applied to advances below Rs. 10 crores. It covers suit filed cases and cases pending with courts and DRTs (Debt Recovery Tribunals). Cases of wilful default and fraud were excluded.

5. **Credit Information Bureau:**A good information system is required to prevent loans from turning into a NPA. If a borrower is a defaulter to one bank, this information should be available to all banks so that they may avoid lending to him. A Credit Information Bureau can help by maintaining a data bank which can be assessed by all lending institutions.

16.4 CAPITAL ADEQUACY

Along with profitability and safety, banks also give importance to solvency. Solvency refers to the situation where assets are equal to or more than liabilities. A bank should select its assets in such a way that the interest of shareholders and depositors is protected. The capital is life blood of any productive activities. This is very much applicable to banking sector due to its nature of business transaction. They are involved in buying and selling of money. In other words, their main job is to accept deposits and lend the same to borrowers.

It also gives the bank the ability to absorb shocks and thereby, avoid the likelihood of bankruptcy. Along with profitability and safety, banks also give importance to solvency. A bank should select its assets in such a way that the shareholders and depositors' interest is protected.

16.4.1 Definition of Capital Adequacy Ratio

Capital Adequacy Ratio (CAR) is defined as the ratio of bank's capital to its risk assets. Capital Adequacy Ratio (CAR) is also known as Capital to Risk (Weighted) Assets Ratio (CRAR). Basel Committee appointed by BIS, formulated rules and regulations for effective supervision of the central banks. For this, it also prescribed international norms to be followed by the central banks. This committee prescribed Capital Adequacy Norms in order to protect the interests of the customers. Narasimham Committee recommended that all banks are required to have a minimum capital of 8% to the risk weighted assets. The ratio is known as Capital to Risk Assets Ratio (CRAR). All 27 Public Sector Banks in India (except UCO and Indian Bank) have achieved the Capital Adequacy Norm of 8% by March 1997.

The Second Report of Narasimham Committee was submitted in 1998-99 and it recommended for raising the CRAR to 10 per cent in a phased manner. It also recommended an intermediate minimum target of 9 per cent to be achieved by 2000 and 10 per cent by 2002.

The concept of capital adequacy ratio relates to risk weights assigned to an asset raised by the banks in the process of conducting business and to the proportion of capital to be maintained on such aggregate risk weighted assets. Capital adequacy ratio is calculated on the basis of risk weightages on assets in the books of banks. Each business transaction carries a specific risk and a portion of capital has to be earmarked for this risk. Capital adequacy enables banks to expand their balance sheet and strengthen their fundamentals, which in turn, help the banks to mobilize capital at reasonable cost. The RBI stipulates a capital adequacy ratio of 9 per cent for all banks and a capital adequacy ratio below this stipulation indicates the inadequacy of a bank's capital, compared to its assets (largely loans advanced and investments) weighted against the risk they carry.

Capital Adequacy Norms included in different concepts are explained as follows;

1. Tier-I Capital

Capital which is first readily available to protect the unexpected losses is called as Tier-I Capital. It is also termed as Core Capital. Tier-I Capital consists of Paid-Up Capital, Statutory Reserves, Other Disclosed Free Reserves (Reserves which are not kept side for meeting any specific liability) and Capital Reserves (Surplus generated from sale of Capital Assets)

2. Tier-II Capital

Capital which is second readily available to protect the unexpected losses is called as Tier-II Capital. Tier-II Capital Consists of Undisclosed Reserves and Paid-Up Capital, Perpetual Preference Shares, Revaluation Reserves (at discount of 55%), Hybrid (Debt / Equity) Capital, Subordinated Debt, General Provisions and Loss Reserves. There is an important condition that Tier II Capital cannot exceed 50 per cent of Tier-I Capital for arriving at the prescribed Capital Adequacy Ratio.

16.4.2 Risk Weighted Assets

Capital Adequacy Ratio is calculated based on the assets of the bank. The values of bank's assets are not taken according to the book value but they are taken according to the risk factor involved. The value of each asset is assigned with a risk factor in percentage terms. Suppose CRAR at 10 per cent on Rs.150 crores is to be maintained. This means the bank is expected to have a minimum capital of Rs. 15 crores which consists of Tier I and Tier II Capital items subject to a condition that Tier II capital should not exceed 50 per cent of Tier I Capital. Suppose the total value of items under Tier I Capital is Rs.5 crore and total value of items under Tier II capital is Rs.10 crore, the bank will not have requisite CRAR of Rs.15 crore. This is because a maximum of only Rs.2.5 crore under Tier II will be eligible for computation.

16.4.3 Subordinated Debt

These are bonds issued by the banks for raising Tier II Capital.

They are as follows:

1. They should be fully paid up instruments.
2. They should be unsecured debt.
3. They should be subordinated to the claims of other creditors. This means that the bank's holder's claims for their money will be paid at last in order of preference as compared with the claims of other creditors of the bank.
4. The bonds should not be redeemable at the option of the holders. This means the repayment of bond value will be decided only by the issuing bank.

Formula:

$$\textbf{Capital Adequacy Ratio} = \frac{\textbf{Tier 1 Capital + Tier 2 Capital}}{\textbf{Risk-weighted Exposures}}$$

Tier 1 Capital = Common Equity Tier 1 + Additional Tier 1

Total Capital = Tier 1 Capital + Tier 2 Capital

Risk-weighted exposures include weighted sum of the bank's credit exposures (including those appearing on the bank's balance sheet and those not appearing). The weights are determined in accordance with the Basel Committee guidance for assets of each credit rating slab.

Example:

Calculate capital adequacy ratio i.e. total capital to risk weighted exposures ratio for Small Bank Inc. using the following information:

	Exposure	Risk Weight
Government Treasury held as asset	15,00,000	0%
Loans to Corporate	1,50,00,000	10%
Loans to Small Businesses	80,00,000	20%
Guarantees and other non-balance sheet exposures	60,00,000	10%

The bank's Tier 1 Capital and Tier 2 Capital are Rs 200000 and Rs 300000 respectively.

Solution:

Bank's total capital = 200000 + 300000 = Rs500000

Risk-weighted exposures = 1.500000×0% + 15000000×10% + 8000000×20% + 6000000×10% = 3700000

$$\text{Capital Adequacy Ratio} = \frac{500000}{3700000} = 13.51\%$$

If the national regulator requires a capital adequacy ratio of 9 per cent, the bank is safe.

Income Recognition:

(i) Banks may recognize income on accrual basis in respect of the projects under implementation, which are classified as 'standard'.

(ii) Banks should not recognize income on accrual basis in respect of the projects under implementation which are classified as a 'substandard' asset. Banks may recognize income in such accounts only on realization on cash basis.

(iii) Banks which have wrongly recognized income in the past should reverse the interest if it was recognized as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s). As regards the regulatory treatment of 'funded interest' recognized as income and 'conversion into equity, debentures or any other instrument' banks should adopt the following:

a) Funded Interest: Income recognition in respect of the NPAs, regardless of whether these are or are not subjected to restructuring/rescheduling/renegotiation of terms of the loan agreement, should be done strictly on cash basis, only on realization and not if the amount of interest overdue has been funded. If, however, the amount of funded interest is recognized as income, a provision for an equal amount should also be made simultaneously. In other words, any funding of interest in respect of NPAs, if recognized as income, should be fully provided for.

b) Conversion into equity, debentures or any other instrument: The amount outstanding converted into other instruments would normally comprise principal and the interest components. If the amount of interest dues is converted into equity or any other instrument, and income is recognized in consequence, full provision should be made for the amount of income so recognized to offset the effect of such income recognition. Such provision would be in addition to the amount of provision that may be necessary for the depreciation in the value of the equity or other instruments, as per the investment valuation norms. However, if the conversion of interest is into equity which is quoted, interest income can be recognized at market value of equity, as on the date of conversion, not exceeding the amount of interest converted to equity. Such equity must thereafter be classified in the "available for sale" category and valued at lower of cost or market value. In case of conversion of principal and /or interest in respect of NPAs into debentures, such debentures should be treated as NPA, in the same asset classification as was applicable to loan just before conversion and provision made as per norms. This norm would also apply to zero coupon bonds or other instruments which seek to defer the liability of the issuer. On such debentures, income should be recognized only on realization basis. The income in respect of unrealized interest which is converted into debentures or any other fixed maturity instrument should be recognized only on redemption of such instrument. Subject to the above, the equity shares or other instruments arising from conversion of the principal amount of loan would also be subject to the usual prudential valuation norms as applicable to such instruments

Provisioning Norms:

General

The bank managements and the statutory auditors are responsible for making adequate provisions for any diminution in the value of loan assets, investment or other assets.

The bank management and the statutory auditors before taking decision in regard to making adequate and necessary provisions in terms of prudential guidelines use the assessment made by the inspecting officer of the RBI.

Provisioning for Loss Assets:

Loss assets should be written off.

If loss assets are permitted to remain in the books for any reason, 100 per cent of the outstanding should be provided for.

Provisioning for Doubtful Assets:

1. 100 per cent of the extent to which the advance is not covered by the realizable value of the security to which the bank has a valid recourse and the realizable value is estimated on a realistic basis.
2. With regard to secured portion, provision may be made on the following basis, at the rates ranging from 25 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful.

Period for which the advance has remained in 'doubtful' category	Provision requirement (%)
Up to one year	25
One to three years	40
More than three years	100

Note: Valuation of Security for provisioning purposes. With a view to bringing down divergence arising out of difference in assessment of the value of security, in cases of NPAs with balance of Rs. 5 crore and above stock audit at annual intervals by external agencies appointed as per the guidelines approved by the Board would be mandatory in order to enhance the reliability on stock valuation. Collaterals such as immovable properties charged in favor of the bank should be got valued once in three years by values appointed as per the guidelines approved by the Board of Directors.

16.5 PROVISION FOR SUBSTANDARD ASSETS

A general provision of 10 per cent on total outstanding should be made.

The 'unsecured exposure' which are identified as 'substandard' would attract additional provision of 10 per cent.

The provisioning requirement for unsecured 'doubtful' assets is 100 per cent.

Provision for Standard Assets:

Banks are required to make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:

1. Direct advances to agricultural and SME sectors at 0.25%
2. Advances to Commercial Real Estate(CRE) sectors at 1.00%
3. All other loans and advances not included in a) and b) above at 0.40%

Prudential Norms on Creation and Utilization of Floating Provisions:

Principle for creation of floating provisions by banks

The bank's board of directors should lay down approved policy regarding the level to which the floating provisions can be created. The bank should hold floating provisions for 'advances' and 'investments' separately and the guidelines prescribed will be applicable to floating provisions held for both 'advances' & 'investment.

Principle for utilization of floating provisions by banks

The floating provisions should not be used for making specific provisions as per the extant prudential guidelines in respect of non- performing assets or for making regulatory provisions for standard assets. The floating provisions can be used only for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining board's approval and with prior permission of RBI. The boards of the banks should lay down an approved policy as to what circumstances would be considered extraordinary.

To facilitate banks' boards to evolve suitable policies in this regard, it is clarified that the extra-ordinary circumstances refer to losses which do not arise in the normal course of business and are exceptional and non-recurring in nature. These extra-ordinary circumstances could broadly fall under three categories viz. General, Market and Credit. Under general category, there can be situations where bank is put unexpectedly to loss due to events such as civil unrest or collapse of currency in a country. Natural calamities and pandemics may also be included in the general category. Market category would include events such as a general melt down in the markets, which affects the entire financial system. Among the credit category, only exceptional credit losses would be considered as an extra-ordinary circumstance.

Accounting:

Floating provisions cannot be reversed by credit to the profit and loss account. They can only be utilized for making specific provisions in extraordinary circumstances as mentioned above. Until such utilization, these provisions can be netted off from gross NPAs to arrive at disclosure of net NPAs. Alternatively, they can be treated as part of Tier II capital within the overall ceiling of 1.25 % of total risk weighted assets

Disclosures :

Banks should make comprehensive disclosures on floating provisions in the "notes on accounts" to the balance sheet on (a) opening balance in the floating provisions account, (b) the quantum of floating provisions made in the accounting year, (c) purpose and amount of draw down made during the accounting year, and (d) closing balance in the floating provisions account.

Additional Provisions for NPAs higher than prescribed rates:

A bank may voluntarily make specific provisions for advances at rates which are higher than the prescribed under existing regulations, to provide for estimated actual loss in collectible amount. Such higher rates are approved by the Board of Directors and consistently adopted from year to year.

Provision on Leased Assets:

Substandard Assets:

10 percent of the sum of the net investment in the lease and the realized portion of finance income net finance charge component.

Unsecured lease exposure, which are identified as 'substandard' would attract additional provision of 10%, i.e., a total of 20%.

Doubtful Assets:

100 percent of the extent to which, the finance is not secured by the realizable value of the leased asset.

Loss Assets:

The entire asset is required to be written off.

16.6 GUIDELINES FOR PROVISION UNDER SPECIAL CIRCUMSTANCES

Advances granted under rehabilitation packages approved by BIFR/term lending institutions

For advances under rehabilitation package approved by BIFR/Term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as substandard or doubtful asset. As regards the additional facilities sanctioned as per package finalized by BIFR/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement.

16.6.1 Disinvestment

At the very basic level, disinvestment can be explained as follows:

"Investment refers to the conversion of money or cash into securities, debentures, bonds or any other claims on money. As follows, disinvestment involves the conversion of money claims or securities into money or cash."

Disinvestment can also be defined as the action of an organization (or government) selling or liquidating an asset or subsidiary. It is also referred to as 'divestment' or 'divestiture.'

In most contexts, disinvestment typically refers to sale from the government, partly or fully, of a government-owned enterprise.

A company or a government organization will typically disinvest an asset either as a strategic move for the company, or for raising resources to meet general/specific needs.

16.6.2 Objectives of Disinvestment

The new economic policy initiated in July 1991 clearly indicated that PSUs had shown a very negative rate of return on capital employed. Inefficient PSUs had become and were continuing to be a drag on the Government's resources turning to be more of liabilities to the Government than being assets. Many undertakings traditionally established as pillars of growth had become a burden on the economy. The national gross domestic product and gross national savings were also getting adversely affected by low returns from PSUs. About 10 to 15 % of the total gross domestic savings were getting reduced on account of low savings from PSUs. In relation to the capital employed, the levels of profits were too low. Of the various factors responsible for low profits in the PSUs, the following were identified as particularly important:

- Price policy of public sector undertakings
- Under–utilization of capacity
- Problems related to planning and construction of projects
- Problems of labour, personnel and management
- Lack of autonomy

Hence, the need for the Government to get rid of these units and to concentrate on core activities was identified. The Government also took a view that it should move out of non-core businesses, especially the ones where the private sector had now entered in a significant way. Finally, disinvestment was also seen by the Government to raise funds for meeting general/specific needs.

In this direction, the Government adopted the 'Disinvestment Policy'. This was identified as an active tool to reduce the burden of financing the PSUs. The following main objectives of disinvestment were outlined:

- To reduce the financial burden on the Government
- To improve public finances
- To introduce, competition and market discipline
- To fund growth
- To encourage wider share of ownership
- To depoliticize non-essential services

16.6.3 Importance of Disinvestment

Presently, the Government has about Rs. 2 lakh crore locked up in PSUs. Disinvestment of the Government stake is, thus, far too significant. The importance of disinvestment lies in utilization of funds for:

- Financing the increasing fiscal deficit
- Financing large-scale infrastructure development
- For investing in the economy to encourage spending
- For retiring Government debt- Almost 40-45% of the Centre's revenue receipts go towards repaying public debt/interest.

- For social programs like health and education

Disinvestment also assumes significance due to the prevalence of an increasingly competitive environment, which makes it difficult for many PSUs to operate profitably. This leads to a rapid erosion of value of the public assets making it critical to disinvest early to realize a high value. The operational functioning and managerial decision-making should be minimal.

16.7 CASE STUDY

The banking sector reforms in India were started as a follow up measures of the economic liberalization and financial sector reforms in the country. The banking sector being the life line of the economy was treated with utmost importance in the financial sector reforms. The reforms were aimed at to make the Indian banking industry more competitive, versatile, efficient, productive, to follow international accounting standard and to free from the government's control. The reforms in the banking industry started in the early 1990s have been continued till now. The paper makes an effort to first gather the major reforms measures and policies regarding the banking industry by the govt. of India and the Central Bank of India (i.,e. Reserve Bank of India) during the last fifteen years. Secondly, the paper will try to study the major impacts of those reforms upon the banking industry. A positive responds is seen in the field of enhancing the role of market forces, regarding prudential regulations norms, introduction of CAMELS supervisory rating system, reduction of NPAs and regarding the up gradation of technology. But at the same time the reform has failed to bring up a banking system which is at par with the international level and still the Indian banking sector is mainly controlled by the govt. as public sector banks being the leader in all the spheres of the banking network in the country.

Questions;

1. Discuss the various reforms under taken in Indian banking sector.
2. Explain pros and cons of implementing CAMEL model.
3. What are the causes and remedies for NPA in Indian banks.

16.8 NOTES

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16.9 SUMMARY

The Government of India nationalized 14 commercial banks in 1969 and 6 more Commercial banks in 1980.

The Narasimham Committee I was set up in order to study the problems of the Indian financial system and to suggest some recommendations for improvement in the efficiency and productivity of the financial institutions.

The Narasimham Committee II was asked to review the progress of banking reforms and design a programme for further strengthening the financial system of India.

A non-performing asset (NPA) is a loan or advance for which the principal or interest payment remained overdue for a period of 90 days.

Causes of NPA: recession in the economy, infrastructural problem, delay in release of sanctioned limits by banks, delays in settlement of payments by government, natural calamities, etc.

Banks are required to classify non-performing assets into the following three categories based on the period for which the asset remained non- performing and the reliability of the dues:

1. Substandard Assets
2. Doubtful Assets
3. Loss Assets

Measures to Solve Problems of NPA are; Debt Recovery Tribunals (DRTs), Securitization Act, 2002, Lok Adalats, Compromise Settlement, Credit Information Bureau.

Capital Adequacy Ratio (CAR) is defined as the ratio of bank's capital to its risk assets.

Tier-I Capital consists of Paid-Up Capital, Statutory Reserves, Other Disclosed Free Reserves (Reserves which are not kept side for meeting any specific liability) and Capital Reserves (Surplus generated from sale of Capital Assets)

Tier-II Capital Consists of Undisclosed Reserves and Paid-Up Capital, Perpetual Preference Shares, Revaluation Reserves (at discount of 55%), Hybrid (Debt / Equity) Capital, Subordinated Debt, General Provisions and Loss Reserves.

Disinvestment can also be defined as the action of an organization (or government) selling or liquidating an asset or subsidiary.

The following main objectives of disinvestment were outlined:

- To reduce the financial burden on the Government
- To improve public finances
- To introduce, competition and market discipline
- To fund growth
- To encourage wider share of ownership
- To depoliticize non-essential services

16.10 SELF ASSESSMENT QUESTIONS

1. Briefly explain M.Narasimham Committee Reports on Banking Sector Reform.
2. WHAT do you mean by NPA? What are it causes?
3. Explain the guidelines of assets classification in banks.
4. Discuss the measures to minimise NPA.
5. Explain the provisioning norms for NPA.
6. What is disinvestment? What are its objectives? Explain.

16.11 KEY WORDS

Narasimham Committee

Non-performing assets

Capital adequacy

Disinvestment

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DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

M.B.A III Semester

COURSE - 16 A

FINANCIAL MARKETS AND INSTISTUTIONS

BLOCK
5
MARCHANT BANKING

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BLOCK -4 : FINANCIAL AND BANKING INSTITUTIONS

The increase in the numbers of issues and amount raised the number of merchant bankers. Therefore, the field become highly competitive market, where it require a specialized skill in handling the situation. The merchant bankers have a social responsibility to in building an industrial structure in India.

The last block of this course discuss merchant banking consist of 04 units (17-20). Unit 17 explains an overview of merchant banking, meaning, definitions, origin, nature, scope, structure. Functions of merchant banking, industry and bankers, difference between merchant banks and investment banks and qualities. Unit18 elucidates merchant banking and marketing of new issues introduction , new issues, pure prospectus method, offer for sale method, private placement, initial public offer, right issue, bonus issues, book building, brought out deals method. Unit 19 tells credit card introduction, meaning, types, operational cycle, parties in, global players, and emerging trend in payment system. Last unit of this block explains merchant banking in India meaning , post independence, under SEBI regulations in India.

BLOCK - 5
MARCHANT BANKING

UNIT - 17 : AN OVERVIEW OF MERCHANT BANKING

Structure:

17.0 OBJECTIVES

After studying this unit, you should be able to;

- concept of Merchant Banking
- Describe the scope of merchant banker and structure of merchant banking industry
- Explain the functions and qualities of merchant banker
- Differentiate between merchant banks and investment banks

17.1 INTRODUCTION

In this hyper competitive financial environment, merchant banking emerged as an indispensable service that transfers the funds from surplus spending units to deficit spending units through its various activities. The first merchant bank was set up in 1969 by Grind lays Bank. Initially they were issue mangers looking after the issue of shares and raising capital for the company. But subsequently they expanded their activities such as working capital management; syndication of project finance, global loans, mergers, capital restructuring, etc., initially the merchant banker in India was in the form of management of public issue and providing financial consultancy for foreign banks. In 1973, SBI started the merchant banking and it was followed by ICICI. SBI capital market was set up in August 1986 as a fully fledged merchant banker. Between 1974 and 1985, the merchant banker has promoted lot of companies. However they were brought under the control of SEBI in 1992.

17.2 MEANING AND DEFINITIONS

Securities and Exchange Board of India (Merchant Bankers) Rules, 1992 -A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management.

Random House Dictionary -Merchant banker is an organization that underwrites securities for corporations, advices such clients on mergers and is involved in the ownership of commercial ventures. These organizations are sometime banks which are not merchants and sometimes merchants who are not banks and sometimes houses which are neither merchants nor banks.

Charles P. Kindleberger -Merchant banking is the development of banking from commerce which frequently encountered a prolonged intermediate stage known in England originally as merchant banking. **The Notification of the Ministry of finance** defines A merchant banker as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management.

17.3 ORIGIN, NATURE AND SCOPE OF MERCHANT BANKING

The origin of merchant banking is traceable to the developments of foreign trade and finance during the 13th century. During this period, a few firms engaged in coastal trade and finance spread throughout the European continent were engaged both in commercial activities and banking activities. These firms also acted as the bankers to the Kings of the European States, financial coastal trade among European nations, bore exchange risk and security risk in financing the Kings, Monarchs and Governments engaged in continental wars. The main centre for world trade and finance at that time was Amsterdam, where the Dutch traders relied upon the expertise of merchant bankers (then known as commission agents) for financing of trade. During the seventeenth and eighteenth century, the Italian grain merchants also started merchant banking activities in Italy and France. It comprised of merchant bankers who intermediated in financing the transactions of the traders and their own trade also. The Italian merchant bankers introduced into England not only the bill of exchange, but also all the institutions and techniques connected with the organized money market. Thus, the modern merchant banking started from London where the merchants started to finance the foreign trade through acceptance of bill of exchange. The industrial revolution in England gave further boost to the merchant banking due to the growth of the home industry.

In India, prior to the enactment of Indian Companies Act, 1956, managing agents acted as issue houses for securities, evaluated project reports, planned capital structure and to some extent provided venture capital for new firms. Few share broking firms also functioned as merchant bankers.

The need for specialized merchant banking service was felt in India with the rapid growth in the number and size of the issues made in the primary market. The merchant banking services were started by foreign banks, namely the National Grindlays bank in 1967 and the City Bank in 1970. The banking commission in its report in 1972 recommended the setting up of merchant banking institutions by commercial banks and financial institutions. This marked the beginning of specialized merchant banking in India.

To begin with, merchant banking services were offered along with other traditional banking services. In the mid-eighties, the Banking Regulations Act was amended permitting commercial banks to offer a wide range of financial services through the subsidiary rule. The state bank of India was the first Indian Bank to set up Merchant Banking division in 1972. Later ICICI set up its merchant banking division followed by Bank of India, Bank of Baroda, Canara Bank, UCO bank.

17.4 STRUCTURE OF MERCHANT BANKING INDUSTRY

Initially Merchant Bankers were classified into 4 categories with regard to their nature and range of activities and their responsibilities to SEBI, investors and issuers of securities. Since September 1997 only a single category exists. The requirements are as under: There are four different categories of merchant bankers. Only category 1 merchant bankers are allowed to act as lead managers to the issue: Category 1: Those merchant bankers who can conduct all above mentioned activities, relating to management of issues. They may, if they so choose, act only in an advisory capacity or as co-manager, underwriter or as portfolio manager. Category 2: Those merchant bankers who can act as consultant, advisor, portfolio manager and co-manager. Category 3: Those merchant bankers who can act as underwriter, advisor and consultant. Category 4: Those merchant bankers who can act only as advisor or consultant to an issue. Different types of organizations in India which provide merchant baking services: i. Commercial Banks ii. All India Financial Institutions iii. Private Consultancy Firms iv. Technical Consultancy Organizations.

17.5 FUNCTIONS OF MERCHANT BANKER

Merchant bankers carry out a variety of functions and offer diverse range of services. Some of the most important functions carried out by merchant bankers in India are :-

a) Corporate counseling

b) Project Counseling

c) Capital Structuring

d) Portfolio Management

e) Issue Management

f) Credit Syndication

g) Working capital

h) Venture Capital

i) Fixed Deposits

j) Other functions

(i) Corporate counseling: Corporate counseling covers counseling in the form of project counseling, capital restructuring, project management, public issue management, loan syndication, working capital fixed deposit, lease financing, acceptance credit etc., The scope of corporate counseling is limited to giving suggestions and opinions to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

(ii) Project counseling Project counseling is a part of corporate counseling and relates to project finance. It broadly covers the study of the project, offering advisory assistance on the viability and procedural steps for its implementation.

a. Identification of potential investment avenues.

b. A general view of the project ideas or project profiles.

c. Advising on procedural aspects of project implementation

d. Reviewing the technical feasibility of the project

e. Assisting in the selection of TCO s (Technical Consultancy Organizations) for preparing project reports

f. Assisting in the preparation of project report

g. Assisting in obtaining approvals, licenses, grants, foreign collaboration etc., from government

h. Capital structuring

i. Arranging and negotiating foreign collaborations, amalgamations, mergers and takeovers.

j. Assisting clients in preparing applications for financial assistance to various national and state level institutions banks etc.,

k. Providing assistance to entrepreneurs coming to India in seeking approvals from the Government of India.

(iii) Capital Structure Here the Capital Structure is worked out i.e., the capital required, raising of the capital, debt-equity ratio, issue of shares and debentures, working capital, fixed capital requirements, etc.,

(iv) Portfolio Management It refers to the effective management of Securities i.e., the merchant banker helps the investor in matters pertaining to investment decisions. Taxation and inflation are taken into account while advising on investment in different securities. The merchant banker also undertakes the function of buying and selling of securities on behalf of their client companies. Investments are done in such a way that it ensures maximum returns and minimum risks.

(v) Issue Management: Management of issues refers to effective marketing of corporate securities viz., equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it. The issue function may be broadly divided in to pre issue and post issue management.

a. Issue through prospectus, offer for sale and private placement.

b. Marketing and underwriting

c. pricing of issues

(vi) Credit Syndication: Credit Syndication refers to obtaining of loans from single development finance institution or a syndicate or consortium. Merchant Banks help corporate clients to raise syndicated loans from commercials banks. Merchant banks helps in identifying which financial institution should be approached for term loans. The merchant bankers follow certain steps before assisting the clients approach the appropriate financial institutions.

a. Merchant banker first makes an appraisal of the project to satisfy that it is viable

b. He ensures that the project adheres to the guidelines for financing industrial projects.

c. It helps in designing capital structure, determining the promoters contribution and arriving at a figure of approximate amount of term loan to be raised.

d. After verifications of the project, the Merchant Banker arranges for a preliminary meeting with financial institution.

e. If the financial institution agrees to consider the proposal, the application is filled and submitted along with other documents.

(vii) Working Capital: The Companies are given Working Capital finance, depending upon their earning capacities in relation to the interest rate prevailing in the market.

(viii)Venture Capital: Venture Capital is a kind of capital requirement which carries more risks and hence only few institutions come forward to finance. The merchant banker looks in to the technical competency of the entrepreneur for venture capital finance.

(ix). Fixed Deposit: Merchant bankers assist the companies to raise finance by way of fixed deposits from the public. However such companies should fulfill credit rating requirements.

(x) Other Functions

- **Treasury Management-** Management of short term fund requirements by client companies.
- **Stock broking-** helping the investors through a network of service units
- **Servicing of issues-** servicing the shareholders and debenture holders in distributing dividends, debenture interest.
- **Small Scale industry counseling-** counseling SSI units on marketing and finance
- **Equity research and investment counseling** – merchant banker plays an important role in providing equity research and investment counseling because the investor is not in a position to take appropriate investment decision.
- **Assistance to NRI investors -** the NRI investors are brought to the notice of the various investment opportunities in the country.
- **Foreign Collaboration**: Foreign collaboration arrangements are made by the Merchant bankers.

17.6 DIFFERENCE BETWEEN MERCHANT BANKS AND INVESTMENT BANKS

Merchant banks and investment banks, in their purest forms, are different kinds of financial institutions that perform different services. In practice, the fine lines that separate the functions of merchant banks and investment banks tend to blur. Traditional merchant banks often expand into the field of securities underwriting, while many investment banks participate in trade financing activities. In theory, investment banks and merchant banks perform different functions.

Pure investment banks raise funds for businesses and some governments by registering and issuing debt or equity and selling it on a market. Traditionally, investment banks only participated in underwriting and selling securities in large blocks. Investment banks facilitate mergers and acquisitions through share sales and provide research and financial consulting to companies. Traditionally, investment banks did not deal with the general public.

Traditional merchant banks primarily perform international financing activities such as foreign corporate investing, foreign real estate investment, trade finance and international transaction facilitation. Some of the activities that a pure merchant bank is involved in may include issuing letters of credit, transferring funds internationally, trade consulting and co-investment in projects involving trade of one form or another.

The current offerings of investment banks and merchant banks varies by the institution offering the services, but there are a few characteristics that most companies that offer both investment and merchant banking share.

As a general rule, investment banks focus on initial public offerings (IPOs) and large public and private share offerings. Merchant banks tend to operate on small-scale companies and offer creative equity financing, bridge financing, mezzanine financing and a number of corporate credit products. While investment banks tend to focus on larger companies, merchant banks offer their services to companies that are too big for venture capital firms to serve properly, but are still too small to make a compelling public share offering on a large exchange. In order to bridge the gap between venture capital and a public offering, larger merchant banks tend to privately place equity with other financial institutions, often taking on large portions of ownership in companies that are believed to have strong growth potential.

Merchant banks still offer trade financing products to their clients. Investment banks rarely offer trade financing because most investment banking clients have already outgrown the need for trade financing and the various credit products linked to it.

17.7 QUALITIES OF A MERCHANT BANKER

Merchant Bankers are individual's experts who organize and manage the merchant banks. The operations of merchant banks are influenced by the personality, traits and nature of merchant bankers. Some of the important qualities that a merchant banker should possess are highlighted below

a. Proactive and Leading

b. Aggressive

c. Cooperation and Friendly

d. Networking and Liasioning skills

e. Problem Solving skills

f. Inquisitiveness for acquiring new knowledge

17.8 NOTES

17.9 SUMMARY

Merchant Banking services are gaining a lot of momentum in this century with wide variety of services being offered such as Corporate counseling, Project Counseling, Capital Structuring, Portfolio Management, Issue Management, Credit Syndication, Working capital, Venture Capital, Fixed Deposits and Other functions namely treasury management, stock broking, foreign collaboration, assistance to NRI investors etc. The role of merchant bankers has become an integral part of our day to day activities in business.

17.10 KEY WORDS

Corporate Counseling

Portfolio Management

Credit Syndication

NRI

Venture Capital

Lease Finance

Issue Management

17.11 SELF ASSESSMENT QUESTIONS

1. Define Merchant Banking
2. Discuss briefly the origin and growth of merchant banking
3. Write an explanatory note on structure of merchant banking
4. Critically evaluate the services rendered by merchant bankers

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UNIT- 18 : MERCHANT BANKING AND MARKETING OF NEW ISSUES

Structure:

18.0 OBJECTIVES

After studying this unit, you should be able to;

- Steps involved in marketing of issue of securities
- Explain different methods available for marketing the securities in the new Issues Market State the pros and cons of each of the methods

18.1 INTRODUCTION

Issue management by merchant bankers mainly focuses on three basic functions viz, origination, underwriting and distribution of securities. Distribution services of lead managers include the activities and cost incurred in selling and delivering the securities to the investors. Along with performing the function as a bridge between the issuing company and the investors, merchant bankers also have to generate interest and build the confidence of the investors in the capital market. So distribution is a function of sale of securities to the ultimate investors. This service, managed by lead manager, is performed by brokers and dealers in securities who maintain regular direct contact with the ultimate investors. Merchant bankers make efforts for the promotion and marketing of the issue. They plan, co-ordinate and control the entire activities relating to public issues and direct different agencies to contribute to the successful marketing of securities. In India, lead managers do not own an issue before its distribution to general public. They simply underwrite and arrange the distribution through the underwriters. Advancement of technology in communication and data processing has posed a new challenge for the merchant bankers in the area of marketing of public issues. Today, merchant bankers need top care about being in the centre of 'information flow' rather than in the centre of 'capital flow'.

18.2 MARKETING OF NEW ISSUES

Following are the steps involved in the marketing of the issue of securities to be undertaken by the lead manager:

1. Target market: The first step towards the successful marketing of securities is the identification of a target market segment where the securities can be offered for sale. This ensures smooth marketing of the issue. Further, it is possible to identify whether the market comprises of retail investors, wholesale investors or institutional investors.
2. Target concentration: After having chosen the target market for selling the securities, steps are to be taken to assess the maximum number of subscriptions that can be expected

from the market. It would work to the advantage of the company if it concentrates on the regions where it is popular among prospective investors.

3. Pricing: After assessing market expectations, the kind and level of price to be charged for the security must be decided. Pricing of the issue also influences the design of capital structure. The offer has to be made more attractive by including some unique features such as safety net, multiple options for conversion, attaching warrants, etc.

4. Mobilizing intermediaries: For successful marketing of public issues, it is important that efforts are made to enter into contracts with financial intermediaries such as an underwriter, broker/sub-broker, fund arranger, etc.

5. Information contents: Every effort should be mad3e to ensure that the offer document for issue is educative and contains maximum relevant information. Institutional investors and high net worth investors should also be provided with detailed research on the project, specifying its uniqueness and its advantage over other existing or upcoming projects in a similar field.

6. Launching advertisement campaign: In order to push the public issue, the lead manager should undertake a high voltage advertisement campaign. The advertising agency must be carefully selected for this purpose. The task of advertising the issue shall be entrusted to those agencies that specialize in launching capital offerings. The theme of the advertisement should be finalized keeping in view SEBI guidelines. An ideal mix of different advertisement vehicles such as the press, the radio and the television, the hoarding, etc. should be used. Press meets, brokers and investor s conference, etc. shall be arranged by the lead manager at targeted in carrying out opinion polls. These services would useful in collecting data on investors opinion and reactions relating to the public issue of the company, such a task would help develop an appropriate marketing strategy. This is because; there are vast numbers of potential investors in semi-urban and rural areas. This calls for sustained efforts on the part of the company to educate them about the various avenues available for investment.

7. Brokers and investors conferences: As part of the issue campaign, the lead manager should arrange for brokers‘ and investors‘ conferences in the metropolitan cities and other important centre which have sufficient investor population. In order to make such endeavors more successful, advance planning is required. It is important that conference materials such as banners, brochures, application forms, posters, etc. reach the conference venue in time. In addition, invitation to all the important people, underwriters, bankers at the respective places, investors‘ associations should also be sent.

8. A critical factor that could make or break the proposed pu8blic issue is its timing. The market conditions should be favorable. Otherwise, even issues from a company with an excellent track record, and whose shares are highly priced, might flop. Similarly, the number and frequency of issues should also be kept to a minimum to ensure success of the public issue.

Methods used for marketing of new issues

Following are the various methods being adopted by corporate entities for marketing the securities in the new Issues Market:

1. Pure Prospectus Method
2. Offer for Sale Method
3. Private Placement Method
4. Initial Public Offers Method
5. Rights Issue Method
6. Bonus Issue
7. Book-building Method
8. Stock Option Method and
9. Bought-out Deals Method

18.3 PURE PROSPECTUS METHOD

The method whereby a corporate enterprise mops up capital funds from the general public by means of an issue of a prospectus, is called Pure Prospectus Method. It is the most popular method of making public issue of securities by corporate enterprises.

The features of this method are

a. **Exclusive subscription**: Under this method, the new issues of a company are offered for exclusive subscription of the general public. According to the SEBI norms, a minimum of 49 percent of the total issue at a time is to be offered to public.

b. **Issue price:** Direct offer is made by the issuing company to the general public to subscribe to the securities at a staged price. The securities may be issued either at par, of at a discount or at a premium.

c. **Underwriting:** Public issue through the pure prospectus method's usually underwritten. This is to safeguard the interest of the issuer in the event of an unsatisfactory response from the public.

d. **Prospectus:** A document that information relating to the various aspects of the Issuing company, besides other details of the issue is called a Prospectus. The document is circulated to the public. The general details include the company's name and address of the registered office, the names and addresses of the company's promoters, manager, managing director, directors, company secretary, legal adviser, auditors, bankers, brokers, etc. the date of opening and closing of subscription list, contents of Articles, the names and addresses of underwriters, the amount underwritten and the underwriting commission, material details regarding the project, i.e. Location, plant and machinery, technology, collaboration, performance guarantee, infrastructure facilities etc. nature of products, marketing set-up, export potentials and obligations, past performance and future prospects, managements perception regarding risk factor, credit rating obtained from any other recognized rating agency, a statement regarding the fact that the company will make an application to specified stock exchange(s) for listing its securities and so on.

Advantages

a. **Benefits to Investors:** The pure prospectus method of marketing the securities serves as an excellent mode of disclosure of all the information pertaining to the issue. Besides, it also facilitates satisfactory compliance with the legal requirements of transparency etc. It also allows for good publicity for the issue. The method promotes confidence of investors through transparency and non-discriminatory basis of allotment. It prevents artificial packing up of prices as the issue is made public.

b. **Benefits to Issuers:** The pure prospectus method is the most popular method among the large issuers. In addition, it provides for wide diffusion of ownership of securities contributing to reduction in the concentration of economic and social power.

Draw Backs

a. **High Issue Costs:** A major drawback of this method is that it is an expensive mode of raising funds from the capital market. Costs of various hues are incurred in mobilizing capital. Such costs as underwriting expenses, brokerage, administrative costs, publicity costs, legal costs and other costs are incurred for raising funds. Due to the high cost structure, this type of marketing of securities is followed only for large issues.

b. **Time consuming:** The issue of securities through prospectus takes more time, as it requires the due compliance with various formalities before an issue could take place. For instance, a lot of work such as underwriting, etc. should be formalized before the printing and the issue of a prospectus.

18.4 OFFER FOR SALE METHOD

Where the marketing of securities takes place through intermediaries, such as issue houses, stockbrokers and others, it is a case of Offer for Sale Method. Under this method, the sale of securities takes place in two stages. Accordingly, in the first stage, the issuer company makes an end-block sale of securities to intermediaries such as the issue houses and share brokers at an agreed price. Under the second stage, the securities are re-sold to ultimate investors at a market-related price. The difference between the purchase price and the issue price constitutes profit for the intermediaries. The intermediaries are responsible for meeting various expenses such as underwriting commission, prospectus cost, advertisement expenses, etc. The issue is also underwritten to ensure total subscription of the issue. The biggest advantage of this method is that it saves the issuing company the hassles involved in selling the shares to the public directly through prospectus. This method is, however, expensive for the investor as it involves the offer of securities by issue houses at very high prices.

18.5 PRIVATE PLACEMENT METHOD

A method of marketing of securities whereby the issuer makes the offer of sale to individuals and institutions privately without the issue of a prospectus is known as Private Placement Method. This is the most popular method gaining momentum in recent times among the corporate enterprises. Under this method, securities are offered directly to large buyers with the help of shares brokers. This method works in a manner similar to the Offer for Sale Method whereby securities are first sold to intermediaries such as issues houses, etc. They are in turn placed at higher prices to individuals and institutions. Institutional investors play a significant role in the realm of private placing. The expenses relating to placement are borne by such investors.

Advantages

1. Less expensive as various types of costs associated with the issue are borne by the issue houses and other intermediaries.
2. Less troublesome for the issuer as there is not much of stock exchange requirements connecting contents of prospectus and its publicity etc. to be complied with.
3. Placement of securities suits the requirements of small companies.
4. The method is also resorted to when the stock market is dull and the public response to the issue is doubtful.

Disadvantages

1. Concentration of securities in a few hands. 2. Creating artificial scarcity for the securities thus jacking up the prices temporarily and misleading general public. 3. Depriving the common investors of an opportunity to subscribe to the issue, thus affecting their confidence levels.

18.6 INTIAL PUBLIC OFFER (IPO) METHOD

The public issue made by a corporate entity for the first time in its life is called Initial Public Offer (IPO). Under this method of marketing, securities are issued to successful applicants on the basis of the orders placed by them, through their brokers. When a company whose stock is not publicly traded wants to offer that stock to the general public, it takes the form of Initial Public Offer. The job of selling the stock is entrusted to a popular intermediary, the underwriter.

An underwriter is invariably an investment banking company. He agrees to pay the issuer a certain price for a minimum number of shares, and then resells those shares to buyers, who are often the clients of the underwriting firm. The underwriters charge a fee for their services. Stocks are issued to the underwriter after the issue of prospectus which provides details of financial and business information as regards the issuer. Stocks are then released to the underwriter and the underwriter releases the stock to the public. The issuer and the underwriting syndicate jointly determine the price of a new issue. The approximate price listed in the red herring (the preliminary prospectus – often with words in red letters which say this is preliminary and the price is not yet set) may or may not be close to the final issue price. IPO stock at the release price is usually not available to most of the public. Good relationship between the broker and the investor is a prerequisite for the stock being acquired. Full disclosure of all material information in connection with the offering of new securities must be made as part of the new offerings. A statement and preliminary prospectus (also known as a red herring) containing the following information is to be filed with the Registrar of Companies:

1. A description of the issuer s business
2. The names and addresses of the key company offers, with salary and a 5 year business history on each
3. The amount of ownership of the key officers
4. The company's capitalization and description of how the proceeds from the offering will be used and

5. Any legal proceedings that the company is involved in. Applications are made by the investors on the advice of their brokers who are intimated of the share allocation by the issuer. The amount becomes payable to the issuer through the broker only on final allocation. The allotment is credited and share certificates delivered to the depository account of the successful investor.

The essential steps involved in this method of marketing of securities are as follows:

a. Order Broker receives order from the client and places orders on behalf of the client with the issuer.

b. Share allocation: The issuer finalizes share allocation and informs the broker regarding the same.

c. The client: The broker advises the successful clients of his share allocation Clients then submit the application forms for shares and make payment to the issuer through the broker.

d. Primary issue account: The issuer opens a separate escrow account (primary issue account) for the primary market issue. The clearing house of the exchange debits the primary issue account of the broker and credits the issuer s account.

e. Certificates: Certificates are then delivered to investors. Otherwise depository account may be credited. The biggest advantage of this method of marketing of securities is that there is no need for the investors to part with the money even before the shares are allotted in his favor. Further, the method allows for elimination of unnecessary hassles involved in making a public issue.

Under the regulations of the SEBI, IPOS can be carried out through the secondary market and the existing infrastructure of stock exchanges can be used for this purpose.

18.7 RIGHTS ISSUE METHOD

Where the shares of an existing company are offered to its existing shareholders, it takes the form of rights issue. Under this method, the existing company issues shares to its existing shareholders in proportion to the number of shares already held by them. The relevant guidelines issued by the SEBI in this regard are as follows;

1. Shall be issued only by listed companies

2. Announcement regarding rights issue once made, shall not be withdrawn and where withdrawn, no security shall be eligible for listing up to 12 months

3. Underwriting as to rights issue is optional and appointment of Registrar is compulsory

4. Appointment of category I Merchant Bankers holding a certificate of registration issued by SEBI shall be compulsory
5. Rights shares shall be issued only in respect of fully paid shares
6. Letter of Offer shall contain disclosures as per SEBI requirements
7. Agreement shall be entered into with the depository for materialization of securities to be issued
8. Issue shall be kept open for a minimum period of 30 days and for a maximum period of 60 days
9. A minimum subscription of 90 percent of the issue shall be received
10. No reservation is allowed for rights issue as regards FCDs and PCDs
11. A No Complaints Certificate's to be filed by the Lead Merchant Banker' with the SEBI after 21 days from the date of issue of offer document
12. Obligatory for a company where increase in subscribed capital is necessary after two years of its formation or after one year of its first issue of shares, whichever is earlier?

Advantages

Rights issue offers the following advantages:

1. **Economy:** Rights issue constitutes the most economical method of raising fresh capital, as it involves no underwriting and brokerage costs. Further, the expenses by way of advertisement and administration, etc. are less.
2. **Easy**: The issue management procedures connected with the rights issue are easier as only a limited number of applications are to be handled.
3. **Advantage of shareholders**: Issue of rights shares does not involve any dilution of ownership of existing shareholders. Further, it offers freedom to shareholders to subscribe or not to subscribe the issue.

Drawbacks

The method suffers from the following limitations:

1. Restrictive: The facility of rights issue is available only to existing companies and not to new companies.
2. Against society : The issue of rights shares runs counter to the overall societal considerations of diffusion of shares ownership for promoting dispersal of wealth and economic power.

18.8 BONUS ISSUE METHOD

Where the accumulated reserves and surplus of profits of a company are converted into paid up capital, it takes the form of issue of bonus shares . It merely implies capitalization of exiting reserves and surplus of a company. The issue of bonus shares is subject to certain rules and regulations. The issue does not in any way affect the resources base of the enterprise. It saves the company enormously of the hassles of capital issue. Issued under Section 205 (3) of the Companies Act, such shares are governed by the guidelines issued by the SEBI (applicable to listed companies only) as follows:

1. Reservation - In respect of FCDs and PCDs, bonus shares must be reserved in proportion to such convertible part of FCDs and PCDs. The shares so reserved may be issued at the time of conversion(s) of such debentures on the same terms on which the bonus issues were made.

2. Reserves - The bonus issue shall be made out of free reserves built out of the genuine profits or share premium collected in cash only. Reserves created by revaluation of fixed assets are not capitalized.

3. Dividend mode - The declaration of bonus issue, in lieu of dividend, is not made

4. Fully paid - The bonus issue is not made unless the partly paid shares, if any are made fully paid-up.

5. No default - The Company has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption thereof and has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

6. Implementation - A company that announces its bonus issue after the approval of the Board of Directors must implement the proposal within a period of 6 months from the date of such approval and shall not have the option of changing the decision.

7. The articles- The articles of Association of the company shall contain a provision for capitalization of reserves, etc. If there is no such provision in the Articles, the company shall pass a resolution at its general body meeting making provisions in the Articles of Associations for capitalization.

8. Resolution - Consequent to the issue of bonus shares if the subscribed and paid-up capital exceeds the authorized share capital, the company at its general body meeting for increasing the authorized capital shall pass a resolution.

18.9 BOOK BUILDING METHOD

A method of marketing the shares of a company whereby the quantum and the price of the securities to be issued will be decided on the basis of the bids received from the prospective shareholders by the lead merchant bankers is known as book-building method. Under the book-building method, share prices are determined on the basis of real demand for the shares at various price levels in the market. For discovering the price at which issue should be made, bids are invited from prospective investors from which the demand at various price levels is noted. The merchant bankers undertake full responsibility for the same. The option of book building is available to all body corporate, which are otherwise eligible to make an issue of capital to the public. The initial minimum size of issue through book-building route was fixed at Rs.100 crores. However, beginning from December 9, 1996 issues of any size will be allowed through the book-building route. Book-building facility is available as an alternative to firm allotment. Accordingly, a company can opt for book-building route for the sale of shares to the extent of the percentage of the issue that can be reserved for firm allotment as per the prevailing SEBI guidelines. It is therefore possible either to reserve securities for firm allotment or issue them through the book-building process. The book-building process involves the following steps:

1. Appointment of book-runners:

The first step in the book-building process is the appointment by the issuer company, of the book-runner, chosen from one of the lead merchant bankers. The book-runner in turn forms a syndicate for the book-building. A syndicate member should be a member of National Stock Exchange (NSE) or Over-the-Counter Exchange of India (OTCEI). Offers of bids' are to be made by investors to the syndicate members, who register the demands of investors. The bid indicates the number of shares demanded and the prices offered. This information, which is stored in the computer, is accessible to the company management or to the book-runner. The name of the book-runner is to be mentioned in the draft prospectus submitted to SEBI.

2. Drafting prospectus:

The draft prospectus containing all the information except the information regarding the price at which the securities are offered is to be filed with SEBI as per the prevailing SEBI guidelines. The offer of securities through this process must separately be disclosed in the prospectus, under the caption placement portion category . Similarly, the extent of shares offered to the public shall be separately shown under the caption net offer to the public . According to the latest SEBI guidelines issued in October 1999, the earlier stipulation that at least 25 percent of the securities were to be issued to the public has been done away with. This is aimed at enabling companies to offer the entire public issue through the book-building route.

3. Circulating draft prospectus

A copy of the draft prospectus filed with SEBI is to be circulated by the book-runner to the prospective institutional buyers who are eligible for firm allotment and also to the intermediaries who are eligible to act as underwriters. The objective is to invite offers for subscribing to the securities. The draft prospectus to be circulated must indicate the price band within which the securities are being offered for subscription.

4. Maintaining offer records:

The book-runner maintains a record of the offers received. Details such as the name and the number of securities ordered together with the price at which each institutional buyer or underwriter is willing to sub scribe to securities under the placement portion must find place in the record. SEBI has the right to inspect such records.

5. Intimation about aggregate orders:

The underwriters and the institutional investors shall give intimation on the aggregate of the offers received to the book-runner.

6. Bid analysis:

The bid analysis is carried out by the book-runner immediately after the closure of the bid offer date. An appropriate final price is arrived at after a careful evaluation of demands at various prices and the quantity. The final price is generally fixed reasonably lower than the possible offer price. This way, the success of the issue is ensured. The issuer company announce the pay-indate at eh expiry of which shares are allotted.

7. Mandatory Underwriting:

Where it has been decided to make offer of shares to public under the category of Net Offer to the Public; it is incumbent that the entire portion offered to the public is fully underwritten. In case an issue is made through book-building route, it is mandatory that the portion of the issue offered to the public be underwritten. This is the purpose, an agreement has to be entered into with the underwriter by the issuer. The agreement shall specify the number of securities as well as the price at which the underwriter would subscribe to the securities. The book-runner may require the underwriter of the net offer to the public to pay in advance all moneys required to be paid in respect of their underwriting commitment.

8. Filling with ROC:

A copy of the prospectus as certified by the SEBI shall be filed with the Registrar of Companies within two days of the receipt of the acknowledgement card from the SEBI.

9. Bank accounts:

The issuer company has to open two separate accounts for collection of application money, one for the private placement portion and the other for the public subscription.

10. Collection of Completed Applications:

The book-runner collects from the institutional buyers and the underwriters the application forms along with the application money to the extent of the securities proposed to be allotted to them or subscribed by them. This is to be done one day before the opening of the issue to the public.

11. Allotment of securities:

Allotment for the private placement portion may be made on the second day from the closure of the issue. The issuer company, however, has the option to choose one date for both the placement portion and the public portion. The said date shall be considered to be the date of allotment for the issue of securities through the book-building process. The issuer company is permitted to pay interest on the application moneys till the date of allotment or the deemed date of allotment provided that payment of interest is uniformly given to all the applicants.

12. Payment schedule and listing:

The book-runner may require the underwriters to the net offer to the public to pay in advance all moneys required to be paid in respect of their underwriting commitment by the eleventh day of the closure of the issue. In that case, the shares allotted as per the private placement category will become eligible for being listed. Allotment of securities under the public category is to be made as per the prevailing statutory requirements.

13. Under-subscription:

In the case of under-subscription in the net offer to the public‘ category, any spillover to the extent of under-subscription is to be permitted from the placement portion category subject to the condition that preference is given to the individual investors. In the case of under subscription in the placement portion, spillover is to be permitted from the net offer to the public to the placement portion.

Advantages of Book Building

Book-building process is of immense use in the following ways: 1. Reduction in the duration between allotment and listing 2. Reliable allotment procedure 3. Quick listing in stock exchanges possible 4. No price manipulation as the price is determined on the basis of the bids received.

18.10 STOCK OPTION OF EMPLOYEES STOCK OPTION PLAN (ESOP)

A method of marketing the securities of a company whereby its employees are encouraged to take up shares and subscribe to it is known as stock option. It is a voluntary scheme on the part of the company to encourage employees‘ participation in the company. The scheme also offers an incentive to the employees to stay in the company. The scheme is particularly useful in the case of companies whose business activity is dominantly based on the talent of the employees, as in the case of software industry. The scheme helps retain their most productive employees in an industry, which is known for its constant churning of personnel.

SEBI Guidelines Company whose securities are listed on any stock exchange can introduce the scheme of employees‘ stock option. The offer can be made subject to the conditions specified below:

1. **Issue at discount -** Issue of stock option at a discount to the market price would be regarded as another form of employee compensation and would be treated as such in the financial statements of the company regardless the quantum of discount on the exercise price of the options.
2. **Approval -** The issue of ESOPs is subject to the approval by the shareholders through a special resolution.
3. **Maximum limit -** There would be no restriction on the maximum number of shares to be issued to a single employee. However, in case of employees being offered more than 1 percent shares, a specific disclosure and approval would be necessary in the AGM.
4. **Minimum period** - A minimum period of one year between grant of options and its vesting has been prescribed. After one year, the company would determine the period during which the option can be exercised.
5. **Superintendence -** The operation of the ESOP Scheme would have to be under the superintendence and direction of a Compensation Committee of the Board of Directors in which there would be a majority of independent directors.

6. **Eligibility -** ESOP scheme is open to all permanent employees and to the directors of the company but not to promoters and large shareholders. The scheme would be applicable to the employees of the subsidiary or a holding company with the express approval of the shareholders.

7. **Director's report -** The Director's report shall make a disclosure of the following : a. Total number of shares as approved by the shareholders b. The pricing formula adopted c. Details as to options granted, options vested, options exercised and options forfeited, extinguishments or modification of options, money realized by exercise of options, total number of options in force, employee-wise details of options granted to senior managerial personnel and to any other employee who receive a grant in any one year of options amounting to 5 percent or more of options granted during that year d. Fully diluted EPS computed in accordance with the IAS IPO

SEBI's stipulations prohibiting initial public offerings by companies having outstanding options should not apply to ESOP. If any ESOPs are outstanding at the time of an IPO issue by an unlisted company, the promoters' contribution shall be calculated with reference to the enlarged capital that would arise if all vested options were exercised.

18.11 BOUGHT OUT DEALS METHOD

A method of marketing of securities of a body corporate whereby the promoters of an unlisted company make an outright sale of a chunk of equity shares to a single sponsor or the lead sponsor is known as bought-out deals .

The following are the characteristics of Bought out deals

1. **Parties:** There are three parties involved in the bought-out deals. They are promoters of the company, sponsors and co-sponsors who are generally merchant bankers and investors.

2. **Outright sale:** Under this arrangement, there is an outright sale of a chunk of equity shares to a single sponsor or the lead sponsor.

3. **Syndicate:** Sponsor forms syndicate with other merchant bankers for meeting the resource requirements and for distributing the risk.

4. **Sale price:** The s ale price is finalized through negotiations between the issuing company and the purchaser, the sale being influenced by such factors as project evaluation, promoters image and reputation, current market sentiments, prospects of off-loading these shares at a future date, etc.

5. **Fund-based**: Bought-out deals are in the nature of fund-based activity where the funds of the merchant bankers get locked in for at least the prescribed minimum period.

6. **Listing:** The investor-sponsors make a profit, when at a future date, the shares get listed and higher prices prevail. Listing generally takes place at a time when the company is performing well in terms of higher profits and larger cash generations from projects.

7. **OTCEI:** Sale of these shares at Over-the-Counter Exchange of India (OTCEI) or at a recognized stock exchanges, the time of listing these securities and off loading them simultaneously are being generally decided in advance.

18.12 NOTES

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18.13 SUMMARY

The process of marketing of securities by merchant bankers in primary market starts with the preparation of prospectus. The success of public issue depends upon the excellent marketing techniques worked out by the lead manager/merchant banker. It covers the institutional and retail distribution capacity, equity research capability, retail distribution network, advertising strategies and international distribution capability. A general standardized methodology of marketing may not be ideal for all issues. It may be worked out on a case to case basis depending on the nature of public issues in hand.

18.14 KEY WORDS

Private Placement

ROC

Book Building

Subscription

ESOP

OTCEI

Rights Issue

IPOs

18.15 SELF ASSESSMENT QUESTIONS

1. Explain briefly the steps involved in marketing of new issues
2. Write a note on pure prospectus method of issuing new issues, highlighting the features, advantages and disadvantages of this method
3. Write an explanatory note on book building process
4. What are ESOPs? Explain the conditions under which ESOPs can be issued
5. Bring out the difference between offer for sale method and brought out deal method

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UNIT –19 : CREDIT CARDS

Structure :

19.0 OBJECTIVES

After studying this unit, you should be able to ;

- To explain the concept of credit cards
- To identify the types, parties involved and global players of credit cards
- To study the operating cycle of credit cards
- To understand the emerging trends in the payment system

19.1 INTRODUCTION

The credit card business got momentum in the sixties and a number of banks entered the field in a big way. Credit card culture is an old hat in western countries. In India, it is relatively a new concept that is fast catching on. The present trend indicates that the coming years will witness a burgeoning growth of credit cards which will lead to a cashless society. Credit has become an important vehicle of trade promotion. Credit cards provide convenience and safety to the buying process. One of the important reasons for the popularity of credit cards is the sea change witnessed in consumer behaviour. Credit cards enable an individual to purchase products or services without paying immediately. The buyer only needs to present the credit cards at the cash counter and sign the bill. Credit card can, therefore, be considered as a good substitute for cash or cheques.

19.2 MEANING

A Credit card is a card/mechanism that enables cardholders to purchase, travel and dine without making immediate payments. The holders can use the cards to get credit from banks up to 50 days free of cost. The credit card relieves the consumers from immediate payment of cash and ensures safety. It is a convenience of extended credit without formality. Thus credit card is a passport to, "safety, convenience, prestige and credit." A credit card is a plastic card having a magnetic strip, issued by a bank or business authorizing the holder to buy goods or services on credit. Any card, plate or coupon book that may be used repeatedly to borrow money or buy goods and services on credit is called credit card.

A credit card is a card establishing the privilege of the person to whom it is issued to charge bills. Most retail firms accept credit cards. Credit cards allow consumers to make purchases without paying cash immediately or establishing credit with individual stores. They eliminate the need to check credit ratings and to collect cash from individual customers. The issuing institution establishes the card's terms, including the interest rate, annual fees, penalties, the grace period, and other features. Credit card debt is typically an unsecured debt. Repossession is not easily accomplished by the lender to ensure payment. Banks have often priced the product assuming maximum risk exposure.

19.3 TYPES OF CREDIT CARD

Catering to different types of consumer needs, credit card companies issue several types of credit cards. Each type has its own benefits. They can be classified as follows:-

Based on Franchise / Tie-up

1. Proprietary Card: Cards that are issued by the banks themselves without any tie-up, are called proprietary cards. A bank issues such cards under its own brand. Examples include SBI Card, CanCard of Canara Bank, Citicard.
2. Master Card: This is a type of credit card issued under the umbrella of MasterCard International. The issuing bank has to obtain a franchise from the MasterCard Corporation of the USA. The franchised cards will be honoured in the MasterCard network.
3. VISA Card: This type of credit card can be issued by any bank having tie-up with VISA International Corporation, USA. The banks that issue such cards are said to have a franchise of VISA International. The advantage of a VISA franchise is that one can avail the facility of the VISA network for transactions.
4. Domestic tie-up Card: These cards are issued by a bank having a tie-up with domestic card brands such as CanCard and Indcard are called 'Domestic cards'

Based on geographical validity

1. Domestic Card: Cards that are valid only in India and Nepal are called 'domestic cards'. They are issued by most of the banks in India all transactions will be in rupees.
2. International and Global Card: Credit cards with international validity are called 'international cards'. They are issued to people who travel abroad frequently. They are honoured in every part of the world except India and Nepal. The cardholder can make purchases in foreign currencies subject to RBI sanction and FERA rules and regulations.

Based on the issuer category.

1. Individual Card: These are the non-corporate credit cards that are issued to individuals. Generally, all brands of credit cards are issued to individuals.
2. Corporate Card: They are credit cards issued to corporate and business firms. The executives and top officials of the firms use them. They bear the names of the firms, and the bills are paid by the firms.

Based on mode of credit recovery

1. Revolving Card: This type of credit card is based on the revolving credit principle. A credit limit is fixed on the amount of money one can spend on the card for a particular period. The cardholder has to pay a minimum percentage of the outstanding credit which may vary from 5 to 10 percent at the end of a particular period. Interest varying from 30 to 36 percent per annum is charged on the outstanding amount.
2. Charge Card: A charge card is not a credit instrument, it is a convenient mode of making payment. This facility gives a consolidated for a specific periods and bills are payable in full on presentation. There is neither interest liability nor no per-set spending limits.

Based on status of Card

1. Standard Card: Credit cards that are regularly issued by all card-issuing banks are called 'standard cards'. With these cards, it is possible for a cardholder to make purchases without having to pay cash immediately. They however, offer only limited privileges to cardholders. Some banks issue standard cards under the Brand name "Classic" cards, which are generally issued to salaried people.
2. Business Card: Business cards also known as 'Executive cards', are issued to small partnership firms, solicitors, firms of chartered accountants, tax consultants and others, for use by executives on their business trips. They enjoy higher credit limits and more privileges than the standard cards.
3. Gold Card: The gold card offers high value credit for elite. It offers many additional benefits and facilities such as higher credit limits, more cash advance limits that are not available with the standard or the executive cards.

Other types of credit card

1. Special purpose Card: The eighties saw the development of special purpose cards. A host of special purpose cards were issued by departmental stores, airlines, oil companies. For instance, the International Bank of Asia in Hong Kong launched the first 'women only' card, 'My card' in the year 1988. A highly encouraging membership and increasing potential of such special purpose cards are called "Lady's card" in Malaysia. In 1990, the Green card was launched in the U.K and Europe to promote contributions towards the protection of the environment. HDFC issued 'My City' credit cards used in particular city with special discount offer for oil and petrol and also an offer for cash back. AXIS Bank also offers special purpose credit cards like Gift card, Travel currency card and Remittance card.

2. Add-on card: An add-on card is more of an additional Credit card that the customer can apply in the name of their family members (father, mother, sister, brother, spouse, children), within the overall credit limit. Family members applying for Add-on cards have to be 18 years and above. All the payments for the services made from Add-on card(s) is done by the original cardholders. Most banks allow for at least two Add-on cards.
3. Photo card: If a card comes with the imprinted photo, then it is a Photo card. This type of card is considered safer as it is easier to identify the credit card user. It also serves as more identity card.
4. Power card: It is a comprehensive credit card product that enables banks and financial industry to enter into issuing and acquiring business of Credit Cards. The basic advantage of this efficient tool is to improve productivity and control the risks involved in day-to-day activities of any financial institutions in credit cards. The product is 24 × 7, multi language, multi currency, multi-bank and multi country.
5. Regular credit card: This is the most basic type of credit card. It has a low credit limit and the most basic status among various credit cards. Credit card companies can club various other reward programs like travel rewards, cash back offers to enhance its value and appeal to customers.
6. Silver credit card: Silver credit cards have higher eligibility criteria than regular credit cards. They bring more benefits to the customers, and have higher credit limits than regular credit cards.
7. Gold credit card: Gold credit cards have a higher status and credit limits than silver credit cards. Needless to say these types of credit cards have higher income requirements as their eligibility criteria. In addition to the regular benefits, banks extend special privileges to their gold credit card holders.
8. Platinum or Titanium credit card: These types of credit cards bring more benefits to credit card holders than regular, silver or gold card. These credit cards generally have platinum or titanium hue and are issued to a select class of clients who have excellent financial background and good income levels. Platinum credit cards have personal concierge services, in addition to exclusive platinum benefits.
9. Signature credit card: A league of its own, the Signature Credit Cards usually have no pre-set spending limits, personal concierge service, signature travel, and lounge and membership benefits. Offered to a very elite group these credit cards, requires an excellent financial status. On June 9, 2007 ICICI bank introduced the Visa Signature Card and

became the first credit card issuer in India to launch a premium credit card. This has a joining fee of Rs.25,000/- and an annual fee of Rs.2,500/-. The exclusivity of this signature card is exemplified by the statement.

10. Credit cards by invitation only: The earliest of the elite, no one can apply for these card. For example, the American Express Black Credit Card, popularly called the Centurion Card, is issued by invitation to the most exclusive and elite, to those who spend a certain minimum amount (which can run into crores of rupees). These cards have huge annual fees and minimum spending levels. In fact, these credit cards are so exclusive, that they have an aura of mystery surrounding them and are considered status symbols.

11. Reward card: There are cards which offer rewards for specific kinds of purchases. For example, the Airline Reward Card offer rewards on air travel, Cash back card offer cash rewards on every card purchases, Fuel Reward Card offer rebates on petroleum and other fuel purchases from specified outlets and preferred partners. Similarly, Hotel Reward Card give rebates on hotel stay and related expenses and Health Rewards Card give benefits on medical expenses, health treatments and related activities. The rewards offered by credit card companies in alliance with various brands and stores, make them more attractive for the credit card holders.

12. Student credit card: As the name implies, these credit cards are especially designed for students and help them start their credit card journey. These bring lots of rewards especially suited for students, which help them save time, money and enjoy their student life. They are a first step towards building credit history. A good credit history goes a long way in creating a relationship with banks helping to secure much needed loans and credit in the future.

13. Special feature credit card: Credit cards can also be grouped on the basis of their features. For example, based on their introductory interest rates, credit cards can be low introductory interest credit cards, or 0 (zero) Interest credit cards. The Zero introductory interest credit cards provide interest free credit (0%) for a specified time period, which is called the introductory period. Similar is the case with credit cards that come without any annual fee what so ever and are called ‘no annual fee’ credit cards.

14. Balance transfer credit card: Credit card companies provide lucrative offers with 0 per cent introductory interest or low introductory interest charges on balance transfers. This allows credit card holders to transfer the outstanding balances on their existing credit cards to a credit card with low or zero interest on balance transfers. This brings them a

lot of savings in the interest rates. The balance transfer credit cards may charge a balance transfer fees for every such operation.

15. Kisan Credit Card (KCC): The Kisan Credit Card Scheme aims at providing need based and timely credit support to the farmers for their cultivation needs as well as non-farm activities and cost effective manner to bring about flexibility and operational freedom in credit utilization. The Kisan Card is for a period of 3 years subject to an annual review. It was launched in 1998-99 by the Government of India in consultation with the Reserve Bank of India and National Bank for Agricultural and Rural Development is a huge hit with the farmers in India. According to the RBI, presently there are about 66.56 million Kisan Credit Cards in use across India, which have been issued by various banks.

16. Secured credit card: Secured credit card is a type of credit card secured by a deposit account owned by the cardholder. This deposit is held in a special savings account. The cardholder of a secured credit card is still expected to make regular payments, as with a regular card, but should they default on a payment, the card issuer has the option of recovering the cost of the purchases paid to the merchants out of the deposit. The advantage of the secured card for an individual with negative or no credit history is that most companies report regularly to the major credit bureaus. This allows for building of positive credit history.

19.4 CREDIT CARD OPERATION CYCLE

The credit card operation comprises the following steps as follows:

i. Credit purchases: A Cardholder purchases goods/services and gives the credit card.

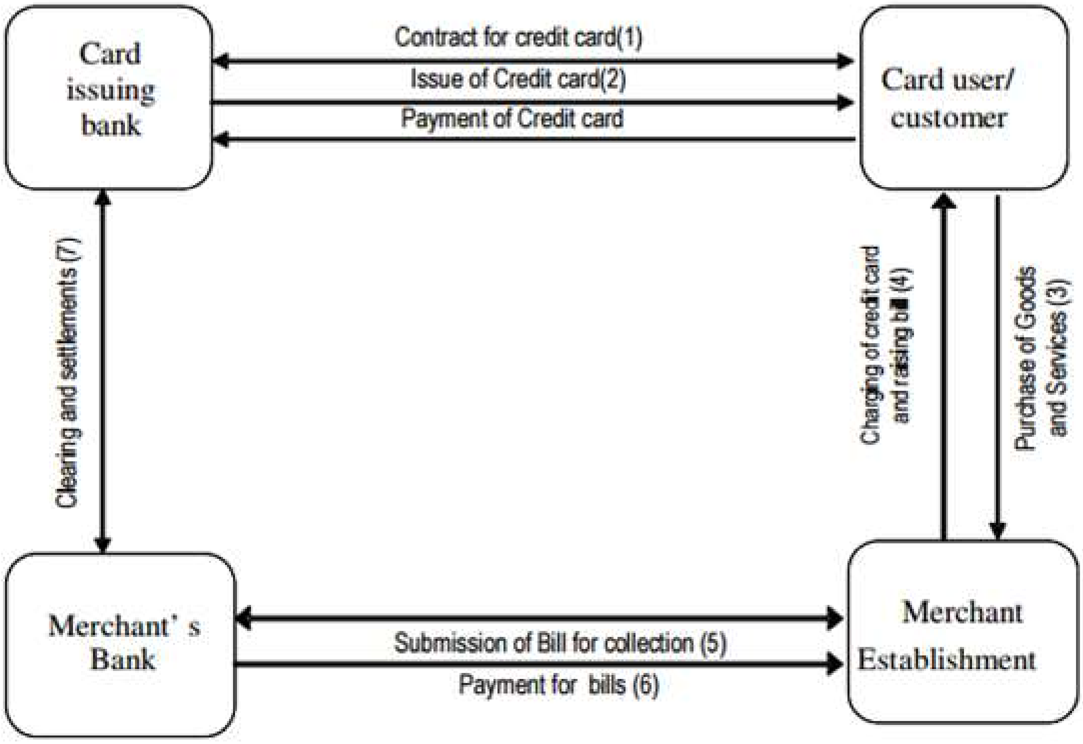
ii. Processing of credit card: A Merchant establishment delivers goods after taking an authenticated credit card and noting the number and taking signatures on certain forms.

iii. Raising of bill: The Merchant establishment raises the bill for the purchase and sends it to the credit card issuing bank for payment.

iv. Marking payment: The issuing bank pays the amount to the merchant establishment.

v. Bill to cardholder: The issuing bank raises bill on the credit cardholder and sends it for payment.

vi. Card Payment: The credit cardholder makes the payment to the issuing bank.



19.5 PARTIES IN CREDIT CARDS

The following important parties involved in the operation of credit cards are:

Credit cardholders: The person named on the card. This may be customer of a bank to whom the card has been issued or any such person to whom the bank has issued a card authorized by the customer of the bank to hold and use the card. This individual is also responsible for payment of all charges made to that card. The holder of the credit card who uses to make a purchase is called the consumer.

Card-issuing bank: The financial institution or other organization that issued the credit card and also responsible for billing the cardholders for charges. The bank bills the consumer for repayment and bears the risk that the card is used fraudulently. The issuing bank extends a line of credit to the consumer. Liability for non-payment is then shared by the issuing bank and acquiring bank.

Merchant Establishments: The individual or business accepting credit cards for sold products or services to the cardholders.

Acquiring bank: The financial institution accepts payment for the products or services on behalf of the merchant establishments.

Independent sales organization: Resellers (to merchants) of the services of the acquiring bank. i.e outside services providers for marketing of cards .

Merchant account: This could refer to the acquiring bank or the independent sales organization, but in 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 that set transaction terms for merchants, card-issuing banks, and acquiring banks.

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. Transaction processing networks include Cardnet, Nabanco, Omaha, Paymentech, NDC Atlanta, Nova, Vital, Concord EFSnet, and Visa Net.

Affinity partner: Some institutions lend their names to an issuer to attract customers that have a strong relationship with that institution, and get paid a fee or a percentage of the balance for each card issued using their name. Examples of typical affinity partners are sports teams, universities, charities, professional organizations, and major retailers.

19.6 GLOBAL PLAYER IN CREDIT CARD MARKET

1. MasterCard: MasterCard is a product of MasterCard International and along with VISA is distributed by financial institutions around the world. Cardholders borrow money against a line of credit and pay it back with interest if the balance is carried over from month to month. Its products are issued by 25,000 financial institutions in 220 countries and territories. In 1998, it had almost 700 million cards in circulation, whose users spent $650 billion in more than 16.2 million locations. The company, which had been organized as a cooperative of banks, had an initial public offering on May 25, 2006 at $39.00 USD. The stock is traded on the NYSE under the symbol MA.

2. VISA card: A VISA card is a product of VISA USA and along with Master Card is distributed by financial institutions around the world. Visa Inc. commonly referred to as VISA, is a multinational corporation based in San Francisco, California, USA. The company operates the world's largest retail electronic payment network, managing payments among financial institutions, merchants, consumers, businesses and government entities. Before Visa Inc's IPO in early 2008, it was operated as a cooperative of some 21,000 financial institutions that issued and marketed Visa products including credit and debit cards. A VISA cardholder borrows money against a credit line and repays the money with interest if the balance is carried over from month to month in a revolving line of credit. Nearly

600 million cards carry one of the VISA brands and more than 14 million locations accept them. In 2006, according to The Nilson Report, Visa held 44 per cent of the credit card market share and 48 per cent of the debit card market share in the United States. Visa Inc. is the world's largest payments company, with more than US$ 4.0 trillion of total volume as of March 31, 2008.

3. American Express: The world's favourite card is American Express Credit Card. More than 57 million cards are in circulation and growing and it is still growing further. Around US $ 123 billion was spent last year through American Express Cards and it is poised to be the world's no.1 card in the near future. In a regressive US economy last year, the total amount spent on American Express cards rose by 4 percent. They are very popular in the U.S., Canada, Europe and Asia and are used widely in the retail and everyday expenses segment.

4. Diners Club International: Diners Club International, originally founded as Diners Club, is a charge card company formed in 1950 by Frank X. McNamara, Ralph Schneider and Casey R. Taylor. When it first emerged, it became the first independent credit card company in the world. Diners Club is the world's no.1

5. Charge Card. Diners Club cardholders reside all over the world and the Diners Card is a all time favourite for corporate. There are more than 8 million Diners Club cardholders around the world. They are affluent and are frequent travelers in premier businesses and institutions, including Fortune 500 companies and leading global corporations. In April 2008, Discover Card and Citibank announced that Discover would purchase the Diners Club Network from Citi for $165 million. Discover Bank has no plans on issuing Diners Club branded cards. Discover purchased the network, but not the licensees issuing the cards. The deal was completed on July 1, 2008.141

6. Discover Card: The Discover Card was originally introduced by Sears in 1985, and was a unit of Dean Witter, which merged with Morgan Stanley in 1997. In 2007, the unit was spunoff as an independent, publicly traded company. To-day, Discover is headquartered in the Chicago suburb of Riverwoods, IIinois. Discover Financial Services is an American financial services company, which issues the Discover Card and operates the Discover and Pulse networks. Discover Card is the third largest credit card brand in the United States, when measured by cards in force, with nearly 50 million cardholder.142

7. JCB Card (Japan Credit Bureau): Japan Credit Bureau, usually abbreviated as JCB, is a credit card company based in Tokyo, Japan. Founded in 1961, it established dominance over the Japanese credit card market when it purchased Osaka Credit Bureau in 1968

and its cards are now issued in 20 different countries. Fifty-nine million JCB card members worldwide use their cards to purchase over US$62.7 billion of goods and services annually in 190 countries worldwide. JCB also operates a network of membership lounges targeting Japanese, Chinese, and Korean travelers in Europe, Asia, and North America. The JCB philosophy of "identify the customer's needs and please the customer with service from the Heart" is paying rich dividends as their customers spend US$ 43 billion annually on their JCB cards.

19.7 EMERGING TRENDS IN PAYMENT SYSTEM

In addition, credit cards which have evolved into a variety of innovative cards over the years are also issued by banks.

1. ATM Card: ATM cards allow customers to access their accounts at any time-24 hours a day, every day of the year, through Automated Teller Machines. Customers can withdraw cash, transfer funds, find out their account balance and perform other banking and financial transactions with the help of ATMs.
2. Debit Card: A debit card, like an ATM card, directly accesses a customer's account. It is a hybrid of ATM and credit card. The card directly debits a designated savings bank account. Whereas in the case of credit cards, a grace credit period of 20 to 50 days for making the payment is available, no such credit period is allowed under debit cards. These cards can be used either at merchant locations who have this facility to buy goods and services or at ATMs. Presently, ATM-Cum Debit cards issued by Indian banks are in use.
3. Prepaid Card: Prepaid cards are also known as 'Stored Value Cards'. These cards are with stored value paid in advance by the holder. The card issuer and the service provider are identical. They are also called Limited Purpose Prepaid Cards which can be used for a limited number of well –defined purposes. Its use is often restricted to a number of identified points of sales within a specified location
4. Private Label Card: These cards are uniquely tied to the retailer issuing the card and can be used only in that retailer's stores. A bank, on the basis of a contractual agreement with the retailer extends credit under this type of card.
5. Affinity Group Card: These are credit cards designed for a collection of individuals with some form of common interest or relationship, such as professional, alumni, retired persons' organizations, sports teams, schools, or service organizations. This credit card carries the logo of the affiliated organization on the card design and brings special benefits and discounts on products from that company. In case the affiliated company is a charity

or non-profit organization, a part of the credit card expenses go into the affiliate organization's account. For example: The Help Age India Credit Card issued by ICICI bank

6. Smart Card: A smart card is a credit card sized plastic card with an embedded computer chip. The chip allows the card to carry a much greater amount of information than a magnetic strip card. The telecom industry, was perhaps the pioneer in smart cards, the most prominent being Subscriber Identity Module (SIM) cards in the GMS digital cellular network. Using special terminals designated to interact with the embedded chip, the card can perform special functions. This is essentially a prepaid card.

7. Chip Card: A chip card is a plastic card with an embedded integrated circuit or as microchip as opposed to magnetic strips on a conventional card. The chip can be used on existing debit and credit cards as well as on emerging products like stored value cards. Inserting the card in a pin-pad effects the transaction, and the value on it reduces accordingly. It is re-loadable and disposable. The idea is to do away with the trouble of carrying cash. The chip card also scores over the magnetic card, in that it can retain 50 to 60 of the latest transactions, which can be produced on demand. It is also considered more durable and secure since the cardholder alone can access it through a Personal Identification Number (PIN).

8. Co-branded card: The Times Card, a co-branded credit card, is the first of its kind, from a publishing house in the Asian subcontinent. This is a cobranded credit card of Times of India Group and Citibank MasterCard. The co-branding concept caught the credit card industry the world over during the last five years

19.8 SUMMARY

The market for credit cards is growing very fast. Cards are now tailor made to cater to diverse segments of the society be it professionals, business men, entrepreneurs, households etc. Credit cards can be used for multiple purposes such as emergency cash withdrawal, fuel facility, medical advance facility, hotel and online discount facility etc.

19.9 NOTES

19.10 KEY WORDS

Plastic Money

Franchiser

ATM

VISA

Merchant Establishments

19.11 SELF ASSESSMENT QUESTIONS

1. What is a credit card? Highlight its features
2. Explain the cycle of credit card
3. Classify the cards based on its utility
4. Explain various benefits that are available to credit card holders
5. Name a few global players in the credit card markets

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UNIT - 20: MERCHANT BANKING IN INDIA

Structure :

20.0 OBJECTIVES

After study this unit, you should be able to;

- To understand the growth of merchant banking in India
- To familiarize with SEBI regulations on merchant banking

20.1 INTRODUCTION

SEBI, in exercise of the powers conferred under section 30 of the SEBI Act, 1992 has made the different regulations for almost all aspects of capital market. For regulating the activities of merchant bankers, the Board has enacted SEBI (Merchant Bankers) Regulations, 1992. The objectives of the merchant banking regulations are to regulate the raising of funds in the primary market would assure for the issuer a market for raising resources at low cost, effectively and easily, ensure a high degree of protection of the interest of the investors and provide for the merchant bankers dynamic and competitive market with high standard of professional competence, honesty, integrity and solvency. The regulations would promote a primary market which is fair, efficient, flexible and inspire confidence.

20.2 MERCHANT BANKING IN INDIA

Agency houses were the traditional name given to the merchant trading in India and Far East. During 1813, trade and commerce developed in India through the 'agency houses' based in London. John Palmer & Co. was the leading agency house during this period and it operated the banking activities from Calcutta. These agency houses had employed their growing capital in trade and commerce. Thomas Skinner's annual directories 'London Banks' (1880) traces the origin and growth of merchant banking activities in India and Far East. An Anglo-American merchant bank (Baring Brothers) moved into the financing of India and Far Eastern trade during 1830. When the First World War broke out, there were as many as twenty one financial firms with considerable commitment in Central Europe and at least eighteen firms with major interest in India and Far East.

Crooper Benson & Co, the premier cotton importer of Europe was operating in India during 1820s and conducted major trade for about three generations through Calcutta. They were followed by Ogilvy Gillanden & Co. in 1824 and Hong-Kong & Shanghai Bank in 1864. The foreign merchant bankers operated in India through an agency house which was known as 'East India House'. It was representing a group that produced several merchant bankers during the 19th century; two of them, that is, Gladstone and the Arbuthnot remained in East India trade. But the merchant bankers had to face stiff competition from Persian Finance House and ultimately failed. In the late 1860s, East India merchants had enough capital to invest in trade and they floated joint stock banks with their own investments. Despite the opposition from East India Company, some new banks were founded which included: Orient Bank in 1845, Chartered Bank of India and Chartered bank of Asia in 1853, Chartered Mercantile Bank of India, London; and Agra & United Provinces Bank in 1857. These banks were operating not only in the area of banking, but were also financing trade transactions. London based merchant bankers had full control over the management of these banks through their Managing Agents. The managing agency system devised by these merchant bankers gave major fillip to trading and banking activities of foreign merchants in India. The managing agency system enabled a single firm to look after a number of firms in complimentary industries. As a result, the banking industry developed in India on the full support of London based merchant bankers.

20.3 MERCHANT BANKING IN POST INDEPENDENCE PERIOD

India inherited an underdeveloped capital market from the British rulers. Managing agency system was more driven by their personal gains rather than being helpful in the development of capital market in the economy. After independence, Government of India adopted the model of planned economic development for the country and a need was felt to have a strong industrial base in the economy. Growth of Indian capital market was considered as one of the key areas for accelerating the pace of economic development by mobilising savings from household and business sector into the channel of investment for trade and industry. Drastic amendments were made in the legislative framework relating to growth of corporate sector, viz, Companies Act, Capital Issues (Control) Act, Banking Companies Act etc. The managing agency system was sought to be abolished. Post independence period up to the year 1969 saw the emergence of All India financial institutions like IFCI, ICICI, IDBI, LIC, UTI and commercial banks playing, in one way or other, the role of merchant banking in the Indian financial system. They had a significant role in underwriting the capital issues besides lending support to 7 broking houses for placing the issue through prospectus before the public for subscription. But the growth of the capital market remained limited during this period. So the need for broad based merchant banking services was felt to meet the growing need for capital. The formal merchant banking service in Indian capital market was initiated in 1967, when Reserve Bank of India (RBI) granted licence to 'The National Grindlays Bank' to perform the services relating to issue management. The Bank started merchant banking services by opening merchant banking Division within the bank in 1969. The First National City Bank followed the Grindlays Bank by opening a 'Management Consultant Division in 1970. Both these banks acted as 'managers to the issues'. In 1971, Stock Exchange Division under the Ministry of Finance examined the merchant banking role of these foreign banks vis-à-vis the old existing organization of stock brokers. It came to the conclusion that the services rendered by these foreign merchant bankers were not different from those what the Indian investment broking firms have been extending to new issues. These banks did not handle any issue promoted by new entrepreneurs or any small issues during this period. Also, they could not provide any new skill and expertise in the area of merchant banking activities. With a view to end monopoly of these foreign banks in merchant banking activities, the Govt. traced out the possibility of commercial banks to undertake the management and underwriting of public issues. Banking Commission 1972, in its report considered the need for specialized financial institutions and banks which could provide facilities like backing the issue, underwriting and distribution of capital issues. The Commission suggested not only the commercial banks, but also other institutions may also be allowed to set up merchant banking institutions subject to proper safeguards to ensure integrity to the operations. On the recommendations of Banking Commission, State Bank of India (SBI) became the first Indian bank to start with the merchant banking activities in 1972-73 by opening 'Merchant Banking Division' at its head office in Bombay and sub offices as ' management banking bureau' at the other major cities. The other commercial banks that followed the SBI were Central Bank of India, Bank of India and Syndicate Bank who started merchant banking services in 1977; Bank of Baroda, Chartered Bank and Mercantile Bank in 1978; Union Bank of India, UCO Bank, Punjab 8 National Bank, Canara Bank and Indian Overseas Bank undertook merchant banking activities in late 1970s and the early 1980s. Among the development banks, ICICI started merchant banking activities in 1973, followed by IFCI (1986) and IDBI (1991). Merchant banking divisions of commercial banks have been active in a narrow range of traditional merchant banking services, which mainly included issue management, underwriting and syndication of loans and provision of advisory services to corporate clients on fund raising and other financial aspects. Corresponding to the growth of capital market, the development of merchant bank scenario has been significant. Following the notification under section 6(1) (o) of the Banking Regulation Act, 1949, commercial banks were permitted during 1984 to set up subsidiaries for undertaking equipment leasing or investments in shares within the limits specified in section 19(2) of the above Act. The notification provided the real impetus to commercial banks and consequently a number of subsidiaries were established by them to undertake merchant banking activities. On August 1, 1986, State Bank of India established a wholly owned subsidiary namely, SBI Capital Market Ltd. to handle the merchant banking activities of the bank hitherto handled by its merchant banking division. The lead taken by SBI in launching a subsidiary exclusively for performing the merchant banking services has attracted the attention of other leading commercial banks in India. At the end of

June 1992, there were nine merchant banking subsidiaries set up by commercial banks with prior approval of RBI.

20.4 MERCHANT BANKING UNDER SEBI REGULATIONS

SEBI, in exercise of the powers conferred under section 30 of the SEBI Act, 1992 has made the different regulations for almost all aspects of capital market. For regulating the activities of merchant bankers, the Board has enacted SEBI (Merchant Bankers) Regulations, 1992. The objectives of the merchant banking regulations has been stated by H.R.Machiraju as follows:

"The merchant bankers regulations which seek to regulate the raising of funds in the primary market would assure for the issuer a market for raising resources at low cost, effectively and easily, ensure a high degree of protection of the interest of the investors and provide for the merchant bankers dynamic and competitive market with high standard of professional competence, honesty, integrity and solvency. The 9 regulations would promote a primary market which is fair, efficient, flexible and inspire confidence."

Recognition by SEBI on merchant bankers

SEBI will grant recognition a merchant banker after taking into account the following aspects.

1. Professional competence of merchant bankers.
2. Their capital adequacy.
3. Track record, experience and general reputation of merchant bankers.
4. Adequacy and quality of personal employed by them and also the available infrastructure. After considering the above aspects, SEBI will grant permission for the merchant banker to start functioning.

Conditions laid down by SEBI for merchant bankers

SEBI the following conditions on the merchant bankers, for conducting their operations. They are:

a. SEBI will give authorization for a merchant banker to operate for 3 years only. Without SEBI's authorization, merchant bankers cannot operate.
b. The minimum net worth of merchant banker should be Rs. 1 crore.
c. Merchant banker has to pay authorization fee, annual fee and renewal fee.

d. All issue of shares must be managed by one authorized merchant banker. It should be the lead manager.

e. The responsibility of the lead manager will be clearly indicated by SEBI.

f. Lead managers are responsible for allotment of securities, refunds, etc.,

g. Merchant banker will submit to SEBI all returns and send reposrts regarding the issue of shares.

h. A code of conduct for merchant bankers will be given by SEBI which has to be followed by them.

i. Any violation by the merchant banker will lead to the revocation of authorization by SEBI.

Conditions by SEBI pertaining to pre issue obligations:

Recent regulations by SEBI on Merchant bankers with regard to pre issue obligations involve the following;

- Registration
- Capital structure decision
- Public issue
- Rights issue
- Prospectus

Registration:

All merchant bankers must compulsorily register themselves with SEBI. SEBI will grant certificate of registration to merchant bankers under following conditions;

1. Merchant bankers should be a body corporate and should not be a NBFC.
2. They must have necessary infrastructure for maintaining an office.
3. They must have employed a minimum of two persons with experience in merchant banking business.
4. They should not be connected with any company directly or indirectly.
5. They should not have involved in any litigation connected with Stock Exchanges.
6. They must have a professional qualification in finance, law or business management.
7. Their registration must be in public interest.

Capital structure decision:

According to SEBI, they must have a minimum net worth (paid up capital + Free reserves) of Rs. 5 crores. But this will vary according to the category Rs. 5 crores for first category and none for the fourth category.

Registration fee to be paid to SEBI:

1. For category, 1 Rs. 2.5 crores per annum for the first 2 years and Rs. 1 lakh for the third year have to paid to SEBI towards registration fee.
2. For category 2. Rs.1.5 lajhs for the first 2 years per annum and Rs. 50,000 for the third year.
3. For category 3 Rs. 1 lakh per annum for the first 2 years and Rs. 25,000 for the third year.
4. From 1999 onwards, Rs.2.5 lakhs for every year, failing which the registration will be suspended for all categories.

Role of Merchant banker in public issue:

While acting as a banker to an issue, a merchant banker has to disclose full detail to SEBI. The details should contain the following.

1. Furnishing information:

a. Number of issues for which the merchant banker is engaged axis banker to issue.

b. Number of applications received and details of application money received.

c. Dates on which applications from investors were forwarded to issuing company.

d. Details of amount as refund to investors.

2. Books to be maintained:

a. Books of accounts for a minimum period of 3 years.

b. Records regarding the company.

c. Documents such as company applications, names of investors, etc.,

3. Agreement with issuing company:

a. Number of collection centers.

b. Application money received.

c. Daily statement by each branch which is a collecting centre.

4. Action by RBI:

Any action by RBI on Merchant banker should be informed to SEBI by the Merchant banker concerned.

5. Code of Conduct:

a. Having high integration in dealing with clients.

b. Disclosure of all details to the authorities concerned. Avoid making exaggerated statements.

c. Disclosing all the facts to its customers.

d. Not disclosing any confidential matter of the clients to third parties.

Responsibilities of Merchant Banker in Right Issue:

1. The merchant banker will ensure that when Rights issues are taken by a company, the merchant banker who is responsible for the right issue shall see that an advertisement regarding the same is published in an English national daily, in an Hindi national daily and in a regional daily. These newspapers should be in circulation in the city/town where the registered office of the company is located.
2. It is the duty of the merchant banker to ensure that the application forms for Rights issue should be made available to the shareholders and if they are not available, a duplicate composite application form is made available to them within a reasonable time.
3. If the shareholders are not able to obtain neither the original not the duplicate application for Rights shares, they can apply on a plain paper through the merchant banker.
4. The details that should be furnished in the plain paper , while applying for rights shares shoul be provided by the merchant banker.
5. The merchant banker should mention in the advertisement, the company official to whom the shareholders should apply for Rights shares.
6. The merchant banker should also inform that no individual can apply twice, in standard form as well as in plain paper.

Role of Merchant banker in the issue of prospectus:

It is the duty of the lead merchant banker to ensure that the prospectus are properly made and should not contain any false information. The merchant banker will also ensure that

a. The application form issued will be accompanies by abridged prospectus by the issuer company.

b. In the abridged prospectus, application form may be inked as a perforated part.

c. Unconnected matters should not be furnished in the prospectus.

Disclosure to SEBI:

Action can be taken against a merchant banker when he is found guilty of non compliance of regulations. The defaults committed by the merchant banker can be categorized into

a. General

b. Minor

c. Major

d. Serious defaults.

General default: The general default may be the failure to submit the diligence certificate in the prescribed manner to SEBI or failure to despath refund orders, etc.,

Minor default: May consist of advertisements not being n conformity with prospectus, delay in allotment of securities, etc.,

Major default: When underwriting is not properly taken up or when there are excess metabers of merchant bankers for an issue that the permissible limit.

Serious default: Unethical practice or non cooperation with SEBI.

Furnishing details on capital structure of the company: - A merchant banker should provide details of the capital structure of the company in the following manner.

1. Authorized, Issued, Subscribed and paid up capital.
2. Size of the present issue including contribution by promoters.
3. Paid up capital after the issue
4. Share premium account.

The merchant banker should also provide details regarding lock-in-period nature of allotments rights, bonus and face value of securities and issue price of securities etc.

20.5 SEBI (MERCHANT BANKERS) REGULATIONS, 1992

SEBI (Merchant Bankers) Regulations, 1992 have provided five chapters. Chapter first states the definitions relating to the subject, chapter II contains the provisions for compulsory registration of merchant bankers with SEBI, capital adequacy requirements, renewal of certificate and fee payable to SEBI. Chapter III deals with the general obligations and responsibilities of merchant bankers including code of conduct to be observed while performing merchant banking activities. In chapter IV, procedure for inspection of books of accounts, records and documents of the merchant bankers by SEBI has been specified. Chapter V states the procedure for action against merchant bankers in case of default: suspension or cancellation of registration of merchant bankers by SEBI. Important provisions of the above regulations have been explained below:-

(i) Classification of Merchant Bankers

The SEBI has classified merchant bankers under four categories for the purpose of registration. Category-I can act as issue manager, advisor, consultant, underwriter and portfolio manager. Category-II can act as advisor, consultant, underwriter and portfolio manager.

Category-III can act as underwriter, advisor and consultant only.

Category-IV can act as consultant or advisor to the issue of capital.

Thus, only Category-I merchant bankers could act as lead managers to an issue. However, with effect from December 9, 1997, different categories of merchant bankers were abolished and only Category-I merchant bankers are registered by the SEBI.

(ii) Capital Adequacy Norms

For registration of merchant bankers of various categories, SEBI has prescribed capital adequacy norms. Minimum 'net worth' of category I was fixed at Rs. 1.00 crore which was further raised to Rs. 5.00 crore by an amendment in the regulations in 1995. For category II, the minimum net worth was fixed as Rs. 50.00 lakhs, while for category III, this amount was Rs. 20.00 lakhs. Category IV was not required to have any capital or net worth. 10

(iii) Restriction on Appointment of Lead Managers

The regulations state that the number of lead merchant bankers (issue manager to the issue) may not exceed in the case of any issue of :

Size of the issue	No. of lead managers
(a) Less than Rs. 50 crore	Two
(b) Rs. 50 crore but less than Rs. 100 crore	Three
(c) Rs. Rs. 100 crore but less than Rs. 200 crore	Four
(d) Rs. 200 crore but less than Rs. 400 crore	Five
(e) Above Rs. 400 crore five or more as may be agreed by the board.	

This restriction on the number of lead managers for an issue was omitted by an amendment in regulations on April 19, 2006.

(iv) Responsibilities of Lead Managers

The Regulations state that no lead manager shall agree to manage or be associated with any issue unless his responsibilities relating to issue mainly those of disclosures, allotment and refund are clearly defined, allocated and determined and a statement specifying such responsibilities is furnished to the Board at least one month before the opening of the issue for subscription: Provided that where there are more than one lead merchant bankers to the issue, the responsibilities of each of such lead merchant banker shall clearly be demarcated and a statement specifying such responsibilities shall be furnished to the Board at least one month before opening of the issue for subscription.

(v) Underwriting Obligations

In respect of every issue to be managed, the lead merchant banker holding a certificate under category I shall accept a minimum underwriting obligation of five percent of the total underwriting commitment or rupees twenty five lakhs, whichever is less: Provided that, if the lead merchant banker is unable to accept the minimum underwriting bligation, that lead merchant banker shall make arrangement for having the issue underwritten to that extent by a merchant banker associated with the issue, shall keep the Board informed of such arrangement.

(vi) Appointment of Compliance Officer

(a) Every merchant banker shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc., issued by SEBI or the Central Government and for redressal of investors' grievances.

(b) The compliance officer shall immediately and independently report to SEBI any non-compliance observed by him and ensure that the observations made or deficiencies pointed out by SEBI on/in the draft prospectus or the letter of offer as the case may be, do not recur. However, during the period from 1992-97, there was mushrooming of merchant bankers registered with SEBI. This was due to low entry barriers (i.e. minimum net worth of Rs. 1.00 crore for category I merchant bankers up to 1995). The number of merchant bankers in 1992-93 was only 74. However, the number of merchant bankers registered with SEBI rose to 422 in 1993-94, 790 in 1994-95, 1012 in 1995-96 and 1163 at the end of 1996-97. Out of the total 1163 merchant bankers at the end of 1996-97, as many as 720 did not handle any assignment in any capacity and only 234 category I merchant bankers out of 435, were active in business of issue management. 130 merchant bankers were also issued show cause notice for their failure to meet underwriting commitments during 1996-97. During this period, merchant bankers in India were involved in many malpractices and they did not bother about the quality of issue, connived with promoters in floating bad issues and also in cheating investors through price rigging. Due to intense competition, merchant bankers vied with one another to attract issuing companies by assuring a good public response to even overpriced issues. There was a lack of proper appraisal of the issues by the merchant bankers.

20.6 SEBI (MERCHANT BANKERS) (AMENDMENT) REGULATIONS, 1997

CRB Scam in the capital market in 1997 led to the amendment in the SEBI (Merchant Bankers) Regulations, 1992. CRB Capital Market, which was registered with SEBI as category-I merchant banker and had also obtained licence to act as nonbanking financial company from RBI collapsed in May 1997 due to bouncing of cheques issued by the company in favour of its fixed deposit investors. Then came the end of CRB group, which had floated around 133 subsidiaries and unlisted companies and had managed to raise around Rs. 900 crore from the public. Then came to light the various irregularities on the part of RBI and loopholes in the regulatory frame work in context of merchant bankers functioning as a non banking financial institutions also. There was a lack of co-ordination between RBI and SEBI as in case of Non banking financial company performing fund based activities (Leasing, hire-purchase etc.) are controlled by RBI and their fee based activities (merchant banking activities and underwriting) are regulated by SEBI. Consequently, SEBI (Merchant bankers) Amendment Regulations, 1997 was enacted w.e.f. 9th December, 1997. Under this amendment, only body corporate was allowed to function as merchant bankers and multiple categories of merchant bankers were abolished. The new entity (merchant banker) was allowed to undertake only those activities which were related to securities market including issue management activities and was prohibited from carrying on fund based activities other than those related exclusively to the capital market. The SEBI regulations required that the applicant for the regulations of merchant banker should be a fit and proper person.

In USA, The Glass-Steagall Act, 1933 separated commercial banking (i.e. deposit taking and loan granting functions) from investment banking (i.e. underwriting and trading functions). It prohibited any institution from having both the business. The main purpose behind the segregation was to prevent commercial banks from taking an extra-ordinary risk. However, this Act was repealed in November, 1999.

With the enactment of SEBI (Merchant Bankers) Amendment Regulation in 1997, the number of merchant bankers registered with SEBI also declined due to segregation of fund based and fee based activities, tightening regulations, increase in the requirement of net worth to rupees five crore and eligibility of only body corporate to be the merchant bankers. The number of merchant bankers declined from 802 in 1997-98 to 415 in 1998-99 and further to 186 in 1999-2000. From 2001-02 onward, the number of SEBI registered merchant bankers varied from 145 to 150. On March 31, 2008, their number stood at 155 which increased to 164 at the end of March 2010. As a result, there has been a quantitative and qualitative change in merchant banking scenario in India and only professional merchant bankers, committed to the profession remained in the field due to tight control of SEBI.

After the above amendments, measures like more transparency in disclosure requirements in offer documents, submission of prospectus to SEBI for approval, size of the issue, its firm allotment to different categories of investors, free pricing through book building process and mandatory underwriting by lead managers have been introduced.

20.7 NOTES

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20.8 SUMMARY

The formal merchant banking services in Indian capital market started with the setting up of the merchant banking division by Grindlays Bank in 1969. Further, on the recommendation of Banking Commission, 1972, public sector banks and financial institutions entered in this field. With the abolition of CCI and the setting up of SEBI in 1992, the role of merchant banking in India has become more diverse. Inspite of diverse nature of merchant banking services and the responsibilities involved therein, issue management remains the major function performed by merchant bankers.

20.9 KEY WORDS

IPO

Rights Issue

Prospectus

SEBI

Book Building

Lead Manager

Broker

Underwriter

20.10 SELF ASSESSMENT QUESTIONS

1. Briefly explain the state of merchant banking in India
2. Highlight the developments that occurred in merchant banking services post independence period
3. Write a note on SEBI regulations on merchant bankers

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