Indian Financial System and Financial Market Operations

Jaydeb Sarkhel | Seikh Salim

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and
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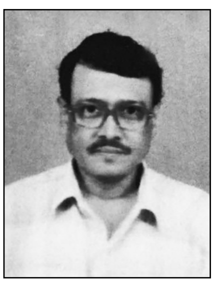
Jaydeb Sarkhel is retired Professor of Economics at the Department of Commerce, The University of Burdwan, West Bengal. He has more than four decades of teaching experience at undergraduate and postgraduate levels. He has published many textbooks in Economics for the students of H.S., B.A., B.Sc., B.Com., M.A. and M.Com. courses in English and Bengali. Some of his popular books are *Higher Secondary Economics*, *Microeconomic Theory*, *Macroeconomic Theory*, *Mathematical Techniques for Economic Analysis*, and many more. He has also published many research papers in national as well as international journals and in edited volumes. He has guided over two dozens Ph.D students. He is a life member of Indian Economic Association, Bengal Economic Association, and Indian Accounting Association. He is the President of IAA South Bengal (Midnapore) Branch. He is associated with several academic journals as a member of editorial boards. He has attended several conferences and seminars held in India and abroad.



Seikh Salim has more than 35 years of teaching experience at undergraduate and postgraduate levels. He received his Master's degree in Economics in 1978 from The University of Burdwan. An awardee of University Gold Medal and Jahar Roy Memorial Gold Medal for his performance in Master's Examination, Dr Salim got his Ph.D degree for his thesis, *Economic Development and Structural Change with Special Reference to West Bengal*. He is former Associate Professor in Economics, Burdwan Raj College, West Bengal. He has also served as a guest faculty in the PG departments of Economics, Commerce and Business Administration of The University of Burdwan, and also in the MBA department of DSMS, Durgapur, West Bengal. He also taught Economics and allied subjects at both UG and PG levels in the Department of Distance Education conducted by The University of Burdwan, and has authored many study-materials supplied to the students for a fairly long period. Dr Salim has about 15 textbooks to his credit as author and co-author. Some of his textbooks are *International Economics*, *Economic Development: Institutions, Theory and Policy*, *Microeconomics and Indian Economic Environment*, *Economic Principles and Indian Economic Problems*, and *An Introduction to Business Economics*.

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PREFACE

This book has been written for the students of B.Com. (Honours) of Calcutta University, West Bengal State University and other major Eastern India Universitites. Although there are several books available in the market on this subject, but most of the books are not student-friendly. They mainly focus on the content rather than the specific needs of the students. Hence, the primary focus of the present book is to cater to the needs of the students. The authors have fair experience in teaching commerce students and this book has been written considering their requirements and fundamentals of the subject.

The book is divided into following two parts, which have five units each:

1. **Indian Financial System:**
   - Financial System
   - Money and Indian Banking System
   - Development Banks
   - Other Financial Institutions
   - Interest Rate Structure
2. **Financial Market Operations**
   - An Overview of Financial Markets in India
   - Money Market
   - Capital Market
   - Investors' Protection
   - Financial Services

In all the units, the prescribed syllabus has been faithfully followed. The book contains question papers, with hints to the answers, of West Bengal State University from 2009–2016 and of Calcutta University from 2005–2016. These question papers will provide a good idea about the types and typicality level of questions asked in university exams. For the benefit of the students, each unit consists of a chapter-end summary which will present a quick review of the content studied in the chapter. Each unit ends with several exercise questions which are organised into Short-Answer Type Questions, Medium-Answer Type Questions and Long-Answer Type Questions. Solving these exercises will enable the students to fully prepare themselves for the examination. A glossary of technical terms used in the book is provided towards the end of the book to help the students quickly get the definition or meaning of any technical term. For advance learning, students can refer to the books listed in the Bibliography, provided at the book-end, to increase their knowledge.

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Acknowledgements

Several books have been consulted while writing this textbook and we acknowledge our debt to the authors of these books. A list of such books is given in the bibliography. In this context, we like to thank Mr Suman Sen and Mr Amit Chatterjee of McGraw Hill Education (India), for encouraging us to write this book and for providing all kind of help. Without their encouragement, the book could not have been possible as it is in its present shape. We extend our deepest thanks to all other team members of MHE associated with the project.

We hope that this book will find favour with the students. Any constructive suggestions would be highly appreciated for further improvement, and hence we request our teacher-friends in colleges to give their feedback about the book. We also request them to recommend the book to the students, if they consider it to be useful for them. We beg to be excused for any deficiency that may be present despite our sincere efforts to avoid it.

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Syllabus

Indian Financial System and Financial Market Operations for B.Com. Hons. (Accounting & Finance)

MODULE–1: Indian Financial System

Full Marks-50

Unit – 1: Financial System **(Marks–5)**

Meaning and significance; Role of finance in an economy, Components (instruments, markets, etc.); kinds of finance – Rudimentary finance, Direct and Indirect finance; Role of financial intermediaries. The structure of Indian Financial System

Unit – 2: Money and Indian Banking System **(Marks–15)**

Functions; Alternative measures to money supply in India – Their different components; Commercial Banks – Importance and functions; Structure of Commercial banking system in India; Distinction between Commercial and Central bank; Credit Creation Process of Commercial banks; High powered money – meaning and uses – Concept of Money Multiplier. The Reserve Bank of India: Functions; Instruments of Monetary and Credit control, Main features of Monetary Policy since independence.

Unit – 3: Development Banks **(Marks–10)**

Concept of Development bank and their needs in Indian financial system – Difference with Commercial banks – Major Development banks and their functions (IFCI, IDBI, ICICI, EXIM Bank, SIDBI, SFCs, NABARD)

Unit – 4: Other Financial Institutions **(Marks–10)**

Other Financial Institutions: Introduction; Life Insurance Corporation of India, General Insurance Corporation of India, Unit Trust of India.

Unit – 5: Interest Rate Structure **(Marks–10)**

Meaning – Gross and Net interest rate – their difference, Nominal and Real interest rate – their difference, Differential interest rate, Causes of variation of interest rate, relationship between interest rate and economic progress, Administered and Market determined interest rate. Recent changes in interest structure in India.

MODULE–2: Financial Market Operations
Full Marks-50

Unit – 1: Financial Markets in India: An Overview **(Marks – 5)**

Unit – 2: Money Market **(Marks – 10)**

Concept, Structure of Indian Money Market, Acceptance Houses, Discount Houses, Call money market, Recent trends of Indian money markets

Unit – 3: Capital Market **(Marks – 15)**

Concept, Security market, Primary & Secondary markets-Functions & Role, Functionaries of stock exchanges-Brokers, Sub- Brokers, Jobbers, Consultants, Institutional Investors & NRIs

Unit – 4: Investors' Protection **(Marks – 10)**

Grievances concerning Stock Exchange dealings & their removal, Grievance Redressal Cell in Stock Exchanges, Role of The SEBI, Company Law Board, Judiciary & Media

Unit – 5: Financial Services **(Marks – 10)**

Merchant Banking-Functions & Roles, SEBI guidelines, Credit rating-concept & types, Functions & limitations, Profile of Indian Rating Agencies

CONTENTS

MODULE 2: FINANCIAL MARKET OPERATIONS

MODULE 1

Indian Financial System

UNIT
1 FINANCIAL SYSTEM

UNIT OUTLINE

SUBJECT MATTER OF THE UNIT

In this introductory unit, we have tried to present an overview of the financial system. In particular we have discussed the meaning of the financial system, its significance in an economy, structure of the financial system, its functions and so on. There are different kinds of finance. Advantages and disadvantages of different kinds of finance have also been considered. Financial system mainly functions through financial intermediaries. Hence, financial intermediaries and their role in economic development of a country have also been analysed. Finally, the structure of the Indian financial system has also been presented in this unit.

1.1 MEANING OF FINANCIAL SYSTEM

L.M. Bhole, in his book *'Financial Markets and Institutions'*, has given a satisfactory definition of the financial system. According to him,

Financial system means a set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy.

We may broadly define finance as all types of monetary resources consisting of debt and ownership funds of the state, company or person. Hence, any system or institutional arrangement that deals with such monetary resources may be regarded as a part of the financial system of an economy. It is a set of *institutional arrangements* through which financial surplus in the economy is mobilised from surplus spending units and is channelised to deficit spending units of the economy. Here, by institutional arrangements we mean all conditions and mechanisms governing production, distribution, exchange and holding of financial assets of all kinds and the operations of all financial markets and institutions. Hence, the financial system of any economy consists of three main elements, namely, financial assets, financial markets and financial institutions. All these points are reflected in the above-mentioned definition of financial system stated by Bhole.

Let us try to explain the above definition of the financial system in more detail. The financial system of an economy deals with money, credit, debt and finance. These terms are closely related and are often used synonymously. However, they are slightly different. Money refers to the current medium of exchange or means of payment. Credit is broadly defined as finance made available by one party (i.e., lender) to another (i.e., borrower). The lender is called the creditor and the borrower is called the debtor. However, the term 'credit' is generally defined in a narrow sense. In this sense, the term credit is used to mean only debt finance. In the same sense, credit is simply the opposite of debt. Debt of an individual can be termed as an obligation to make future payments to someone, whereas credit is the claim to receive these payments. Both are created in the same act of borrowing and lending, and this act is a special kind of exchange transaction. It involves future payments. We know that in an exchange transaction, corresponding to every purchase, there is an equal sale since, by definition, purchase and sale are two sides of the same transaction. Similarly, in a credit transaction, the amount lent is equal to the amount borrowed, and the amount of interest paid is equal to the amount of interest received. At any time, the total volume of credit is equal to the total volume of debt. Finally, finance may broadly be defined as monetary resources comprising debt and ownership funds of the state, company or individual. The financial system means a set of arrangements that incorporate all these things, namely, money, credit, debt and finance.

It is a set of institutional arrangements that interlink financial assets, financial markets and financial institutions dealing in transfer of funds from surplus spending units to deficit spending units.

1.2 SIGNIFICANCE OF FINANCIAL SYSTEM

The financial system of an economy plays a very significant role in the growth process of that economy. It helps in production, capital accumulation and economic growth of a country in the following ways:

(i) By encouraging savings or raising inducement to save
(ii) By mobilising savings
(iii) By allocating savings in proper uses

The above three methods are discussed in detail as follows:

1.2.1 By Encouraging Savings or Raising Inducement to Save

Savers require stores of value to hold their savings. The financial system provides a wide range of financial assets as stores of value. These assets are aided by services of financial markets and various financial intermediaries. In this way, the financial system promotes savings in the economy. For wealth holders, the financial system offers ample choice of portfolios with attractive safety and return. With the development of the financial system, the scope of portfolio choice also improves. As a result, the saving–income ratio of the economy also increases. This means that financial progress generally induces larger savings out of the same level of real income.

As stores of value, financial assets have certain extra advantages over tangible assets like physical capital, inventories of goods and so on. Financial assets are convenient to hold or easily storable. They are more liquid, that is, more easily encashable than physical assets. Further, financial assets are more easily divisible and less risky than physical assets. Again, the pecuniary yield from money is zero. However, as a generalised means of payment, it provides convenience yield to its holders and users. Non-money financial assets yield money return to their holders. In addition, some of them render other specific services as well. For example, life insurance policies cover life risk, corporate equities serve as a hedge against inflation and so on. All these benefits of financial assets induce people to hold them and indirectly increase the inducement to save.

Again, financial assets do not require regular management like tangible assets. Factories, farms, shops and so on are required to be run by their owners in order to earn income. Owners of financial assets are completely free from this responsibility. They can devote their full time and energy in other activities of their likings. Owners of financial assets are only the ultimate (or indirect) owners. They are not like the immediate (or direct) owners (except for equity shareholders) of tangible assets. The owners of the tangible assets are the borrowers of funds and hence they are responsible for the actual management of the tangible assets. They bear all the risks of production. Thus, financial assets have made a separation between ultimate ownership and management of the tangible assets. In the case of corporations or joint stock companies, even the immediate owners (i.e., the shareholders) do not run the management. This separation of saving from management has greatly encouraged savings. Financial assets are now available as store of value. The public can save and hold their savings in these assets without the need for converting these savings into tangible assets and then managing these assets. Rather, management can now be professionalised. This means that the management of the tangible assets can be entrusted to professional managers, and these managers do not require owning these assets. All these improve productivity.

Savings are done by households, business firms and government. Of these three sectors, generally the dominant saver is the household sector, followed by the domestic private corporate sector. The contribution of the public sector to total net domestic saving is relatively small. This is particularly true in developing countries like India. Now, savings by households are done for several reasons. Households may save to meet known future needs, such as old age, education and marriage of children, the desire to own property, to buy costly consumer durables and so on. They may also save to meet uncertain future needs such as sickness, accident and so on. Household and business savings also arise due to the fact that income and expenditure are not synchronised. Generally, expenditure follows the income. Now, different kinds of financial assets can meet diverse needs and preferences of different categories of savers. As the financial system develops, new and innovative financial assets are introduced in the market. Many kinds of financial services are provided by financial intermediaries. As a result of their activities the liquidity and rate of return of these assets improve. On the other hand, the risk of default and market riskiness of financial assets decrease. All these have great positive impact on the willingness to save by the public. An improved financial system thus greatly helps in encouraging saving in an economy.

1.2.2 By Mobilising Savings

Savings are done by numerous individuals and firms. They may be in large and small amounts and of long or short terms. All these savings are to be collected or mobilised before they become available to the deficit spending units. The financial system is a highly efficient mechanism for mobilising saving. In a fully monetised economy, this is done automatically when the public hold their savings in the form of money. However, this is not the only way of instantaneous mobilisation of savings. In provident fund deduction at source and other deductions under various saving schemes, savings are mobilised instantaneously. More generally, mobilisation of savings takes place when savers hold financial assets. This may be in the forms of currency, bank deposits, post office saving deposits, insurance policies, bills, bonds, equity shares and so on.

Financial assets may broadly be divided into two categories: primary securities and secondary securities. Primary securities are the securities issued by the ultimate borrowers, such as bills, bonds, equity shares and so on, whereas secondary securities are the securities issued by financial institutions or financial intermediaries, such as banks, insurance companies and so on. When an individual buys primary securities, he\she makes his\her surpluses available directly to the deficit spending units. It represents direct mobilisation as well as allocation of credit, though in this case there is mediation of financial assets and markets. On the other hand, when the individual buys secondary securities, he\she hands over his\her saving to financial institutions. These institutions again allocate them among the borrowers. This represents financial intermediation (or indirect finance). However, sometimes a part of the saving does not go through the financial system. This happens when savers directly invest a part of their savings in tangible assets like houses, businesses or precious metals.

For financial planning and control, institutionalisation of savings is important. For, it is easier to control lending/investing policies of financial institutions rather than controlling the activities of thousands of direct lenders or direct investors in physical assets. The financial system thus helps not only in the mobilisation of savings, but also in financial planning and control.

1.2.3 By Allocating Savings in Proper Uses

The financial system of a country helps in smooth, efficient and socially equitable allocation of credit. Activities of moneylenders and indigenous bankers have several defects; such activities reduce the effectiveness of monetary policy of the central bank. They do not have any credit allocation plan for the economy as a whole. Their allocation of credit is not according to any social design, but a modern financial system with new financial instruments, assets and markets can play an important role in the provision of credit. We know that there may be direct purchase of primary securities by the public, but such direct dealings have been made possible by the stock markets and marketable financial assets, such as corporate bonds and equities. In addition, there are banks, insurance companies and other financial institutions. They work as financial intermediaries between the ultimate lender and the ultimate borrower. They mobilise savings of the lenders by selling their own liabilities, such as deposits, insurance policies and so on. Then, they allocate these funds to deficit spenders at their own risk. Therefore, many savers find the secondary securities of financial institutions much more acceptable than the primary securities of ultimate borrowers.

We know that only corporations can raise funds through public issue of equity shares and bonds. Even this also requires the help of financial institutions as buyers of securities. On the other hand, non-corporate borrowers cannot issue marketable securities. Hence, they have to depend on bank finance or private finance. Financial institutions determine how institutional finance will be allocated among various sectors of the economy and among competing borrowers.

Thus, the financial system promotes savings, mobilises savings and allocates savings. All these are essential for production, capital formation and economic growth of an economy. The financial system, through its activities, significantly increases the rates of savings and investment. It mobilises all kinds of savings, that is, large or small, long term or short term. This leads to the maximum utilisation of saving. Again, a developed financial system facilitates the flow of savings throughout the economy. Thereby, it drives the flow of funds to those directions where returns are high. This leads to the maximisation of returns from resources.

1.3 COMPONENTS OF FINANCIAL SYSTEM

We know that the financial system of an economy is a set of institutional arrangements through which financial surpluses in the economy are mobilised from surplus spenders and are transferred to deficit spenders. By institutional arrangements we mean all conditions and mechanisms involving production, distribution, exchange and holding of financial assets of all kinds and the organisation as well as the operation of all financial markets and institutions. This description of the financial system of an economy clearly reveals that any financial system has three main components. They are as follows:

(i) Financial assets
(ii) Financial markets and
(iii) Financial institutions

We shall briefly describe these three components of a financial system one by one.

1.3.1 Financial Assets

An asset is an entity which possesses market or exchange value and forms part of the wealth or property of the owner. In economics, an important distinction is made between real assets and financial assets. Real assets are tangible resources like plants, buildings, land and so on which yield services in production or directly to consumers. On the other hand, financial assets are claims or titles to receive income, or to receive value from others. Examples of financial assets are money, bonds, equities, and so on.

Financial assets or claims are generally divided into two categories, namely, primary securities and secondary securities. Primary securities (also called direct securities) are the securities which are created by real-sector units as ultimate borrowers for raising funds to finance their deficit spending. They are financial claims against real sector units. Examples of direct or primary securities are bills, bonds, equities, book debts and so on. On the other hand, secondary securities (also called indirect securities) are the securities or financial claims issued by financial institutions or intermediaries against themselves to raise funds from the public. Examples of secondary securities or secondary financial assets are currency, bank deposits, life insurance policies, units of mutual funds, post office deposits, non-banking company deposits and so on. Various financial institutions create these secondary financial assets and sell them to the surplus-spending public and thus raise funds. These funds are then given to deficit spending units as credit.

On the basis of their maturity period, both primary and secondary financial assets are divided into three categories, namely, short-term financial assets, medium-term financial assets and long-term financial assets. Here short-term means a period of less than 1 year. Medium-term generally refers to a period of 1–5 years. Lastly, long-term generally refers to a period exceeding 5 years.

1.3.2 Financial Markets

In Economics, the word 'market' refers to a social relation or a social institution between buyers and sellers of a product. Generally speaking, market refers to any context in which sale and purchase of goods and services take place. Hence, markets which deal in financial assets and instruments of various kinds such as currency, deposits, bills, bonds and so on are called financial markets. The financial system operates through financial markets and institutions. Theoretically, financial markets are very much similar to the markets for goods and services.

Like the markets for goods and services, financial markets also have demand, supply, price, and so on, for their financial assets or financial products.

Financial markets can be classified from different angles, namely, functional, institutional or sectoral point of view. The **functional classification** is made on the basis of the term of credit. On this basis, financial markets are divided into markets for short-term and long-term credit. The former markets are called money markets whereas the latter markets are called capital markets. The **institutional classification** tells us whether the markets are organised or unorganised. It also tells us whether the markets deal in new securities or in old or existing securities. If the financial assets are introduced for the first time in the market, the market is called a primary market. On the other hand, if the market deals in existing or old financial assets, the market is called a secondary market. The **sectoral classification** tells us about the sector in which the market is dealing in credit. Thus, we have markets dealing in credit arrangements for agricultural or industrial or export–import sector and so on.

1.3.3 Financial Institutions

Financial institutions, or more popularly, financial intermediaries include all kinds of organisations which intermediate and facilitate financial transactions of both individuals and corporate customers. They refer to all kinds of financial organisations which act as a bridge between borrowers and lenders in the financial markets. They are generally classified under two heads: banks and non-bank financial intermediaries (NBFIs). Banks occupy a very important position in the financial system of a country. A major part of the financial transactions of an economy is undertaken by banks.

Sometimes, financial institutions are divided into three categories, such as, regulatory, intermediary and non-intermediary financial institutions. Regulatory financial institutions are those institutions which regulate the activities of other financial institutions. In case of Indian economy, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) are two examples of regulatory financial institutions. We know that the Reserve Bank of India (RBI) is the central bank of India. As the central bank of the country, it regulates the activities of commercial banks, other banks and non-bank financial institutions. The Securities and Exchange Board of India (SEBI) regulates the activities of stock exchanges or stock markets of India. On the other hand, intermediaries are those institutions which act as a bridge between borrowers and lenders. All banking institutions are intermediaries. Many non-banking institutions also act as intermediaries. When they do so, they are called non-bank financial intermediaries (NBFIs). Finally, there may be some special-purpose financial institutions which get funds from the government and lend them to target borrowers for special purposes. They are called non-intermediaries or, popularly, development financial institutions (DFIs). In the Indian context, examples of such financial non-intermediaries are Industrial Finance Corporation of India (IFCI), National Bank for Agriculture and Rural Development (NABARD), Industrial Reconstruction Corporation of India (IRCI), State Industrial Development Corporation (SIDC), State Financial

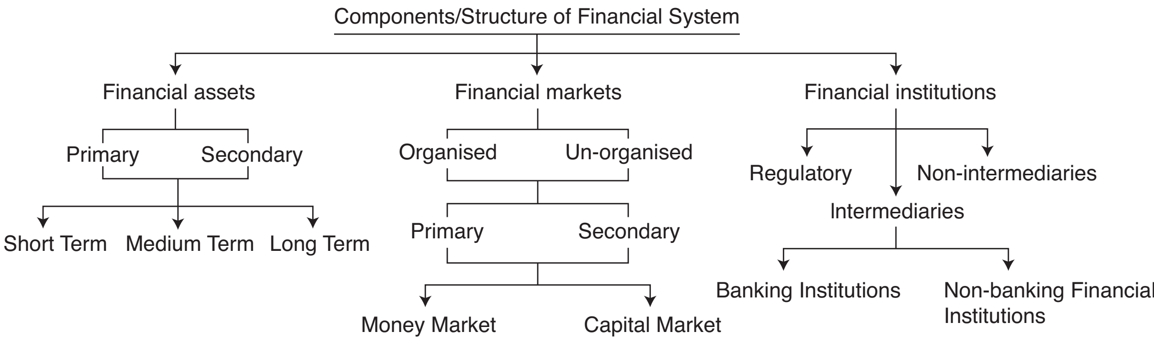


Figure 1.1 Components/Structure of Financial System of a Country

Corporations (SFCs) and so on. In Figure 1.1 given above, we have shown the components or the structure of financial system of any country.

1.4 FUNCTIONS OF FINANCIAL SYSTEM

In Section 1.2, while considering the significance/importance of financial system, we have mentioned the basic functions of the financial system. The main function of the financial system is to mobilise savings of the economy and to channelise those savings into productive investment. In addition to that, the financial system of an economy performs some important functions. We summarise them under the following points.

1.4.1 Supply of Liquidity/Money

Production of goods and services requires regular and sufficient supply of money. If the supply of money is not regular and sufficient, production will be hampered. There should not be any shortage of money in productive activities. The major function of the financial system is to provide money and monetary assets for the production of goods and services. In financial language, money and monetary assets are referred to as liquidity. All activities in a financial system are related to liquidity—either provision of liquidity or trading in liquidity. The financial system in an economy provides liquidity and thus helps the economy to continue production without any interruption.

1.4.2 Mobilisation of Savings

Another important function of the financial system is to mobilise savings. There are numerous small savers scattered all over the country. They are surplus spending units and the savings of these surplus units are to be mobilised. The financial system, through its various financial institutions such as banks, insurance companies, mutual funds and so on mobilises these savings. Not only that, the existence of a developed financial system with various types of financial assets and securities raises the inducement to save of the householders. It thus helps in the promotion and mobilisation of savings.

1.4.3 Channelising Savings into Productive Investment

Mere mobilisation of savings is not enough for economic development of a country. The mobilised savings are to be employed into productive activities. Financial intermediaries or financial institutions channelise the savings of the householders into most productive uses. They have the necessary information, expertise and infrastructure to determine the right investment option(s). A small or individual saver very often is unable to make right investment decision.

1.4.4 Transformation Services

Financial intermediaries or institutions perform various types of transformation services. These are as follows:

- Liability-asset transformation function
- Size transformation function
- Risk transformation function
- Maturity transformation function

Let us briefly describe them one by one.

1.4.4.1 Liability-Asset Transformation Function

Financial intermediaries or institutions issue claims to their customers. These claims have characteristics different from their own assets. For examples, banks accept deposits from individuals and organisations. These deposits are assets of the depositors and liabilities of the banks. Banks now issue loans to the deficit spending units. These loans are now assets of the banks and liabilities of the borrowers. Thus banks convert their liabilities into assets such as loans. This is known as liability-asset transformation function of financial institutions.

1.4.4.2 Size Transformation Function

Financial institutions can provide large volumes of finance on the basis of small deposits. They can pool huge amount of deposits from numerous small savers and can provide large funds to the deficit spenders. These institutions can acquire better information and thus can reduce transactions costs. They are able to do so through economies of scale in lending and borrowing. This is called size transformation function of financial intermediaries or institutions.

1.4.4.3 Risk Transformation Function

Financial institutions can reduce the risk and raise the return of portfolios. A portfolio is a particular combination of different types of financial assets. Holding of different types of assets is called asset diversification. If asset diversification in a portfolio rises, then the associated risk of holding financial assets falls. Financial institutions distribute risk through asset diversification. A developed financial system has various types of financial assets. The savers then have greater opportunities of asset diversification. Financial institutions thus help savers to reduce risk. For example, mutual funds collect deposits from small savers by selling 'units' and then invest the pooled sum in various kinds of financial assets. This reduces risks of the depositors or unit holders. This is called risk transformation function of financial institutions.

1.4.4.4 Maturity Transformation Function

Financial intermediaries offer alternative forms of deposits to the depositors according to their needs and liquidity preferences. Different depositors have different needs and different preferences for liquidities. An advance financial system with various types of financial securities provides opportunities to the surplus units to satisfy their needs and preferences. Financial intermediaries also provide borrowers with loans of requisite maturities. This is known as **maturity transformation function** of financial intermediaries.

1.4.5 Efficient Functioning of Payment Mechanisms

A developed financial system also ensures that transactions are done safely and swiftly on an on-going basis. For smooth and efficient functioning of an economy, it is necessary that payment instruments are accepted and honoured by all parties. Otherwise, transactions of goods and services will be hampered. The financial system ensures **efficient functioning of the payment mechanisms**.

Thus, the financial system in an economy performs some important functions. It provides money or liquidity to the producers. It also mobilises savings of the small savers of the country and channelises it to productive investment. Further, it provides various opportunities to the corporate houses to utilize their financial resources in the optimum way. It also provides opportunities to the savers to reduce risk through asset diversification. All these help in economic development of a country. Hence, financial system plays a very positive role in the process of economic development of a country. Without a suitable and sound financial system, economic development of a country is not possible and its development process is bound to be halted.

1.5 DIFFERENT KINDS OF FINANCE

In common parlance, the term 'finance' is used to mean money. However, finance does not exactly mean money; it is the source of providing funds for a particular activity. Thus, public finance does not mean the money with a government, but it means sources of raising revenue for the activities and functions of the government. Finance may broadly be defined as monetary resources comprising debt and ownership funds of the state, company or persons. We may mention different kinds of finance, namely, rudimentary finance, direct finance and indirect finance. We briefly discuss them below.

1.5.1 Rudimentary Finance

Rudimentary finance refers to the financial system in an underdeveloped or traditional economy in which per capital output is low and declining over a period of time (Gurley and Shaw: *Money in a Theory of Finance*). The basic feature of the rudimentary finance is the absence of a series of financial assets/instruments that would stimulate savings and the absence of a series of financial markets that would allocate savings competitively to investment.

Under rudimentary finance, there is no financial asset other than money. Then, no economic unit could invest more than its savings because there would be no way to finance the excess expenditure. Also, no unit can invest less than its savings because there would be no financial asset to put the excess savings. Hence, each spending unit would be forced into a balanced budget position with savings equalling investments. This sort of arrangement would very likely lead to a relatively low level of investments and savings and hence would lead to a relatively low rate of growth of output.

The other characteristic of rudimentary finance is the absence of financial markets. As a result, there would be no mechanism to accumulate the savings of numerous individuals and allocate them to investment on a large scale. Since the system provides only one financial asset, it cannot fully exploit financial incentives to savings. As, such efficient allocation of savings into various investment opportunities is not possible. All these factors lead to a lower propensity to save and, hence, to a low rate of growth. So the immature financial system in rudimentary finance is in itself an obstacle to growth.

In order to remove this obstacle of rudimentary finance, the financial system must bring together the two groups, namely, savers and investors, and reconcile their conflicting objectives. Two types of basic financial techniques/marketing have evolved and developed gradually. The first of these is direct in the sense that there is no intermediary financial institution to link between the savers and the investors. The second type of financial marketing as a technique to link the savers and the investors involves various financial intermediaries. The first type of arrangement is referred to as direct finance and the second type of arrangement is called indirect finance. We shall now consider these two types of basic financial techniques/marketing one by one.

1.5.2 Direct Finance

When there is no financial intermediary between the saver and the investor, that is, between the lender and the borrower in a financial transaction, it is called **direct finance**. In this case, financial intermediaries, such as, banks, mutual funds, insurance companies, unit trusts and so on do not exist. Funds go directly from surplus spenders to deficit spenders. In the case of direct finance, securities are sold directly to institutional investors. Hence, the cost of underwriting and other transaction costs and service charges could be avoided. Direct finance represents an improvement over rudimentary finance as it removes the obstacles to efficient capital formation. The ability of the financial systems to mobilise more savings is improved under direct finance, through the introduction of three innovations: (i) financial assets/instruments, (ii) brokers/investment bankers, and (iii) secondary markets/stock exchanges. These three innovations are of considerable value to both the savers and the investors. All these innovations contribute to the efficiency of flow of savings from the ultimate savers to the ultimate users (i.e., investors). As a result, capital formation is greatly stimulated. It leads to an increase in the rate of growth.

However, there are some limitations of direct finance. First, direct transfer of funds to a distant place may be expensive. Second, direct transfer of funds may be inconvenient also. Third, if savers are investment-shy, direct finance will not take place.

Under direct finance, only large investors can acquire industrial securities, and savings of only such a class of people will be mobilised through the financial system. The savings of the relatively smaller savers who are the majority, would not become available to the financial system. Hence, for more efficient capital formation, savings have to be mobilised from as large population as possible. There is need for intermediary financial institutions which will take care of the problems of investment management of the small investors. This will evolve a vibrant financial organisation and speed up economic growth. The institutional arrangement to fulfil this requirement is covered under indirect finance.

1.5.3 Indirect Finance

As the term “indirect” indicates, indirect finance is just opposite to direct finance. When there are financial intermediaries between the lender (saver) and the borrower (investor) in a financial transaction, it is called **indirect finance**. In this case, financial intermediaries, such as banks, mutual funds, insurance companies and so on operate. Here funds go from savers to investors through these financial intermediaries. Hence, this process is called intermediation or indirect finance. Most of the transactions in money and capital markets are of this type, that is, indirect transactions. This is due to some advantages or merits of indirect finance. These merits of indirect finance are briefly mentioned below:

- First, in indirect finance, there is lower risk. Risks can be reduced through asset diversification, as there are various types of financial assets under the system of indirect finance.
- Second, indirect finance has three types of conveniences, such as, maturity, divisibility and flexibility where savers can enjoy redemption facility, can purchase securities of different denominations and can purchase various types of securities through financial intermediaries.
- Third, savers can enjoy the benefits of expert management of financial intermediaries.
- Fourth, cost of financing will be low due to economies of scale.
- Fifth, financial intermediaries offer to the entrepreneurs, advisory services relating to the preparation of feasibility reports, identifying growth potential and training them in project management. They thus provide technical assistance to the investors which is an important bottleneck faced by entrepreneurs in developing countries.

For all these merits, most of the financial transactions of today are indirect finance in all countries.

1.6 FINANCIAL INTERMEDIARIES

As we have already mentioned, financial intermediaries mediate or stand between ultimate lenders and ultimate borrowers. They act as a bridge between surplus spending units and deficit spending units. The examples of financial intermediaries are banks, insurance companies, unit trusts or mutual funds, investment companies and so on. The main function of all financial intermediaries is to collect surpluses or savings of surplus spending units and to lend them on to deficit spending units. Both the surplus spenders and the deficit spenders belong to the real sector of the economy. Their main economic activity is to buy and sell productive factors and current output. On the other hand, the main economic activity of financial institutions is to purchase and sell financial assets.

Financial assets or securities may be divided into two categories: (a) primary securities and (b) secondary securities. Primary securities are bought by both surplus real-sector units and financial intermediaries. When surplus spending units buy these securities, they are providing finance to ultimate borrowers or deficit units directly. Finance provided by surplus units in this manner is called direct finance. However, only a small part of total surpluses of surplus units is provided to deficit units in this way. In a modern money-using economy, most of surpluses (i.e., savings) of surplus units are placed in secondary securities created by financial intermediaries. Thus most of the savings of surplus units goes to the financial intermediaries. The financial intermediaries now make these surpluses available to ultimate borrowers. The ultimate lenders are still the surplus-spending units, but they mostly lend to ultimate borrowers (or deficit spending units) not directly, rather indirectly through financial intermediaries. Finance provided by surplus spending units to deficit spending units in this manner through financial intermediaries, is called indirect finance.

From the above discussion, it is clear that financial institutions are dealers in securities. They buy primary securities from surplus units and sell secondary securities to deficit units. They include primary securities in their asset portfolios and create secondary securities to finance those primary securities. In this process, they virtually transform primary securities into secondary securities. Only the financial intermediaries have this ability. They are able to produce securities which are more acceptable to surplus units than the primary securities produced by deficit units. Surplus units have varied preferences for different types of financial securities. Deficit units cannot produce those various kinds of financial securities which satisfy the asset preferences of surplus units in terms of risk, liquidity, convenience and so on. However, they are done by secondary securities of financial intermediaries. Financial institutions can satisfy disparate asset-debt preferences of both lenders and borrowers.

In order to clarify this asset-transmutation function of the financial intermediaries, we may cite an example. We suppose that a farmer wants a crop loan against his promissory note which is supported by the crop sown on the farmer's land. Generally, the local village moneylender will provide this finance. But an urban household will not provide this loan to the farmer because it involves some risk and inconvenience. First of all, normally there will be no point of contact between the two parties. However, the case will be different with a bank or a co-operative credit society. The bank may have several such borrowers among its customers. It may also have organisational links and staff to provide service for such loans. The urban household may have a savings account with this bank. He is thus entrusting a part of this surplus (savings) to the bank. The bank will then lend a part of the savings of the urban household to the farmer. The urban household will not mind for it. This is because he has the confidence that the bank will pay back his deposit on demand. Thus, the secondary security in the form of savings deposits has enabled the bank to mobilize savings of the household and these savings can be used to lend even to a distant farmer. The farmer could not otherwise borrow directly from the urban household on the strength of his promise to repay. The success and significance of the financial intermediaries lies in this asset transformation. Here the primary security of the urban household is transformed into the secondary security and it is sold to the farmer by the bank.

Financial intermediation is beneficial to both lenders and borrowers. The gains to lenders are in the following forms:

- Low risk
- Greater liquidity
- Convenience of transactions
- Some other services provided by financial intermediaries

The gains to borrowers are in the following forms:

- Fulfilment of demand for large funds
- Greater certainty of the availability of funds from financial intermediaries
- Low rate of interest
- Some preferential treatment from the financial intermediaries

How is financial intermediation beneficial to both borrowers and lenders at the same time?—The answer lies in the economic basis of financial intermediation. There are three main economic bases of financial intermediation. They are as follows:

(i) Separation of saving from investment
(ii) Law of large numbers
(iii) Economies of scale in portfolio management

These economies may arise in the following forms:

- Reduction in risk through portfolio diversification
- Professional management
- Indivisibility and market imperfections and so on

1.7 FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

The contribution of the financial system of an economy towards its economic development cannot be overstated. The financial system of a country plays a very vital role in the process of economic development of that country. Financial intermediaries provide various financial services and create many innovative credit instruments. This increases the inducement to save of the individuals. Financial intermediaries can promote investment and, thereby, the rate of growth in a less developed but developing economy. These economies suffer from scarcity of savings and this acts as an obstacle to raising investment. Further, even this low saving is often misallocated. People tend to spend their savings in social and religious festivals. Financial intermediaries encourage saving by ensuring security of funds of the savers, by providing reasonable returns, by extending branches to the close neighbourhood of the savers and so on. Further, in less developed countries, savings are low and scattered. These small savings are to be mobilised. Financial institutions mobilise these savings through branch expansion particularly in rural areas. These pooled savings are then provided to firms and government. Financial authorities supervise the utilisation of these allocated funds. Hence, in most cases, the allocated savings are properly utilised. Sometimes mobilisation and allocation activity are performed by savers directly. This happens when savers purchase primary securities created by borrowers and investors.

However, the amount of saving involved in this type of direct finance is negligible. Most of the savings in an economy are mobilised and allocated by financial intermediaries. Thus, financial intermediaries help in mobilising savings and channelise these savings to productive investment. They thus play vital role in the process of economic development of a country. In fact, the more organised and developed the financial system of a country is, the higher will be the rate of growth or expansion of that country. Financial intermediaries can help in the process of economic development of a country in the following ways:

1.7.1 Generation of Savings

Underdeveloped countries suffer from lack of capital. According to Nurkse, this lack of capital creates a vicious circle of poverty in these economies. The main reason behind this is the low amount of savings. In such economies, people's inducement to save is low. Now, savers require various types of financial assets to put their savings. Their needs are varied. Financial intermediaries offer a variety of securities and financial instruments in order to satisfy the varied needs of the savers. This encourages savers to save more. They thus help raise the inducement to save of the potential savers.

1.7.2 Mobilisation of Savings

We know that in a developing economy, people have low income and saving. There are numerous small savers, and they are scattered all over the country. Financial intermediaries help in mobilising these small savings through a network of branch expansion. For example, a developed financial system has branches of commercial banks and network of insurance companies even in rural areas. Financial intermediaries including commercial banks thus help in the mobilisation of savings of the myriads of small savers in less developed countries.

1.7.3 Allocation of Funds

Generation of savings and mobilisation of savings are not enough. These pooled funds are to be properly allocated. They are to be channelised into productive investment. To ensure this, central bank and the government of any country adopt many controlling devices which are required to be followed by financial intermediaries. Through these devices, funds are encouraged to flow into the desired sectors and discouraged or restricted in undesired sectors.

Thus, financial system of an economy ensures proper allocation of funds and helps in capital formation of that economy.

1.7.4 Financing Industry

Financial intermediaries channelise the mobilised saving into productive investment. They provide short-term, medium-term and long-term finance to the industrial sector. All these three types of capital or funds are required for smooth and uninterrupted production. Short-term working capital is required to finance current operations of business. Medium-term capital is required for buying tools and equipment. Long term capital is required for making fixed investment in physical plant (i.e., land, buildings, and machinery). Shortage of any kind of capital in any firm can hurt badly its productive activities and growth. The financial system helps firms in raising funds for meeting its requirements for various kinds of capital.

1.7.5 Financing Trade

Some financial intermediaries including commercial banks help in financing both internal and external trade of an economy. They provide loans to retailers and wholesalers to run their business. They also provide some important services like discounting and acceptance of bills, overdraft facilities, draft facilities and so on. Some financial intermediaries help in exports and imports by providing foreign exchange facilities to exporters and importers. For example, in India, Export and Import Banks (EXIM Banks) help in the expansion of exports and imports of the country.

1.7.6 Financing Agriculture and Small Scale Industries

In most of the developing economies, agriculture is the main economic activity, though this sector is not developed or diversified. Development of such economies depends heavily on the development of the agricultural sector. Financial intermediaries help in the development of the agricultural sector also. Some development financial institutions (DFIs) are specially designed for developing the agricultural and rural sector of the economy in many ways. They provide finance for agricultural marketing, for land development, for irrigation facilities, for purchasing farm implements and so on. Again, in developing economies, there is high inequality in the distribution of income. Further, most of these economies suffer from huge unemployment problem. To address these problems, expansion of small-scale industries in rural areas is urgently required. Financial institutions help in the expansion of small-scale industries. They provide credit to the village artisans and to the small and cottage industries. Thus, various financial institutions provide rural credit which is much needed for the development of agriculture and small-scale industries of a less developed economy.

1.7.7 Developing Money and Capital Markets

Economic development of a country requires a developed financial system, and developed financial system means developed money and capital markets. For economic development of a country, existence of developed money and capital markets is utmost required.

Developed money and capital markets increase the velocity of circulation of money, develop professional attitude among the people, increase the mobility and availability of funds, raise the effectiveness of monetary policy of the central bank, ensure more rational and proper allocation of resources and so on. All these help in economic development of a country in numerous ways. Hence, the central bank of a country adopts some promotional and developmental activities for the expansion and development of money and capital markets of the country. It also undertakes some regulatory activities in order to control the activities of financial intermediaries and to ensure their functioning in an orderly and healthy manner under competitive situations. This indirectly helps in economic development of the country.

Thus, financial system makes a huge contribution to the process of economic development of a country in so many ways. As we have earlier said, without a developed financial system, development process of a country is bound to face many obstacles or may even be halted.

1.8 STRUCTURE OF INDIAN FINANCIAL SYSTEM

We have stated that the financial system is a set of **institutional arrangements** through which financial surpluses in the economy are mobilised from surplus units and transferred to deficit units. Financial markets, financial institutions and financial assets are the three main constituents of any financial system.

1.8.1 Financial Markets

The most significant component of India's financial system is the **financial market**. This market acts as a link between the savers (surplus units) and investors (deficit units) both at individual and institutional levels. The financial market in India is divided basically into two parts on the basis of the nature of funds demanded and supplied on the term of financial assets traded. These two parts are **money market** and **capital market**. They together constitute the organisational structure of Indian Financial market.

1.8.1.1 Money Market

Money market is the market of short-term loans or financial assets having a maturity period of less than 1 year. It is a market for short-term assets which are valid for less than 1 year. This market mainly meets the working capital needs of trade and industry. It refers to that segment of the financial market which performs two functions. **First**, it raises short-term funds for meeting temporary shortage of cash and, **second**, it deploys excess funds for earning quick returns. In India, two major participants of the money market are the Reserve Bank of India and commercial banks. In addition, Indian money market at present has a number of sub-markets. They are call (money) market, treasury bill market, commercial bill market, market for commercial papers (CPs), market for certificate of deposits (CDs) and money market mutual funds (MMMFs). In recent years, the money market has been strengthened by setting up primary dealers and satellite dealers. The money market has also been recently integrated with the foreign exchange market (forex market).

1.8.1.2 Capital Market

Capital market is the market for medium-term and long-term financial assets. Generally, it deals in securities having a maturity period of 1 year and above. The capital market provides long-term funds for fixed investments. It is also called security market. The main participants in the capital market are commercial banks, mutual funds, insurance companies, development financial institutions (DFIs), corporates and individuals. They are all regulated by the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

The capital market or the security market has two major components: (1) Primary or new issue market, and (2) Secondary market or stock exchange (or stock market).The new issue market or primary market deals in new securities, that is, securities which are offered to the investors for the first time. These may be issued by the government (gilt-edged or government securities market) or may be issued by private corporate houses (industrial securities market). On the other hand, secondary market deals in old/existing securities. It is also called stock exchange or stock market. Thus, stock exchange is a market for old/existing securities.

1.8.2 Financial Institutions or Intermediaries

The second component of the Indian financial system is various financial institutions and financial intermediaries (FIs). These are institutional sources of finance to industry. They make a bridge between the savers and the investors. They collect funds from the surplus spending units and make them available to the deficit spending units. The main financial institutions in the Indian money market are commercial banks. The principal institutions/intermediaries in the Indian capital market are non-banking financial companies (NBFCs), development financial institutions (DFIs), mutual funds and insurance companies. We briefly describe them one by one.

1.8.2.1 Commercial Banks

Commercial banks are the main components of the organised sector of Indian money market. These banks are of two main categories: nationalised or public sector banks and non-nationalised or private sector banks. The non-nationalized or private sector banks are again of two categories, namely, Indian banks and foreign banks. In addition to commercial banks, there are co-operative banks also. All banks are basically depository institutions. They collect savings of the non-bank public primarily in the form of deposits and give mainly short-term loans to industries and business firms. After the liberalisation of the financial sector since July1991, commercial banks in India have been providing term credit also. Hence, commercial banks are financial institutions of both money and capital markets.

1.8.2.2 Non-banking Financial Companies

Non-banking financial companies closely resemble commercial banks, but they are not banks in the true sense. The deposits with the non-banking financial companies are not a part of money supply, but those with commercial banks are a part of money supply of the country. These non-banking financial companies compete closely with commercial banks in attracting public deposits. They then allocate these funds to industries and business firms generally for a period of 1 year or more. NBFCs are not a homogeneous entity, rather they are heterogeneous. They offer various types of services. On the basis of their diverse services, they are divided into the following categories:

- Merchant banks giving advice to business enterprises on financial matters, corporate mergers, underwriting new issues, loan syndication and so on.
- Housing finance companies providing finance for house building.
- Hire purchase and consumer finance companies providing finance to business firms to purchase equipment and to households to purchase durable consumer goods on hire-purchase basis.
- Venture capital funds providing initial risk or seed capital to business firms.
- Leasing companies lending equipment on lease.
- Credit rating agencies providing information on credit worthiness of different corporate houses.
- Factoring services, that is, taking the credit risk by the financial intermediaries for their clients.

1.8.2.3 Development (Public) Financial Institutions (DFIs)

Development financial institutions are special purpose development institutions created by the Government of India and some state governments in order to supply finance to specific categories of industries. They are important financial institutions in the capital market of Indian financial system. In this group, we have Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), Small Industries Development Bank of India (SIDBI), Industrial Investment Bank of India (IIBI), National Industrial Development Corporation (NIDC), National Small Industries Corporation Limited (NSIC) and so on.

1.8.2.4 Mutual Funds

A mutual fund pools the small savings of the public and invests them in a well-diversified portfolio. It enables the small savers to enjoy the benefits of investment in industrial securities. Investment in mutual funds has some benefits such as tax benefits, reduced risk, low transaction costs and so on. In India, Unit Trust of India (established as a public sector enterprise in 1964) is the premiere mutual fund in India. At present, mutual funds are an important component of the Indian capital market.

1.8.2.5 Insurance Organisations

Insurance organisations have also become major players in the capital market of India. Two most important public sector institutions in India are Life Insurance Corporation of India (LICI) and General Insurance Corporation of India (GICI). Recently, the Government of India has opened up the insurance sector and as a result, many private sector insurance companies have entered the Indian market. Insurance organisations have enormous financial resources and are now providing finance to the industrial sector.

1.8.3 Financial Instruments

The third component of financial system is financial instruments. At present there are various types of financial instruments in the capital market of India. They may broadly be divided into two categories: traditional instruments and new or innovative instruments. In the category of traditional instruments, there are equity or ordinary shares, various types of debentures and preference shares. A variety of debt instruments have been introduced into Indian capital market in recent years. They are called new innovative instruments. These new instruments may again be divided into two categories: instruments issued by corporates and instruments issued by financial intermediaries. In the first category, we have participating debentures, convertible debentures with options, fully convertible debentures, warrants and so on. In the second category, we may mention floating rate bonds, zero coupon bonds, regular income bonds, retirement bonds, growth bonds, index bonds, deep discount bonds and so on.

SUMMARY

S.1 Meaning of Financial System

The financial system of an economy is a set of institutional arrangements through which financial surplus in the economy is mobilised from surplus spending units and is channelised to deficit spending units of the economy.

S.2 Significance of Financial System

The financial system of an economy is very significant as it helps in production, capital accumulation and economic growth of a country in the following ways:

- By encouraging savings
- By mobilising savings
- By allocating savings in proper uses

S.3 Components of Financial System

Financial system of any country has three main components. They are as follows:

- Financial assets
- Financial markets
- Financial institutions

S.4 Functions of Financial System

The financial system of an economy performs some important functions. They are as follows:

- Supply of liquidity of money
- Mobilisation of savings
- Channelising savings into productive investment

- Efficient functioning of payment mechanism
- Transformation services.

There are again four types of transformation services. They are as follows:

1. Liability-asset transformation function
2. Size transformation function
3. Risk transformation function
4. Maturity transformation function

S.5 Different Kinds of Finance

We may mention mainly three kinds of finance, namely rudimentary finance, direct finance and indirect finance. Under rudimentary finance, there is no financial asset other than money. Under this type of financial system, saving, investment and rate of growth all are low. Again, in a financial transaction, if there is no financial intermediary between the lender and the borrower, it is called direct finance. On the other hand, when there are financial intermediaries between the lender and the borrower in a financial transaction, it is called indirect finance. Direct finance is risky, uncertain and expensive. On the other hand, indirect finance is less risky, flexible and relatively cheap. Hence, most of the financial transactions are indirect finance.

S.6 Financial Intermediaries

Financial intermediaries are institutions or firms that mediate between ultimate lenders and ultimate borrowers or between surplus spending units and deficit spending units. The surplus units lend to ultimate borrowers indirectly through financial intermediaries and not directly. This type of finance is called indirect finance.

S.7 Financial System and Economic Development

The financial system of a country can play a vital role in the process of economic development of that country. It helps in economic development in the following ways:

- generating savings
- mobilising savings
- allocating funds in a proper way
- financing industry
- financing agriculture and small scale industries
- developing money and capital markets of the country

Without a developed financial system, development process of a country is bound to be halted.

S.8 Structure of Indian Financial System

The three main components of any financial system are financial markets, financial institutions and financial assets. The financial market of India has two components: money market and capital market. Money market deals in short term securities having maturity period of less than one year while capital market deals in securities having maturity period of one year or more. Two major participants in the Indian money market are the Reserve Bank of India and commercial banks. Its sub-markets are call (money) market, treasury bill market, commercial bill market, market for commercial papers (CPs), market for certificate of deposits, etc. The main participants in the capital market are commercial banks, mutual funds, development financial institutions and insurance companies. The capital market or security market has two major components: primary or new issue market and secondary or stock market.

The main financial institutions in the Indian money market are commercial banks while the main financial institutions in the Indian capital market are non-banking financial companies, development financial institutions, mutual funds and insurance companies.

The third component of financial system is financial assets/instruments. There are various types of financial instruments in Indian capital market. Among traditional instruments, important are equity or ordinary shares, various types of debentures and preference shares. Among new innovative instruments, important are participating debentures, convertible debentures with options, fully convertible debentures, floating rate bonds, zero coupon bonds, regular income bonds, retirement bonds, etc.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. Define financial system.
2. What is the full form of SEBI?
3. What is rudimentary finance?
4. Distinguish between primary market and secondary market.
5. Give the full forms of IFCI and NIDC.
6. What are the main components of a financial system?
7. What is money market?
8. Define capital market.
9. What is direct finance?
10. What is indirect finance?
11. What do you mean by primary market?
12. What is secondary market?
13. What are the main functions of a financial system?
14. What do you mean by financial intermediation?
15. What is meant by initial public offer?
16. What is new issue market?
17. What are the main traditional financial instruments?
18. Give names of some new innovative financial instruments in Indian Capital Market.

19. Name some development financial institutions of India.
20. What is financial market?

B. Medium Answer-Type Questions (4–5 marks each)

1. Briefly explain the concept of financial system of a country.
2. What are the main components of a financial system?
3. Distinguish between direct finance and indirect finance.
4. Describe two main functions of the financial system of a country.
5. Write a note on transformation services of financial intermediaries of a country.
6. What is rudimentary finance? Mention its major limitations.
7. Briefly mention some non-bank financial companies operating in the capital market of India.

C. Long Answer-Type Questions (10 marks each)

1. What is financial system? Briefly describe the major components of the financial system **(Section 1.3)**
2. Define financial system. Discuss the main functions of the financial system of a country. **(Section 1.4)**
3. Clearly explain the significance of financial system in an economy. **(Section 1.2)**
4. Make a brief comparison among rudimentary finance, direct finance and indirect finance. **(Section 1.5)**
5. Write a note on financial intermediation done by financial institutions of an economy. **(Section 1.6)**
6. Discuss the role of financial intermediaries in economic development of a country. **(Section 1.7)**
7. Give a full description of the structure of Indian financial system. **(Section 1.8)**

UNIT
2

MONEY AND INDIAN BANKING SYSTEM

UNIT OUTLINE

2.1 Definition of Money
2.2 Classification of Money
2.3 Functions of Money
2.4 Different Components of Money Supply in India
2.5 Bank and Its Different Types
2.6 Commercial Banks
2.7 Functions of Commercial Banks
2.8 Role of Commercial Banks in Economic Development
2.9 Credit Creation Process of Commercial Banks
2.10 Central Bank
2.11 Instruments of Monetary and Credit Control
2.12 Difference between Central Bank and Commercial Banks
2.13 High-powered Money and Concept of Money Multiplier
2.14 Reserve Bank of India (RBI)

SUBJECT MATTER OF THE UNIT

At the outset, this unit considers the definition, classification, and functions of money. There are different approaches to the definition of money. These approaches and different measures of money supply in India have also been briefly discussed. Next, the unit focuses on banks and their classification. In the banking system of any country, commercial banks are the most important. Hence, we have discussed in detail about commercial banking. We have considered principles of commercial banking, functions, importance, and credit creating power of commercial banks and the structure of commercial banking in India.

(*Contd.*)

The unit also picks up central banking which includes objectives, functions, and methods of credit control by the central bank. A brief discussion on the distinction between commercial banks and the central bank has also been made. To supplement the concept of money supply, a discussion on money multiplier has also been made in the present unit. The unit ends with a discussion on the Reserve Bank of India. Under this heading, we have considered functions, monetary policy or policy of credit control, and promotional or developmental activities of the Reserve Bank of India.

2.1 DEFINITION OF MONEY

Money is anything which is generally accepted as a medium for payment of goods and services and repayment of debts in a given country. All modern economic systems make use of money. Simply speaking, money is anything which acts as a medium of exchange. Anything which is universally acceptable in the case of making transactions may be regarded as money. The general acceptability is the most important feature of money. It can be enforced by law or it may be determined by custom. Historically, pebbles, shells, goats, cows, and so on, were used as media of exchange, and hence they may be regarded as 'money' at a given time period. At present, coins, currency notes and some bank deposits are widely used as media of exchange. Hence, in the traditional definition, they are generally treated as money. Among these components of money, bank money usually forms by far the largest part of money supply. Formally, we may define money in the following manner:

Anything which is recognised and accepted as a medium of exchange or means of payments for goods and services or repayment of debts in a given country may be regarded as money.

2.1.1 Different Approaches to the Definition of Money

According to Harry G. Johnson, there are four approaches to the definition of money. In brief, they are as follows:

(i) Traditional Approach
(ii) Chicago Approach
(iii) Gurley–Shaw Approach
(iv) Central Bank Approach

From these approaches to the definition of money, we may get an idea about the components of money supply. Let us briefly describe these approaches one by one.

2.1.1.1 Traditional Approach

According to the traditional approach, money is anything which acts as a medium of exchange or as a means of payment. In most countries, it includes currency with the non-bank public and demand deposits with commercial banks. Thus, as per traditional approach, money supply = $M^S = C + D$,

where C = hand-to-hand currency with the non-bank public and

D = demand deposits with commercial banks.

2.1.1.2 Chicago Approach

The Chicago approach is advocated by Chicago monetarists, headed by Milton Friedman. This approach defines money more broadly than the traditional approach. It includes not only currency(C) with the non-bank public and demand deposits with the commercial banks (D) but also commercial bank time deposits (T) in the definition of money. Thus, according to the Chicago approach, money supply, $M^S = C + D + T$.

2.1.1.3 Gurley–Shaw Approach

John G. Gurley and Edwards S. Shaw, in their book, *Money in a Theory of Finance*, have taken a still broader view of money supply. They have included currency, demand deposits, time deposits, post office savings bank deposits, and all other money substitutes in the definition of money.

2.1.1.4 Central Bank Approach

In the Central Bank approach, money is taken to be synonymous with credit. In this approach, money means not just credit by commercial banks but credit by any financial institution. It thus takes the broadest view of money supply.

2.2 CLASSIFICATION OF MONEY

Money can be classified on the basis of different criteria. It can be classified on the basis of actual existence, on the basis of commodity used in making money, on the basis of legal status and on the basis of commodity value of money. We mention below some important classifications of money.

2.2.1 Actual Money and Money of Account

On the basis of actual existence, money can be either **actual money** or **money of account**. Actual money means money which is present in practice in a country. In other words, actual money is the money which has physical existence. Various metallic coins and currency notes which are in circulation in India or in some other country are examples of actual money. On the other hand, money of account or accounting money is the money which exists only in the books of account. For example, SDR (Special Drawing Rights), introduced by International Monetary Fund (IMF), is the accounting money or money of account. Accounting money does not have any real existence. It is only a notional entity and is used only to keep accounts. Accounting money is thus found only in the books of account.

2.2.2 Metallic Money and Paper Money

On the basis of the commodity used in money's making, money may be classified as **metallic money** and **paper money**. Metallic money is the money made of a particular metal, such as, gold, silver, copper and so on. On the other hand, paper money is the money made of paper. For example, in India, we have metallic coins and some metallic money of small denominations like one-rupee, two-rupee, five rupee and ten-rupee coins.

2.2.3 Legal Tender Money and Optional or Customary Money

On the basis of legal status, money may be classified **as legal tender money and optional** or **customary money**. Legal tender money is the money which has a legal backing or legal support. No one can refuse to accept legal tender money as a means of payment. It is also called **fiat money.** 'Fiat' means an official order given by somebody in power or authority. On the other hand, optional money is that type of money which has no legal sanction behind it. It is acceptable by people on the basis of custom. Nobody can be forced to accept this type of money against his or her wishes. For example, a lender may refuse to accept cheque issued by the borrower while settling or repaying a debt. Cheque is not a legal tender.

2.2.4 Standard Money and Token Money

On the basis of commodity value of money, we can classify between **standard money** and **token money**. In the case of standard money, the metallic value is equal to its value as the medium of exchange. To put it in other words, the face value of standard money is equal to its intrinsic value. On the other hand, token money is the money whose face value exceeds its intrinsic value. For example, suppose a one rupee coin contains such amount of metal whose value is exactly one rupee. Then this one rupee coin will be called standard money. In the case of token money, however, its face value exceeds its intrinsic value. For example, the face value of a hundred rupee note is ₹100. However, its intrinsic value is very negligible. The intrinsic value of money is determined by the commodity content of the money. So, in our example, the value of paper used for making a hundred rupee note will be its intrinsic value. Before 1893, Indian one rupee coin was a standard coin. It was made of silver and its intrinsic value was one rupee, that is, its intrinsic value was exactly equal to its face value. Hence, it was a standard coin. However, at present, Indian rupee is a token money as its face value is higher than its intrinsic value. In fact, at present, token money is in circulation in all the countries of the world. There is no standard money in any country on the globe.

It should be noted that the intrinsic value of a metallic coin may be less than or equal to its face value but it can never be greater than its face value. For example, if a one rupee coin contains metal whose value is more than one rupee, then the coin will be melted and sold as metals. Then the coin will disappear from the market. For this reason, the intrinsic value of money cannot be greater than its face value.

In this connection, another point should also be noted. Token money may or may not have any physical form of existence. For example, bank deposits are used as money, but they do not have any physical form of existence. They exist only in the ledger books of the banks. Bank deposits do not have any intrinsic value though they have face value.

Token money is used for three reasons. **First**, if the market value of metals of a coin rises above the face value, then it becomes profitable to melt the coin. In that case, the coin will gradually disappear from the market. This can be avoided by making the coin a token money. **Second**, sometimes it is not possible to issue standard money due to the scarcity of metals. In that case, token money is issued into the market. **Third**, at the time of emergency, the supply of token money can be increased more quickly than that of standard money.

2.2.5 Paper Money or Currency Notes

Now-a-days, paper money or currency notes are in circulation in all countries of the world. China is the first country in the world to introduce paper currency in the 9th century. The use of paper money or currency note gradually spread to other countries. However the use of paper money on a large scale began only in the 17th and 18th centuries. In India, the use of paper money began in the 19th century. The Bank of Bengal was the first bank in India to issue paper currency in 1806.

There are several **advantages** of the use of paper money or currency notes. We briefly mention them as follows:

- First, in case of paper money, the country can economise the use of valuable metals. Under this system, paper notes circulate. Hence, it is possible to avoid the national loss of depreciation of valuable metals.
- Second, paper notes issued by the monetary authority are not fully backed by gold and silver. Hence the supply of paper notes is more elastic than the supply of metallic coins. As and when need arises, the monetary authority can quickly increase the supply of paper money. But, to increase the supply of metallic coins, adequate amount of required metals should be collected first.
- Third, paper notes are issued by virtue of government's order. Hence paper notes enjoy the confidence of the public.

However, paper notes have also some **disadvantages**. The main disadvantages of paper notes may be summarised as follows:

- First, the supply of paper notes can be easily increased. Hence, there is always the danger of over-issue of paper notes. This leads to inflationary pressures in the economy. If the price level increases at a very rapid rate due to excessive increase in the supply of paper notes, the confidence of the public in paper notes may be lost. Then people may be unwilling to accept paper notes. Such a situation developed in Germany after the First World War.
- Second, paper notes circulate within a country. Paper notes of one country are not generally accepted in other countries. Thus, the field of circulation of paper notes is limited.

- Third, metallic coins are more durable than paper notes. Paper notes are perishable. They soon become mutilated and disfigured. When the existing paper notes become mutilated, new notes are to be issued.
- Fourth, paper notes have no intrinsic value or commodity value. These are token money or fiat money. If the government demonetises paper money at any time, then the paper notes will be mere pieces of paper having no worth or value.

Thus, we see that paper notes have some advantages and disadvantages. However, advantages of paper notes far exceed their disadvantages. Hence, the system of paper money or currency notes is present in all countries. The disadvantages of paper notes can be controlled if the supply of paper money is regulated by the monetary authority.

If the monetary authority controls the supply of paper money effectively, the danger of inflation will be minimised. Thus paper money can play a useful role in promoting economic development of a country.

2.2.6 Deposit Money

Apart from coins and notes, bank deposits are also used as means of payment. Such bank deposits which act as medium of exchange and means of payment, are regarded as money. This money is called deposit money. Now, there are different aspects of deposit money. Banks accept mainly three kinds of deposits, namely, current account deposits, fixed or term deposits and savings account deposits. We will consider them one by one.

2.2.6.1 Current Account Deposits

These deposits are payable on demand. They can be drawn upon by cheques without any restriction. No or very little interest is paid on these deposits. Generally current account deposits are held by business firms and other organisations which use them for making various payments.

2.2.6.2 Fixed Deposits or Term Deposits

They are deposits for a fixed term which may vary from a few days to a few years. They are not withdrawable on demand and do not enjoy chequing facilities. This means that cheques cannot be issued against them for making payment. Fixed deposits earn interests. Generally the rate of interest rises with the term of the deposits. A variant of fixed deposits is recurring or cumulative time deposit. In this type of deposit, a depositor makes a regular deposit of an agreed sum of money over an agreed period. Interest is given on the accumulated monthly balance. Such deposits cannot also be withdrawn before the expiry of the agreed period.

2.2.6.3 Savings Account Deposits

These deposits have the features of both current account deposits and fixed deposits. Like the current account deposits, they are payable on demand. They are also withdrawable by cheques. However, there are certain restrictions on the number of withdrawal or the amount of withdrawal. Again, like fixed deposits, savings account deposits earn interests.

Among these three kinds of deposits, only those deposits are included in the definition of money which can be used for making payments. Such deposits are obviously current account deposits and a part of savings account deposits. Fixed deposits cannot be withdrawn by drawing cheques on them. Hence, fixed deposits are not included in the supply of money.

2.3 FUNCTIONS OF MONEY

We know that anything which is generally accepted as a medium for payment of goods and services and repayment of loans in a given economy may be regarded as money. All modern economies make use of money. In such economies, prices are quoted in terms of monetary units; incomes are paid and received in the form of money, and so on. Sometimes, money is also defined as *'Money is what money does'*. In fact, money can best be explained by the functions it performs. In today's money-economy, money performs many important functions. There is a couplet which describes the functions of money. It is as follows:

'Money is a matter of functions four,
A medium, a measure, a standard, a store.'

As this couplet mentions, there are four main functions of money. They are as follows:

1. Performing as a medium of exchange,
2. Performing as a unit of account,
3. Performing as a standard of deferred payment, and
4. Performing as a store of value.

We shall discuss these four main functions of money one by one.

2.3.1 Medium of Exchange

Money has the quality of general acceptability. All individuals agree to accept money in exchange of goods and services. Thus, the main function of money is to act as a medium of exchange. Introduction of money has removed the difficulties of transactions under barter system and has smoothened the transactions of goods and services. Money acts, so to say, as the lubricant in the transaction process.

2.3.2 Unit of Account

Money also acts as a unit of account or as a measure of value. We cannot add up heterogeneous commodities as different commodities have different units of measurement. Hence, it is not possible to add them without converting them to a common denominator. However, this is possible with the help of money. Multiplying the quantity of each commodity with its price we can get the money value of that commodity. Now, adding the money values of all the commodities we can get their aggregate value. In this way, we can get a collective measure of value. Money thus acts as the unit of account or the *numeraire*.

2.3.3 Standard of Deferred Payment

Money is used as the standard of deferred payment. This means that borrowing and lending are done in terms of money. Money is suitable for the standard of deferred payments for the following three reasons:

(i) The value of money is more stable than the values of other commodities.

(ii) Money is more durable than other commodities and

(iii) Money has general acceptability.

For these reasons, money is most suitable to be used as the standard of deferred payment.

2.3.4 Store of Value

Money also acts as a store of value. This means that people can save through money. In the barter system, one had to save in the form of commodities. Hence, it was difficult to save because some of the commodities are perishable. However, in a money-using economy, it is possible to save in terms of money. Further, in the barter system, whenever one commodity is sold, another commodity of more or less equal value is to be purchased. However, in a money-using economy, an individual may not spend his or her entire sales revenue. He or she may save a part of it and use it to purchase commodities in future. For this, money is also known as the **temporary abode** of purchasing power. Again, people hold a part of their assets in the form of money, because holding money has some extra advantages over other forms of assets. Then also money acts as a store of value.

2.4 DIFFERENT COMPONENTS OF MONEY SUPPLY IN INDIA

Theoretically, there are four main approaches to the definition of money supply. In the **traditional approach**, money is the sum of currency and demand deposits with the commercial bank. In the **Chicago approach**, money supply is the sum of currency, demand deposits and time deposits with the commercial banks. In the **Gurley-Shaw approach**, money supply is the sum of currency, demand deposits, time deposits, post office saving bank deposits and all other money substitutes. In the **Central Bank approach**, money is taken to be synonymous with credit given by any financial institution.

Since 1977, the Reserve Bank of India has been calculating money supply and monetary aggregates in four forms: M_1, M_2, M_3 and M_4. Here, M_1 = currency + demand deposits + other deposits with the RBI.

$M_2 = M_1$ + savings deposits with post office savings banks

$M_3 = M_1$ + term deposits of banks and $M_4 = M_3$ + total deposits with post office

However, only M_1, and M_3 have been used in practice. The definitions of M_2 and M_4 include people's deposits with post office. The RBI did not collect figures for such deposits. Hence, M_2 and M_4 are actually irrelevant.

In 1998, the RBI appointed a working group on money supply. This working group dropped savings bank deposits of post offices. This was included previously in M_2. It also dropped all deposits with post office saving banks which were included previously in M_4. Accordingly, there are, at present, only three monetary aggregates, namely, M_1, M_2 and M_3. The previous measure of M_4 has now been abolished.

For better understanding of the students and a quick comparison of the two estimates, we present the original definition and the revised definition of monetary measures in India as shown in Table 2.1 given below.

Table 2.1 Monetary aggregates in India

Original definition	Revised definition
M_1 = Currency + demand deposits + other deposits with RBI	M_1 = Currency + demand deposits + other deposits M_1 = unchanged with RBI M_1 is called narrow money
$M_2 = M_1$ + savings deposits with post office savings banks	$M_2 = M_1$ + time liability portion of savings deposits with banks + certificates of deposits issued by banks + short-term deposits maturing within 1 year
$M_3 = M_1$ + term deposit of banks	$M_3 = M_2$ + term deposits over 1-year maturity + call/short-term borrowings of banks M_3 is referred to as broad money
$M_4 = M_3$ + total deposits with post office	M_4 = abolished

Certain points may be noted from the table.

- There is no change in the calculation of money supply with the public (M_1). This concept is known as **narrow money**.

It is called narrow money because it consists of currency plus bank deposits held by the public. But there are other liquid or monetary resources with the public.

- The revised definition of M_2 excludes post office savings bank deposits and includes short-term deposits of 1-year maturity and certificates of deposits issued by banks. These last two items have been included in the definition of M_2 because they can be easily converted into cash.
- In the new revised definitions of M_2 and M_3, post office savings deposits and other deposits of post office have been excluded.
- Saving deposits and term deposits held by the public with banks have been divided into two components: (i) deposits with short-term maturity (up to 1 year), and (ii) deposits with long-term maturity (above 1 year). The first has been included in the measure of M_2 while the second has been included in the measure of M_3.
- In the new definition, $M_3 = M_2$ + term deposits over 1-year maturity + call/short term borrowing of banks. Thus, in M_3, borrowing of banking system has been included. M_3 is

referred to as **broad money** by the RBI. It is called broad money because it includes not only narrow money (= M_1 = currency + bank money held by the public) but also other liquid or monetary resources with the public.

- Out of the three revised measures (M_1, M_2 and M_3), M_1 is the most widely used measure of money supply in India.
- Deposits with non-bank financial institutions have not been included by the RBI in any new measure of money supply. This is because such deposits are used as medium of savings, not as medium of exchange. We know that anything which acts as a medium of exchange or is used as a means of payment is regarded as money.

2.5 BANK AND ITS DIFFERENT TYPES

2.5.1 What is a Bank?

A bank is defined as an institution that accepts deposits of money from the public withdrawable by cheque and used for lending. From this definition we find that a bank has two main features. First, the bank accepts deposits of money which are withdrawable by cheques. Second, the bank uses the deposits for lending. Three points should be noted about deposits acceptable by a bank:

(i) A bank accepts deposits of money and not of commodities or non-monetary assets.

(ii) Deposits are accepted from the general public and not merely from the shareholders of the bank.

(iii) Deposits are withdrawable on demand by cheques.

However, acceptance of deposits of money withdrawable by cheques is a necessary condition but not a sufficient condition. To be recognised as a bank, the institution must use the deposits to give loans to the general public.

If an institution accepts deposits withdrawable by cheques but uses the deposits for its own purpose, such an institution cannot be regarded as a bank. These are known as **pure deposit system**. Post office savings banks in India are the examples of such pure deposit system. They accept deposits from the public and these deposits are also withdrawable by cheques. But these deposits are not used for lending. They are used for governmental work and post offices are owned by the government. Hence post office savings banks are not to be treated as banks in the strict sense of the term. Again, there are some other financial institutions which accept deposits from the public and give loans from those deposits but whose deposits are not withdrawable by cheques. The Life Insurance Corporation of India (LICI) or the Unit Trust of India (UTI) are the examples of such institutions. These are called **pure financial intermediaries**. They are not banks because their deposits are not withdrawable by cheques. All these financial institutions are together known as non-bank financial institutions. Commercial banks of the present day world are a combination of the pure financial system and the pure deposit system.

2.5.2 Different Types of Banks

A bank is an institution that accepts deposits of money from the public withdrawable by cheque, and used for lending. There are different types of banks. These are central bank, commercial banks, foreign exchange banks, and so on. We give a brief description of them as follows:

2.5.2.1 Central Bank

Central bank is the apex bank in the banking system of a country. In each country, there is a central bank to regulate the entire banking system of the country. In India, the name of the central bank is the Reserve Bank of India (RBI).

2.5.2.2 Commercial Banks

A commercial bank collects deposits from the public and lends that money to producers and businessmen. Among all types of banks, commercial banks are the most important banks in any country. In India, State Bank of India, Canara bank, Bank of India, Punjab National Bank, and so on are some of the important commercial banks.

2.5.2.3 Development Banks

Development banks are specialized financial institutions which supply medium and long-term finance to the target sectors. They are created by the government in order to provide finance to specific sectors. The government allocates necessary fund to them. These development banks also perform various promotional roles to help the process of economic development. These are also called development financial institutions (DFIs). Whereas commercial banks mainly provide short-term credit, development banks provide medium- and long-term credit. Examples of such development banks in India are Industrial Finance Corporation of India (IFCI), National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), National Industrial Development Corporation (NIDC), Industrial Investment Bank of India (IIBI) and so on.

2.5.2.4 Co-operative Banks

Banks which are organised under the provisions of the law of the co-operative societies of the country are called co-operative banks. In India, co-operative banks were originally set up to provide credit to the primary agricultural credit societies at lower rate of interest. However, at present, co-operative banks operate in urban areas also and they provide loans not only for agricultural activities but also for a variety of other economic activities.

2.5.2.5 Agricultural Banks/Land Mortgage Banks

Agricultural banks, also called land mortgage banks, provide long-term credit to the farmers for the development of agricultural land. They also give long-term loans to the farmers for purchasing land. In India, land mortgage banks are known as land development banks.

2.5.2.6 Foreign Exchange Banks

Banks which are engaged in buying and selling of foreign exchange are known as foreign exchange banks. These banks help in the expansion of foreign trade. In India the example of foreign exchange bank is EXIM Bank (Export–Import Bank).

2.5.2.7 Merchant Banks

Merchant Banks are those financial organisations which perform not only the banking activities of borrowing and lending but also serve many needs of business enterprises. Some of these services are: giving advice on financial alternatives, corporate mergers, loan syndication, underwriting of new issues and so on

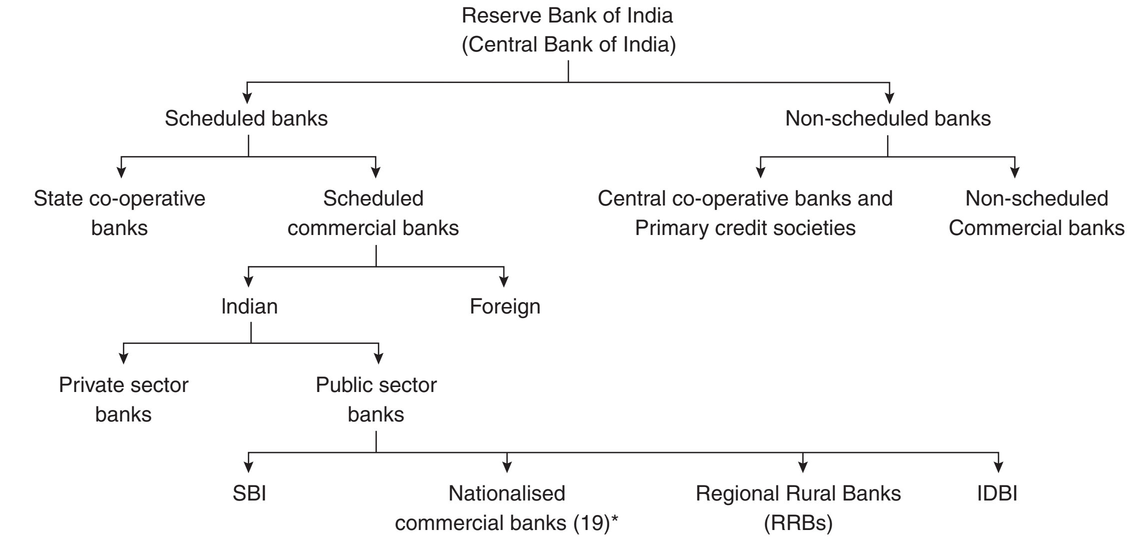
Apart from these banks, there are indigenous banks. These banks are individuals or private firms who operate like banks as such and receive deposits and give loans. Their activities are not regulated by the central bank. Hence, they belong to the unorganised sector of the money market.

Among these different types of banks, commercial banks are the most important banks in any country. Their savings deposits and current account deposits are used as means of payments. In this sense, commercial banks are regarded as the creators of money. Deposits of other banks do not enjoy this benefit. Other banks are specialized institutions giving loans to specific sectors of the economy. Hence, as financial institutions in a country, the importance of commercial banks is the greatest. Unless otherwise mentioned, by the word 'bank' we mean a commercial bank.

2.5.3 Banking Structure in India

We know that the Reserve Bank of India (RBI) is the central bank of the country. It is the apex bank in the Indian banking system. Hence, RBI is at the top of the Indian banking system. It conducts and regulates the whole banking system of the country. All the banks in India may be mainly divided into two categories: scheduled banks and non-scheduled banks. The scheduled banks are those banks which are entered in the second schedule of the RBI Act, 1934. Such banks have a paid-up capital and reserves of not less than ₹5 lakhs. These banks are wholly controlled by the RBI. They get the benefits of discounting bills and of clearing house from the central bank. Commercial banks and state co-operative banks fall into this category. On the other hand, non-scheduled banks are banks which are not included in the second schedule of RBI Act, 1934. These banks are not under the control of the RBI. Non-scheduled banks in India include primary credit societies and some commercial banks.

Both scheduled and non-scheduled banks in India include Indian banks and foreign banks. The scheduled Indian commercial banks can again be divided into two categories: public sector commercial banks and private sector commercial banks. The public sector commercial banks can again be divided into three sections: State Bank of India, other public sector commercial banks and regional rural banks (RRBs). In Figure 2.1 given below, we have shown the structure of Indian banking system.



*Number of banks in the relevant group

Figure 2.1 Structure of Indian banking system

In the Indian banking system, public sector banks are the most important. They perform about 90 percent of total bank transactions in the country. Taking State Bank of India and nineteen nationalised banks, (Out of twenty nationalised banks, the New Bank of India was merged with the Punjab National Bank or PNB later), India has now twenty two public sector banks. The nineteen nationalised banks are as follows: (i) Allahabad Bank, (ii) Bank of Baroda, (iii) Bank of India, (iv) Bank of Maharashtra, (v) Canara Bank, (vi) Central Bank of India, (vii) Dena Bank, (viii) Indian Overseas Bank, (ix) Indian Bank, (x) Punjab National Bank, (xi) Syndicate Bank, (xii) Union Bank of India, (xiii) United Bank of India, (xiv) United Commercial Bank (UCO Bank), (xv) Andhra Bank, (xvi) Corporation Bank, (xvii) Oriental Bank of Commerce (xviii) Punjab and Sindh Bank and (xix) Vijaya Bank. Again, to provide credit to the rural sector, regional rural banks (RRBs) have been set up in India since June 1975.

Two new public sector banks came up in recent years. Industrial Development Bank of India (IDBI) was originally set up as a development bank in 1964. In 2004, it has been converted into a commercial bank called IDBI Bank in the public sector. Moreover, in 2013, Bharatiya Mahila Bank (BMB) was set up as a public sector bank in India. However, in March 2017, the government of India proposed to merge it with the SBI. All these are shown in Figure 2.1 given above.

Among the public sector banks, the State Bank of India is the most important bank in India. It is in fact the largest public sector bank of India. Before 13 August 2008, the State Bank of India (SBI) had seven subsidiaries. They were as follows:

1. State Bank of Bikaner and Jaipur (SBBJ)
2. State Bank of Hyderabad (SBH)
3. State Bank of Indore (SBIR)

4. State Bank of Mysore (SBM)
5. State Bank of Patiala (SBP)
6. State Bank of Saurashtra (SBS)
7. State Bank of Travancore (SBT)

However, on 13 August 2008, State Bank of Saurashtra, and on 19 June 2009, State Bank of Indore, were merged with the State Bank of India. Hence, the State Bank of India had five subsidiaries or affiliates. These five affiliates along with the State Bank of India formed the State Bank group but only up to March 2017.

Following the approval of Union Cabinet, the State Bank of India merged its all five subsidiaries with itself w.e.f 1.4.2017. Again the government of India had suggested the SBI in March, 2017 to take over the newly setup Bharatiya Mahila Bank (BMB).

Further, as per 2016 Budget proposal, the Union Government has started the process of transforming IDBI Bank into a private bank by reducing its government share of 80 percent to less than 51 percent. Hence, it may happen in near future that the IDBI will cease to exist in the field of public sector banks in India.

The Government of India announced the New Economic Policy in 1991 and adopted the policy of privatisation and liberalisation. As a result, entry of private and foreign banks into the banking sector of India has considerably increased. Some of the important private sector banks in India are as follows:

1. ICICI Bank
2. HDFC Bank
3. ING Vysya Bank (in the first week of April 2015, it has been acquisitioned by Kotak Mahindra)
4. IndusInd Bank
5. Axis Bank
6. Centurion Bank and so on

At present, ICICI Bank is the largest private sector bank in India.

Among the foreign banks operating in India at present, following names are important:

1. ABN AMRO Bank
2. Citibank
3. HSBC (Hong Kong and Sanghai Banking Corporation) or, in short, Hong Kong Bank
4. Standard Chartered Bank
5. American Express Bank
6. Bank of Tokyo and so on

With the policy of globalisation and liberalisation and the reform programme adopted by the Union Government of India, it may be expected that the role of private sector banks, both Indian and foreign, will considerably rise in near future. The supporters of liberalisation policy claim that this will develop and diversify the Indian capital and money markets. On the other hand, the other group has been opposing this policy. The labour unions of public sector banks have also strongly opposed the entry of private sector banks including foreign banks. They are afraid of increased competition and losing their jobs. The Narasimham Committee (1991) has, however, welcomed and supported the entry of private banks including foreign banks into the financial sector of India. The Government of India has also accepted the Narasimham Committee Report as a matter of policy and has been conducting the financial sector reforms in line with its recommendations.

2.6 COMMERCIAL BANKS

We know that commercial banks collect deposits from the public and lend that money to the public. Among all types of banks, commercial banks are the most important banks in any country. The most important commercial bank in India is the State Bank of India together with its affiliates or subsidiaries. Other important banks are Allahabad Bank, Canara Bank, Bank of India, United Bank of India, Bank of Baroda, United Commercial Bank, Central Bank of India and so on.

2.6.1 Principles of Commercial Banking

For the smooth and effective functioning of commercial banks, some specific principles are followed. These principles are together called **the principles of commercial banking**. There are mainly three principles of commercial banking: **liquidity**, **profitability** and **safety**. Modern bankers have added three other principles for a sound banking system. They are **stability, flexibility** and **expansion**. Thus, there are mainly six principles of commercial banking. We briefly describe them one by one.

2.6.1.1 Liquidity

Commercial banks must have sufficient cash to meet the cash demand of the depositors. This is known as **liquidity of banks**. For the very existence of banks, they must maintain liquidity. If banks are illiquid, that is, if they are unable to maintain liquidity, people will have no confidence on the banks. People will not then keep their money in banks. To ensure liquidity, commercial banks are required to keep certain proportion of their deposits in the form of cash. This proportion is known as **cash-deposit ratio** or **liquidity ratio**.

2.6.1.2 Profitability

Any organization must earn profit for its existence as a company; a bank should also earn sufficient profit for its viability. If a bank lends its entire deposits to others, its profit will be maximum, but then its liquidity will be zero. It will not be able to satisfy the cash demand of depositors. Again, if the bank holds its entire deposits in the form of cash, it will remain fully liquid. But then its profitability will be zero. Hence, there is a 'trade-off' between liquidity and profitability. A prudent banker has to strike a right balance between profitability and liquidity.

2.6.1.3 Safety

A bank must ensure the safety of money of its depositors. A bank accepts deposits from the public. So, it must give top priority to the safety of money of its depositors. It should give safe loans and make safe investments. It should avoid unnecessary risks. If the debtors of the bank cannot repay the loans, the bank will become insolvent, and it will be unable to return the money to its depositors. Hence, for its own viability, the bank must ensure the safety of money of its depositors.

2.6.1.4 Stability

Stability of any organisation means growth of that organisation at a steady rate. A sound banking system must be stable. It should operate rationally and judiciously. There should neither be undue contraction nor undue expansion of credit. Again, during depression, it should expand credit, and during inflation, it should contract credit.

2.6.1.5 Flexibility

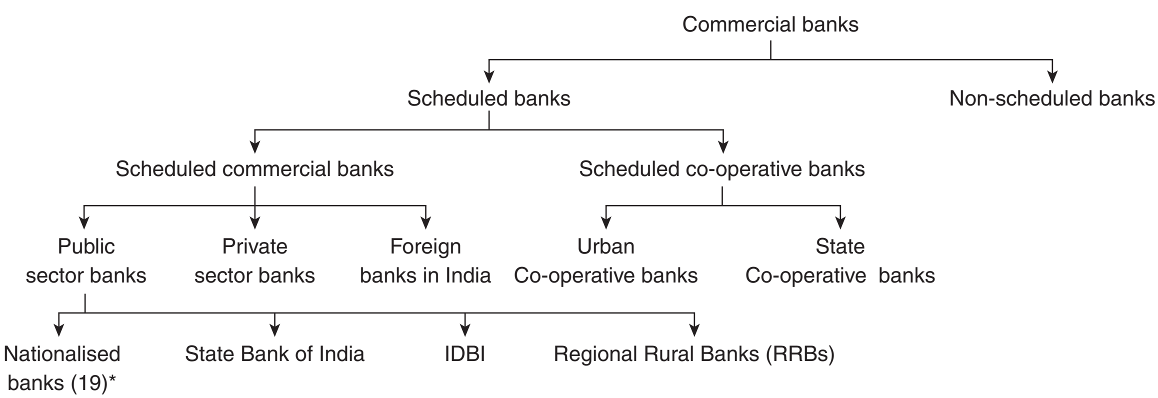
A sound banking system should be flexible. It should be able to expand or contract credit as per requirement of the economy. It should be able to provide more loans during depression and to contract loans during inflation. If a banking system is flexible, then it will be able to follow the directives of the central bank quickly.

2.6.1.6 Expansion

A sound banking system should be expanded to rural areas also. Then rural saving can be easily mobilised. Expansion of banking facilities in rural areas will increase the inducement to save of the rural people. All these will help in capital formation and economic development of a country.

2.6.2 Structure of Commercial Banking System in India

In Figure 2.2, we have shown the structure of commercial banks in India.



*Number of banks in the relevant group

Figure 2.2 Structure of commercial banks in India

Let us briefly explain different components of this chart. Commercial banks in India may be basically divided into two groups: (i) scheduled banks, and (ii) non-scheduled banks. Scheduled banks are the banks which are included in schedule 2 of the Reserve Bank of India (RBI) Act, 1934. These banks have a paid-up capital and reserve of an aggregate value of not less than ₹5 Lakhs. On the other hand, banks which are not included in schedule 2 of the RBI Act, 1934 are called non-scheduled banks.

Scheduled banks in India may again be grouped under two heads: (i) scheduled commercial banks, and (ii) scheduled co-operative banks. Co-operative banks are run on the basis of the principle of co-operation. They may broadly be classified under two heads: (i) scheduled urban co-operative banks, and (ii) scheduled state co-operative banks. They finance agriculture and allied activities, small-scale industries, home finance, consumer finance, and so on.

On the other hand, commercial banks are conducted as company type of organisations. Scheduled commercial banks may again be divided into three groups, namely, (i) public sector banks, (ii) private sector banks, and (iii) foreign banks. Public sector banks are the banks which have their shares listed in the stock exchanges like National Stock Exchange (NSE) and Bombay Stock Exchange (BSE). The Government of India holds majority stake in these banks.

Under the category of public sector banks we have nineteen nationalised banks, the State Bank of India, IDBI Bank and Regional Rural Banks (RRBs). On 19 July 1969, 14 major commercial banks were nationalised. Again, on 15 April 1980, six more banks in the private sector were nationalised. However, among these twenty nationalised banks, the New Bank of India was later merged with the Punjab National Bank (PNB) which is one of the nationalised banks. Hence, the total member of nationalised banks in India is nineteen. Again, the Industrial Development Bank of India (IDBI) was set up in 1964 as a development bank in order to provide mid-term and long-term finance to the industrial sector. However, it was later converted into a public sector bank. Further, Bharatiya Mahila Bank (BMB) was set up in 2013 as a public sector bank for women. However, in March 2017, the government of India proposed to merge it with the SBI. Again, Regional Rural Banks (RRBs) were declared to be set up in 20-point Economic Programme announced in June 1975 by the-then Prime Minister, Mrs Indira Gandhi. Accordingly, RRBs have been set up as public sector banks in order to provide finance to the rural sector.

2.7 FUNCTIONS OF COMMERCIAL BANKS

A commercial bank may simply be defined as an institution which (i) accepts deposits from the public which are withdrawable by cheques, and (ii) makes loans and advances to the public. A commercial bank performs some important activities. We may summarise them as follows:

- The main function of commercial banks is to change cash for bank deposits and bank deposits for cash. Banks are both borrowers and lenders. They accept deposits from the public and again lend that sum to others. Commercial banks, like other private enterprises, want to earn profit which is the difference between revenue and expenditure. They have three main sources of revenue: (i) interest on loans, (ii) charges made for the operation of current accounts, and (iii) commissions on particular services. They have two main items of expenditure: (i) interest paid to the depositors, and (ii) operating expenses.

- A commercial bank holds different types of assets with varying degrees of liquidity and profitability. It determines the optimum combination of these assets so that it can earn satisfactory profit without losing its liquidity. To maintain liquidity, commercial banks keep a certain percentage of their deposit liabilities in the form of cash.
- Commercial banks issue cheques which are used to settle transactions and debt. They thus provide an important medium of exchange.
- Commercial banks also provide different non-banking services. These are classified as (i) Agency services, and (ii) General utility services.

  (i) Agency Services

  These services include:

  - To make payments for bills, cheques, dividends, premiums, and so on.
  - To remit funds on behalf of clients by drafts or mails or telegrams.
  - To act as an executor, trustee, and attorney for the customers' will.

  (ii) General Utility Services

  Commercial banks perform following general utility services:

  - Letters of credit are given to customers to enable them to import commodities from abroad.
  - Bank drafts are issued to facilitate transfer of funds. Now-a-days, commercial banks use different electronic systems in order to transfer funds. Some of these systems are National Electronic Fund Transfer (NEFT), Real Time Gross Settlement (RTGS) and so on. These systems have made the transfer of funds easy, quick and cheap.
  - Certain banks arrange for safe deposit vaults.
  - Banks publish valuable journals or bulletins on commercial and economic matters.
  - Banks accept foreign bills of exchange.
  - Banks may act as referees with respect to the financial standing and business reputation of customers.
  - Shares floated by government, public bodies and corporations may be underwritten by commercial banks.

To conclude, commercial banks are assuming wider functions and greater responsibilities day-by-day. It is very difficult to make an exhaustive list of these functions and services.

2.8 ROLE OF COMMERCIAL BANKS IN ECONOMIC DEVELOPMENT

Commercial banks are the most important financial institutions in any country. They can play a vital role in the process of economic development in the following ways:

Mobilising savings for capital formation: Commercial banks help in mobilising savings through a network of branch banking. In underdeveloped countries, most people have low income and low savings. These people are scattered all over the country. Commercial banks induce them to save more by various deposit schemes and mobilise those savings. They thus help in capital formation of a country.

Financing industry: Commercial banks channelise a part of the mobilised savings into productive investment. They provide short-term, medium-term and long-term finance to the industrial sector.

Developing money market and capital market: For economic development, money market and capital market of the economy should be developed. Commercial banks take various steps to develop the money and capital markets of an economy. They also underwrite shares and debentures of large-scale industries. They also help in the process of development of a country.

Financing trade: Commercial banks help in financing both internal and external trade. They provide loans to retailers and wholesalers to run their business. They provide some important services like discounting and acceptance of bills, overdraft facilities, draft facilities, and so on. They help in exports and imports by providing foreign exchange facilities to exporters and importers.

Financing agriculture: Commercial banks help the agricultural sector of a developing economy in many ways. They open branches in rural areas to provide agricultural credit for agricultural marketing, for land development, for irrigation facilities, for purchasing farm implements, for purchasing seeds and fertilisers and so on. Village artisans and small businessmen also get loan from them. Thus, commercial banks provide rural credit which is much needed for economic development of a country.

Financing employment generating activities: Commercial banks provide loans for studying engineering, medical and other vocational courses. This helps in human capital formation of an economy. They also provide loans and training facilities to young entrepreneurs. All these help in employment generation as well as economic development of a country.

Help in implementation of monetary policy: The success of monetary policy of the central bank of a country depends much on the behaviour of commercial banks of that country. By obeying the regulations and guidelines of the central bank, they help in making the monetary policy successful.

Thus, commercial banks make a considerable contribution to the process of economic development of a country by providing finance to agriculture, industry and trade, by helping in physical and human capital formation and by making monetary policy successful.

2.9 CREDIT CREATION PROCESS OF COMMERCIAL BANKS

Commercial banks accept deposits from the public and again lend from that sum to others. In the process of lending, commercial banks can make a multiple expansion of credit. To understand the process, we should first know how deposits with the commercial banks are created. Deposits with the commercial banks may be created in two ways.

First, an individual can deposit cash with a commercial bank. The bank creates a deposit in the name of the depositor and in this way bank deposit may be created. This type of deposit is known as **primary deposit** and this type of transaction is known as **passive transaction**. This is so because in this case the bank's role is passive. The initiative of depositing cash has come from the individual. When primary deposits increase, cash at the hands of the non-bank public decreases, while bank deposits increase by the same amount. So, the total supply of money remains the same as total money supply means cash at the hands of the non-bank public and deposits with commercial banks.

Second, a deposit may also be created in an indirect manner. For example, suppose an individual seeks a loan from a commercial bank. He mortgages an asset which is not money. On the basis of the asset acquired by the bank, the bank grants the loan. Instead of paying the amount directly to the debtor, the bank deposits the loan amount in the deposit account of the debtor. In this case, bank deposit increases even though the amount of cash with the non-bank public remains the same. This type of deposit is known as **derivative deposit**. Thus, when a bank takes the initiative to create a deposit for a customer, it is called derivative deposit. This type of transaction is known as **active transaction**. It is called active transaction because in this transaction, the bank takes an active role. The main difference between the primary deposit and the derivative deposit is that in the case of primary deposit, the total money supply of the economy remains the same. But in the case of derivative deposit, the total money supply of the economy increases. Whenever a bank grants loan on the basis of non-monetary assets acquired by it, a derivative deposit is created. For this reason, it is said that *every loan creates a deposit*.

Now, to show the process of multiple expansion of credit by commercial banks, we make the following assumptions:

- There are several commercial banks in the economy.
- Each bank maintains a reserve ratio of 10 per cent.
- There is no leakage of cash from the banking sector in the process of granting loans.
- No credit control policy of the central bank is in operation.
- The business conditions are normal.
- There is sufficient demand for loans and each bank is able to grant loans up to its excess reserves.

On the basis of these assumptions we shall show how the banking system as a whole can make multiple expansion of deposits. We suppose that Bank I has an excess reserve of ₹100. The bank grants a loan of ₹100 to an individual. It credits the amount to the deposit account of the debtor. The debtor withdraws the amount of ₹100 from Bank I and makes payment to another individual. The recipient deposits the entire amount in Bank II. If the reserve ratio is 10%, Bank II has now an excess reserve of ₹90. So, it can grant loans up to ₹90. When Bank II makes this loan to another person, it again comes back to other bank. This bank then makes a loan of ₹81, keeping ₹9 (i.e., 10% of ₹90) to maintain liquidity. This process will continue until the excess reserve is exhausted. Thus, the total amount of credit,

$$S = 100 + 90 + 81 + \cdots \quad \text{up to } \infty \text{ terms}$$

$$= 100 + 100 \times \frac{9}{100} + 100 \times \left(\frac{9}{10}\right)^2 + \cdots \quad \text{up to } \infty \text{ terms}$$

$$= 100 \times \frac{1 - \left(\frac{9}{10}\right)^n}{1 - \frac{9}{10}} \quad [\text{sum up to } n \text{ terms}]$$

As $n \to \infty, \left(\frac{9}{10}\right)^n \to 0$

So, total credit $= S = \dfrac{1}{1 - \frac{9}{10}} \times 100 = \dfrac{1}{\frac{1}{10}} \times 100 = 10 \times 100 = 1000$

Here, multiplier $= 10 = \dfrac{1}{\frac{1}{10}} = \dfrac{1}{10\%} = \dfrac{1}{\text{reserve ratio}}$

The result can also be generalised. Let Δz denote the initial excess reserve of the banking system and r the minimum reserve ratio. In the absence of any leakage, the banking system as a whole can create a multiple expansion of credit. The total amount of credit creation,

$$\Delta K_r = \frac{1}{r} \times \Delta z.$$

This can be shown in this manner. By our previous argument,

$$\Delta K_r = \Delta z + (1 - r)\Delta z + (1 - r)^2 \times \Delta z + \cdots \ \infty \ \text{terms}$$

$$= \frac{1}{1 - (1 - r)} \times \Delta z$$

$$= \frac{1}{r} \times \Delta z$$

We see that the amount of credit creation depends on the excess reserve of the banking system (Δz) and the reserve ratio (r). Here ΔK_r is directly proportional to (Δz) and inversely proportional to r. Here, $\frac{1}{r}$ is called credit-creation multiplier or money creation coefficient or credit creation co-efficient. Higher the value of reserve ratio (r), lower will be the value of credit multiplier and vice versa. Again, larger the volume of excess reserves (Δz), larger will be the volume of credit creation and vice versa.

In our example, there was no leakage of cash. This means that initial advance which goes out of the banking system, again comes back to it. We now relax this assumption. We now assume that there is a permanent leakage of cash from the banking system. In our numerical example, we now assume that the minimum reserve ratio is 10 per cent and the leakage of cash in the course of new credit expansion is 50 per cent. Now, suppose that Bank I has an excess reserve of ₹100 and it grants new loans of the same amount. The recipient keeps ₹50 with him and deposits ₹50 with Bank II. Bank II keeps ₹5 (i.e., 10% of ₹50) as reserves and grants new loans equal to ₹45. This second round expansion of credit can be expressed as follows:

$$100 - \tfrac{1}{2} \times 100 - \tfrac{1}{10}\left(100 - \tfrac{1}{2} \times 100\right) = \left(100 - \tfrac{1}{2} \times 100\right)\left(1 - \tfrac{1}{10}\right)$$
$$= \left(1 - \tfrac{1}{2}\right)\left(1 - \tfrac{1}{10}\right) \times 100$$

Similarly, in the third round, new credit will be $100\left(1 - \tfrac{1}{2}\right)^2\left(1 - \tfrac{1}{10}\right)^2$ and so on. The total amount of new credit is given by,

$$100 + 100\left(1 - \tfrac{1}{2}\right)\left(1 - \tfrac{1}{10}\right) + 100\left(1 - \tfrac{1}{2}\right)^2\left(1 - \tfrac{1}{10}\right)^2 + \cdots$$
$$= \frac{1}{1 - \left(1 - \frac{1}{2}\right)\left(1 - \frac{1}{10}\right)} \times 100$$
$$= \frac{1}{\frac{11}{20}} \times 100 = \frac{20}{11} \times 100 = 181.82$$

This result can also be generalised. Let Δz denote the excess reserve of the banking system, r be the minimum reserve ratio and c be the fraction of new credit which remains in the new banking sector (leakage ratio). Then the total expansion of credit is given by,

$$\Delta K_r = \Delta z + (1 - r)(1 - c)\Delta z + (1 - r)^2(1 - c)^2\Delta z + \cdots$$
$$= \frac{1}{1 - (1 - r)(1 - c)} \times \Delta z$$

Here the credit multiplier $= \dfrac{1}{1 - (1 - r)(1 - c)} = \dfrac{1}{r + c(1 - r)}$

Thus, the total credit creation is determined by the size of the excess reserve (Δz), minimum reserve ratio (r) and the payment habit or cash-preference (c) in the non-banking sector.

2.9.1 Limitations of Credit Creation Process

The credit creation process of commercial banks has some limitations. We mention some major limitations below.

- The reserves of the banking system are determined by the monetary authority. It depends on the policy of the central bank. By manipulating the credit instruments at its disposal, the central bank can influence the credit-creation power of commercial banks.
- In addition to legal requirement, commercial banks very often maintain excess reserves. The larger the excess reserves, the lesser is the expansion of credit.
- Banks create credit against approved securities. These are called negotiable instruments. If such securities are not sufficiently available in the economy, banks cannot expand credit.

- The amount of credit demanded by the non-bank public also depends on the terms on which the credit is granted. If the banks impose strict terms, then the demand for credit will be low and the banks will not be able to utilise their lending potential.
- The credit-creating capacity of commercial banks depends on the general level of economic activities. It there is a boom in economic activity, businessmen will be optimistic about the future. They will take more loans and more credit will be granted by commercial banks. On the other hand, if there is a depression in the general level of economic activity, businessmen will be pessimistic about the future. They will take less loans from commercial banks and hence less credit will be granted by the commercial bank.
- Even if banks are willing to expand loans, their desire will not be fulfilled if the borrowers take a non-conformist attitude, that is, they do not come up to take loans. In this context, R. L. Sayers has rightly said, 'You can take the horse to water, but you cannot make it drink.'

2.10 CENTRAL BANK

The apex bank which controls, regulates and stabilises the banking system and the monetary system of a country in the national interest, is called the central bank. Every country has a central bank of its own which controls its entire banking system. It occupies the pivotal position in the monetary and banking structure of the country. It is the undisputed leader in the money and capital markets of an economy. The central bank is also given the responsibility of implementing the monetary policy of government. As such, it supervises, controls, and regulates the activities of commercial banks affiliated with it. In India, the name of the central bank is the Reserve Bank of India. It was set up in 1935. Similarly, the Bank of England is the central bank of England. In the USA, the central bank is known as the Federal Reserve System.

Central bank is needed in a country for various reasons. Some of the important reasons behind the establishment of central bank in a country are as follows:

- **First**, the central bank is required to issue paper currency. If different commercial banks are given the power to issue notes, then there will be different types of notes, and all the notes may not be equally preferred by the public. On the other hand, if the power to issue notes is given only to the central bank, then only a uniform type of notes will circulate in the country. Further, notes issued by the central bank will enjoy more confidence of the public than the notes issued by any other financial institution.
- **Second**, a central bank is needed to help the commercial banks to face economic crises. In the absence of the central bank, commercial banks are likely to fail at the hour of economic crisis.
- **Third**, a central bank is urgently needed to control the credit granted by commercial banks in an economy. In the absence of the central bank, there will either be over-issue

or under-issue of credit by commercial banks. This will hamper the economic growth of the economy.

- **Lastly**, a central bank is utmost required in a country to implement the monetary policies of the government of that country.

2.10.1 Objectives of Central Bank

The objectives of central banks have changed from time to time. Before the great depression of 1930, the main objectives of central banks in many countries were (i) exchange stability and (ii) price stability. Thus, the objective was to maintain external stability as well as internal stability. However, during 1930s, the capitalist economies of the world faced great depression and unemployment. Hence the objective of external stability was discarded for the time being and the principal objective was to remove depression and unemployment. Then the central banks of different capitalist countries followed a 'cheap' money policy, that is, the supply of money was increased.

After the Second World War, the economic situation changed. The major economies of the world experienced inflationary pressure. As a result, the objectives of central banks of different countries also changed. We may mention some major objectives of central banks of different countries as follows:

- High levels of production and employment
- Adequate economic growth
- Exchange rate stability
- Reasonable price stability
- Implementation of monetary policy of the government
- Control of bank credit
- Expansion of rural banking
- Debt management of the government
- Development of money and capital markets of the economy
- Conduction of economic survey and research on major economic matters of the economy

Thus, the objectives of central banks in different countries have changed over time as the economic situation has undergone change. Before the great depression of 1930, maintenance of exchange stability was perhaps the most important objective. In the great depression period, removal of unemployment and maintenance of a high rate of employment was the topmost priority of the central banks of different countries. In the present world, the central bank of any country has a number of objectives as mentioned above.

It may be mentioned in this connection that different objectives are not necessarily compatible. Rather, some of them are even competitive or incompatible. For example, maintenance of high employment and control of bank credit may be incompatible. Hence, there should be a judicious mixture of different objectives depending on existing circumstances in the economy.

2.10.2 Functions of Central Bank

As the apex banking and monetary institution, the central bank of any country has to perform some important functions. Its main function is to control, regulate and stabilise the banking and the monetary system of the country in the national interest. However, as the economic circumstances vary from country to country, the functions of the central bank also vary from one country to another. Still there are certain common functions performed by the central banks of all countries. Professor De Kock has mentioned **six such common functions** which are performed by the central banks of almost all countries of the world. These six functions are as follows:

(i) Issuing notes,
(ii) Acting as the banker of the government,
(iii) Acting as the banker of commercial and other banks,
(iv) Preserving the gold and foreign exchange reserve of the country,
(v) Acting as the controller of credit and
(vi) Publishing important economic statistics on the economy.

We shall briefly describe these functions one by one.

2.10.2.1 Note Issue

The central bank enjoys the monopoly of issuing notes. In the nineteenth century, commercial banks had the right to issue notes. But this system had some drawbacks. *First*, there was a lack of uniformity in the notes issued by commercial banks. *Second*, sometimes commercial banks failed to convert their notes into cash on public demand. *Third*, commercial banks could not also supply notes for transactions according to the need. *Fourth*, people had less confidence on notes issued by commercial banks.

For all these reasons, the system of issuing notes by commercial banks was gradually discarded. It was felt that the central bank should be given the authority to issue notes. This system has the following **advantages**:

- Notes issued by the central bank enjoy public confidence.
- There is uniformity in the monetary system. The central bank can estimate the requirement of cash and it can increase or decrease the supply of notes.
- The central bank can also control the credit created by commercial banks through controlling the issue of notes.

For all these reasons, the central bank has been given the monopoly power to issue notes. In India, the Reserve Bank of India, the central bank of the country, has been given the monopoly power to issue currency notes. All notes other than the one rupee note, one rupee currency and small coins, are issued by the Reserve Bank of India. One rupee notes, one rupee coins and small coins are issued by the Ministry of Finance of the Government of India. However, these are distributed by the Reserve Bank of India throughout the country as the representative of the Government of India.

2.10.2.2 Banker of the Government

The central bank acts as the banker of the government. As the government's banker, the central bank keeps the accounts of various government departments and institutions. It accepts deposits from the government. It undertakes the collection of cheques and drafts deposited in the government account. The central bank also transfers government funds from one place to another or from one account to another. It also advances short-term loans to the government when requested by it. In its capacity as agent of the government, the central bank accepts loans and manages the public debt on behalf of the government. It also receives taxes and other payments from the public on behalf of the government. It also provides useful advice to the government on important economic matters.

2.10.2.3 Bankers' Bank

The central bank of any country acts also as the bankers' bank. In this capacity, the central bank performs the following three functions:

(i) It acts as the custodian of cash reserves of commercial banks of the country.
(ii) It acts as the lender of the last resort of the commercial banks.
(iii) It acts as the bank of central clearance, settlement and transfers.

We shall discuss these three functions one by one.

The central bank is the apex bank in an economy. All commercial banks are affiliated to the central bank. They are required to keep a certain percentage of their deposits with the central bank as reserve. Commercial banks can use their reserves with the central bank in the time of need. The central bank has the power to increase or decrease the reserve ratio to be maintained by commercial banks.

Again, if commercial banks are not able to secure financial accommodation from other sources, they can approach the central bank as the last resort for needed credit facilities. In such a situation, the central bank generally grants accommodation, that is, grants credit to commercial banks against eligible securities. Thus, commercial banks depend heavily on the central bank during financial emergency. In this fashion, the central bank acts as the lender of last resort.

As the bankers' bank, the central bank is the bank of central clearance, settlement and transfers. It acts as the clearing house for commercial banks. All commercial banks have their accounts with the central bank. Hence, it becomes easier and more convenient for the central bank to act as the clearing house of commercial banks. It can easily settle the claims and counter-claims of commercial banks with the minimum use of cash, that is, mainly by book-transfers.

2.10.2.4 Custodian of Nation's Gold and Foreign Exchange

The central bank acts as the custodian of nation's gold and foreign exchange reserve. This is an important function of the central bank. It is the responsibility of the central bank to maintain stability in the rates of foreign exchange. If there are fluctuations in the foreign exchange rates, the central bank purchases or sells foreign currencies in the market in order to keep the foreign exchange rate stable. Further, the gold reserve is also necessary for issuing paper currency. In each country, paper notes are issued against a reserve of certain amount of gold.

2.10.2.5 Controller of Credit

The most important function of the central bank is to act as the controller of credit. The central bank enjoys the monopoly of note issue. It is also the custodian of cash reserves of commercial banks. In these two capacities, the central bank is in a position to control credit in the economy. In order to control credit, the central bank uses several instruments of credit control. These instruments of credit control are changes in bank rate, open market operations, changes in the reserve ratio and some selective methods of credit control. With the help of these instruments, the central bank tries to control the volume of credit and thereby to maintain stability in the level of economic activity. In many countries, cyclical fluctuations in the level of income take place. These cyclical fluctuations in the level of economic activities are known as business cycles or trade cycles. These business cycles may be controlled with the help of the instruments of credit control. For example, during depression or downswing, the central bank tries to increase the volume of bank credit. Similarly, during upswing or inflationary situation, the central bank tries to contract the volume of bank credit.

2.10.2.6 Publisher of Economic Statistics

The central bank publishes economic statistics and other useful information of the country. It collects statistics about the various aspects of the functioning of the national economy and publishes those statistics. This provides valuable information to the government. The government can formulate and implement suitable economic policies on the basis of this information. In India, the Reserve Bank publishes monthly bulletins which provide useful statistics on different aspects of Indian economy.

In addition to the above functions, the central bank performs some minor functions as well. In fact, the functions of the central bank in an economy are expanding day-by-day. This is particularly true for the developing economies. In such economies, one of the important functions of the central bank is to promote economic growth in the economy. The central bank takes different measures in order to help the process of economic development. For example, in developing economies, the central bank tries to expand and develop the money market and the capital market in order to promote economic development. This promotional role of the central bank is more important today in the developing countries on the globe.

2.11 INSTRUMENTS OF MONETARY AND CREDIT CONTROL

One of the important functions of the central bank is to control bank credit. This is essential for the steady growth of a country. For example, during a period of inflation or during upswing of the business cycle, if commercial banks provide more credit, this will aggravate the problem of inflation and intensify the upswing. Hence, in such a situation, the credit-creation power of commercial banks should be curbed. On the other hand, during a period of depression or downswing in business cycle, volume of bank credit should be increased. Hence, the credit-creation power of commercial banks should be increased. In order to expand or contract the volume of credit, there are several instruments at the disposal of the central bank. These instruments are known as the methods of credit control. These methods of credit control can be classified into two groups:

(i) Quantitative methods
(ii) Qualitative or selective methods of credit control

The methods which try to control quantity or volume of bank credit are known as *quantitative methods* or general methods of credit control. The important quantitative methods of credit control are bank rate, open market operations and variable reserve ratio. On the other hand, methods which seek to control the volume of credit going to specific sectors of the economy are known as qualitative methods of credit control. These methods try to change the quality or nature of credit. Hence they are called 'qualitative' methods. They are also known as selective methods of credit control. There are certain qualitative or selective methods of credit control. They are: variation in margin requirements, regulations of consumer credit, direct action, moral suasion, and so on. Various methods of credit control at the disposal of the central bank have been shown in Figure 2.3 as given below.

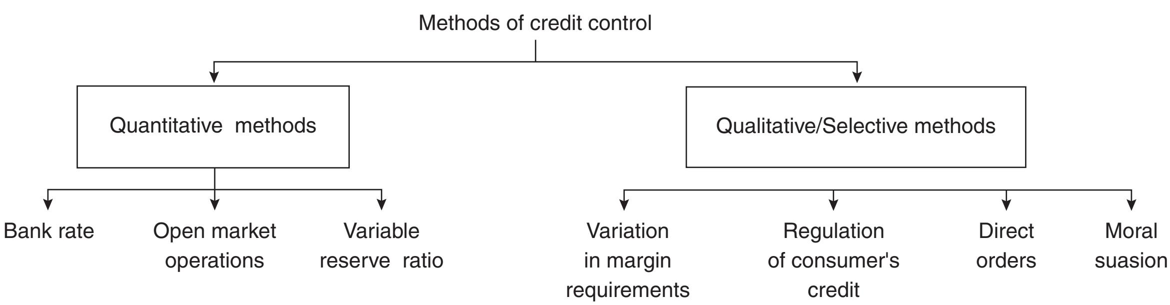


Figure 2.3 Methods of credit control

We shall briefly describe these methods one by one.

2.11.1 Quantitative Methods

Quantitative methods of credit control of the central bank of a country are those methods which try to control (i.e., expand or contract) the volume of bank credit. In this category, there are three instruments or three methods at the disposal of the central bank. These three instruments are bank rate, open market operations and variable reserve ratio. We shall try to explain how these instruments may be used by the central bank to regulate the volume of credit.

2.11.1.1 Bank Rate

Bank rate is the rate at which the central bank discounts bills of exchange presented to it by commercial banks. Simply speaking, bank rate is the lending rate of the central bank. When commercial banks take loans from the central bank; they have to pay interest to the central bank at the bank rate. Now if the central bank increases the bank rate, commercial banks will have to pay higher rate of interest. Hence commercial banks will also increase their rates of interest. Then people will take less loans from commercial banks. As a result, the volume of bank credit will decrease. In the opposite case, if the central bank reduces the bank rate, commercial banks will also reduce their rates of interest. People will be willing to take more loans. As a result, volume of bank credit will increase. During an inflationary situation, bank credit is to be reduced. So during inflation, the central bank raises the bank rate. In the opposite case, during depression, bank credit is to be expanded. So, during depression, the central bank lowers the bank rate.

However, the bank rate policy has some **limitations**. In brief, they are as follows:

- The bank rate policy works indirectly.
- There is no compulsion in the bank rate policy. This means that even if the bank rate is raised, people may take loans even at a higher rate of interest. Again, even if the bank rate is raised, commercial banks may not increase their lending rate if they have excess reserves and do not come to the central bank for credit.
- By the bank rate policy, lending of only commercial banks can be controlled.
- For the success of the bank rate policy, the money market and the capital market should be broad and well organised. Hence the effectiveness of the bank rate policy is somewhat limited in less developed economies.
- For the effectiveness of the bank rate policy, there should be a rigid link between the bank rate and the market rate of interest.
- For the success of the bank rate policy, the economic system should be flexible. Otherwise this policy will not be successful.

2.11.1.2 Open Market Operations

When the central bank of a county purchases and sells securities on its own initiative, it is called open market operations. Through these operations, the central bank can regulate the volume of bank credit. For example, when securities are sold in the open market, they are purchased by commercial banks, non-bank public and other financial institutions. As a result, their cash reserves fall. We know that commercial banks can make multiple expansion of credit on the basis of their excess reserves. Now, when commercial banks purchase securities, their excess reserves fall. As a result, there will be less credit creation. Similarity, if the central bank purchases securities, commercial banks will get more money, their excess reserves will rise and hence they will give more credit. Thus, the central bank can expand or contract credit by purchase or sale of securities in the market.

The method of open market operations is an important quantitative method of credit control. Unlike bank rate, this method operates directly. However, the method of open market operations has some **limitations**. In brief, they are as follows:

- Under open market operations, the purchase or sale of securities is not obligatory. Commercial banks are not legally bound to oblige the central bank.
- This policy will be ineffective if commercial banks have sufficient excess reserves.
- The effectiveness of open market operations requires that the money market and capital market are well organised. Hence this policy is not so effective in a less-developed economy.
- For the success of this policy, the central bank should have huge and various kinds of securities. Otherwise it cannot absorb the excess reserves of commercial banks.
- For the success of open market operations, commercial banks should maintain stable cash–deposit ratio. Otherwise this policy will not be successful.

2.11.1.3 Variable Reserve Ratio

We know that commercial banks have to keep a fixed proportion of their deposits as reserve ratio. The central bank can vary (i.e., increase or decrease) this reserve ratio. Hence this method is known as the method of variable reserve ratio. By changing this reserve ratio, the central bank can influence the credit creation power of commercial banks. We know that the credit creation multiplier of commercial banking system is the reciprocal of the reserve ratio, that is, $1/r$ where r is the reserve ratio. Now, if the central bank raises the reserve ratio (r), credit creation multiplier will fall. In other words, when r is raised, commercial banks will be left with less money. Then the credit-creating capacity of commercial banks will fall. In the opposite case, if the central bank reduces the reserve ratio (r), commercial banks will be left with more money and their credit-creating capacity will rise. During inflation, volume of credit is required to be reduced. So, during inflation, the central bank will raise the reserve ratio. Again, during depression, money supply with the public should be increased. So, during depression, the central bank reduces the reserve ratio.

The method of variable reserve ratio has the following main **advantages**:

- This method works directly and gives quick results. According to S.N Sen, by this method, the reserves of commercial banks can be increased or decreased by the central bank 'at a pen's stroke'.
- This method is equally effective in both developed and underdeveloped countries. Its success does not require the presence of developed capital and money markets.
- This method is very suitable when the reserves of commercial banks are to be changed by large amounts.

However, this method has some **limitations** also:

- This method is discriminatory against small banks and in favour of large banks.
- This method creates shock effect among small banks.

- This method is inflexible. The same reserve ratio is applied for the whole economy.
- This method is applicable only to commercial banks and not to non-bank financial institutions. This is because non-bank financial institutions are not required to maintain reserves with the central bank.

The major **limitation** of the quantitative methods is that these methods try to increase or decrease all types of credit at the same time without considering the quality or the nature of credit. However restriction of credit to all sectors of the economy may not be desirable. Expansion of credit to some selective sectors and contraction of credit in some other sectors may be desirable at the same time. In that case, qualitative methods or the selective methods of credit control are better than the quantitative methods. We shall now turn to some of the major qualitative or selective methods of credit control.

2.11.1.4 Selective or Qualitative Methods of Credit Control

Those methods of credit control by which the central bank of a country expands or contracts the flow of credit to certain selective sectors of the country are known as selective or qualitative methods of credit control. There are different forms of selective methods of credit control. Important forms among them are differential bank rates, variations in margin requirements, regulation of consumer credit, import pre-deposit requirement, direct orders and so on. We shall briefly describe them one by one.

Differential bank rates: The central bank may charge different bank rates for different types of eligible papers. The commercial banks will also charge different rates of interest on different kinds of credit. This system is known as the **differential bank rate system**.

Variations in margin requirements: Margin means the percentage value of share to be paid by the purchaser in cash. If the central bank raises this margin, the bank will provide less money to the purchaser of share for purchasing shares. Then less money will go to the share market. In the opposite case, if the central bank reduces the margin, more money will flow into the share market. Thus, the central bank can regulate the flow of credit to the share market through variations in margin requirements.

Regulation of consumer credit: Now-a-days, many durable consumer goods are purchased on hire-purchase scheme; very often banks provide loans to purchase these durable consumer goods. The central bank can change the terms of such consumer credit. If the terms of consumer credit are made stringent, the volume of consumer credit will fall. In the opposite case, if the terms of consumer credit are made more liberal, volume of consumer credit will expand.

Import pre-deposit requirement: The central bank may stipulate that importers will have to deposit a pre-determined part of the value of imports while applying for import licenses. This system is known as import pre-deposit requirement. If this requirement is increased by the central bank, money supply in the economy will fall. In the opposite case, money supply will increase.

Direct orders: The central bank is the apex bank—it is the leader in the financial market. Hence the central bank can direct commercial banks not to grant credit beyond a certain limit in a particular project or sector.

The **most important merit** of selective methods of credit control is that it is effective in both developed and underdeveloped economies. *Second*, this method can encourage the desirable sectors as well as discourage undesirable sectors of the economy.

However, there are some *limitations* of the selective or qualitative methods of credit control. Those are briefly mentioned below as follows:

- Borrowers can misuse the funds borrowed from commercial banks. It is very difficult to ensure that funds are properly used by borrowers.
- It is essential for the success of selective methods of credit control that commercial banks abide by the guidelines prescribed by the central bank. Otherwise the methods will not give described results.
- In the case of selective or qualitative methods of credit control, administrative complexities and operational expenses of commercial banks increase.
- Sometimes selective discrimination leads to corruption.

2.11.1.5 Moral Suasion

When the central bank tries to regulate the volume of bank credit through advises to commercial banks from time to time it is known as the method of moral suasion. The central bank is the apex body of all financial institutions. All commercial banks are affiliated to the central bank. Hence, the central bank can advise commercial banks from time to time. It only requests commercial banks and it is hoped that commercial banks will honour such requests.

The method of moral suasion suffers from one major limitation. This method will be successful only if commercial banks keep the requests of the central bank. These requests are not backed by law. So, there is no guarantee that these requests will be fulfilled by commercial banks. If the requests fail to produce desired results, the central bank must give orders to commercial banks.

2.12 DIFFERENCE BETWEEN CENTRAL BANK AND COMMERCIAL BANKS

By nature and functions, the central bank and commercial banks are totally different. There are many **important differences** between them. In brief, they are as follows:

- The central bank is the apex institution in the banking and monetary structure of a country. Commercial banks are one organ in this structure.
- The central bank is a non-profit organisation. It implements economic policies of the government. However, commercial banks are profit-making institutions.
- The central bank is owned by the government, but commercial banks are owned by their shareholders or the government.
- The central bank is a banker of the government. It does not perform ordinary banking activities of the public.

- The central bank has the monopoly of note issue. Commercial banks have no such power. They issue cheques which are near-money, but notes are legal tender.
- The central bank is the bankers' bank. It gives loans to commercial banks, keeps all their reserves, advises them on monetary matters, and so on. On the other hand, commercial banks give loans to the public and accept deposits from the public.
- The central bank is the custodian of the foreign currency reserves of the country. A commercial bank is a dealer in foreign currencies.
- The central bank controls credit according to the needs of the economy. On the other hand, commercial banks create credit to meet business requirement.
- The central bank helps in establishing financial institutions in order to strengthen money and capital markets in the economy. On the other hand, commercial banks provide financial assistance to industry, trade and agriculture for their development.
- The central bank conducts clearing house in order to settle claims and counter-claims of commercial banks. However, commercial banks have no such activity.

2.13 HIGH-POWERED MONEY AND CONCEPT OF MONEY MULTIPLIER

2.13.1 High-powered Money

High-powered money may simply be defined as the sum of currency held by the non-bank public and reserves maintained by commercial banks. This money has the backing of highest monetary authority of the country. Hence it is called high-powered money. It is equal to the sum of currency in circulation and reserves maintained by commercial banks. The term 'high-powered money' has been given and popularised by the Chicago school, headed by Milton Friedman.

2.13.2 Money Multiplier Doctrine

According to Friedman and Schwartz, the stock of money in an economy is determined by three factors. Those three factors are: (i) high-powered money, (ii) the ratio of total reserves to total deposits maintained by commercial banks, and (iii) the ratio of total currency to total deposit maintained by non-bank public. This theory is known as *money multiplier doctrine* or *H-theory of money supply*.

This theory tries to determine the proximate determinants of money supply with the help of a simple model. The theory is based on the following assumptions:

- Commercial banks maintain a fixed ratio of total reserves to total deposits. Let this ratio be r. So, $r = \frac{R}{D}$, where R = total reserves and D = total deposits.
- Public maintains a fixed ratio of total currency to total deposits. Let this ratio be c. So, $c - \frac{C}{D}$, where C = total currency.
- The supply of high-powered money (H) is equal to the sum of currency in circulation (=) and reserves maintained by commercial banks (R), that is, $H = C + R$.
- Supply of money consists of total currency and total deposits, that is, $M = C + D$.

Now, from definition, $\frac{M}{H} = \frac{C+D}{C+R} = \frac{\frac{C}{D}+1}{\frac{C}{D}+\frac{R}{D}}$

Putting $\frac{C}{D} = c$ and $\frac{R}{D} = r$ (from assumptions 2 and 1, respectively), we have

$$\frac{M}{H} = \frac{c+1}{c+r}$$

$$\therefore \quad M = \frac{1+c}{c+r} \times H.$$

The expression $\frac{1+c}{c+r}$ is known as the money multiplier. It shows that given the values of c and r, the amount of money supply (M) depends directly on the amount of high-powered money (H).

In fact, here M is directly proportional to H. Hence, this theory is also called the H theory of money supply. The theory shows that the monetary authority or the central bank can make a multiple expansion of money supply through the supply of high-powered money. The multiplier is equal to $\frac{1+c}{c+r}$. For example, if $c = 0.05$ and $r = 0.10$, then multiplier $\frac{1+0.05}{0.05+0.10} = \frac{1.05}{0.15} = 7$. This means that if the supply of high-powered money increases by one unit, money supply in the economy will increase by seven units (provided the assumptions of $r = 0.10$ and $c = 0.05$ hold).

The money multiplier doctrine or the H-theory of money supply suffers from some **limitations**. In brief, they are as follows:

- The money multiplier has been derived from some definitions. There is no behavioural assumption involved in it. Hence it has been described as a definitional identity.
- In the derivation of money multiplier, the ratios c and r have been taken as mechanical or technical relations, hence, Levacic and Rebman have termed the theory as a mechanistic view. Instead, the cash-deposit ratio (c) and the reserve-deposit ratio (r) should be considered as optimum ratios. This means that c should be defined as the optimum cash–deposit ratio which people wish to maintain. Similarly, r should be defined as the optimum reserve-deposit ratio which commercial banks wish to maintain.
- The same reserve ratio has been assumed for all types of deposits. This in unrealistic; demand deposits can be withdrawn by depositors on demand. Time deposits cannot be withdrawn so easily. Further, depositors of time deposit do not generally withdraw the sum before maturity. Hence, it may be expected that banks will maintain a higher reserve deposit ratio for demand deposits and a lower reserve deposit ratio for time deposits. However, this fact has not been considered in the money-multiplier theory or in the H-theory.

2.13.3 An Extension of Money Multiplier Theory (or H-Theory)

We can construct a more satisfactory theory of money supply determination by modifying some of the assumptions of Friedman and Schwartz.

Let R be the amount of total reserves with commercial banks. Further, let r_d and r_t be the reserve requirement ratios against demand deposits and time deposits, respectively. These are set by the central bank. Let C and T be the respective amounts of currency and time deposits demanded and determined by the non-bank public. Again, let E be the excess reserves of commercial banks. Then the supply of demand deposits, D, will be given by the following equation:

$$R = r_d D + r_t T + E \tag{1}$$

Now the supply of money, $M = C + D$ (2)
We now assume that $C = cD$, $T = t \times D$ and $E = e \times D$.
So, $M = C + D = c \times D + D = (1 + c)D$ (3)
Again, from Eq. (1) $R = r_d \times D + r_t \times T + E$

$$= r_d \times D + r_t \times t \times d + e \times d$$

$$\therefore\ R = (r_d + r_t \times t + e)D$$

$$\therefore\ D = \frac{1}{r_d + r_t \times t + e} \times R$$

Putting this value of D in Eq. (3), we get

$$M = \frac{1+c}{r_d + r_t \times t + e} \times R \tag{4}$$

This is the equation of money supply. Here, multiplier $= \frac{1+c}{r_d + r_t \times t + e}$.

Eq. (4) shows that money supply is determined by six factors: c, e, t, r_d, r_t and R. Assuming that c, t and e are constants, the central bank can influence the money supply by controlling R, r_d and r_t. However, if the rate of interest *(i)* and/or the level of income *(y)* change, then the ratios, c, t and e will change.

Let us consider the nature of their change. *First*, we consider the change in c with the change in level of income.

As the level of income increases, the demand for both currency and demand deposits rises. But the demand for demand deposits increases more rapidly than the demand for currency. So, $c\left(=\frac{C}{D}\right)$ falls. Thus, $c = c(y)$ such that $\frac{dc}{dy} < 0$. *Second*, as y rises, demand for time deposits will rise more rapidly than demand deposits. So, $t = \left(=\frac{T}{D}\right)$ will rise as y rises. Thus $t = t(y)$ such that $\frac{dt}{dy} > 0$. *Third*, as interest rate rises, opportunity cost of excess reserve rises; then commercial banks will hold less excess reserves. Hence, $e\left(=\frac{E}{D}\right)$ falls. Thus, $e = e(i)$, such that $\frac{de}{di} < 0$.

Now considering Eq. (4), we have

$$M = \frac{1+c}{r_a + r_t \times t + e} \times R$$

As Y rises, c falls and t rises. Both of them tend to reduce the value of multiplier. Again, as the rate of interest rises, e falls. It will tend to raise the value of the multiplier. Hence, the supply of money will vary directly with the rate of interest. Thus we can write, $M = f(R, r_d, r_t, i, y)$ such that

$$\frac{\Delta M}{\partial R} > 0, \frac{\Delta M}{\partial r_d} < 0, \frac{\Delta M}{\partial r_t} < 0, \frac{\Delta M}{\partial i} > 0 \text{ and } \frac{\Delta M}{\partial y} < 0.$$

Thus we see that money supply depends on some factors (R, r_d and r_t) which are under the control of the central bank and on some factors (i and y) which are determined by market forces. Hence we may say that money supply is partly exogenous and partly endogenous. It is determined jointly by the behaviour of the central bank, commercial banks and the non-bank public. No one group has complete control over the size of the money supply.

But does one group dominate?—There are two views on this question. According to the traditional view, money supply is 'mostly' an exogenous variable determined by central bank policy. But according to the modern view, money supply is 'primarily' determined by the rate of interest and other market forces.

Empirical evidence supports the traditional view. It does not deny the influence of market forces but claims that the role of market forces is subordinate to the influence of central bank's behaviour. Thus, the safe conclusion is that money supply is partly exogenous and partly endogenous.

2.14 RESERVE BANK OF INDIA (RBI)

The name of India's central bank is the Reserve Bank of India (RBI). As the central bank of the county, the RBI promotes and regulates the financial transactions in India. It is the top-most or apex financial institution and the undisputed leader in the financial market of India. The RBI was set up under the Reserve Bank of India Act 1934. It started its function since 1 April 1935. Initially, the RBI was a shareholders' bank. On 1 January 1949, the RBI was nationalised and made a state-owned institution. Naturally, the Reserve Bank of India is the most important and powerful financial institution in India.

2.14.1 Organisation and Management

A central board of directors is entrusted with the overall management of the RBI. This board has 20 members and it conducts the affairs and business of the RBI. Apart from the central board of directors there are four local boards situated in four metro cities of India.

The structure of the organisation and management of RBI may be described as follows:

As mentioned above, the central board of directors has 20 members. This board consists of one governor and four deputy governors, four directors from four local boards, ten directors and one government official from the ministry of finance. The four local boards are situated at Mumbai, New Delhi, Kolkata and Chennai. The organisation and management of the RBI is shown in Figure 2.4.

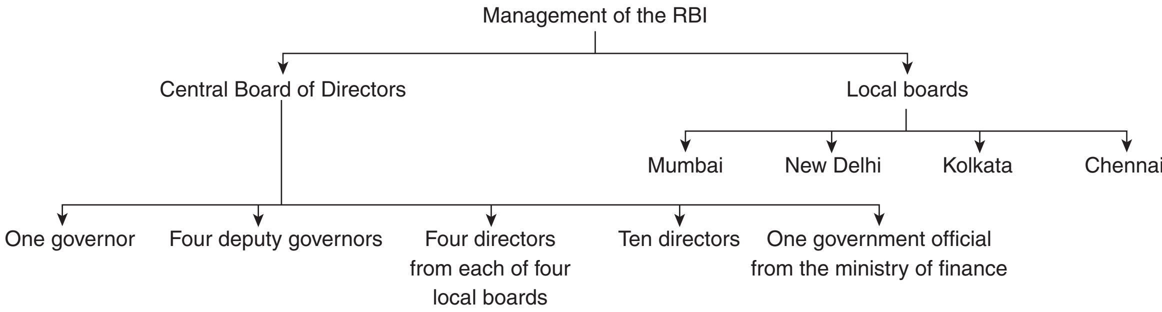


Figure 2.4 Organisation and management of the RBI

Let us briefly describe the offices of the above position-holders. The Governor and the four deputy governors are appointed by the central government. They are whole-time officers of the RBI. The term of appointment will not exceed 5 years for them. The governor is the executive head of the Bank. He is assisted by the four deputy governors.

The central government also nominates four directors. These four directors are taken one from each of the four local boards. These four local boards are located at Mumbai, New Delhi, Kolkata and Chennai. The tenure of appointment is for a period of 5 years.

Apart from these four directors from four local boards, there are ten other directors. They are also appointed by the central government. The tenure of their appointment is 4 years. These directors are experts in business, industry and finance. Further, the central government nominates one government official from the ministry of finance in the central board of directors. Generally, the Secretary, Ministry of Finance of the Government of India is nominated. The nominated person attends the meeting of the central board of directors as one of its 20 members. But the official does not have the voting right in the meeting of the central board of directors.

All the powers of the RBI are exercised by the central board. The board must meet six times each year and at least once in each quarter.

For smooth and efficient working, the activities of the RBI have been divided into various departments. Some of the important departments are Issue department, Banking department, Exchange control department, Agricultural credit department, Industrial finance department, Inspection department, Legal department, Accounts and expenditure department and so on. The very name of each department indicates its field of activities.

2.14.2 Functions of the Reserve Bank of India

The Reserve Bank of India (RBI) is the central bank of India. As the central bank of the country, the RBI controls the entire financial sector of the economy. It regulates the activities of the money market, acts as the custodian of the money market, tries to execute the monetary policy of the government, uses its powers to promote economic development of the country and so on. Various functions performed by the RBI may be conveniently divided into two categories. They are as follows:

(i) Traditional functions

(ii) Promotional functions

We have presented these functions in the form of a chart (Figure 2.5).

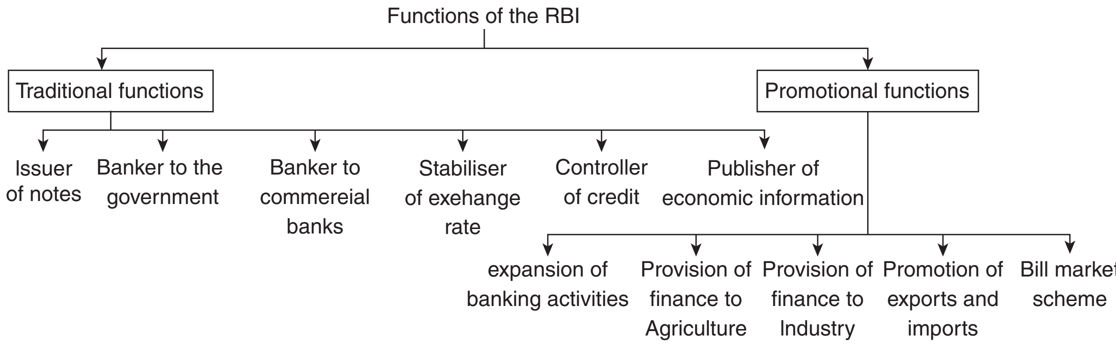


Figure 2.5 Functions of the RBI

We briefly describe them one by one.

2.14.2.1 Traditional Functions

Issue of notes: The first and the main traditional function of the RBI is to issue currency notes. The RBI has the sole right or authority to issue all types of paper currency except some notes of small denominations which are now circulated as metallic coins. These small denomination metallic notes and coins are circulated by the Government of India. At present, notes of denominations of ₹10, 20, 50, 100, 500 and 2000 are issued by the RBI. One-rupee, two-rupee and five-rupee notes are not printed now. They are now issued as coins. Ten-rupee notes are issued both as paper currency and metallic coin. Though metallic coins are issued by the Government of India, their amount is determined by the Reserve Bank of India. With the monopoly power of note issue, the RBI regulates the volume of money supply in the economy.

Bankers to the government: The RBI functions as the banker to the government. In this capacity, the RBI maintains the accounts of the central and state governments. These governments deposit their revenues with the Reserve Bank of India. They also meet their expenditures by withdrawing their deposits from the RBI. Apart from that, the RBI provides various services to the central and state governments, manages public debt, repays loans on behalf of the government and so on. It generally acts as a representative of the government when the government takes any loan from any domestic or foreign source. Further, funds of the government are transferred from one place to another by the RBI. Again, the RBI gives useful advice to the government on financial and banking matters. In a word, the RBI acts as the banker to the government.

Banker to commercial banks: The RBI acts as the banker to commercial banks of the country. Commercial banks have to keep a percentage of their deposits as reserves with the RBI. This is called cash reserve ratio (CRR). The RBI can vary this reserve ratio. Hence it is also called variable reserve ratio. Again, commercial banks have to keep a portion of their deposits to themselves as reserves in the form of cash or gold or authorised securities. The RBI stipulates or determines these reserve ratios. It is called statutory liquidity ratio (SLR). Again, the RBI acts as the lender of last resort to commercial banks. It provides credit to commercial banks in the hour of need for finance. Further, the RBI acts as the clearing house of commercial banks. The claims and counter-claim among commercial banks are settled (cleared) at the clearing house. All commercial banks have their accounts with the RBI. Hence the RBI can settle the claims and counter-claims of commercial banks with the minimum use of cash. In a nutshell, the RBI acts as the banker to commercial banks.

Stabiliser of exchange rate: The RBI tries to maintain a stable value of Indian rupee against major foreign currencies. This is necessary for smooth transactions in foreign trade. When the value of US dollar rises against Indian rupee, the RBI sells US dollars in the market. Thus the upward trend in the price of US dollar is somewhat retarded. Vice versa, when the price of US dollar against Indian rupee falls, the RBI purchases US dollar from the market. Then the downward trend in the price of US dollar is somewhat checked. The foreign exchange reserves of the country are held by the RBI. The RBI tries to maintain the stability of exchange rates of Indian rupee with major currencies of the world. The RBI also acts as the representative of the government in matters relating to the IMF and the World Bank.

Controller of credit: One of the main functions of the Reserve Bank of India is to control or regulate the volume of bank credit. This is by far the most important function of the RBI. There are different instruments of credit control at the disposal of the RBI. Through these instruments, the RBI controls the volume of bank credit. These instruments are the bank rate, open market operations, variable reserve ratio and selective methods of credit control. During depressional situation, the RBI tries to expand the volume of bank credit. On the other hand, during inflationary situation, the RBI tries to contract the volume of bank credit. The RBI also uses the method of moral suasion in order to control credit. The RBI sends letters or circulars to commercial banks regarding credit policies in general and also regarding credit to particular sector(s). Non-bank financial institutions also grant credit like commercial banks. The RBI controls the activities of non-bank financial institutions also.

Publisher of economic information: The RBI collects and publishes important economic information and statistics on different aspects of Indian economy. For this purpose, it publishes monthly bulletins and an annual report on currency and finance. The RBI has a strong research wing which conducts research on different economic matters. The findings of these research works are reported in occasional papers published by the Reserve Bank of India. Various information on the national economy are obtained from different publications of the RBI.

2.14.2.2 Promotional Functions

Promotional functions or activities are those functions which promote economic development of the country. The RBI performs several promotional activities. Important among them are briefly mentioned below:

Expansion of banking activities: The RBI helps in the expansion of the banking sector, particularly in rural areas. The approval of the RBI is necessary for establishing a new bank or opening a new branch of a commercial bank. By expanding banking activities in rural areas, the RBI helps in the mobilisation of rural savings. This again helps in capital accumulation and economic development of the economy.

Provision of finance to agriculture: Agriculture is the backbone of Indian economy. For the development of our agriculture, small and marginal farmers should be provided with adequate finance. To provide finance to the agricultural sector, the RBI has set up National Bank for Agriculture and Rural Development (NABARD) in July 1982. It has also established Regional Rural Banks (RRBs) in July 1975.

Provision of finance to industry: For economic development, industrial sector should also be developed. To provide credit to the industrial sector, the RBI has helped to set up IFCI (Industrial Finance Corporation of India), SFCs (State Financial Corporations), SIDBI (Small Industries Development Bank of India), IIBI (Industrial Investment Bank of India) and so on.

Promotion of exports and imports: The RBI has taken initiative to expand the volume of trade. For promoting exports and imports, it has helped to establish Export–Import (EXIM) Bank.

Bill market scheme: To improve the quality of financing, the Reserve Bank of India introduced two bill market schemes—one in 1952 and the other in 1970. The RBI also helps in the process of economic development of the economy bringing economic growth in any area with the help of commercial banking, the RBI has launched programmes like Lead Bank Scheme, Service Area Approach and so on

Thus we see that the Reserve Bank of India, as the central bank of the country, performs various important activities. In a developing country like India, the area of promotional or developmental functions of the RBI is expanding day-by-day.

2.14.3 Monetary Policy of the Reserve Bank of India

As the central bank of India, the main function of the Reserve Bank of India is to control credit. It conducts the monetary policy of the Government of India. The policy which seeks to achieve certain objectives, such as maintaining stability in income, employment, price level, and so on, by changing the volume of money supply and credit, and thereby affecting the rate of interest, is known as monetary policy. To achieve these objectives of monetary policy, the RBI has used different instruments of credit control from time to time. We know that there are some methods of credit control. These methods may be classified into two groups, namely, (A) **quantitative methods,** and (B) **qualitative methods**. The quantitative methods or the general methods are the methods which seek to expand or contract the total volume of credit in the banking system. In this category, we have three methods, namely (i) open market operations, (ii) bank rate, and (iii) variable reserve ratio. On the other hand, qualitative methods of credit control refer to those methods by which the RBI regulates the flow of credit to certain selective sectors of the economy, without regulating all types of credit. These methods are the methods which try to change the character or quality of credit. It is also known as selective methods of credit control. In this category, there is no specific credit control instrument. The RBI selects any method as it is considered to be fit for the situation. Hence these methods are called 'selective' methods of credit control. In this category, we may mention some methods such as (i) statutory liquidity ratio (SLR), (ii) interest rate structure, (iii) credit monitoring arrangement (CMA), (iv) direct action, (v) moral suasion, and so on.

We have shown various instruments of credit control of the RBI in Figure 2.6 given below.

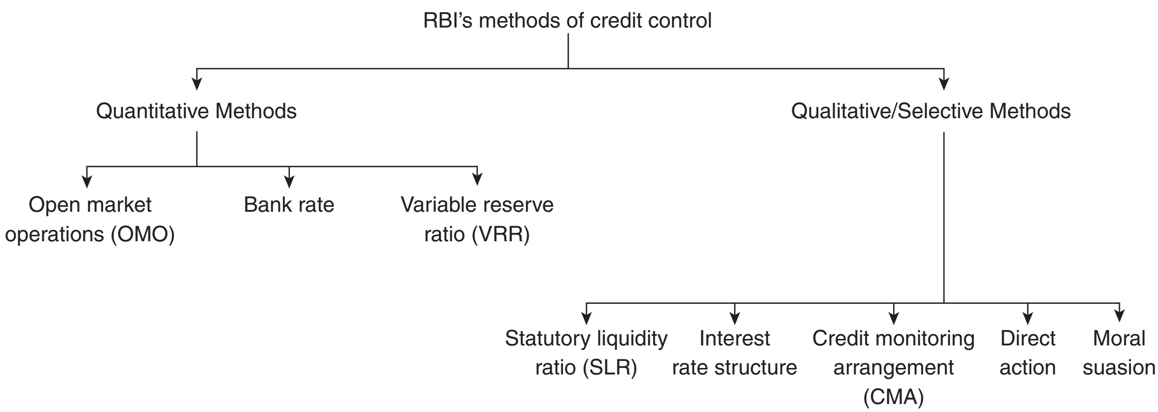


Figure 2.6 RBI's methods of credit control

We shall describe them one by one.

2.14.3.1 Quantitative Methods

Open market operations (OMO): By open market operations, we generally mean purchase and sale of government securities by the central bank of a country in the open market. The RBI has also engaged itself in open market operations. The Reserve Bank mainly uses this instrument to meet seasonal variations in the demand for credit. In the Indian economy, there are two seasons. The period from October to April is the busy season when *kharif* and *rabi* crops are harvested. On the other hand, the period from May to September is the slack season. In the busy season, the RBI purchases government securities from commercial banks. It thus supplies money to commercial banks in order to enable them to give more loans to the private sector. On the other hand, during slack season when commercial banks have idle funds, the RBI sells government securities to commercial banks. It thus enables commercial banks to earn some interest income. Then the volume of money with commercial banks decreases. As a result, their power to give loans falls. In this way, the Reserve Bank of India uses open market operations to meet the seasonal demand for credit in the Indian economy. Apart from this, the RBI also conducts open market operations to meet the cash requirement of the government.

Bank rate policy: Simply speaking, bank rate is the rate at which the central bank provides loan to commercial banks and other financial institutions. The RBI provides financial accommodation in the form of rediscounting of bills of exchange and promissory notes, and loans to banks, IFCI, SFCs, EXIM Bank and other approved financial institutions. Now, there is a connection between the bank rate and the interest rates charged by commercial banks and other financial institutions. When the bank rate is raised, commercial banks also charge higher interest rate on their loans. Then the volume of bank credit decreases. Similarly, if the RBI decreases bank rate, the market rate of interest will also fall and the volume of bank credit will expand. Thus the RBI can influence the volume of credit by changing the bank rate. The Reserve Bank has changed the bank rate several times to control credit. At the time of independence, the bank rate was as low as 2 per cent. It was increased to 3.5 per cent in 1951. In July 1991, it was increased gradually to 11 per cent and further to 12 per cent in October 1991. After that, it was reduced several times. Thus, sometimes the bank rate has been increased and sometimes it has been reduced in order to regulate the volume of bank credit.

Variable reserve ratio (VRR): All the scheduled commercial banks are required to maintain reserves with the Reserve Bank of India. This is called cash reserve ratio (CRR). The Reserve Bank of India can vary this reserve ratio. Hence it is also called variable reserve ratio (VRR). If this cash reserve ratio is reduced, commercial banks will have to keep less reserve. So, their credit-creating power will increase. On the other hand, if this CRR is raised, commercial banks have to keep more reserves. So their credit-creating power will increase. According to the Reserve Bank of India Act as amended in 1962, the RBI can vary the reserve ratio between 3 to 15 per cent

In June 1973, the CRR was raised from 3 to 5 per cent and further to 7 per cent in September 1973. Since then, the RBI has increased or reduced the CRR a number of times in order to regulate the volume of bank credit. In June 2002, the CRR was reduced to 5 per cent.

2.14.3.2 Selective Credit Control (SCC)

The RBI has used selective methods of credit control several times. Under this method, the RBI makes the conditions of credit easy and liberal if that credit goes to the socially desirable sectors. On the other hand, the RBI makes the conditions of credit strict and stringent if that credit goes to the socially undesirable sectors. The RBI first applied this method in 1956 to control speculative holding of rice by the traders. The RBI directed commercial banks to reduce credit to rice-traders. It also increased the margin rate to 10 per cent. Since then, selective methods of credit control have been used by the RBI several times as and when it was necessary.

We may mention some selective methods of credit control used by the RBI from time to time. In brief, they are as follows:

Statutory liquidity ratio (SLR): Apart from cash reserve ratio (CRR), the RBI can impose another restriction on commercial banks. This is statutory liquidity ratio (SLR). Commercial banks have to maintain a certain percentage (at least 25 per cent) of their deposits in the form of cash or gold or approved securities. This percentage is known as the statutory liquidity ratio (SLR). The SLR was 38 per cent in January, 1988. It was then reduced to 30 per cent in 1992.

As per recommendation of Narasimham Committee (1991), the RBI reduced the SLR by successive steps to 25 per cent in October 1997. There are two objectives of introducing SLR. One is to force commercial banks to hold (i.e., to invest in) government securities. The other is to control the power of commercial banks to grant credit.

Interest rate structure: The RBI can also regulate the flow of credit by changing the interest rate structure suitably. A differential interest rate structure is followed by the RBI in accordance with the priorities. This means that the rate of interest is kept low in desirable activities and it is kept high in undesirable activities.

Credit monitoring arrangement (CMA): Under this system, credit exceeding a certain amount would require prior permission of the RBI. This system was in operation during 1988–97. However, during the period of liberalisation and market economy, this system of CMA has been abandoned in 1997.

Direct action: The RBI can caution or prohibit banks generally or a particular bank to enter into specific transaction or transactions. It can also inspect any bank and its books of account.

Moral suasion: Under this method, the RBI sends letters or circulars to commercial banks from time to time. It occasionally holds meetings with the representatives of commercial banks. In these letters or meetings, the RBI requests commercial banks to issue credit in order to fulfill national interest. The nationalised commercial banks can hardly disobey the directives of the RBI.

Through these methods of credit control, the RBI pursues a monetary policy which is better described as the **policy of controlled expansion**. On the one hand, this policy tries to expand credit to the socially desirable sectors. On the other hand, this policy tries to control credit to the socially undesirable sectors.

2.14.4 Limitations of Monetary Policy of the RBI

The monetary policy or the credit control policy of the RBI has some **limitations**. In brief, they are as follows:

- India has a vast unorganised sector which remains outside the control of the RBI. This reduces the effectiveness of monetary policy of the RBI.
- The success of monetary policy depends also on the nature of fiscal policy. For example, suppose the RBI wants to reduce the volume of bank credit or money supply. However,

suppose, the government follows a deficit budget policy. Then the RBI will have to give more loans to the government. As a result, money supply in the economy will increase. In this case, the attempt of the monetary policy to reduce money supply will be frustrated.

- The volume of international trade influences the supply of money. The RBI does not have sufficient control over the volume of international trade. Then also, the success of monetary policy to control money supply will be retarded.

Thus we see that the effectiveness of monetary policy of the RBI in an underdeveloped economy like India is somewhat limited.

2.14.5 Promotional or Developmental Activities of the Reserve Bank of India

The RBI performs two roles: regulatory role and promotional role. In its regulatory role, the RBI regulates and controls the volume of credit. In its promotional role, the RBI performs various functions to promote economic development of India.

Promotional or developmental activities of the central bank of a country refer to those activities which promote economic development of the country. The RBI as the central bank of India also performs various promotional activities in order to promote economic development of India. Since its nationalisation in 1949, the extent and variety of promotional or developmental activities of the RBI have been increasing day-by-day. The Reserve Bank of India now performs a variety of developmental and promotional activities. Most of these functions were earlier regarded as outside the normal periphery of the functions of a central bank. But today, these functions are being regarded as necessary and desirable functions of a central bank. The RBI now tries to extend banking facilities to rural and semi-urban areas and to develop banking habit among rural people. It also helps establish and promote new specialised financial institutions. All these help in the mobilisation of savings and utilisation of those savings in productive investment. It thus helps in the process of capital accumulation and economic developments of the Indian economy.

We shall consider the promotional or developmental activities of the Reserve of Bank of India under the following five heads:

(i) Activities for the development of monetary sector.
(ii) Activities for the development of agricultural sector.
(iii) Activities for the development of industrial sector.
(iv) Activities for the development of international trade.
(v) Other developmental activities of the RBI.

We shall briefly discuss them one by one.

2.14.5.1 Activities for the Development of Monetary Sector

For economic development of a country, monetary sector of the economy should be developed. Otherwise, monetary policy of the government will not be effective. Hence, the RBI has taken various measures in order to develop monetary sector of the economy. Some of these measures are as follows:

- The RBI has been working for the integration of unorganised money market with the organised money market. It tries to bring indigenous bankers under its own control.
- To develop the bill market, the RBI has introduced two bill market schemes—one in 1952 and the other in 1970.
- In order to make the Indian banking system strong and liable, it encourages merger of weak banks with strong ones.
- RBI has been trying to make an appropriate geographic distribution of bank branches.
- For economic development, the RBI has formulated and implemented various developmental schemes, such as, lead bank scheme, service area approach and so on.
- The RBI has helped to set up Discount and Finance House of India (DFHI) as a specialised money market institution and to develop a secondary market of credit instruments.

2.14.5.2 Activities for the Development of Agriculture

Agriculture is the backbone of Indian economy. So, the development of India depends much on the development of agriculture. Hence, the RBI has taken some positive steps for the development of the agricultural sector of the country. Some of these measures are mentioned below:

- In the inception year (1935) of the RBI, it set up a separate agricultural credit department. Since 1951, the RBI's role in this field has become very important.
- The RBI has been trying to strengthen co-operative banking. It provides finance to co-operative banks and supervises their activities. These co-operative banks again provide loans to the agricultural sector.
- In 1955, the RBI appointed a separate Deputy Governor in charge of rural credit.
- The RBI provides short-term concessional loans to co-operative banks for seasonal agricultural operations and agricultural marketing.
- The RBI provides finance to land development banks by purchasing its debentures.
- The RBI operates the National Agricultural Credit Fund (Long-term operations) and National Agricultural Credit Fund (Stabilisation) to provide long-term and medium-term finance to co-operative institutions.
- In 1982, the RBI has set up the National Bank for Agriculture and Rural Development (NABARD). It is now the apex body under the RBI to regulate and supervise all agricultural credit operations.
- The RBI provides finance to Small Farmers Development Agency (SFDA) and Marginal Farmers and Agricultural Labourers (MFAL).
- The RBI has also helped in setting up an Agricultural Finance Corporation and Regional Rural Banks (RRBs) to provide finance to the rural sector.

2.14.5.3 Activities for the Development of Industrial Sector

For economic development of a country, its industrial sector must be developed. Labour productivity is much higher in industry than in agriculture. Hence, economic development requires transfer of labour from agriculture to industry and the expansion of the industrial sector. The Reserve Bank of India has played an active role in the development of industries in the country. Almost all the development financial institutions (DFIs) were either created by the RBI itself or were helped by advice and finance. In 1957, the RBI set up an Industrial Credit Department. This department was instrumental in setting up of development financial institutions, such as IFCI, SFCs and so on. These institutions play a vital role in providing finance to the industrial sector of the country. Through these institutions, the RBI has ensured a steady flow of medium-term and long-term credit to the industrial sector. These institutions also provide funds to the rural sector and to small and cottage industries of the economy.

2.14.5.4 Activities for the Development of International Trade

Economic development of a country requires steady growth of exports and imports of the country. To promote exports and imports, the RBI has helped to set up Export–Import Bank (EXIM Bank). This bank provides finance for the expansion of exports and imports. Further, the RBI tries to keep the exchange rate of Indian rupee stable with major foreign currencies. This also helps in the steady growth of exports and imports of India.

Further, there is a permanent committee and separate cell under the RBI to provide loans to the exporters on easy terms. Again, the RBI provides loans to commercial banks at lower rate of interest so that these banks can give loans to exporters at lower interest rates. All these help international trade to develop and expand.

2.14.5.5 Other Development Activities of the RBI

The RBI has evolved consortium, co-operative and participatory approach to lending among banks and other financial institutions. It co-ordinates the finance provided by commercial banks and exchange banks to the exporters. All these indirectly help in the overall development of the economy.

To conclude, stability of banking and financial system is very much important for economic development. In this respect, the RBI has done a commendable job. It has played a very important role to strengthen the Indian banking system and to place it on a sound footing. Of course, the RBI has some limitations. It has to follow government policies and priorities. Further, the unorganised sector of the Indian money market is not under the direct control of the RBI. This reduces the effectiveness of monetary policy of the RBI. Still, the RBI has done a great job in promoting economic development of the country. If the unorganised sector of the money market is brought under the control of the RBI, then the role of RBI in the development of the country will be more effective.

SUMMARY

S.1 Definition of Money

Anything which is recognised and accepted as a medium of exchange or means of payments for goods and services or repayment of debts in a given country may be regarded as money.

S.2 Different Approaches to the Definition of Money

There are four approaches to the definition of money. In traditional approach, money supply is the sum of hand-to-hand currency with the non-bank public and demand deposits with commercial banks. In Chicago approach, money supply is the sum of hand-to-hand currency, demand deposits with commercial banks and commercial bank time deposits. Gurley and Shaw have included currency, demand deposits, time deposits, post office savings bank deposits and all other money substitutes in the definition of money. In the central bank approach, money is taken to be synonymous with credit.

S.3 Classification of Money

On the basis of actual existence money can be divided into actual money and accounting money. On the basis of physical form, money can be divided as metallic coins and paper notes. According to acceptability, money can be classified as legal money and optional money. On the basis of commodity value of money, we can classify between standard money and token money. Again, bank deposits are used as means of payments and hence bank deposits are called deposit money.

S.4 Functions of Money

Money has four functions. It acts as a medium of exchange, as a standard of payment, as a unit of account and as a store of value.

S.5 Different Components of Money Supply in India

The Reserve Bank of India now uses three measures of money supply in India: M_1, M_2 and M_3. Here M_1 is the sum of currency, demand deposits and other deposits. M_2 is the sum of M_1, time liability portion of saving deposits with banks, certificates of deposits issued by banks and term deposits maturing within 1 year. M_3 is the sum of M_2, term deposits over 1-year maturity and call/term borrowings of banks. M_1 is called *narrow money* while M_3 is referred to as *broad money*.

S.6 Bank and Its Different Types

A bank is an institution that accepts deposits of money from the public withdrawable by cheque and lends that money to the public. There are different types of banks, such as, central bank, commercial banks, development banks, co-operative banks, land mortgage banks or agricultural banks, foreign exchange banks, merchant banks, and so on.

S.7 Banking Structure in India

The Reserve Bank of India is the central bank of the country. Hence it is at the top of the Indian banking system. Banks under it can be divided into scheduled and non-scheduled banks. Scheduled banks are the banks which are included in Schedule 2 of the RBI Act, 1934. Scheduled banks are again of two types: scheduled commercial banks and state co-operative banks. Non-scheduled banks can also be divided under two heads: (i) central co-operative banks and primary credit societies, and (ii) non-scheduled commercial banks. Both scheduled and non-scheduled commercial banks have foreign and Indian components. The Indian scheduled commercial banks can again be divided into private sector banks and public sector banks. In the public sector banks, we have 19 nationalised banks, State Bank of India, IDBI, and RRBs.

S.8 Commercial Banks

Commercial banks are the banks which collect deposits from the public and lend that money to the public.

S.9 Principles of Commercial Banking

There are mainly six principles of commercial banking. They are liquidity, profitability, safety, stability, flexibility and expansion.

S.10 Structure of Commercial Banking System in India

Commercial banks in India may basically be divided into scheduled banks and non-scheduled banks. Schedules banks may again be divided into scheduled commercial banks and scheduled co-operative banks. The former may again be classified under three groups, namely, public sector banks, private sector banks and foreign banks. Among the public sector banks, we have nationalised banks, State Bank of India, IDBI, and Regional Rural Banks (RRBs). Scheduled co-operative banks may be divided into urban co-operative banks and state co-operative banks.

S.11 Functions of Commercial Banks

The main functions of commercial banks are to accept deposits from the public and make loans and advances to the public. Apart from that, they perform some agency services and general utility services. Agency services include payments for bills, dividends, premiums and so on, remittance of funds, execution of customers' will and so on. General utility services include issue of bank drafts, letters of credit to the customers, service of safe deposit vaults, publication of journals and bulletins on business and economic matters, underwriting of shares, and so on.

S.12 Role of Commercial Banks in Economic Development

Commercial banks help in economic development of a country in the following ways: (i) by mobilising saving for capital formation, (ii) financing industry, (iii) developing money and capital markets, (iv) financing trade, (v) financing agriculture, (vi) financing employment generating activities, and so on.

S.13 Credit Creation by Commercial Banks

Commercial banks as a whole can make a multiple expansion of credit. If Δz is the initial excess reserve and r is reserve ratio, then the total amount of credit creation $= \frac{1}{r} \times \Delta z$. Here credit multiplier $= \frac{1}{r} = \frac{1}{\text{reserve ratio}}$. Higher the reserve ratio, lower is the credit multiplier and *vice versa*. Again, higher the excess reserve, higher will be the amount of credit creation and *vice versa*. This credit creation process is, however, subject to some limitations.

S.14 Central Bank

The apex bank which controls, regulates and stabilises the banking system and the monetary system of a country in the national interest is called the central bank. Every country has a central bank of its own. It controls the entire banking system of the country. It is the undisputed leader in the money and capital markets of an economy.

S.15 Objectives of Central Bank

Some common objectives of central banks of different countries are (i) high levels of production and employment, (ii) adequate economic growth, (iii) exchange rate stability, (iv) reasonable price stability, (v) control of bank credit, (vi) expansion of rural banking, (vii) debt management of the government, (viii) development of money and capital markets of the economy, and so on.

S.16 Functions of Central Bank

De Kock has mentioned six common functions which are performed by the central banks of almost all countries of the world. They are: (i) issuing notes, (ii) acting as the banker of the government, (iii) acting as the banker of commercial and other banks, (iv) preserving the gold reserve of the country, (v) acting as the controller of credit, and (vi) publishing important economic statistics on the economy.

S.17 Instruments of Monetary and Credit Control

One of the important functions of the central bank is to control bank credit. To do this there are several instruments at the disposal of the central bank. These instruments or methods may be divided into two groups: (i) quantitative methods, and (ii) qualitative methods. The former tries to control the quantity or the volume of credit while the latter seeks to change the nature or the quality of credit. The main instruments of quantitative credit control are bank rate, open market operations and variable reserve ratio. The main instruments of qualitative or selective methods of credit control are variation in margin requirements, regulation of consumer's credit, direct orders, moral suasion, and so on.

S.18 High Powered Money and the Concept of Money Multiplier

The high powered money (H) may simply be defined as the sum of currency held by the public (C) and reserves maintained by commercial banks (R), that is, $H = C + R$. According to the money multiplier doctrine of Friedman and Schwartz, the stock of money (M) in an economy is determined by three factors: high powered money (H), the ratio of reserves to deposits maintained by commercial banks (r) and the ratio of currency to deposits maintained by public (c). Under some assumption, they have shown the relation as $M = \frac{1+c}{c+r} \times H$. This is known as the money multiplier doctrine or the H-Theory of money supply. Here, if $H = (C + R)$ rises, money supply will rise with a multiplier effect. The expression $(1 + c)/(c + r)$ is called the money multiplier. This theory is, however, based on some restrictive assumptions. A more developed theory has later been put forward making more realistic assumptions.

S.19 Reserve Bank of India and Its Functions

The Reserve Bank of India (RBI) is the central bank of India. It is the leader, promoter and regulator of the monetary system in India. As the central bank of the country, the RBI performs some important functions. They are: note issue, banker to the government, bankers' bank, credit control, stabilisation of exchange rate, developmental or promotional functions, publication of important economic information, and so on.

S.20 Monetary Policy or Credit Control Policy of the RBI

To control credit, the RBI has different instruments at its disposal. They are divided into quantitative methods and qualitative methods. The quantitative methods are open market operations, bank rate and variable reserve ratio. The qualitative or selective methods are statutory liquidity ratio, suitable interest rate structure, credit monitoring arrangement (CMA), direct action, moral suasion and so on. To control credit, the RBI adopts both quantitative and qualitative methods. The monetary policy followed by the RBI may be best described as the **policy of controlled expansion**. On the one hand, this policy has tried to expand credit to socially desirable sectors. On the other hand, this policy has tried to contract credit to socially undesirable sectors. However, the effectiveness of monetary policy of the RBI will further increase if the unorganised monetary sector can be integrated with the organised monetary sector.

S.21 Promotional/Developmental Activities of the RBI

The promotional/developmental activities of the RBI may be divided under five heads. It has adopted various activities for the development of (i) monetary sector, (ii) agricultural sector, (iii) industrial sector, (iv) foreign trade sector, and (v) weaker sections or socially desirable sectors. However, the role of the RBI in Indian economic development will increase further if the unorganised sector of the money market can be integrated with the organised monetary sector.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. What is money?
2. What are the four functions of money?
3. What is accounting money?
4. What is standard money?
5. What is token money?
6. What is fiat money?
7. What is money according to traditional definition?
8. What are the components of money supply in Chicago approach?
9. What are the elements of money supply in Gurley–Shaw approach?
10. How does the central bank approach define money?
11. What are the different approaches to the definition of money?
12. What is actual money and what is money of account?
13. Give an example of accounting money.
14. What is legal money and what is optional money?
15. Give an example of standard money.
16. What is M_1?
17. What is narrow money?
18. What is M_2?
19. What is M_3?
20. What is broad money?
21. What is high-powered money?
22. State the main theme of H-theory of money supply.
23. What is money multiplier doctrine?
24. Give the expression of money multiplier.
25. What is a bank?
26. What are development financial institutions?
27. What are scheduled banks?
28. What are non-scheduled banks?
29. When were commercial banks nationalised in India?
30. How many nationalised banks are there in India today?
31. Name some nationalised banks of India.
32. Name some foreign banks now operating in India.
33. Name some private sector banks now operating in India.
34. What is busy season and what is slack season in India?
35. Define monetary policy.

36. Mention some major functions of the central bank of a country.
37. What do you mean by quantitative methods of credit control?
38. What is meant by qualitative methods of credit control?
39. Name the instruments of quantitative methods of credit control.
40. Name some instruments of qualitative methods of credit control.
41. What do you mean by selective methods of credit control?
42. What is bank rate?
43. What do you mean by open market operations?
44. What is variable reserve ratio?
45. What do you mean by promotional functions of the RBI?
46. What is primary deposit?
47. What is derivative deposit?

B. Medium Answer-Type Questions (4–5 marks each)

1. What are the different approaches to the definition of money?
2. Distinguish between actual money and money of account.
3. Differentiate between legal money and optional money.
4. With suitable example, distinguish between standard money and token money.
5. What are the different functions of money? Discuss any one function.
6. Briefly mention the different components of money supply in India, as used by the RBI.
7. Derive the expression of money multiplier with suitable assumptions.
8. Define banks. Mention different types of banks.
9. Briefly describe the structure of commercial banking in India.
10. Distinguish between the central bank and commercial banks.
11. Explain the effect of change in bank rate on the volume of bank credit.
12. Describe how open market operations work to control the volume of bank credit.
13. Briefly mention the major functions of commercial banks.
14. Describe the major merits and demerits of paper money.
15. What are the different types of bank deposits? Which one among them is money?
16. Briefly discuss the principles of commercial banking.
17. What is central bank? What are its main objectives?

C. Long Answer-Type Questions (10 marks each)

1. Define money. Describe the main functions of money. **(Sections 2.1 & 2.3)**
2. Briefly describe the banking structure in India. **(Section 2.5.3)**
3. Write a note on the principles of commercial banking. **(Section 2.6.1)**
4. Describe the structure of commercial banking system in India. **(Section 2.6.2)**

5. What are commercial banks? Discuss the major functions of commercial banks in today's economy. **(Sections 2.6 & 2.7)**
6. Describe the role of commercial banks in economic development of a country. **(Section 2.8)**
7. Explain how commercial banks can make a multiple expansion of credit. What are the limitations of this process? **(Section 2.9)**
8. What is central bank? Describe the major functions of the central bank of a country. **(Sections 2.10 & 2.10.2)**
9. Explain how central bank can control the volume of credit in an economy. **(Section 2.11)**
10. What is bank rate policy? How does it work? What are the limitations of this policy? **(Section 2.11.1)**
11. Briefly discuss the money multiplier doctrine, stating clearly your assumptions. What are the limitations of this doctrine? **(Section 2.13.2)**
12. 'Money supply in an economy is partly exogenous and partly endogenous.' Explain the statement. **(Section 2.13)**
13. When was the RBI set up? When was it nationalised? Describe the organisation and management of the RBI. **(Sections 2.14 & 2.14.1)**
14. Briefly describe the major functions of the Reserve Bank of India. **(Section 2.14.2)**
15. What is monetary policy? Critically examine the monetary policy of the Reserve Bank of India. **(Section 2.14.3)**
16. What do you mean by promotional activities of a central bank? Describe the promotional activities of the Reserve Bank of India. **(Section 2.14.2.2)**
17. With the help of a suitable model, show that money supply in any country is partly exogenous and partly endogenous. **(Section 2.13)**
18. Make a comparison between old and new monetary aggregates in India. **(Section 2.4)**
19. Define a bank. What are its different types? **(Sections 2.5.1 & 2.5.2)**

UNIT

3 DEVELOPMENT BANKS

UNIT OUTLINE

3.1 Introduction
3.2 Sources of Finance for Industrial Units in India
3.3 Different Specialised Financial Institutions and their Classifications
3.4 Distinction between Commercial Banks and Development Banks
3.5 Industrial Finance Corporation of India (IFCI)
3.6 Industrial Development Bank of India (IDBI)
3.7 Industrial Credit and Investment Corporation of India (ICICI)
3.8 Export-Import Bank (EXIM Bank) of India
3.9 Small Industries Development Bank of India (SIDBI)
3.10 State Financial Corporations (SFCs)
3.11 National Bank for Agriculture and Rural Development (NABARD)
3.12 An Overall Evaluation of Development Banks or Development Financial Institutions (DFIs)

SUBJECT MATTER OF THE UNIT

In order to supply finance to industry, agriculture and foreign trade, the Government of India has set up some specialised financial institutions. These are called development financial institutions (DFIs), or more popularly, development banks. There are some differences between commercial banks and these development banks. In this unit, we have mentioned these differences. Some important development banks of India are Industrial Finance Corporation of India Limited, Industrial Development Bank of India, Industrial Credit and Investment Corporation of India, Small Industries Development Bank of India, State Financial Corporations, Export-Import Bank, National Bank for Agriculture and Rural Development, Industrial Investment Bank of India, National Industrial

(*Contd.*)

Development Corporation, and National Small Industries Corporation. In this unit, we have discussed objectives, functions and actual performance of the first seven development banks as mentioned above. We have also tried to make an overall evaluation of the performance of these development banks or development financial institutions.

3.1 INTRODUCTION

Two types of capital are required for an industrial unit: fixed capital and working capital. Fixed capital is required to own fixed assets, such as land, buildings, machinery, etc. On the other hand, working capital is required to meet operating expenses, that is, the amount of money required to purchase raw materials, to pay wages, and so on. Fixed capital is also called long-term capital while working capital is also called short-term capital.

In India, an industrial unit may mobilise its required finance from different sources. These sources may be divided into two categories: internal sources and external sources. In case of company type of organisations, the main internal source is the personal savings of the owners or the partners. Further, share capital obtained through issue of shares may be taken as an internal source. Undistributed profit is also an internal source. Among the external sources of finance, the most important sources are loans from banks and other financial institutions, sale of bonds and debentures, public deposits, and so on. In this unit, we shall consider the sources of industrial finance in India.

3.2 SOURCES OF FINANCE FOR INDUSTRIAL UNITS IN INDIA

In the initial stages of industrial development in India, the internal source was the main source of industrial finance. At that time, the entrepreneurs established industries by collecting funds from personal savings and loans from relatives and friends. But with the growth of joint stock companies, industries became large and their need for funds grew considerably. Naturally, funds from personal source could not meet this demand for industrial finance. Gradually, funds from various financial institutions became more important in supplying industrial finance. Now-a-days, industrial units can obtain finance from the following sources:

- If the industrial concern is a joint stock company, it can obtain funds by selling shares to the ordinary public. This is a very important source of industrial finance. Capital obtained through this source varies between 45 and 98 per cent in different industries in India.
- A company can also get funds by selling bonds or debentures to the public. When a company sells debentures it means that the company is taking loans from the buyers of debentures. The debentures may be convertible on non-convertible. Convertible debentures can be converted into shares but non-convertible debentures cannot be converted into shares.

- A company can also accept deposits from the public for a fixed period of time. Depositors then receive fixed interest against these fixed deposits. This source of industrial finance has become very important in recent years.
- Companies can also get loans from commercial banks. Generally commercial banks give short-term credit. They provide funds for working capital. In India, the major commercial banks have been nationalised in order to make more credit available for the agricultural and industrial sectors of the economy.
- The profit of the company is distributed among shareholders. Now, most often, a part of this profit is kept undistributed. This undistributed profit is also used by the company. Further, each company has some special funds, such as, depreciation fund, bad debt fund, and so on. A company collects a part of its working capital from these funds also.
- Industrial finance can also be obtained from foreign sources. This can take several forms, such as, loans from foreign governments or foreign institutions, funds from foreign companies or multinational corporations, funds from non-resident Indians, and so on.
- The Government of India has set up certain specialised financial institutions to supply long-term finance to the industrial sector. The most important among them are Industrial Finance Corporation of India, Industrial Development Bank of India (up to October 2004), Industrial Credit and Investment Corporation of India (up to march 2002), Unit Trust of India, National Industrial Development Corporation, Industrial Investment Bank of India, and so on. These institutions provide long-term credit by purchasing shares and debentures of the company or by keeping assets of the company as collaterals.

We shall discuss about these specialised financial institutions and their functions in details in the present and the next units.

3.3 DIFFERENT SPECIALISED FINANCIAL INSTITUTIONS AND THEIR CLASSIFICATIONS

The Government of India has set up some specialised financial institutions to supply long-term finance to the industrial sector. These are called statutory financial organisations. They are also called development financial institutions (DFIs) or, more popularly, development banks. The most important among these institutions are Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI, up to October 2004), Industrial Credit and Investment Corporation of India (ICICI, up to March 2002), Life Insurance Corporation of India (LICI), General Insurance Corporation of India (GICI), and Unit Trust of India (UTI). These institutions mainly provide long-term finance to the large industrial units. There are also some financial institutions to provide finance to small- and medium-scale industries. The most important among them are State Financial Corporations (SFCs), National Small Industries Corporation (NSIC), State Industrial Development Corporation (SIDC), and Small Industries Development Bank of India (SIDBI).

These institutions are also called non-bank statutory financial organisations (NBSFOs), though this is not a very precise title for this group. In fact, the diversity of these institutions is so great that any single nomenclature cannot accurately reflect the nature of each institution in this group. These institutions cannot be strictly termed as banks, but the names of some of them include the term 'bank'. The deposits of the non-bank financial institutions are not withdrawable by cheques. Further, unlike banks, the non-bank financial institutions cannot create deposits in the process of giving loans. Again, strictly speaking, these financial institutions are not financial intermediaries, because till recently they did not generally mobilise savings from the surplus spending units. They obtain their resources primarily from the government and the Reserve Bank of India. However, recently, some of them have begun mobilising public savings directly or indirectly. They have mostly been set up by the Government of India. However in recent years, some private capital has entered into the ownership and functioning of the development financial institution in recent years. All these financial institutions or development financial institutions (DFIs) were set up during the plan period and they form a very important part of the financial system of the country.

As we have already mentioned, the functions of these development financial institutions or development banks are diverse. Though some of them are special or specialised institutions, most of them have a much general functional coverage at least in recent years. This makes it very difficult to classify these development financial institutions or development banks. However, for the benefit of discussion, we divide these financial institutions into the following categories:

All India Development Banks for Large Industries: In this category, we have Industrial Finance Corporation of India Ltd. (IFCI), Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India Ltd. (ICICI), Industrial Investment Bank of India (IIBI), and National Industrial Development Corporation (NIDC). However, ICICI Ltd. has ceased to be a development bank after its merger with ICICI Bank with effect from 30 March 2002. Again, IDBI was converted into a public sector bank on 11 October 2004.

All-India Development Banks for Small-Scale Industries: In this category, we have mainly two institutions, namely, Small Industries Development Bank of India (SIDBI) and National Small Industries Corporation (NSIC).

Investment Institutions: In this category, we have Unit Trust of India (UTI), Life Insurance Corporation of India (LICI), General Insurance Corporation of India (GICI) and its subsidiaries.

State Level Institutions: In this section, we have State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs) and State Industrial Investment Corporations (SIICs).

Sector-Specific Development Banks: In this category, we have Export-Import Bank of India (EXIM Bank) and National Bank for Agriculture and Rural Development (NABARD).

Specialised Financial Institutions: Some financial institutions have been set up for providing finance for special purposes. Some of such institutions are Housing Finance Companies

(HFCs), Tourism Finance Corporation of India Ltd. (TFCI), Shipping Credit and Investment Corporation of India (SCICI), Technology Development and Information Company of India Ltd. (TDICI), Infrastructure Development Finance Company Ltd. (IDFC), IFCI Venture Capital Funds (IVCF), and ICICI Venture Ltd. (ICICIV, formerly TDICI Ltd.).

Before considering the role and functions of some of the major development banks, let us make a discussion on the distinctions between commercial banks and these non-bank financial organisations.

3.4 DISTINCTION BETWEEN COMMERCIAL BANKS AND DEVELOPMENT BANKS

A commercial bank is defined as an institution that accepts deposits of money from the public withdrawable by cheques and used for lending. Thus, a commercial bank has two main features. *First*, a commercial bank accepts deposits of money which are withdrawable by cheques. *Second*, a commercial bank uses the deposits for lending.

On the other hand, the institutions which accept deposits from the public and give loans from those deposits but whose deposits are not withdrawable by cheques are called pure financial intermediaries. The Life Insurance Corporation of India and the Unit Trust of India are examples of such pure financial intermediaries. Again, there are some institutions which accept deposits from the public but do not give loans from these deposits. They are known as pure deposit system. Postal savings banks are examples of such pure deposit system. The government, who is the owner of the postal savings banks, uses those deposits in its various activities. Commercial banks of the present day world are a combination of the pure financial system and pure deposit system.

Thus financial institutions can broadly be divided into two groups: banks and non-bank financial institutions (NBFIs). Both of them act as intermediaries between surplus spending units and deficit spending units. But there are certain **differences between banks and non-bank financial institutions**. These differences are as follows:

- Deposits of commercial banks (particularly current account deposits and savings bank deposits) can be withdrawn on demand by the depositors. But deposits with the non-bank financial intermediaries cannot be withdrawn before the expiry of a fixed period of time.
- Commercial banks are required to keep a certain percentage of deposits mobilised by them in the form of reserves with the central bank. But the non-bank financial institutions are not required to keep reserves with the central bank.
- Deposits of commercial banks are withdrawable by drawing cheques on them. But deposits of non-bank financial institutions are not withdrawable by cheques. Since the deposits of commercial banks can be withdrawn by cheques, these deposits can be used for making payments. But the deposits of non-bank financial institutions cannot be used as means of payments. Accordingly, the deposits of commercial banks are included in the supply of money. But the deposits of non-bank financial institutions are not included in the supply of money.

- Commercial banks give loans and the non-bank financial institutions also give loans. But there is a difference between the credit rating capacities of the types of institutions. Commercial banks can create deposits with which they can give loans. But non-bank financial institutions cannot create deposits in the process of giving loans. When a commercial bank grants loans to a customer, the bank credits the amount to the deposit account of the customer. The customer then, on the basis of the deposit, can issue cheques which are used as means of payments. For this reason, it is said that commercial banks are creators of loanable funds. But non-bank financial institutions cannot create loanable funds. They are brokers of loanable funds. Moreover, commercial banks can make multiple expansion of deposits. But non-bank financial institutions cannot make multiple expansion of deposits.

According to Gurley and Shaw, the growth of non-bank financial institutions has reduced the effectiveness of monetary policy conducted by the central bank. Commercial banks have to maintain reserves with the central bank. By varying the reserve ratio, the central bank can control the credit creation of commercial banks. But the non-bank financial institutions are not required to keep reserves with the central bank. Hence, the instrument of variable reserve ratio is not applicable to them. Thus, during a period of inflation, when the reserve ratio is raised, commercial banks reduce their loans whereas non-bank financial institutions do not. Therefore, the central bank's attempt to control inflation may turn futile.

Hence, Gurley and Shaw recommended that the non-bank financial institutions should also be required to keep reserves with the central bank.

However, Ascheim has criticised this view. According to him, it is not correct to say that the growth of non-bank financial institutions has reduced the effectiveness of monetary policies of the central bank. He rather believes that the growth of non-bank financial institutions has raised the effectiveness of open market operations. The non-bank financial institutions hold large amount of government securities. Hence, their credit creating power can easily be controlled by open market purchase or sale of government securities. Further, we may add that the growth of non-bank financial intermediaries implies development of the money market. The success of all the quantitative methods of credit control of the central bank requires that the money market should be developed. Hence, the growth of non-bank financial intermediaries raises the effectiveness of monetary policy of the central bank.

In conclusion, we must admit that there is a vital difference between commercial banks and non-bank financial intermediaries. Commercial banks are the manufactures and destroyers of money as the demand deposits of commercial banks can be used as means of payments. But the non-bank financial institutions have no such power.

For a quick look at the differences between commercial banks and non-bank financial institutions, we may put the differences in the form of Table 3.1 given on next page.

Having this much of introductory discussion, we shall now consider the role and functions of some major development financial institutions or development banks of India. We shall first consider the role and functions of Industrial Finance Corporation of India Ltd. (IFCI).

Table 3.1 Difference between commercial banks and non-bank financial institutions

Points of difference	Commercial banks (CMBs)	Non-bank financial institutions (NBFIs)
Players	Banks are players of both money market and capital market though mainly of money market.	Non-bank Financial Intermediaries are players of capital market.
Types of deposit	There are three types of deposits: (i) Savings deposits, (ii) Current deposits, and (iii) Fixed deposits.	Usually there is only one kind of deposit, that is, fixed deposit.
Credit creation	They can create credit.	They cannot create credit as they are credit agents.
Control of central bank	They are controlled by the credit policy of the central bank.	They cannot be directly controlled by credit control policy of the central bank.
Withdrawal of money	Depositors can withdraw their money with the help of withdrawal slips or cheques.	Depositors cannot withdraw money till the maturity of fixed deposits or bonds.
Period of loan	Banks generally sanction short-term and mid-term loans for working capital purposes.	They provide medium-term and long-term loans to industries, trade and commerce.

Note: The main difference between commercial banks and non-bank financial institutions is that banks can create credit and their deposits are part of money supply. Non- bank financial institutions have no such power. However, many think that the differences between banks and non-bank financial institutions are of degree, not of kind, both dealing with different types of credit and deposit.

3.5 INDUSTRIAL FINANCE CORPORATION OF INDIA (IFCI)

The Industrial Finance Corporation of India (IFCI) was established in July 1948. It is the first all-India development financial institution set up in the country. It has been converted into a public limited company with effect from 1 July 1993 and is now known as Industrial Finance Corporation of India Ltd.

3.5.1 Objectives

The Industrial Finance Corporation of India (IFCI) was set up with the following two major objectives:

(i) To provide medium and long-term finance mainly to large industries.

(ii) To supplement (and not to compete with) the efforts of the then prevailing channels of industrial finance and thus to perform its role as a *gap filler*.

3.5.2 Financial Resources

Financial resources of the IFCI have three major components. They are as follows:

(i) Share capital

(ii) Bonds and debentures
(iii) Other borrowings

The paid-up capital of the IFCI was initially ₹5 crore. Since then, it has been increased several times and on 31 March 2014 it stood at ₹1926 crore. The share capital of IFCI has been subscribed by the Industrial Development Bank of India (IDBI), scheduled banks, insurance companies, co-operative banks and investment trusts. The IFCI has also built up sizeable reserves. Apart from the paid-up capital and reserves, one major financial resource of the IFCI is the issue of bonds and debentures. The IFCI is authorised to issue bonds and debentures in the open market. These are guaranteed by the Government of India in respect of repayment of principal and the payment of interest. The IFCI is also authorised to borrow foreign currency from the World Bank and other organisations. It is also permitted to accept deposits from the public and also to borrow from the Reserve Bank of India. Thus, the resources of the IFCI consist of its share capital and reserves, public deposits, advances from the Reserve Bank of India, the World Bank and other international agencies, and bonds and debentures issued in the open market.

3.5.3 Scope of Activities

Over the years, the activities of the IFCI have increased both in scope and magnitude. The financial assistance from the IFCI may be in the following forms:

- Granting of loans both in rupees and in foreign currencies.
- Direct subscription to the shares and debentures of public limited companies or underwriting of them.
- Providing guarantee for deferred payments for machinery imported or purchased within the country.
- Providing guarantee for foreign currency loans taken by industrial organisations from scheduled banks or state co-operative banks or the market.

The financial assistance from the IFCI is available to industries in corporate and co-operative sectors. These industries may be engaged in manufacturing, food preservation or processing, shipping, mining, hotel, energy generation, transport, fishing, etc. It also provides engineering, technical, financial, marketing and allied services to these industrial units. The IFCI provides long- and medium-term loans to the industries. It thus meets the requirements of fixed capital. It does not generally grant loans for the purpose of working capital or for meeting operating expenses. Financial assistance is also available for setting up of new projects or for renovation, modernisation, diversification and expansion of existing units. Loans in foreign currencies are granted only for the import of capital goods. Similarly, no assistance is granted for the acquisition of capital goods for commercial purposes. The IFCI does not generally provide financial assistance to small-scale industries. By an amendment of 1986, the activities of the IFCI have been extended. Following extra activities have been included in the list of functions of the IFCI:

- The IFCI can act as an agent for World Bank or any other international or national organization.

- It can provide technical, administrative, legal and marketing assistance to any industrial unit for its promotion, management or expansion.
- The IFCI can provide consultancy and merchant banking services in and outside India.
- It can appoint administrator in an industrial unit which has taken financial assistance from it.

3.5.4 Activities/Operations

The IFCI started its activities modestly in 1948. But over the years, with the progress of industrialisation in India, its financing operations have grown in size and complexity. The financing activities of the IFCI may broadly be divided into two categories: project finance and financial services. We briefly consider them one by one as follows:

3.5.4.1 Project Finance

The IFCI provides finance for new projects' expansion, diversification and modernisation. The assistance is given in the form of foreign currency and rupee term loans, underwriting and direct subscription to shares and debentures, and guarantees for deferred payments for plant and machinery. Among these project finances, term loans are the main elements.

3.5.4.2 Financial Services

The IFCI provides both fund-based and fee-based financial services. These services include project consulting, issue management, financial restructuring, and so on. These services have been introduced to increase the revenue and also to diversify the activities of the IFCI. Such services account for about one-tenth of the IFCI's business while the share of project finance is about nine-tenths.

Before granting the loan, the IFCI scrutinises the loan applications carefully. While evaluating the applications, it considers the importance of the industry in the national economy. It also considers the viability of the scheme for which the loan is required. While giving loans, the IFCI keeps the security of fixed assets, such as, land, building, plants, machinery, etc. It ordinarily requires the personal guarantee of the directors of the industrial unit applying for the loan. In the event of long-term default in the repayment of loan, the IFCI has the right to take over the management of the industrial unit or to sell the mortgaged property.

3.5.5 Actual Performance of IFCI

With the growth of industrialisation, lending operations of the IFCI have also increased. In 1970–1971, loan sanctioned was of ₹32.2 crore. In 1995–1996, it reached ₹10,300 crore. However, after that, loan sanctioned by the IFCI steeply declined. In 2002–2003, the amount of loan sanctioned by the IFCI was ₹1850 crore. In the next year (2003–2004) it further declined to ₹1392 crore. The IFCI provides assistance to all the three sectors, namely, the private sector, the co-operative sector and the public sector. However, the private sector is the main recipient of financial assistance of the IFCI. Financial assistance sanctioned and disbursed by the IFCI in 2013–2014 stood at ₹9717 crore and ₹8683 crore, respectively. The industries which have been benefited by the IFCI are fertiliser, power, cement, paper, industrial machinery, etc. We have already mentioned that the assistance given by the IFCI includes rupee loans, foreign currency loans, underwriting of shares and debentures, direct subscription to shares and debentures, deferred payment guarantees and foreign loan guarantees. Recently, the IFCI has been providing financial assistance to set up new projects and to modernise existing projects. In recent years, it has also started new promotional schemes. These are as follows:

- Interest subsidy scheme for women entrepreneurs.
- Consultancy fee subsidy scheme for small units.
- Encouraging the modernisation of small industrial units.
- Control of pollution in small and medium-scale industries.

During 1988–1989, the IFCI introduced two new schemes of financial assistance. One is the Equipment Leasing Scheme. Under this scheme, the IFCI provides equipment to the industrial units by way of financial lease. The second is the Equipment Procurement Scheme. Under this scheme, the IFCI agrees to procure equipment and then resell them to the industrial units. Further, the IFCI has recently increased its assistance to the units located in backward districts.

The IFCI is also diversifying its activities in the field of merchant banking. The objective is to include other financial services, particularly project counselling, loan syndication, formulation of rehabilitation programmes, and so on.

The IFCI set up Risk Capital Foundation in 1975 as its subsidiary. It was later converted into Risk Capital and Technology Foundation Limited (RCTF) in 1988. Its objective is to promote risk capital scheme, technology promotion scheme and venture capital scheme. Since 1988, the RCTF has been renamed as IFCI Venture Capital Funds Limited (IVCF). Other three subsidiaries of the IFCI are IFCI Financial Services Ltd., IFCI Investor Services Ltd. and IFCI Custodial Services Ltd.

The IFCI also helped to establish some institutions related to the capital market. Important among them are Over-the-Counter Exchange of India (OTCEI), Investment Information and Credit Rating Agency of India Ltd. (IICRA) and National Stock Exchange of India Ltd. (NSE). The IFCI has also co-sponsored in setting up some all-India level institutions. Notable among them are: Stock Holding Corporation of India (SHCI) Ltd., Securities Trading Corporation of India (STCI) Ltd., LIC Housing Finance Ltd., GIC Housing Finance Ltd., and Entrepreneurship Development Institute (EDI) of India. These institutions have, directly or indirectly, helped in industrial development of India.

3.5.6 An Appraisal of IFCI's Performance

If we consider the growth of the IFCI's capital and loans sanctioned and disbursed, its performance seems to be quite impressive. However, there are certain flaws in the functioning of the IFCI. These flaws have invited several criticisms from different corners. The main criticisms against the working of the IFCI are as follows:

- The IFCI has done little to remove regional disparities.

- In sanctioning loans, the IFCI has not always followed plan priorities.
- In many cases the IFCI has given assistance to those units which could easily collect capital from the capital market.
- The IFCI has failed to exercise necessary control over the defaulting borrowers.
- It is alleged that the IFCI did not provide encouragement for setting up of new industries. It has confined itself to provide loans to the existing units.
- In providing loans, the IFCI has favoured the consumer goods industries and neglected the basic and heavy industries.
- The IFCI pursues a discriminatory policy against small and medium industrial units.
- The IFCI has also been alleged of corruption and nepotism.

The performance of the IFCI in recent years is not at all satisfactory. In 2002, it has incurred a loss of ₹885 crore. In this year, its interest expense was greater than its interest income. This raises the question about the very logic of its business. Further, the volume of its non-performing assets (NPA) is quite high. At end-March 2005, the share of NPAs in net loans of the IFCI was as high as 28 per cent. The values of other indicators of economic health were also very unsatisfactory. However, the situation somewhat improved from the year 2006–2007 though not quite satisfactorily. Further, the amounts of loans sanctioned and disbursed by the IFCI have steadily declined from 1996–1997 onwards. This makes the IFCI a financial entity increasingly irrelevant in the new era of growing competition arising from liberalisation and privatisation.

3.6 INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)

We know that after independence, the Government of India has set up some specialised financial institutions for supplying medium- and long–term finance to the industrial sector. These are known as development financial institutions (DFIs), or, more popularly, development banks. Among these development banks, the most important is the Industrial Development Bank of India (IDBI). It was set up in July 1964. The IDBI was initially set up as a wholly-owned subsidiary of the Reserve Bank of India (RBI). Later, the Finance Ministry of the Government of India wanted the direct control of the IDBI. Hence it was delinked from the RBI and it was taken over by the Government of India in February 1976. The IDBI was made an autonomous institution and its ownership passed from the Reserve Bank of India to the Government of India. Then, on 11 October 2004, the IDBI was converted into a public sector bank and renamed as IDBI Bank. Hence, it ceases to be a development bank since 11 October 2004. We include IDBI into our discussion of industrial finance because of the important role it played during its lifetime (from 1964 to 2004) in providing finance to the industries in our country.

3.6.1 Objectives of the IDBI

Before the establishment of the IDBI in 1964, there were some institutions like IFCI, ICICI, NIDC, and so on, which were supplying long-term finance to the industrial sector of the country. The volume of credit given by these institutions was quite large and it was increasing day-by-day. Yet, it was found inadequate in relation to the demand for finance made by the growing industrial sector. On the one hand, there was a need to establish a new institution with sufficient financial resources. On the other hand, there was also a need to co-ordinate and harmonise the activities of different institutions providing finance to the industrial sector. To fulfil mainly these two-fold objectives the Government of India established the IDBI. Thus, the IDBI was established to co-ordinate and harmonise among the activities of other development banks and to provide medium- and long-term finance to the large industrial units. It was set up as the apex bank in the field of development banking. Initially, the IDBI was a wholly-owned subsidiary of the Reserve Bank of India. But in 1976, it was taken over by the Government of India and made an autonomous institution. Again, by an amendment of the IDBI Act in 1995, its shares were offered to the public for the first time. The government's share, as a result, came down to around 72 per cent. All these were done in order to bring greater flexibility in the operations of the IDBI. In addition to financing medium- and long-term need of all types of industrial units, the IDBI was asked to perform some special activities. Among them, the most important activities were as follows:

- Planning, promoting and developing industries to fill the gaps in the industrial structure.
- Co-ordinating the activities of other development banks and assisting in their development.
- Providing technical and administrative assistance for expansion of industry.
- Undertaking market and investment research to contribute to the development of the industrial sector.

3.6.2 Financial Resources of the IDBI

We have already mentioned that the IDBI was initially set up as a wholly owned subsidiary of the Reserve Bank of India in 1964. But in 1976, it was taken over by the Government of India and made an autonomous institution. The authorised share capital of the IDBI was raised from ₹100 crore in 1964 to ₹200 crore in 1980. Further, this limit was raised to ₹1000 crore in 1985 and further up to ₹2000 crore. However, the main sources of funds of the IDBI other than its own capital were retained earnings, borrowing from the Reserve Bank of India and borrowing from the market through bonds. Total resources of the IDBI amounted to ₹63,846 crore in 2004. Out of it, the share of bonds and debentures was the most important (₹43,750 crore or 68.5 per cent). We may list the principal sources of funds of the IDBI as follows:

- Share capital
- Reserves and funds
- Bonds and debentures
- Borrowing from the market, from the Reserve Bank of India, and from the Government of India
- Deposits from companies
- Internal generation of resources and repayment of past loans

3.6.3 Management of the IDBI

As mentioned earlier, the IDBI was a wholly-owned subsidiary of the Reserve Bank of India till 1976. The governor and the deputy governor of the RBI were, respectively, the Chairman and the Vice-Chairman of the IDBI. The general management of the IDBI was done by a board of directors consisting of 22 persons. It was the same as the Central Board of Directors of the RBI. In Executive Committee, there were 10 members including the chairman and the managing director. The board of directors dealt with overall policy matters and the executive committee looked after proposals for the sanction of financial assistance and other urgent matters. Day-to-day working was carried under the supervision of the chairman and the managing director. They were assisted by three executive directors.

3.6.4 Evolving Role of the IDBI

Starting in 1964, the IDBI grew into a very significant development bank in the sphere of industrial finance of India within a very short period. Its significance was reflected in its evolving role over the years. For the purpose of discussion, we may divide the evolving role of the IDBI into three broad phases: These phases are as follows:

(i) Expansion phase: From 1964 to 1975
(ii) Consolidation phase: From 1976 to 1985
(iii) Dynamic phase: From 1986 to 2004

We shall briefly discuss the major operations of the IDBI during these three phases.

3.6.4.1 Phase I: Expansion Phase (1964–1975)

In 1964, the IDBI took over the operations of the Refinance Corporation of India (RCI) and started to provide resource support to State Financial Corporations (SFCs) and other primary lending institutions by refinancing term loans granted by them. In 1965, it introduced the rediscounting of machinery bill scheme to promote the sale of indigenous machinery on deferred payment basis. Thus, during the period 1964–1975, the three major schemes of financial assistance to the industrial sector by the IDBI were (i) direct project loans, (ii) refinance, and (iii) bill discounting.

Further, to promote export growth, the IDBI introduced the scheme for financing projects' export of capital goods on deferred payment basis. These activities led to the formation of the Export-Import Bank (EXIM Bank) in 1982. The IDBI also arranged for the credit to SFCs through the IDA (International Development Association), an organ of the World Bank. This was done in order to provide finance to the small- and medium-scale industries. Further, the IDBI set up a Venture Capital Fund (VCF) in 1968. Its purpose was to provide finance in risky operations of the industries.

Another important expansion in the activities of the IDBI during this period was the introduction of Development Assistance Fund (DAF). It was a separate fund to assist large projects into long gestation periods and projects of strategic importance. However, in 1991, the DAF was abolished and merged with the general funds. Thus, during 1964–1975, the IDBI as central financing and co-ordinating agency in the field of industrial finance expanded its activities.

3.6.4.2 Phase II: Consolidation Phase (1976–1985)

The period 1976–1985 may be termed as the consolidation phase of the IDBI. We have mentioned that the IDBI was delinked from the RBI in 1976. Hence, some new responsibilities were given to the IDBI. The initial capital of the IFCI and the UTI and the share capital of the SFCs were transferred from the RBI to the IDBI. Side by side, some powers and supervisory functions relating to them were also transferred from the RBI to the IDBI. In short, the IDBI was given the status of premier institution in the field of industrial finance, wholly owned by the government of India. It became an autonomous institution from the day it was delinked from the RBI.

The IDBI focused on the promotion of small and medium industries and development of industrially backward areas during this phase. It also stressed on modernisation and upgradation of technology. To carry forward the modernisation programme, the IDBI introduced in 1976 a loan scheme with low interest rate. The scheme initially covered traditional industries, such as, jute, cotton textile, sugar, cement, etc. Later in 1984, it was extended to all the industries. The IDBI also gave emphasis on the upgradation of technology, export promotion, import substitution, conservation of scarce raw materials and energy, improvement in capacity utilisation, and so on. To forward the scheme further, the Government of India created a special fund for the modernisation of industries. The name of the fund is Technical Development Fund (TDF). Under this scheme, the IDBI provided cheap finance for the import of equipment, technical know-how and foreign consultancy services. It helped the government in formulating a Technology Upgradation Scheme (TUS) set up in 1978.

During this period, there was a problem of growing incidence of industrial sickness. To deal with the problem, the IDBI set up a separate division in 1976. Its objective was to rehabilitate sick units. For this purpose, the State Industrial Development Corporations (SIDCs) were brought under the refinance scheme of the IDBI in the same year. Further, various measures were introduced during this period (1976–1985) in order to help entrepreneurs of the small, tiny, village and cottage industries. To meet the foreign currency needs of the industries for their modernisation and technology upgradation, the IDBI started borrowing in the international finance market.

The IDBI also tried to create and widen entrepreneurial base in the country. In collaborations with other financial institutions, it set up the Entrepreneurship Development Institute of India (EDII) in 1983. It took the leading part in setting up many such institutions. Thus, the IDBI introduced new services during the consolidation phase (1976–1985).

3.6.4.3 Phase III: Dynamic Phase (1986–2004)

India started its economic reforms since 1985. To cope up with this, the IDBI also increased its activities and played a dynamic role. In 1986, it set up a Textile Modernisation Fund (TMF). Further, the IDBI set up or helped in the setting up of several organisations for the development of capital market. For example it set up in 1987, the Stock Holding Corporation of India Ltd. (SHCIL) which provides depository services to financial institutions. Again, the IDBI took the leading part in setting up of the Securities and Exchange Board of India (SEBI)—the capital market regulator. The IDBI also acted as the nodal agency to establish the National Stock Exchange (NSE). Some other important institutions promoted by the IDBI are National Securities Depository Limited (NSDL), the Credit Analysis and Research in Equities (CARE) and Investor Services of India Limited (ISIL).

During this phase (1986–2004), the IDBI expanded its activities to various fields. For example, it set up a fully owned stock broking subsidiary. Its name is IDBI Capital Market Securities Ltd. (ICMS). Further, it sponsored a mutual fund and set up IDBI Investment Management Company Ltd. (IIMCO). It is a wholly-owned asset management company of the IDBI. It also set up North Eastern Development Finance Corporation Ltd. and played a vital role in the establishment of the Infrastructure Development Finance Company Ltd. The IDBI joined other all-India financial institutions in promoting the following important institutions:

- Over-the-Counter Exchange of India (OTCEI) which helps small and medium-scale industries to enter the capital market.
- Shipping Credit and Investment Corporation of India (SCICI) for financial assistance in shipping and allied industries.
- Tourism Finance Corporation of India Ltd. (TFCI) which provides finance to tourism sector and hotel industry.

Thus, in the liberalised era, the IDBI emerged as a truly autonomous principal financial institution in the country. It had organisational links with other development banks and rendered few of such services to them which only an apex organisation is expected to perform. *First*, it provided refinance facilities to institutions like IFCI, SFCs, etc. *Second*, it subscribed to the share capital and bond issues of the IFCI, SFCs and the IIBI. *Third*, the IDBI played the role of a co-ordinator at all-India level. Thus, the IDBI enjoyed a unique position in the group of development banks. Its position in the field of development financing was similar to the position of the RBI in the field of commercial banking. Apart from various activities related to industrial finance, the IDBI also initiated to offer high-tech commercial banking services. It set up the IDBI Bank Ltd. Later, in October 2004, the IDBI was left with this commercial banking and was converted into a public sector bank and renamed as IDBI Bank.

3.6.5 Functions of the IDBI: Various Forms of Financial Assistance

The IDBI as the apex organisation in the field of development financing has done a commendable job during its lifetime span of 40 years from 1964 to 2004. It provided financial assistance to all kinds of small, medium and large enterprises. Its assistance may be grouped under following forms:

3.6.5.1 Direct Assistance

The IDBI granted direct assistance in the form of project loans, underwriting and direct subscription to shares and debentures and equipment finance loans. It also guaranteed loans raised by industrial concerns in the open market from scheduled banks, state co-operative banks, IFCI and other statutory financial institutions. It also accepted, discounted or rediscounted valid commercial bills or promissory notes of industrial concerns.

3.6.5.2 Indirect Finance

The IDBI also assisted industrial units through other institutions. This is called indirect finance. This was done in mainly four ways: (i) refinance of industrial loans, (ii) rediscounting of bills, (iii) subscription to shares and bonds of financial institutions, and (iv) seed capital assistance.

3.6.5.3 Special Assistance

In 1964, the IDBI created a special fund which is known as the Development Assistance Fund (DAF). This Fund was utilised to provide finance to those industrial units which could not collect finance in normal course because of their low rate of return.

3.6.5.4 Foreign Currency Supply

The IDBI raised foreign funds from international money markets. It then made them available to Indian industrial units.

3.6.5.5 Assistance to Backward Areas

In 1969, the IDBI launched a scheme in order to promote industrial development in backward areas. Under this scheme, financial assistance was given to small and medium projects in backward areas on softer terms, such as, lower interest rate, longer grace and repayment periods, and so on. Special concessions were given to projects in North-Eastern area.

3.6.5.6 Refinance Facilities

In November 1964, the IDBI took over the Refinance Corporation of India (RCI) and started providing refinance facilities to industrial concerns. As an apex financial institution, the IDBI assisted SFCs, IFCI, leasing companies and others working in the field of industrial finance by subscribing to their shares and bonds.

3.6.5.7 Assistance to Small-scale Sector

The IDBI extended financial assistance to small-scale industries and small road transport operators indirectly. This was done through state level institutions and commercial banks by way of refinance of industrial loans.

3.6.5.8 Soft Loan Scheme

In 1976, the IDBI introduced the soft loan scheme. Its aim was to provide finance to productive units in selected industries, *viz.*, cement, cotton textiles, jute, sugar and certain engineering industrial units on concessional terms.

3.6.5.9 Merchant Banking Activities

The IDBI was permitted by the SEBI to carry out merchant banking activities also. Such activities include professional advice and services to industry for raising capital from the market, merger and acquisition, etc.

3.6.5.10 Balanced Regional Development

Since 1970, the IDBI initiated certain development activities. Their aim was to meet the twin objectives of balanced regional development and higher industrial growth.

3.6.5.11 Promotional Functions

Apart from providing finance to industrial units, the IDBI performed certain promotional functions also. These functions included provision of training in project evaluation and development of entrepreneurs. All these have a positive impact on industrial growth of a country.

3.6.6 Actual Performance: Total Financial Assistance

From July 1964 to March 1996, the IDBI sanctioned a total finance of ₹116,500 crore and disbursed ₹76,330 crore. During this period, it became the most important development bank assisting industrial units in India. Its progress had been spectacular till 2000–2001. Thereafter, the IDBI suffered a setback. During its entire lifespan from July 1964 to March 2004, the IDBI sanctioned ₹223,524 crore and disbursed ₹175,572 crore. In view of the underdeveloped nature of capital market, this amount of industrial finance is quite satisfactory. In fact, it is almost equal to the amount of financial assistance provided by all other development banks working in this field of industrial finance. The performance of the IDBI was especially good during the period 1980–1981 to 2000–2001. The amount of loan sanctioned by the IDBI in the year 1980–1981 was ₹1280 crore. It increased to ₹26,830 crore in 2000–2001. Correspondingly, the amount of disbursements were ₹1010 crore and ₹17,480 crore respectively. However, during the last 3 years of the IDBI (2000–2001 to 2003–2004), its financial assistance decreased sharply. The financial assistance sanctioned by the IDBI declined from ₹26,830 crore in 2000–2001 to ₹13,660 crore in 2001–2002 and further to a miserably low of ₹2950 crore in 2002–2003. This was mainly due to slow rate of economic growth and decline in investment in the country and partly due to the heavy accumulation of non-performing assets (NPAs) of the IDBI.

However, the promotional role of the IDBI was really noteworthy. To promote industrial development in backward areas, the IDBI sanctioned soft loans to small and medium projects at concessional rates of interest. Further, as mentioned earlier, it provided soft loans to cotton textiles, jute, cement, sugar and engineering industries for their modernisation and renovation. The IDBI provided refinance facilities to other financial institutions. It extended finance to small-scale industries and small road transport operators indirectly. The IDBI launched the National Equity Fund (NEF) Scheme in 1988 in order to provide finance to tiny and small-scale industrial units. It has played a vital role in the balanced regional development of the country. The IDBI recorded an impressive performance in its operations after it had become autonomous in the year 1975. This is especially true for the period 1980–1981 to 2000–2001.

3.6.7 Limitations of the IDBI

The IDBI was set up in July 1964 and was developed into an apex institution in the field of development finance. During its tenure as a development bank from July 1964 to March 2004, the performance of the IDBI was quite impressive, particularly in terms of the amount of finance sanctioned and disbursed. Further, the range and pattern of assistance also increased over the years. However, there are some limitations in the activities of the IDBI and following criticisms are put forward against the working of the IDBI as the apex financial institution of India.

- The IDBI has failed to develop a well-organised capital market in India.
- There was a disparity in the provision of financial assistance to backward districts in different states.
- The major share of financial assistance has gone to large industries. Small-scale industries did not get adequate attention.
- The IDBI gave more emphasis on financial assistance and less emphasis on promotional and consultancy functions.
- The IDBI failed to develop itself as a true development bank. It stressed more on providing loans and less on underwriting of shares and debentures of industrial units. This was not very appropriate for an apex development bank.

3.6.8 Concluding Remarks

In spite of some limitations in the activities of the IDBI, it must be admitted that it played a very prominent role as a development bank in the industrial development of India. During its tenure, the IDBI set up several subsidiaries and associate concerns for developing capital market infrastructure. In addition to project-specific financing, the IDBI introduced a lot of new products to meet the needs of industrial enterprises. These included technological upgradation, venture capital financing, equipment finance, and so on. Starting modestly in the year 1964, it grew into the principal financial institution in the country. This is especially true since 1976 when the Government of India took over the IDBI. The amount sanctioned and disbursed by the IDBI was about half of the total sanctions and disbursements of all term-lending institutions. However, the role of IDBI during 2001–2002 to 2003–2004 was almost insignificant. The main reason behind this was its heavy non-performing assets (NPAs). This is one of the reasons of ceasing it as a development bank and converting it into a public sector bank with effect from 1 April 2004.

3.7 INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA (ICICI)

The Industrial Credit and Investment Corporation of India (ICICI) was established on 5 January 1955 as a public limited company under Indian Companies Act. It was the second all India development financial institution established after independence, the first being IFCI established in 1948. The ICICI was set up by the Government of India, World Bank and representatives of the Indian private industry. It was later renamed as Industrial Credit and Investment Corporation of India Limited (ICICI Ltd). While IDBI and IFCI were set up as public sector development banks, ICICI was set up as a private sector development bank. However, the ICICI Ltd. merged into ICICI Bank in April 2002, and hence it ceased to be a development bank from April 2002. During its tenure as a development bank from January 1955 to March 2002, it played an impressive role in providing finance to industrial units in the private sector. Hence we consider the role of ICICI Ltd. in the field of industrial finance in India, even though it no longer exists as a development bank. The distinguishing feature of the ICICI was that it provided underwriting facilities which are generally neglected by other financial institutions. Its primary objective was to provide foreign currency loans to industrial units in private sector and thus to assist in industrial investment and development in India. The ICICI was the third important development bank in India after the IFCI and the IDBI.

3.7.1 Objectives of the ICICI

The major objectives of the ICICI may be summarised as follows:

- To provide financial assistance to industrial concerns in the private sector.
- To provide foreign currency loans to industrial projects.
- To provide underwriting facilities.
- To provide guarantees to suppliers of equipment and foreign lenders.

Originally the ICICI provided finance to the private sector units only. But, subsequently, its operations were extended to public sector, joint sector and co-operative sector projects also.

3.7.2 Financial Resources

Initially, resources of the ICICI consisted of share capital which was supplemented by an interest-free loan from the Government of India and an advance in foreign currency from the World Bank. But in the subsequent years, the resources of the ICICI were augmented by further loans, commercial borrowings both in rupee as well as foreign currency and increase in share capital. There was a change in the pattern of holding of the ICICI's equity capital. Initially, all its capital was held privately by companies and institutions. Later, a very large part of equity capital was held by public sector institutions, such as banks, LICI, GICI and its subsidiaries, in addition to the general public. The Unit Trust of India (UTI), set up later in 1964, also invested in the ICICI. In the liberalisation period since 1991, the ICICI diversified its funding resources in tune with its emergence as a universal bank. The financial resources of the ICICI consisted of both rupee and foreign currency. The rupee resources consisted of the following:

- Share capital mainly supplied by public sector institutions
- Various kinds of reserves
- Borrowings which included institutional borrowings, government-guaranteed bonds and bonds to public
- Public deposits

The foreign currency reserves of the ICICI consisted of institutional borrowings and commercial borrowings.

3.7.3 Functions of the ICICI

The objective of the ICICI was to provide financial assistance to industrial concern in the private sector. Later, it also provided assistance to public sector concerns. The main functions of the ICICI were the following:

- To provide assistance to new industries.
- To assist in the expansion and modernisation of existing industries both in the private and public sectors.
- To provide long-term and medium-term loans, both rupee loans and foreign currency loans.
- To participate in equity capital and in debentures.
- To underwrite new issues of share and debentures.
- To guarantee loans from other private investment sources, both Indian and foreign.
- To provide financial services, such as, deferred credit, instalment sales and venture capital.
- To provide consultancy services to industrial concerns in the form of managerial and technical advice.

As stated earlier, the ICICI was originally started as an institution providing finance to the private sector only. But, subsequently, its operations were extended. Its operations later included joint sector, public sector and co-operative sector projects also. For a long time, it provided assistance only to limited liability companies. But since 1990, it started providing foreign currency loans to proprietary and partnership concerns either directly or in association with state financial corporations (SFCs) and banks.

To meet the various demands of the industrial sector in a liberalised era, the ICICI set up a number of specialised subsidiaries and thus entered the new areas of business. Some of these new areas included commercial banking, investment banking, non-banking finance, investor servicing, venture capital servicing and state level infrastructure financing. Further, it took over two non-bank financial companies, namely, ITC classic and Anagram Finance Limited and also SCICI Ltd. The objective was to establish a strong retail distribution and investor service franchise. As a result, the ICICI emerged as a universal banking group. In general, it operated in accordance with the guidelines of the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

3.7.4 Actual Performance

The activities of the ICICI can be classified into five categories. They are as follows:

(i) Fund-based/lending activities
(ii) Investments/capital market operations
(iii) Fee-based/advisory activities
(iv) Setting up of subsidiaries
(v) Sponsorship of institutions

We briefly discuss them one by one.

3.7.4.1 Fund-based/Lending Activities

These activities refer to the provision of funds by the ICICI to the industrial units. Finances provided by the ICICI under this category are of three types: *project finance, non-project finance and technology finance*. These funds were provided in the form of rupee and foreign currency loans, guarantees, underwriting of shares and debentures, and so on. It assisted both private and public sector. But the major beneficiary was the private sector and industries benefited were paper, chemicals and pharmaceuticals, electrical equipment, textiles, sugar, metal ore, lime and cement, glass manufacture, etc.

Overtime, the amount of loan sanctioned by the ICICI steadily increased. Since its inception in January 1955 up to March 1996, the total financial assistance by the ICICI was ₹66,170 crore. The amount of total disbursement was ₹36,590 crore. Its performance specially improved since 1970–1971. In that year the amount sanctioned by the ICICI was ₹43.9 crore. It rose to ₹3744 crore in 1990–1991. In the year 2000–2001, the amount of loan sanctioned by the ICICI was ₹56,030 crore whereas the amount of disbursement was ₹31,960 crore. However, in the next year (2001–2002), the amount of loan sanctioned decreased to ₹36,229 crore. In fact, financial assistance by the ICICI rose spectacularly during the whole of 1990s, particularly during the second half of 1990s.

The non-project finance included (i) corporate loans to meet working capital requirements, (ii) leasing, and (iii) asset credit. The ICICI introduced leasing operations in 1983. It provided leasing assistance for computerisation, equipment of energy conservation, modernisation, export orientation, pollution control, etc. Industries benefited under this scheme were textiles, engineering, chemicals, fertilisers, cement, sugar, etc. The ICICI also joined the consortium of IDBI, IFCI and other financial institutions for providing soft loans to a number of industries for modernisation.

The ICICI also played a very crucial role in the field of technology finance. It emerged as one of the largest financiers of technology in the country. The specific schemes which were offered by the ICICI under technology finance were as follows:

- Sponsored Research and Development Programme (SPREAD)
- Agricultural Commercialisation and Enterprise (ACE) Project
- Programme for Acceleration of Commercial Energy Research (PACER)
- Programme for Advancement of Commercial Technology (PACT)
- Trade in Environmental Services and Technologies (TEST) Programme

3.7.4.2 Investments/Capital Market Operations

The ICICI adopted various investments on capital market operations. It acquired its debt and equity investment (i) in the form of direct subscription to public issues, (ii) taking up rights issues, (iii) private placements, and (iv) underwriting issues.

The investment operation of the ICICI in the capital market increased considerably over the years.

3.7.4.3 Fee-based Activities

These activities of the ICICI were advisory in nature. They included project advisory services, consultancy, etc. For providing such services, the ICICI set up a merchant banking division which worked very creditably.

3.7.4.4 Setting up of Subsidiaries

The ICICI set up a series of specialised subsidiaries in the fields of investment banking, commercial banking, asset management, investor services, and so on. The names of some of its important subsidiaries are given below:

(i) ICICI Brokerage Services Ltd. (ICICI Brokerage)
(ii) ICICI Banking Corporation Ltd. (ICICI Bank)
(iii) ICICI Capital Services Ltd. (ICICI Capital)
(iv) ICICI International Ltd. (ICICI International)
(v) ICICI Properties Ltd.
(vi) ICICI Realty Ltd.
(vii) ICICI Real Estate Company Ltd. (ICICI Estate)
(viii) ICICI Venture Funds Management Company Ltd. (ICICI Venture)
(ix) ICICI West Bengal Infrastructure Development Corporation Ltd. (ICICI WINFRA)
(x) ICICI Kerala Infrastructure Development Corporation Ltd. (ICICI KINFRA)

The areas of activities of these subsidiaries are indicated in their names.

3.7.4.5 Sponsorship of Institutions

The ICICI took initiatives in promoting a number of institutions in association with other financial organisations. These institutions have been playing a very important role in the money and capital markets of India. Some of these institutions are as follows:

Credit Rating Information Services of India Ltd. (CRISIL): To provide credit rating services to the industrial sector.

Technology Development and Information Company of India Ltd. (TDICI): To finance the transfer of technology and to provide information on technology.

Stock Holding Corporation of India Ltd. (SHCI): To expedite works related to the safe custody, delivery of shares and collection of sale proceeds.

Over the Counter Exchange of India (OTCEI) Ltd.: To provide a national, screen-based automated stock exchange for listing the securities of companies.

Discount and Finance House of India (DFHI): To provide liquidity in the money market.

We have mentioned that the ICICI provided foreign currency loans and advances to Indian industrial units. These were provided for securing essential capital goods from foreign countries. To run this scheme, the ICICI was helped by the World Bank. The ICICI also came forward to give house-building loans. For this purpose, it set up Housing Development Finance Corporation (HDFC) in 1977. Its main function was to provide long-term house-building loans to the people in low- and middle-income groups.

3.7.5 Concluding Remarks

As a development bank, the ICICI existed for a period of 47 years. It commenced business in March 1955 and merged into ICICI Bank in April 2002. During these years, the ICICI played a very significant role in providing finance to the private sector in particular and the industrial sector in general. It was pioneer as the underwriting institution in India. It was also a very distinguished financial institution on the provider of foreign currency loans. These are really milestones in the journey of 47 years of the ICICI as a development bank of India. A large number of growth-oriented industries have been benefited from this scheme. Some of such industries are chemicals, petro-chemicals, heavy engineering and metal products industries. There were, however, some **limitations** in the activities of the ICICI. Some criticisms have rightly been put forward by the critics against the performance of the ICICI. In brief, they are as follows:

- It is being alleged that like the IFCI, the ICICI did not take appropriate and adequate measures to remove regional disparities.
- The ICICI assisted mainly the large units and relatively neglected the small and medium units.
- The ICICI did little to promote industrial development in less developed regions. It has been alleged that the ICICI gave more loans to developed states and neglected less developed states. For example, the most advanced industrial State of Maharashtra received more than one-third of the total financial assistance provided by the ICICI. This has, as critics argue, accentuated regional disparities.

In spite of these criticisms, it must be admitted that the ICICI increased its scope of operation tremendously over the years. In the post-1991 era of liberalisation in India, it diversified its activities at an amazing pace. Besides lending operations, it undertook various advisory services, set up many subsidiaries and sponsored many institutions. Further, because of the criticism of accentuating regional disparities, the ICICI increased its assistance to backward areas in ending years of its existence. It also took initiative in setting up technical consultancy organisations in a number of backward areas.

As a development bank, the ICICI performed its basic responsibility of providing finance to industrial units quite satisfactorily. In 2001–2002, the last year of its existence, the ICICI was the top provider of development finance.

The IDBI was set up as the leading public sector development bank. But during the last 4 years of the ICICI, spanning 1997–1998 to 2001–2002, it sanctioned and disbursed more loans than the IDBI. This fact corroborates the bright performance of ICICI as a development bank. Nonetheless, the ICICI quietly gave up its status of development bank and merged into ICICI Bank in April 2002. The ICICI Bank is no longer a development finance institution (DFI) or development bank of India. It is at present the largest private sector bank in India.

3.8 EXPORT-IMPORT BANK (EXIM BANK) OF INDIA

The Export-Import Bank (EXIM Bank) of India was established on 1 January 1982. It was set up by an Act of Parliament passed in September 1981. The EXIM Bank commenced its operation in March 1982. It has taken over the export-finance function of the Industrial Development Bank of India (IDBI) and acts as the apex institution relating to the financing of foreign trade.

3.8.1 Objectives of EXIM Bank

The main objectives or purposes of setting up of EXIM Bank may be summarised as follows:

- To provide financial assistance to exporters and importers.
- To act as the principal financial institution for co-ordinating works of other institutions engaged in the field of financing international trade.
- To undertake development and merchant banking activities in relation to export-oriented industries.
- To provide refinance facilities to commercial banks and other financial institutions against their export-import financing activities.

3.8.2 Capital Resource of EXIM Bank

The issued and paid-up capital of the EXIM Bank are ₹440 crore and ₹100 crore, respectively. The entire amount has been wholly subscribed by the central government. The EXIM Bank raises additional capital from the Government of India, from the Reserve Bank of India and from the market through issue of bonds and debentures. It also borrows foreign currency from other banks.

3.8.3 Functions of EXIM Bank

The main functions of the EXIM Bank are as follows:

- Financing of exports and imports of goods and services, not only of India but also of the third-world countries.
- Financing of exports and imports of machinery and equipment on lease basis.
- Financing of joint ventures in foreign countries.
- Providing loans to Indian parties to enable them to contribute to the share capital of joint ventures in foreign countries.
- Undertaking limited merchant banking functions, such as, underwriting of stocks, shares, bonds or debentures of companies engaged in export or import.
- Refinancing loans and advances granted by banks or other notified financial institutions for purpose of export or import.

- Rediscounting of finance export bills for banks, provision of overseas investment finance and lines of credit for Indian companies.
- Providing technical, administrative and financial assistance to parties in connection with export and import.
- Guaranteeing of obligations, jointly with banks, on behalf of project exporters in the fields of construction, supply and consultancy.

At present, the EXIM Bank undertakes nine lending operations. These operations can be grouped under three broad categories. These are mentioned as follows:

3.8.3.1 Loans to Indian Companies

Under this category, there are following types of finance:

- Direct financial assistance to exporters
- Technology and consultancy service
- Overseas investment financing for equity participation by an Indian company in joint ventures abroad
- Pre-shipment credit in case of export contract for capital goods

3.8.3.2 Loans to Foreign Governments, Companies and Financial Institutions

This category includes the following:

- Overseas buyers' credit scheme
- Lines of credit to foreign governments
- Re-lending facility to banks overseas

3.8.3.3 Loans to Commercial Banks in India

This category includes the following:

- Export bills re-discounting scheme (short-term bills)
- Refinance of export credit

3.8.4 Actual Performance/Assistance by EXIM Bank

Various types of assistance that have been provided by the EXIM Bank may be divided into two groups. *One* may be called *funded assistance* while the *other* may be called *non-funded assistance*. The funded assistance programmes are taken to enable Indian exporters to operate in international markets. On the other hand, non-funded or unfunded assistance is given by way of guarantees of various types.

3.8.4.1 Funded Assistance

The above-mentioned nine forms of lending by the EXIM Bank are collectively called funded assistance programme. These are provided to enable Indian exporters to operate in international markets. During 1982, the amount of funded assistance by the EXIM Bank was ₹240 crore. It increased to ₹2470 crore in 1995–1996. Industries which have been benefited are chemicals, pharmaceuticals, textiles and garments, power, transport, etc. In terms of region, West Asia and Africa received major share of funded assistance of the EXIM Bank. However, in the very recent years, South and South-East Asia received a major share of funded assistance of the EXIM Bank.

3.8.4.2 Non-funded Assistance

The EXIM Bank participates with Indian commercial banks to issue guarantees in foreign currencies on behalf of Indian exporters. In 1982, it executed export guarantees of ₹102 crore. However, it came down to ₹75 crore in 1983 and further to ₹50 crore in 1989–1990. Two main reasons behind this decline in guarantees were (i) recession in civil engineering construction, and (ii) political instability and turmoil in West Asian countries during that period. The major share (86 per cent) of total unfunded assistance went to the construction industry.

The EXIM Bank was specially set up to encourage India's export. After the announcement of the policy of liberalisation by the Government of India in 1991, Indian economy has been quite open. Its exports and imports have greatly been encouraged. With it, the volume of activities of EXIM Bank has also increased since 1991. In 1990–91, financial assistance sanctioned by the EXIM Bank was in the tune of ₹1390 crore and the amount of disbursement was ₹1200 crore. In 2000–2001, these figures increased to ₹2370 crore and ₹2070 crore, respectively. In the year 2004–2005, the sanctioned amount of financial assistance further increased to ₹17,440 crore and the amount of disbursement was ₹13,100 crore.

3.8.5 Some New Schemes of EXIM Bank

Apart from funded and non-funded assistance, the EXIM Bank introduced some new schemes in order to help exporters. Some of them are as follows:

3.8.5.1 Term Finance to Export-oriented Units (EOUs)

In 1984, the EXIM Bank extended term finance to export-oriented units (EOUs) set up in free-trade zones (FTZs). The facility was also extended to units recognised by the Government of India as cent per cent export-oriented units.

3.8.5.2 Finance to Projects Funded by Multilateral Agencies

During the recent past, the EXIM Bank has actively promoted Indian participation in projects funded by multilateral agencies, such as, the World Bank, Asian Development Bank (ADB) and African Development Bank.

3.8.5.3 Three Additional Schemes

With a view to promoting exports, the EXIM Bank has introduced three schemes in recent years. In brief, these schemes are as follows:

Production equipment finance programme: This programme offers rupee term finance to eligible export-oriented units for acquisition of equipment.

Export marketing finance: This scheme helps Indian manufacturing companies to undertake strategic export marketing activities.

Export vendor development finance: This scheme provides integrated financing packages in order to prepare and implement strategic vendor development plans by manufacturer exporters and exporting or trading houses.

Merchant banking: Apart from these functions, the EXIM Bank undertakes merchant banking and development banking functions. These are considered necessary to finance promotional activities. The EXIM Bank also undertakes counselling services.

Thus the EXIM Bank has emerged over time as the apex banking institution in the foreign trade sector of the economy. It has been giving a boost to India's effort in promoting exports. After the adoption of the policy of liberalisation in the year 1991 by the Government of India, the Indian economy is becoming more and more open before the world economy. In this new scenario, it may be expected that the activities of the EXIM bank will assume greater importance in the national economy of India.

3.9 SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)

The Small Industries Development Bank of India (SIDBI) was established as a subsidiary of Industrial Development Bank of India (IDBI) in October 1989. It started its operation since 2 April 1990. It is the apex body for supplying finance to small industries in India.

3.9.1 Objectives of SIDBI

The main objectives behind the establishment of the SIDBI may be mentioned as follows:

- To ensure larger flow of financial assistance to small-scale industries.
- To provide non-financial assistance like leasing, factoring, etc., to small industrial units.
- To provide financial assistance to the institutions engaged in helping small-scale units.

To fulfil these objectives, the Government of India announced in the budget for 1988–1989, its decision to establish the SIDBI as a subsidiary of the IDBI. The SIDBI Act was passed by the Parliament in October 1989 and the SIDBI started its operation on 2 April 1990. To equip the SIDBI to play its apex role in providing credit to small-scale industries more effectively, the Union Budget of 1998–1999 proposed the delinking of the SIDBI from the IDBI and transferring of IDBI shareholding in state financial corporations (SFCs) to the SIDBI.

3.9.2 Financial Resources of SIDBI

The SIDBI started its operation with an initial paid-up capital of ₹250 crore. It also took over the outstanding portfolio of the IDBI relating to small-scale sector held under Small Industries Development Fund. On 31 March 1990, its amount was ₹4200 crore. The paid-up capital was later raised to ₹450 crore. The financial resources of the SIDBI stood at ₹17,900 crore in 2000–2001. On 31 March 2014, its amount was ₹67,810 crore. The major sources of this fund are borrowings from the Reserve Bank of India, Government of India and proceeds from bonds and debentures.

3.9.3 Functions of SIDBI

The SIDBI provides financial assistance to the small-scale industrial units through state financial corporations (SFCs), state industrial development corporations (SIDCs), commercial banks and regional rural banks (RRBs). The major functions of the SIDBI are as follows:

3.9.3.1 Refinance of Loans and Advances

The SIDBI refinances loans and advances extended by the primary lending institutions to small-scale industrial units and also provides resource support to them.

3.9.3.2 Discounting and Re-discounting of Bills

The SIDBI discounts and re-discounts bills arising from sale of machinery to or manufactured by small industrial units.

3.9.3.3 Extension of Soft Loans

The SIDBI extends seed capital/soft loan assistance under National Equity Fund (NEF), Mahila Udyam Nidhi and Mahila Vikas Nidhi and seed capital schemes through specified lending agencies.

3.9.3.4 Direct Assistance for Promotion of Exports

The SIDBI grants direct assistance for financing export of products manufactured by industrial concerns in the small-scale sector. It also refinances loans extended by primary lending institutions for the same purpose.

3.9.3.5 Some other Services

The SIDBI provides services like leasing, factoring, etc., to industrial concerns in the small-scale sector.

3.9.3.6 Support to State SIDCs

The SIDBI extends financial support to state small industrial development corporations (SIDCs) for providing scarce raw materials to and marketing the final products of industrial units in the small-scale sector.

3.9.3.7 Support to NSIC

The SIDBI provides financial support to National Small Industrial Corporation (NSIC) for providing leasing, hire purchase and marketing support to small-scale industrial units.

3.9.4 Actual Performance/Progress in Activities of SIDBI

During 2000–2001, the SIDBI sanctioned ₹10,821 crore of which actual disbursement was ₹64,41 crore. Up to March 2001, cumulative sanctions by SIDBI were of the order of ₹66,227 crore whereas cumulative disbursements were of the order of ₹46,461 crore. During 2001–2002, the SIDBI sanctioned ₹10,900 crore and disbursed ₹6,790 crore among the small-scale units. Up to March 2014, cumulative sanctions and disbursements by SIDBI stood at ₹387,186 crore and ₹337,997 crore, respectively. During 2013–2014, financial assistance sanctioned by SIDBI was of the order of ₹53,033 crore and assistance actually disbursed by SIDBI was of the order of ₹52,321 crore. Thus, within a short span of time, the SIDBI has emerged as a major player in the field of finance for the small-scale sector.

In order to ensure larger flow of assistance to the small-scale unit, the SIDBI gives thrust on some specific activities. Some of these thrust areas are mentioned below:

- The SIDBI initiates steps for technological upgradation and modernisation of existing small-scale units.
- It attempts at expanding the channels for marketing the products of the small-scale units.
- It tries to promote employment-oriented small-scale industries especially in semi-urban areas to create more employment opportunities and, thereby, checking migration of population to urban areas to some extent.

3.9.5 Concluding Remarks

The objective of the Government of India behind the setting up of the SIDBI was to ensure large flow of finance to the small-scale industries. To ensure it, the SIDBI has liberalised its terms and conditions of assistance and has simplified the procedures. The aim is to widen its scope for larger coverage of schemes. Some of the **salient features of SIDBI** may be mentioned in this context. This will give an idea about the nature of SIDBI as a financial institution and its scope of activities.

- The SIDBI has been operating Single Window Scheme (SWS). The scope of this system has been widened by making the proposals for rehabilitation, modernisation and technology upgradation of existing units.
- Under the Automatic Refinance Scheme (ARS), the SIDBI provides refinance facilities to various institutions providing finance to small-scale units. The limit of term loans and the extent of refinance have been raised from time to time.
- The SIDBI has introduced equipment financing to existing well-run small-scale units for technology upgradation/modernisation.
- For re-settlement of voluntarily retired workers of National Textile Corporation (NTC), the SIDBI has introduced a refinance scheme. Under this scheme, the SIDBI helps such workers to buy looms.
- The SIDBI has set up a venture capital fund to assist entrepreneurs of small-scale units.

Thus the SIDBI has taken into account the major problems of small-scale units. Its approach to solve the problems of small-scale sector is very much pragmatic. However, the problems of small-scale units in India are too many, *for example*, problem of capital, problem of marketing, problem of unequal competition from large enterprises, problem of underutilisation of capacity, and so on. In view of the multitude of problems, the activity of the SIDBI is very much limited. The Government of India should raise the financial resources of the SIDBI so that it can make a meaningful contribution to the growth of small-scale sector in the country. If the financial strength of the SIDBI is raised, no doubt, it will be able to address the problem of small-scale industries in India in a better way.

3.10 STATE FINANCIAL CORPORATIONS (SFCs)

The Government of India has set up some financial institutions for financing small- and medium-scale industries. Some important such financial institutions are state financial corporations (SFCs), Small Industries Development Bank of India (SIDBI), National Small Industries Corporation (NSIC) and state industrial development corporations (SIDCs). In the previous section, we have discussed the functions of the SIDBI. In the present section we shall consider the role and functions of state financial corporations (SFCs) in providing finance to small- and medium-scale industries.

We know that the Industrial Finance Corporation of India (IFCI) provides financial assistance mainly to large- and medium-scale industrial units, such as, mining, manufacturing, shipping, power generation and its distribution, and so on. But the small-scale industries also require funds for their expansion and development. To meet this requirement, the Government of India passed the State Financial Corporation Act in 1951 and made it applicable to all the states. The first State Financial Corporation (SFC) was established in Punjab in 1953. Subsequently, SFCs have been set up almost in all other states. Normally, the operations of SFCs are confined to their respective states. However, in some special cases, SFCs extend their financial assistance and other activities to neighbouring states or union territories. Up to 31 March 2014, the number of SFCs in the country was 18.

3.10.1 Financial Resources of SFCs

The financial resources of SFCs consist of the following:

- Capital and reserves
- Bond and debenture issue
- Borrowing from the Reserve Bank of India
- Borrowing from the state governments
- Fixed deposits and
- Refinance from the SIDBI

The SFCs can accept deposits from the public also. The authorised capital of an SFC is fixed by the state government concerned and it varies between ₹5 lakh and ₹5 crore. The shares are subscribed by the relevant state government, Reserve Bank of India, scheduled banks, and insurance companies. As far as SFC bonds and debentures are concerned, they are mostly subscribed by commercial banks, the Life Insurance Corporation of India (LICI) and other financial institutions. At present, these are important sources of financial resources of the SFCs and account for about one-third of total financial resources. There is a stipulation regarding the borrowing made by SFCs. We know that SFCs can borrow from the RBI, state governments and the SIDBI. They can also borrow from the public by issuing bonds. Now, the stipulation is that the borrowings of SFCs including bond issues at any time should not exceed 10 times of their paid up capital and reserves. Recently refinance from the SIDBI has been an important source of funds for the SFCs.

3.10.2 Functions of SFCs

SFCs provide long-term finance (normally up to 20 years) to small- and medium-sized industrial concerns either in the public or in the private sector or in the joint or co-operative sector. Hence, the beneficiary unit may be organised as public or private company, co-operative, partnership or proprietary concern. An SFC provides financial assistance in the following forms:

- It guarantees loans raised by industrial concerns from the market.
- It grants loans and advances to industrial units and such loans are generally repayable within 20 years.
- An SFC can underwrite the issue of shares and debentures of industrial concerns.
- An SFC guarantees deferred payments for purchase of plant, machinery, etc., by an industrial unit.
- SFCs have also been entrusted with IDA (International Development Association) credit for assisting small- and medium-scale industrial units.

An SFC cannot purchase shares of any company. Some SFCs work as agents of their concerned state governments. They can also act as agents of the central governments, the Industrial Finance Corporation of India (IFCI) or some other industrial financing institutions in respect of grants of loans or advances or subscription to bonds or debentures. The bulk of the assistance granted by SFCs is to small-scale industries including road transport operators. SFCs also extend liberal financial assistance on concessional terms to industrial units in the specified backward areas. Further, they grant liberal financial assistance to technical entrepreneurs.

3.10.3 Actual Performance/Lending Operations of SFCs

We have mentioned that the major part of the financial assistance granted by SFCs goes to the small-scale units. They also provide financial assistance to industrial units situated in the backward areas at concessional rates.

SFCs started their operations on a modest scale. In the initial years, their lending was rather small. From the year of their inception in 1953 to March 1975, they sanctioned loan in the tune of ₹437 crore. However after March 1975, their loans and advances picked up momentum. During 2001–2002, SFCs sanctioned loans in the tune of ₹2080 crore and actual disbursement was ₹1760 crore. In the previous year, these figures were even much larger. In the year 2000–2001, the amount of loan sanctioned was ₹2800 crore while the amount of loan disbursed was ₹2000 crore. Up to 2000–2001, the cumulative assistance sanctioned by SFCs aggregated to ₹35,226 crore and actual disbursement was ₹28,576 crore. The cumulative assistance sanctioned by SFCs up to 2003–2004 was in the tune of ₹41,089 crore and the amount disbursed was in the tune of ₹33,344 crore. In 2003–2004, total assistance sanctioned and disbursed by 18 SFCs were ₹1134 crore and ₹857 crore, respectively.

SFCs sanction seed capital assistance under seed capital schemes introduced and operated by the IDBI. This assistance is available to promoters of small business units. Since June 1989, SFCs have also been implementing special schemes of seed capital assistance to women entrepreneurs. Assistance is given in the forms of loan or grant or a combination of both to voluntary agencies working for women in decentralised industries.

The principal objective of SFCs is to provide financial assistance to small and medium enterprises. However, the concept of small unit has changed over the years. Hence, it is somewhat difficult to determine quantitatively how much financial assistance has been provided to small enterprises. But there is enough evidence to suggest that in their early years, SFCs preferred to assist medium-sized enterprises. In 1966, there has been a change in their approach. It is seen that from that year, SFCs have provided a large amount of their loans to small enterprises. At present, there is a clear shift in their lending policies in favour of small enterprises.

An important feature of the lending policy of SFCs is to assist industrial enterprises located in backward areas. SFCs have launched a scheme of concessional financial assistance to such industries. The objective is to increase industrial activity in backward areas and to develop these regions industrially.

In terms of this scheme, industrial units in backward areas get soft loans at concessional rates, lower margins, reduced service charges, and so on. As a result of these measures, many new industries have been set up in backward regions of the country.

3.10.4 Critical Evaluation

SFCs have helped the small-scale industries in many ways. Still, their performance is not satisfactory. The working of SFCs has been criticised on various grounds.

- SFCs have failed to mobilise sufficient financial resources. Hence, they have not been able to meet the demand for credit adequately of the small-scale units.
- SFCs also suffer from the problem of mounting overdue.
- There has been always a large gap between loan sanctioned and loan disbursed. This is mainly due to administrative inefficiency.
- Except on soft loans, the rates of interest on all other loans given by SFCs are high and the terms and conditions are also stringent.
- SFCs have failed to diversify their business activities efficiently over the years. They depend excessively on loan finance. This has reduced the revenue of SFCs.
- Multiplicity of financial institutions has also limited the area of operations of SFCs. Due to their inefficiency, SFCs could not effectively compete with other financial institutions operating in the same field.

3.10.5 Concluding Remarks

The Reserve Bank of India appointed a working group to look into the functioning of SFCs. This group has found that SFCs have failed to meet the credit demands of medium and small industries adequately. Their overdue position has also deteriorated considerably in recent years. Hence, their ability to provide financial assistance has been adversely affected to a large extent. In order to come out of this situation, SFCs should improve their management and operations. We may make some suggestions for SFCs in order to enable them to survive in changing financial environment and increased competition.

- The operational efficiency of the management of SFCs should be increased. For this, their management needs to be restructured.
- Efficiency of the staff and personnel should be increased through proper training and workshop.
- SFCs should diversify their activities. This will lower business risk on the one hand and increase earnings on the other.
- As recommended by the Working Group on SFCs appointed by the RBI, each SFC should have at least one office in each region. This will ensure balanced allocation of finance to all regions.

If these steps are taken, SFCs may be expected to be a great help to small- and medium-scale industrial units. However, their increasing overdue should be reduced or at least checked first. Otherwise, SFCs will very soon face the problem of resource crisis and be unable to provide finance to their target industrial concerns.

3.11 NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

The Government of India has established the National Bank for Agriculture and Rural Development (NABARD) in July 1982. It is the most important incident in the field of rural credit. The NABARD now operates as the apex bank for supplying rural credit. It has taken over the agricultural credit functions of the Reserve Bank of India and the re-finance functions of the Agricultural Refinance and Development Corporation (ARDC). The main responsibility of the NABARD is to supply finance for agricultural activities and rural development. It provides credit to commercial banks, state co-operative banks and regional rural banks (RRBs). These institutions again provide credit to farmers and village artisans. Commercial banks give a part of this sum directly to farmers and a part through primary credit societies. The state level co-operative banks give this fund to the district-level co-operative banks which again give it to primary co-operative credit societies. These societies distribute credit among their member farmers. The money received by RRBs from the NABARD is directly distributed among farmers as credit.

3.11.1 Financial Resources of NABARD

Initially, the amount of paid-up capital of the NABARD was ₹100 crore. Half of this has been provided by the Government of India and the remaining half has been subscribed by the Reserve Bank of India. The authorised capital of the NABARD is ₹500 crore. The paid-up capital of the NABARD was raised from ₹100 crore to ₹500 crore and then to ₹2000 crore by the year 1999–2000. Further, the World Bank and the IDA (International Development Association, a wing of the World Bank) have been providing funds to the NABARD for the implementation of the projects financed by them. Thus, the financial resources of the NABARD have increased considerably over the years. It can also take loan from the Reserve Bank of India. Further, it can raise funds from domestic and foreign money markets. Again, the NABARD can mobilise funds by selling bonds or debentures and accepting deposits.

3.11.2 Management of NABARD

The management of the NABARD is vested on the Board of Directors consisting of 15 members. One of the Deputy Governors of the Reserve Bank of India is the Chairman of this board of directors.

3.11.3 Functions of NABARD

The NABARD was established as the apex development bank in the field of rural credit. To comply with that role, the NABARD performs various important functions. The main functions of the NABARD are discussed briefly as follows:

- The NABARD refinances credit given by commercial banks, co-operative banks and co-operative credit societies for agriculture, small and cottage industries and allied activities.
- This bank provides credits to the state co-operative banks, regional rural banks and to any financial institution recognised by the Reserve Bank of India.
- The NABARD conducts all the agricultural credit activities of the Reserve Bank of India.
- It performs re-finance activities of Agricultural Re-finance and Development Corporation (ARDC).
- This bank provides loan to the state governments for purchasing the share capital of co-operative credit societies.
- The NABARD provides financial assistance to any institution which is recognised by the government and which is associated with agricultural and rural development.
- This bank tries to co-ordinate the activities of the planning commission and the government organisations associated with the development of small and cottage industries.
- The NABARD supervises the activities of regional rural banks, co-operative banks and other primary co-operative banks.
- This bank conducts research on agriculture and rural development.
- The NABARD works as a representative of the Reserve Bank of India in the activities of rural credit.

The NABARD has taken an important responsibility to develop co-operative activities in the whole country. It is helping co-operative banks and primary agricultural credit societies (PACS) in many ways. Further, one of its main functions is to conduct agricultural research and to spread agricultural education. It thus seeks to attain long-term development of agriculture. To motivate the farmers to repay agricultural loans, it has formed a team of volunteers. It consists of successful farmers, retired agricultural scientists and others. Further, to rejuvenate weak co-operative banks both at the district and the state levels, the NABARD has come forward. Again, it sanctions the lion's share of its long-term credit to establish minor irrigation projects.

3.11.4 Actual Performance/NABARD and Rural Credit

The NABARD is the apex organisation with respect to all the matters relating to financial assistance to agriculture and rural industries. As the apex institution, NABARD has tried to ensure the flow of credit to weaker sections in the rural economy. It follows the earlier policy laid down by the Reserve Bank of India while sanctioning agricultural credit. It also grants long-term credit to state governments for contribution to the share capital of co-operative credit institutions. The performance of the NABARD regarding assistance to the rural sector may be considered under following heads:

3.11.4.1 Extension of Credit

The NABARD provides short-term, medium-term and long-term credit. It provides short-term loans to state co-operative banks for financing seasonal agricultural operations, marketing of crops, pisciculture, production and marketing activities of industrial and weavers' co-operatives, financing of farmers and rural artisans through primary agricultural credit societies (PACS), and so on. Medium-term loans are provided to state co-operative banks and RRBs for various agricultural activities. Long-term loans, as already mentioned, are provided to state governments for contribution to the share capital of co-operative credit institutions.

3.11.4.2 Refinance Activities

The NABARD provides two types of refinance. The first type of refinance is provided to RRBs, state co-operative banks and state governments. The second type of refinance is given to provide resources for ground level deployment of rural credit. In the first case, the NABARD provides refinance to state co-operative banks and RBBs for their short-term and medium-term lending. Its refinance facilities to state governments are for long periods. These facilities are specifically meant to help state governments to contribute to the share capital of weak co-operative credit societies and banks. The second type of refinance from NABARD is provided to increase ground level credit to finance short-term seasonal agricultural operations through credit co-operatives. The central co-operative banks can secure refinance facilities from NABARD under certain conditions. Further, the NABARD provides refinance facilities for purchase, store and distribution of fertilisers and other inputs. It also provides refinance facilities for production and marketing activities of weavers' societies, industrial co-operative societies, and so on. During 2011–12, the amount of refinance assistance given by the NABARD to co-operative banks and RRBs to disburse crop loans reached an all-time high of ₹48,000 crore. This amount was higher by ₹14,000 crore or by 41 per cent over the figure for the previous year.

3.11.4.3 Schematic or Scheme-based Lending

The NABARD also provides schematic lending. Minor irrigation occupies an important place in schematic lending of the NABARD. Farm mechanisation is also a major area of NABARD refinance. It is around 28 per cent of total refinance by the NABARD. Under Integrated Rural Development Programme (IRDP), the NABARD provides refinance facilities to help weaker sections of the rural population for minor irrigation, dairy development, fisheries, etc. Other important schemes financed by the NABARD are land development, command area development, plantations and horticulture, poultry and sheep rearing.

3.11.4.4 Microfinance by NABARD

Poor farmers and rural artisans have very little access to credit from commercial banks due to lack of collateral securities and high transactions cost even in case of small borrowing. In this case, microfinance system is very effective and helpful to them. Under this system, non-government organisations (NGOs) form and develop self-help groups (SHGs) and provide credit to them. In this context, the NABARD has been playing a key role. It tries to develop and promote SHGs and other microfinance organisations. SHG-bank linkage programme has now become a major source of micro-finance among the low-income group both in rural and urban areas. The NABARD provides refinance at special rates in such programmes.

3.11.4.5 Rural Infrastructure Development Fund (RIDF)

The NABARD has been playing an important role to develop infrastructure in rural areas. The government was worried at the lacklustre growth in rural infrastructure. Hence it proposed to set up Rural Infrastructure Development Fund (RIDF) in the Union Budget for 1995–1996 with a corpus of ₹2000 crore. The RIDF runs on an annual basis. The amount of fund allocated under the RIDF has gradually increased from ₹2000 crore in 1995–1996 (RIDF-I) to ₹20,000 crore in 2012–2013 (RIDF-XVIII). Cumulative allocation over the period stood at ₹172,500 crore.

3.11.4.6 Kisan Credit Card (KCC) Scheme

The Kisan Credit Cards (KCCs) scheme was introduced in 1998–1999. Under this scheme, each farmer is given a Kisan Credit Card and a passbook for providing revolving cash credit facilities. Commercial banks, co-operative banks and RRBs are implementing this scheme. The NABARD has taken initiatives to accelerate the pace of issuing KCCs.

3.11.4.7 Developing Co-operative Activities

The NABARD has been playing an active role in strengthening and re-organising the co-operative credit structure in the country. It has formulated a set of guidelines for planning the future development of primary co-operative credit societies. It also provides help for improvement in their organisational and managerial efficiency. The NABARD set up the Co-operative Development Fund (CDF) in 1993. Its objective is to strengthen the co-operative credit institutions in the fields of organisational structure, human resource development, resource mobilisation, loan recovery, and so on. The financial assistance for this purpose is given to state co-operative banks (StCBs), state co-operative agriculture and rural development banks (SCARDBs), central co-operative banks (CCBs) and primary co-operative agricultural and rural development banks (PCARDBs).

3.11.4.8 Supervision Work

The NABARD is the supervisory authority for all co-operative credit institutions of the country. Accordingly, it undertakes periodic on-site inspection and keeps off-site surveillance on the activities of such institutions. This has helped greatly in the improvement of co-operative credit operations in the country.

3.11.5 Critical Evaluation

The NABARD has played a very important role in the field of rural credit. There are, however, some limitations in its activities. The main criticisms made against the activities of the NABARD may be summarised as follows:

3.11.5.1 Problem of Overdue

Overtime the amount of un-recovered loan has mounted up. This is a very serious problem faced by NABARD at present.

3.11.5.2 Underutilisation of RIDF

The progress of utilisation of RIDF was very satisfactory for the initial 3 years, that is, from 1995–1996 to 1997–1998. But after that, a large part of the fund allocated each year in the Union Budget remains underutilised. Against a total allocation of ₹172,500 crore up to 2012–2013, ₹151,154 crore had been sanctioned to various state governments. Out of it, ₹100,051 crore was disbursed up to November 2012. The main reasons behind this under-utilisation of RIDF are: (i) inefficiency of implementing departments of various governments, (ii) problem of land acquisition for construction of rural roads and bridges, and (iii) inadequate monitoring.

3.11.5.3 Uneven Distribution of Kisan Credit Cards (KCCs)

The progress of the Kisan Credit Card scheme has not been uniform across states. It is particularly dismal in the Northeast. The main reasons behind this are: (i) poor financial position of the co-operatives and RRBs compared to the need of the farmers, and (ii) lack of proper infrastructure in some regions.

3.11.5.4 More Attention to Refinance Function

The three main functions of the NABARD are refinancing, institutional development and inspection of client organisations. However, the refinance function has attracted relatively more attention and resources over the years. Further, as pointed out by V. Krishnadevan, a major part of the personnel of the NABARD is stationed at the head office, regional offices and sub-offices. Thus rural offices have got insignificant number of employees. An organisation like NABARD dealing with agricultural finance should have employed most of its employees in rural areas. This has badly affected its efficiency in providing rural credit.

3.11.5.5 Weak Co-operative Movement

A major problem faced by NABARD today is the lack of healthy credit delivery motivation at the field level. It poses difficulties for sustaining rural credit on a continuous basis. The NABARD has not been able to strengthen co-operatives. The main reason is that the onus of management control is on the state governments which have failed to discipline the erring co-operative institutions.

3.11.6 Concluding Remarks

The NABARD has been playing a pivotal role in providing credit to the rural sector. It provides refinance and improves the resource base of institutions giving loans to the rural economy. It also supervises the working of the co-operative banks of different categories. The NABARD has attempted to increase the coverage of rural credit institutions by bringing in areas of non-traditional agriculture and new ventures in farm activities under their purview. It is also taking steps to restructure the institutional rural credit system.

However, there are some problems of NABARD. The main problem faced by it at present is its large amount of bad debt. One study shows that about 40 per cent of the total loan sanctioned by NABARD has not been repaid by farmers. If this trend continues, there is every doubt how long the NABARD will be able to finance agriculture and allied activities. It should be more careful while screening the loan applications and should not follow very liberal policy of granting loans. Further, there should be supervision on the utilisation of loan amount. If a loan is given to worthy farmer and if it is properly utilised, then the loan is unlikely to be a bad debt in future. The NABARD should also evolve a better procedure of realising its debt. Otherwise, if the amount of bad debt goes on increasing, the NABARD itself will turn into a sick unit sooner or later. Its sources of financial resources will dry up.

3.12 AN OVERALL EVALUATION OF DEVELOPMENT BANKS OR DEVELOPMENT FINANCIAL INSTITUTIONS (DFIs)

There are several term lending institutions which have been playing a special role in agricultural and industrial finance in India. These institutions are together called development banks or development financial institutions (DFIs) or statutory financial organisations. The most important organisations among them are IFCI, IDBI, ICICI, SIDBI, SFCs, and NABARD. Among them, the IDBI was later converted into a public sector bank from October 2004. The ICICI was merged into ICICI Bank with effect from March 2002. So, both the IDBI and the ICICI now cease to be development banks. We shall make in this section a brief evaluation of their performance as a whole. We shall mention some general limitations of the working of these institutions and also mention some suggestions and recommendations to improve their activities.

3.12.1 Role of Development Banks

During the last six decades or so, these financial institutions have provided financial assistance to many industrial units. During this period of their operation, the number of industrial units benefited, the amount of loans sanctioned and distributed—all have increased steadily. The growth of private sector during this period is largely due to the finances provided by these financial organisations. The public sector has also been tremendously benefited from financial assistance supplied by these development banks. Not only amount of loans to large-scale units has increased, the amount of loans to small-scale industries has also considerably increased. These institutions have also helped various projects in backward regions of the country. They have also promoted new industries.

These development banks have undertaken a wide range of promotional activities. These activities include the following:

- Entrepreneurship development programmes
- Technological assistance
- Help in the preparation and evaluation of new schemes
- Some special steps and suggestions for sick units
- Assistance to backward areas
- Assistance to small-scale units
- Management development

Financial assistance provided by these development banks has increased by leaps and bounds particularly during the last three decades or so. These institutions now account for a major share of corporate debt. Further, growth and expansion of these financial institutions have brought considerable development of capital market in India. In order to raise funds from the open market, these institutions have evolved various types of credit instruments. This has also brought diversification in the capital market of the county. They have also helped mobilise savings and thus contributed to capital formation and economic development of the country.

3.12.2 Limitations of Development Banks

Though development banks have made great contributions towards industrial development of the country, there are some limitations in the activities of these financial institutions. They may be summarised as follows:

- In the field of term lending, these institutions have no competitors. This has reduced their efficiency.
- Sometimes these institutions have financed unviable projects for some reasons other than economic.
- State level institutions have been working as wings of the state governments rather than as autonomous financial institutions. As a result, they have sometimes given more importance to non-economic factors than economic factors while granting loans or in other activities.

- While considering loan applications of industrial units, they do not always maintain their appraisal standards.
- Very often they have provided financial assistance to sick units which are not commercially viable.
- The development banks have granted a major part of their assistance to large industrial houses and thus neglected the small and medium size industrial units.
- Instead of granting more assistance to industries established in backward regions, financial institutions have contributed more to industries established in developed states. This would be clear from the fact that the three advanced industrial states of Maharashtra, Gujarat and Tamil Nadu together obtained 46 per cent of total assistance sanctioned by all-India financial institutions up to March 2000.

Another difficulty of the financial institutions facing recently may also be mentioned in this connection. On the one hand, the burden of non-performing assets (NPAs) of these institutions has been increasing. On the other hand, the cost of raising funds of these institutions has been rising. As a result, their profitability has fallen steeply in recent years. The capital adequacy ratio (CAR) of the IFCI and the IIBI has touched very low levels and is around the minimum stipulated limit. The non-performing assets of large financial institutions have reached around 20 per cent of net assets. This is very high by any standard. The cost of raising funds of these institutions is also considerably higher than that of commercial banks in the country. Because of the lacklustre performance of these financial institutions, they are also finding it very difficult to raise resources from the capital market.

Another limitation of development banks or development financial institutions may also be mentioned. These institutions have been operating almost like a cartel. Different institutions join together and offer consortium finance. Borrowers have little choice in the matter of selecting an institution for finance. This system has an advantage. The borrowers need not approach several institutions for finance. But it has two major limitations also. *First*, if the consortium rejects the application of a borrower company, it does not have another option. *Secondly*, it damages the sense of accountability and responsibility among the participating financial institutions.

3.12.3 Recommendations of Narashimham Committee and their Implementation

In order to improve the quality of operations and remove the limitations of the development banks, Narashimham Committee has made some recommendations. In brief they are as follows:

- The ownership pattern of development banks should be broad-based.
- There should be autonomy of the DFIs in matters of internal administration.
- The boards of different financial institutions should include representation from the industrial sector.
- The link between the state-level financial institutions and the respective state governments should be broken.
- The DFIs should raise their funds from the capital market at market-related rates.

- While sanctioning credit, only the economic and technical aspects should be taken into account.
- The present system of consortium funding should be given up.
- The appointment of the Chief Executive of development banks should be made on the recommendations of a panel of eminent persons.
- Development banks should adopt internationally accepted norms on term lending finance. This will provide greater choice to the borrowers.

Some of these recommendations have been implemented. Hence it may be expected that the effectiveness of these development banks will increase in near future. The Government of India has introduced the following policy reforms in the field of development finance:

- The system of consortium finance by development banks is being gradually replaced by informal loan syndication.
- Development banks have liberalised interest rates following Narashimham Committee recommendations.
- The access to some concessional funds has been reduced. They are now encouraged to approach capital market for funds. In recent years, DFIs have taken steps to widen their resource base and mobilise funds from domestic as well as international markets.
- In March 1984, the Reserve Bank of India issued guidelines on prudential norms to be followed by the five all-India development banks *viz.*, IFCI, IDBI, ICICI, IIBI and EXIM Bank. These norms are concerned with credit concentration and asset classification, and are necessary to follow to maintain financial health.

3.12.4 Recommendations of Working Group of RBI

Besides above, the RBI set up a high-powered working group headed by S. H. Khan for the purpose of harmonising the role of development financial institutions and banks. This group submitted its report to the RBI in April 1998. The main recommendations of this working group were as follows:

- The DFIs should be allowed to perform banking activities besides their original activities.
- Debt recovery of banks and DFIs should be given top priority.
- Measures should be taken to smoothen out the regulator discrepancies between banks and DFIs.
- Directed lending and concessional lending by DFIs to certain sectors should be replaced by specifically targeted subsidies to the sector.
- IDBI shareholding of SFCs should be transferred to the SIDBI.
- The ownership of the SIDBI should be transferred to the RBI or to the Government of India.

The RBI has accepted some of the recommendations of Khan Working Group. For example, the first universal bank has been set up by merging ICICI with ICICI Bank in 2002. The UTI has also started banking operations as UTI Bank, in addition to its normal activities as a mutual fund organisation. The IDBI has been converted into a public sector bank. The RBI has also adopted some measures towards debt recovery of these financial institutions and to reduce their non-performing assets. With these measures, it may be expected that the performance of development bank will improve in the years to come. But first of all, their non-performing assets (NPAs) should be reduced. Otherwise, the efficiency and effectiveness of their activities are bound to be limited.

SUMMARY

S.1 Sources of Finance for Industrial Units in India

An industrial unit requires both fixed capital and working or circulating capital. They may be mobilised from internal sources and external sources. Internal sources are personal savings, loans from relatives and friends and loans from indigenous moneylenders. But with the increase in size of the industrial units, the role of banks and other financial institutions became more important over time in supplying industrial finance. Various external sources of industrial finance are sale of shares, sale of debentures or bonds, deposits from the public, commercial banks, foreign sources and, above all, development financial institutions (DFIs) or, popularly called, development banks. Some important development banks are Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI, up to October 2004), Industrial Credit and Investment Corporation of India (ICICI, up to March 2002), Unit Trust of India (UTI), Life Insurance Corporation of India (LICI), General Insurance Corporation of India (GICI), Industrial Investment Bank of India (IIBI), and National Industrial Development Corporation (NIDC).

S.2 Classification of Different Specialised Financial Institutions

The Government of India has set up a number of development financial institutions or development banks to supply finance to the industrial sector. They may be classified into few groups as follows:

All-India development banks for large industries: In this category we have IFCI, IDBI, ICICI, IIBI, and National Industrial Development Corporation.

All-India development banks for small-scale industries: In this group we have Small Industries Development Bank of India (SIDBI) and National Small Industries Corporation (NSIC).

Investment institutions: In this category we have Unit Trust of India (UTI), Life Insurance Corporation of India (LICI), General Insurance Corporation of India (GICI) and its subsidiaries.

State level institutions: In this group, there are state financial corporations (SFCs), state industrial development corporations (SIDCs) and state industrial investment corporations (SIICs).

Sector-specific development bank: In this category, there are Export-Import Bank of India (EXIM Bank) and National Bank for Agriculture and Rural Development (NABARD).

Specialised financial institutions: In this category, we have Housing Finance Companies (HFCs), Tourism Finance Corporation of India Ltd. (TFCI), Shipping Credit and Investment Corporation of India (SCICI), Technology Development and Information Company of India Ltd. (TDICI), Infrastructure Development Finance Company Ltd. (IDFC), IFCI Venture Capital Fund (IVCF), and ICICI Venture Limited (ICICIV).

S.3 Distinction between Commercial Banks and Development Banks

Financial institutions can broadly be divided into two groups: banks and non-bank financial institutions. There are certain differences between these two types of institutions. First, commercial banks are required to keep a certain percentage of their deposits in the form of reserves with the central bank, but non-bank financial institutions are not required to do so. Second, the deposits of commercial banks are withdrawable by cheques, but the deposits of non-bank financial institutions are not withdrawable by cheques. Third, commercial banks can make multiple expansion of credit, but non-bank financial intermediaries have no such power.

S.4 Industrial Finance Corporation of India (IFCI)

The Industrial Finance Corporation of India (IFCI) was set up in July 1948. It has been converted into a public limited company with effect from 1 July 1993. The IFCI performs some important functions as follows: (i) It grants loans and advances to industrial concerns and subscribes to the debentures floated by them, (ii) It guarantees loans raised by industrial concerns in the capital market, (iii) It underwrites the issue of shares, bonds and debentures of industrial concerns, (iv) It also subscribes to the equity and preference shares and debentures of companies.

The financial resources of the IFCI consist of three main components: (i) share capital, (ii) bonds and debentures, and (iii) other borrowings.

The IFCI is authorised to give long and medium-term finance only to companies engaged in manufacturing, mining, shipping, and generation and distribution of electricity. Before granting loans, the IFCI scrutinises the applications carefully and considers the importance of the industry in the national economy. It also considers the viability of the scheme for which the loan is required. While giving loans, the IFCI requires the security of fixed assets, such as, land, buildings, plants, machinery, etc. It ordinarily requires the personal guarantee of directors of the industrial concern or the power to sell the mortgaged property in the event of continuous default in the payment of interest and principal advanced to a concern.

Since its inception in 1948, up to March 1996, the IFCI has sanctioned ₹33,690 crore as financial assistance. In 2013–2014, financial assistance sanctioned and disbursed by the IFCI stood at ₹9,717 crore and ₹8,663 crore, respectively. The main industries which have been benefited are fertiliser, cement, power generation, paper, industrial machinery, etc. Recently the IFCI has been providing financial assistance to set up new projects and to modernise existing projects. In recent years, the IFCI has started new promotional schemes. These are as follows:

- Interest subsidy scheme for women entrepreneurs

- Consultancy fee subsidy scheme for small units
- Encouraging the modernisation of small industries
- Control of pollution in the small and medium-scale units

During 1988–1989, the IFCI introduced two new schemes of financial assistance. One is the Equipment Leasing Scheme. Under this scheme, the IFCI provides equipment to the industrial units by way of financial lease. The other is the Equipment Procurement Scheme. Under this scheme, the IFCI agrees to procure equipment and then resell them to the industrial units in corporate or co-operative sector. Finally, the IFCI has recently increased its assistance to the units located in backward districts.

However, the IFCI has been badly affected and burdened with heavy non-performing assets (NPAs). Hence, it has become a sick financial unit. The Government of India has taken several measures to rehabilitate the IFCI. Still, it appears that the IFCI cannot be easily rehabilitated.

S.5 Industrial Development Bank of India (IDBI)

The Industrial Development Bank of India was set up on 1 July 1964. It was established to co-ordinate and harmonise among the activities of other term lending institutions. The IDBI was set up to act as the apex bank in the field of development banking. However, in October 2004, the IDBI has been converted into a public sector bank and renamed as IDBI Bank. Initially it was a wholly-owned subsidiary of the RBI. But in 1976, it was taken over by the Government of India and made an autonomous institution. The main function of the IDBI during its existence as a development bank (*that is*, from July 1964 to October 2004) was to provide long-term finance to industry and to act as the apex bank in the field of industrial finance.

The authorised share capital of the IDBI was raised from ₹100 crore to ₹200 crore in 1980. Further this limit was raised to ₹1000 crore in 1985 and further up to ₹2000 crore. However, the main sources of funds of the IDBI other than its own capital were retained earnings, borrowing from the RBI and borrowing from the market through bonds.

The IDBI provided long-term industrial finance both directly and indirectly. Directly it provided finance by way of project loans, subscription to bonds, provision of soft loans, purchase of equity shares, and so on. Indirectly it provided finance by granting refinance to IFCI, SFCs, commercial banks, and state co-operative banks, for their term loans to industrial concerns. The IDBI also adopted measures to develop industries in backward areas by providing finance at concessional rates. It acted as a guarantor when an industrial unit took loan from any financial institution. Further, the IDBI has under-written new issues of industrial concerns. Moreover, it accepted, discounted or re-discounted commercial bills or promissory notes of industrial organisations. Apart from providing finance, the IDBI provided certain promotional facilities. It provided training for project evaluation, development of entrepreneurship, and so on. The IDBI provided assistance to small-scale industries also.

The IDBI set up a special fund called the Development Assistance Fund (DAF). Financial assistance was given to the financially weaker units out of this fund. In 1991, DAF was abolished and merged with the general fund. Further, the IDBI raised foreign funds from international money markets and made them available to these industrial units which needed them.

During the 40 years of IDBI's lifespan from July 1964 to March 2004, it sanctioned ₹223,524 crore and disbursed ₹175,572 crore. It became the most important institution assisting industrial units in the country. To promote industrial development in backward areas, the IDBI adopted a scheme. In this scheme, soft loans were given to small and medium projects at concessional rates of interest. Further, it provided soft loans to cotton textiles, jute, cement, sugar and engineering industries for modernisation, replacement and renovation of plant and machinery. The IDBI provided refinance facilities to other financial institutions. It extended assistance to small-scale industries and small road transport operators indirectly. The IDBI launched the National Equity Fund Scheme in 1988 for providing finance to tiny and small-scale industrial units. It played a vital role in the balanced regional development of the country. The IDBI recorded an impressive performance in its operations particularly after 1976 when it became autonomous.

S.6 Industrial Credit and Investment Corporation of India (ICICI)

The Industrial Credit and Investment Corporation of India (ICICI) was established in January 1955 as a company under Indian Companies Act in order to provide credit mainly to the industrial units in the private sector. However, in April 2002, the ICICI merged into ICICI Bank. Hence, it is no longer a development bank and at present is a private sector bank. The ICICI was the third important development bank in India after the IDBI and the IFCI. While the IDBI and the IFCI were public sector development banks, the ICICI was a private sector development bank. The capital of the ICICI was subscribed by banks, insurance companies, other companies, general public, and so on. The objective of the ICICI was to provide financial assistance to industrial concerns in the private sector. However, in later years of the ICICI, it also provided assistance to concerns in the public sector. The main functions of the ICICI were as follows:

- To promote new industries, to assist the expansion and modernisation of existing industries both in the private and public sectors.
- To provide long-term and medium-term loans, both rupee loans and foreign currency loans.
- To participate in equity capital and in debentures.
- To underwrite new issues of shares and debentures.
- To guarantee loans from the private investment sources.
- To provide financial services, such as, deferred credit, instalment sale and venture capital.
- To provide consultancy services to industrial concerns in the form of managerial and technical advice.

The ICICI provided financial assistance only to acquire capital assets, such as, land, buildings, machinery, etc.

The ICICI assisted industries manufacturing paper, chemicals and pharmaceuticals, electrical equipment, textiles, sugar, metal ore, lime and cement, glass manufacture, and so on. Though it assisted all the sectors, the major beneficiary was the private sector. Since its inception in January 1955 up to March 1996, the total financial assistance sanctioned by ICICI was ₹66,170 crore. The amount of total disbursement was ₹36,590 crore. In 2000–2001, the amount of loan sanctioned was ₹56,030 crore whereas the amount of disbursement was ₹31,960 crore. This assistance comprised of foreign currency loans, rupee loans, guarantees and subscription of shares and debentures. It also helped in later years in the development of new industries in backward regions.

The ICICI introduced leasing operation in 1983. It provided leasing assistance for computerisation, modernisation, equipment of energy conservation, export orientation, pollution control, etc. Industries benefited under this scheme were textiles, engineering, chemicals, fertilisers, cement, sugar, etc.

The ICICI set up a Merchant Banking Division. It also joined the consortium of IDBI, IFCI and other financial institutions for providing soft loans to a number of industries for modernisation. It also established a number of institutions for providing different non-financial services. For example, Credit Rating Information Services of India Limited (CRISIL) was set up to provide credit rating services to the corporate sector. Further, Technology Development and Information Company of India Ltd. (TDICIL) was established to finance the transfer of technology and provide information on technology.

The ICICI also provided foreign currency loans and advances to enable Indian industrial units to secure essential capital goods from foreign countries. In this matter, the World Bank helped the ICICI. Again, to provide house-building loans, the ICICI set up Housing Development Finance Corporation (HDFC) in 1977. Its function is to provide long-term house-building loans to the low and middle-income group. There are however some criticisms against the activities of the ICICI. The main criticisms are as follows: (i) lack of measures to remove regional disparities, (ii) favour to large units, and (iii) neglect of less developed regions.

S.7 Export-Import Bank (EXIM Bank) of India

The Export-Import Bank (EXIM Bank) of India was established on 1 January 1982. It now acts as the apex institution relating to the finance of export-import. Its main functions are to provide financial assistance to exporters and importers, to co-ordinate the works of other institutions engaged in the field of financing international trade and to undertake limited development and merchant banking activities in relation to export-oriented industries. The EXIM Bank provides financial assistance by way of direct loans and advances for the purpose of export or import, refinance of loans and advances granted by banks or other notified financial institutions for purposes of export or import, rediscounting of export bills for banks, provision of overseas investment finance, and so on. At present, the EXIM Bank undertakes nine lending operations. They can be grouped under three broad categories, namely, (i) loans to

Indian companies, (ii) loans to foreign governments, companies and financial institutions, and (iii) loans to commercial banks in India. In recent years, the EXIM Bank has introduced some new schemes. Important among them are as follows:

- Production equipment finance programme
- Export marketing finance
- Export vendor development

Apart from these functions, the EXIM Bank undertakes merchant banking and development banking functions.

S.8 Small Industries Development Bank of India (SIDBI)

The Small Industries Development Bank of India (SIDBI) was established as a subsidiary of the Industrial Development Bank of India (IDBI). The SIDBI is the apex body for supplying finance to small industries in India. It started its operations from 2 April 1990 with an initial paid-up capital of ₹250 crore. It was subsequently raised to ₹450 crore. In 2000–2001, the financial resources of the SIDBI aggregated to ₹17,900 crore. On 31 March 2014, the amount increased to ₹67,810 crore. The major sources of this fund are borrowings from the Reserve Bank of India, Government of India and proceeds from sale of bonds and debentures.

The SIDBI provides assistance to small industries through state financial corporations (SFCs), state industrial development corporations (SIDCs), commercial banks and regional rural banks (RRBs). The major functions of the SIDBI are, in brief, as follows:

- Refinance of loans and advances
- Discounting and re-discounting of bills
- Extension of soft loans
- Direct assistance for promotion of exports, etc.
- Support to state industrial development corporations
- Support to National Small Industries Corporation
- Some other services like leasing, factoring, etc.

The objective of the Government of India behind the setting up of the SIDBI was to ensure larger flow of finance to the small-scale industries. To ensure it, the SIDBI has liberalised its terms of assistance and simplified the procedures. The aim is to widen its scope for larger coverage of schemes. For example, it has introduced Equipment Financing Scheme, scheme for resettlement of voluntarily retired workers of National Textile Corporation (NTC), setting up of venture capital fund, enlargement of Single Window Scheme (SWS), and so on.

In order to ensure larger flow of credit to the small-scale units, the SIDBI gives emphasis on some specific activities. Some of these thrust areas are as follows:

- Technological upgradation and modernisation of existing units.
- Marketing of the products of small-scale units.
- Promotion of employment-oriented small-scale industries especially in semi-urban areas in order to check rural–urban migration.

However, in view of the multitude of problems of small units, the ability of the SIDBI is very much limited. The government should look into this problem.

S.9 State Financial Corporations (SFCs)

To meet the requirement of funds for the development of small and medium-scale industries, the Government of India has set up financial institutions in many states. These are known as state financial corporations (SFCs). The SFCs provide long-term finance to small and medium-sized enterprises in private, public, joint or co-operative sector. The main functions of an SFC are as follows:

- It guarantees loans raised by industrial concerns from the market.
- It grants loans and advances to industrial units generally for a period of 20 years.
- An SFC underwrites the issue of shares and debentures of industrial concerns.
- It guarantees deferred payments for purchase of plant, machinery, etc., by an industrial unit.

The financial resources of SFCs consist of the following:

(i) capital and reserves, (ii) bond and debenture issue, (iii) borrowing from the RBI, (iv) borrowing from the state governments, (v) fixed deposits and, most importantly, (vi) refinance from the SIDBI. As far as SFC bonds and debentures are concerned, they are mostly subscribed by commercial banks, the Life Insurance Corporation of India and other financial institutions.

The major part of the financial assistance granted by the SFCs goes to the small-scale industrial units. They also provide financial assistance to industrial units situated in the backward areas at concessional rates. The SFCs have helped the small-scale industries in many ways. Still, their performance is not satisfactory. They have not been able to meet the demand for credit adequately of the small-scale units. They also suffer from the problem of mounting overdue.

S.10 National Bank for Agriculture and Rural Development (NABARD)

In order to meet the credit requirements of agricultural sector, the Reserve Bank of India (RBI) has established the National Bank for Agriculture and Rural Development (NABARD) in 1982. This bank now works as the apex bank for supplying agricultural finance. It has taken over the agricultural credit functions of the RBI and the refinance functions of the Agricultural Refinance and Development Corporation (ARDC). The main responsibility of the NABARD is to supply finance for agricultural activities and rural development. The NABARD provides credit to commercial banks, state co-operative banks and regional rural banks (RRBs). These institutions again provide credit to the farmers either directly or indirectly.

The amount of share capital of the NABARD is ₹100 crore. Half of this has been provided by the Government of India and the remaining half has been given by the RBI. The authorised capital of the NABARD is ₹500 crore. It can also take loan from the RBI. Further, it can raise funds from domestic and foreign markets. Again, the NABARD can mobilise funds by selling bonds or debentures and by accepting deposits.

The management of the NABARD is vested on a Board of Directors consisting of 15 members. One of the Deputy Governors of the RBI is the chairman of the NABARD.

The main functions of the NABARD are as follows:

- This bank refinances credit for agriculture, small and cottage industries and allied activities.
- It provides credit to state co-operative bank, RRBs (regional rural banks), land development bank (LDB) and any financial institution recognised by the RBI.
- The NABARD conducts all the agricultural credit activities of the Reserve Bank of India.
- It performs refinance activities of Agricultural Refinance and Development Corporation (ARDC).
- It provides loan to the state governments for purchasing the share capital of co-operative credit societies.
- The NABARD supervises the activities of regional rural banks, co-operative banks and other primary co-operative banks.
- This bank conducts research on agriculture and rural development.
- The NABARD works as a representative of the Reserve Bank of India in the activities relating to rural credit.

The NABARD has taken an important responsibility to develop co-operative activities in the whole country. It is helping co-operative banks and primary co-operative credit societies in many ways. Further, one of its main functions is to conduct agricultural research and to spread agricultural education. The NABARD plays an important role in the development of rural infrastructure and to set up minor irrigation projects. It also tries to rejuvenate weak co-operative banks both at the district and at the state levels.

The main problem faced by the NABARD at present is its large amount of bad debt (about 40 per cent). If this trend continues, the NABARD will be unable to finance agriculture and allied activities today or tomorrow.

S.11 An Overall Evaluation of Development Banks or Development Financial Institutions (DFIs)

To supply finance to the industrial sector of India, several term lending institutions have been set up by the Government of India since Independence. These institutions may together be termed as Development Banks or Development Financial Institutions (DFIs) or Statutory Financial Organisations. Important among them are IFCI, IDBI, ICICI, SIDBI, SFCs, SIDCs, NSIC, NIDC, EXIM Bank, and UTI. During the period since Independence, these financial institutions have provided financial assistance to many industrial units. Apart from that, they have undertaken a wide range of promotional activities. These are as follows:

- Entrepreneurship development programmes
- Technological assistance
- Help in the preparation and evaluation of new schemes
- Assistance to sick industrial units

- Assistance to backward areas
- Assistance to small-scale units
- Management development

The volume of financial assistance given by these development banks has sharply increased over time, particularly, during the last three decades. However, there are some limitations in the activities of these financial institutions. In brief, these are as follows:

- The monopoly position of these institutions has reduced their efficiency.
- Sometimes, these institutions have financed unviable projects.
- State-level institutions have given more importance to non-economic factors while granting loans.
- Large industrial units have grabbed a major part of the financial assistance and the small and medium units have been neglected.
- Industries of backward regions and states have been neglected.
- The burden of non-performing assets (NPAs) of these institutions has been increasing over time.

To remove these limitations of the statutory financial organisations, Narashimham Committee has made some recommendations. In brief, they are as follows:

- The ownership pattern of these financial institutions should be broad-based.
- There should be autonomy of these institutions in matters of internal administrations.
- The link between the state-level financial institutions and the respective state governments should be broken.
- While granting loans, only the economic and technical aspects of the industrial unit should be considered.

The Government of India has accepted some of these recommendations and steps have been taken accordingly. Hence the quality of operations of these statutory financial institutions may be expected to improve in near future.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. What are the different types of capital required for an industrial unit?
2. What is fixed capital and what is working capital?
3. What do you mean by development bank?
4. Mention the names of some development banks operating in India.
5. What is meant by development financial institution?
6. Give names of some development financial institutions working in India.
7. Mention the names of all-India development banks for large industries.
8. Which all-India development banks provide credit to small-scale industries?

9. Give full forms of IFCI, IDBI and ICICI.
10. What are the full forms of SIDBI and NSIC?
11. Give names of some investment institutions operating in India.
12. What are the full forms of NIDC, TFCI and SCICI?
13. Give names of two sector-specific development banks of India.
14. Give full forms of TDICI, IDFC and SIDC.
15. What is a commercial bank?
16. What are pure financial intermediaries?
17. What is pure deposit system? Give an example.
18. What is the main difference between commercial banks and non-bank financial institutions?
19. What is the full form of IFCI? When was it established?
20. Mention two major objectives of the IFCI.
21. Give full forms of STCI and NBFC.
22. What is the full name of IDBI? When was it established?
23. Give the full form of SEBI and NSDL.
24. What are the full names of CARE and CRISIL?
25. When was the ICICI established? When did it merge into ICICI Bank?
26. Mention two major objectives of ICICI.
27. What were the main objectives of establishing IDBI?
28. Mention two major functions of the IFCI.
29. Describe two main functions of the IDBI.
30. State two major functions of the ICICI.
31. Give names of some subsidiaries of the ICICI.
32. What are the full forms of OTCEI and DFHI?
33. Mention two major criticisms against the IFCI.
34. State two major limitations of the activities of IDBI.
35. When was the EXIM Bank established? What are its major objectives?
36. State two major functions of the EXIM Bank.
37. Give the full forms of EOU and FTZ.
38. When was the SIDBI established? When did it start its operations?
39. What are the major objectives of the SIDBI?
40. Mention two major functions of the SIDBI.
41. When and where the first SFC was established?
42. What are the major functions of SFCs?
43. Mention two limitations of the activities of SFCs.
44. What is the full form of NABARD? When was it established?
45. What was the main objective of establishing NABARD?

46. State two major functions of NABARD
47. Give the full forms of ARDC and PACS.
48. What is the full form of RIDF? When was it first set up?
49. Mention two main criticisms made against the activities of the NABARD.
50. Mention some promotional activities undertaken by development banks of India.
51. State two major limitations of development banks working in India.
52. Mention two major recommendations made by Narashimham Committee in order to improve the activities of development banks of India.
53. State two recommendations of the Working Group of RBI in order to harmonise the activities of development financial institutions and banks.
54. Describe two major objectives of development banks.
55. When was ICICI merged into ICICI Bank? When was the IDBI converted into a public sector bank?
56. What do you mean by microfinance?
57. What are the major internal sources of finance of an industrial unit?
58. What are the main external sources of finance of an enterprise?

B. Medium Answer-Type Questions (4–5 marks each)

1. Briefly describe the major sources of finance for industrial units in India.
2. Make a suitable classification of various development banks operating in India.
3. Distinguish carefully between commercial banks and development banks of an economy.
4. Discuss the major objectives of development banks.
5. Describe the major functions of the IFCI.
6. Make a brief appraisal of activities of the IFCI.
7. Analyse the major objectives of the IDBI.
8. Discuss the various forms of financial assistance provided by the IDBI to industrial units in India.
9. What are the major limitations in the activities of the IDBI?
10. State the major objectives of the ICICI.
11. Briefly describe the major functions of the ICICI.
12. Write a short note on the actual performance of the ICICI.
13. Make a brief evaluation of the activities performed by the ICICI.
14. When was the EXIM Bank set up? What are its major objectives?
15. Briefly mention the major functions of the EXIM Bank of India.
16. Mention some new schemes undertaken by the EXIM Bank in recent years.
17. What is the full form of SIDBI? What are its major objectives?
18. Give a brief description of the functions of SIDBI.
19. Make an evaluation of actual performance of SIDBI as a development bank.

20. Make a critical evaluation of the activities of SFCs.
21. Mention the major functions performed by the NABARD in India.
22. Critically examine the activities of the NABARD as the apex body for supplying rural credit.
23. Discuss the role of development banks in the industrial progress of India.
24. Describe the promotional activities of development financial institutions of India.
25. What are the major limitations of activities of development banks in India?

C. Long Answer-Type Questions (10 marks each)

1. Describe the major sources of finance for industrial units in India. **(Section 3.2)**
2. Define commercial banks and development banks. Make a distinction between these two types of financial institutions. **(Section 3.4)**
3. Describe the objectives, functions and limitations of the IFCI. **(Section 3.5)**
4. Discuss the role of the IFCI in providing finance to the industrial sector of India. **(Sections 3.5.4 & 3.5.5)**
5. Describe the evolving role of the IDBI in providing assistance to the industrial concerns in India. **(Section 3.6.4)**
6. Discuss the major functions of the ICICI and evaluate its actual progress in performing those functions. **(Sections 3.7.3 & 3.7.4)**
7. Analyse the role of EXIM Bank in providing financial assistance to exporters and importers in India. **(Sections 3.8.3 & 3.8.4)**
8. Discuss the role of Small Industries Development Bank of India (SIDBI) in supplying credit to the small-scale units. **(Sections 3.9.2 & 3.9.3)**
9. Describe the functions and analyse the performance of SFCs in providing financial assistance to the small and medium-sized industrial units. **(Sections 3.10.3 & 3._10.4)**
10. Discuss the functions and working of NABARD. **(Sections 3.11.3 & 3.11.4)**
11. Critically examine the role of NABARD in providing finance to the rural sector of India. **(Sections 3.11.4, 3.11.5 & 3.11.6)**
12. Make an overall evaluation of development banks in providing finance to the industrial sector of India. **(Section 3.12)**

UNIT

4 OTHER FINANCIAL INSTITUTIONS

UNIT OUTLINE

SUBJECT MATTER OF THE UNIT

In Unit 3, we have considered the role and functions of some all-India development banks such as IFCI, ICICI, IDBI, NABARD, and SIDBI, and also state-level institutions such as State Financial Corporations (SFCs). There are some other financial institutions operating in India; two important types among them are insurance companies and mutual funds. These are popularly called investment institutions. Insurance companies collect large funds through premiums of their insurance policies and provide finance to the industrial sector. They are basically of two types: life insurance companies and general insurance companies. Life insurance companies insure life of their customers whereas general insurance companies insure different assets of their customers. In this unit, we shall discuss the role and functions of the Life Insurance Corporation of India (LICI) and those of the General Insurance Corporation of India (GICI) and its subsidiaries. The second type of financial institutions are those investment companies which try to mobilise savings of small savers by selling units of small denominations and channelise those savings to productive

(*Contd.*)

investment and are called mutual funds. The Unit Trust of India (UTI) is the premier mutual fund in the country. We shall discuss the role and functions of the UTI in this chapter in providing finance to the industrial sector of India. We shall also consider some recent reforms introduced in the insurance sector of India.

4.1 INTRODUCTION

In the previous unit, we discussed about development banks or development finance institutions (DFIs). These banks mostly get funds from the government or the Reserve Bank of India and they use these funds to provide finance to business and industrial units. Apart from these DFIs, there are two types of institutions who collect the small savings of the savers and invest them in business and industrial units. They may be called investment institutions. One of them is insurance companies and the other is mutual funds.

There are different risks associated with a business for which the unit may suffer losses. There are also possibilities of sudden accidents resulting in losses. Insurance is one way to compensate these losses. Basically, insurance is a contract by which an individual or a firm promises to compensate the losses incurred due to an accident or promises to pay a fixed amount of money after a stipulated period of time to another individual or firm in return to the periodic payment of a fixed sum of money. The individual or institution who commits to pay compensation is known as the insurer, whereas the individual or institution who receives the compensation is known as the insured. The document of contract is called the insurance policy and the periodic payment made by the insured is known as insurance premium.

Insurance may be of two types—general insurance and life insurance. When the purpose of insurance is to protect against the loss of property due to accident, it is known as general insurance. Compensation is paid only if the loss of property takes place. For this reason general insurance is known as the **contract of indemnity**.

Insurance on the life of a person is known as life insurance. In the case of life insurance, the insured person pays premium to the insurer for a pre-determined term. In return, the insured person gets an assured sum of money after the pre-determined term. In the event of death of the insured person, the heir of the insured or his nominee receives the assured sum of money. Thus, life insurance is not a contract of indemnity but a **contract of assurance**.

Insurance companies collect savings from their customers through premiums and invest those funds to business or industrial units. A mutual fund also collects small savings from the savers by selling claims on it, named as units. The units of the mutual fund are secondary securities created by the mutual fund as claims on itself. The mutual fund invests these funds in a diversified portfolio and earns profit. From this profit, unit holders are given dividend. The unit holders can also get back money by selling the units to the mutual fund. In this way, the savings of the unit holders are mobilized by the mutual fund and invested in the capital market.

We shall now consider these two types of institutions one by one in the Indian context. We shall first consider insurance institutions in India. Then we shall consider the premier mutual fund institution in India—the Unit Trust of India (UTI).

4.2 MEANING AND IMPORTANCE OF INSURANCE

Insurance may be defined as a contract wherein one party (the insurer) agrees to pay to the other party (the insured) or its beneficiary, a certain sum upon a given contingency (the risk) against the payment of some premium by the insured. In other words, insurance is a contract between the insurer and the insured under which insurer indemnifies (compensates) the loss of the insured) against the identified perils for which mutually agreed upon premium has been paid by the insured. The contract lays down the time framework within which the losses will be borne by the insurer. The document that embodies the contract or the terms and conditions, is called a policy.

Insurance is basically of two types: life insurance and general insurance. In case of life insurance, the insurer bears the risk of life of the insured against the payment of some premium by the insured to the insurer. On the other hand, in case of general insurance, the insurer bears the risk of anything other than life of the insured. General insurance covers insurance of health, accident, theft, riot, earthquake, fire, and so on. Companies dealing in life insurance are called life insurance companies. On the other hand, companies dealing in any field other than life of the insured are called general insurance companies.

Insurance sector plays a vital role in the process of economic development of a country. It mobilises savings through premiums of insurance and channelises those savings to productive investment. It thus helps in capital formation of an economy. Further, insurance facilities help trade, commerce and industry by reducing insurable risks. Again, this sector acts as a financial intermediary. The funds pooled through premiums are provided to the industrial sector for its expansion and development.

4.3 NATURE OF INSURANCE COMPANIES

Business organisations or companies offering insurance service may simply be called insurance companies. They are basically financial intermediaries as they collect huge funds of premiums from the insured persons and invest those funds in different companies. They offer protection to the investors, provide means for accumulating savings and channelise funds to different sectors of the economy. They are, more specifically, contractual saving agencies. They receive a steady flow of funds in the forms of premiums of regular contributions to pension plans. These insurance companies also know, almost accurately, when and what amounts of insurance of pension benefits have to be paid. Further, their liabilities in most of the cases are long-term liabilities, as many life policies held for 20–30 or even more years. As a result, liquidity is not a problem for the insurance companies. Their major activity is in the field of long-term investment. The life insurance companies insure lives of their customers whereas general insurance companies insure different assets of their customers. Since the life insurance companies offer life-cover to the investors, the guaranteed rate of return specified in their insurance policies is relatively low. Therefore, they do not need to seek high rates of return of their investments. For all these reasons, investments of insurance companies are largely made in government bonds, mortgages, state and local (municipal) government claims and corporate bonds.

Today, insurance companies are active in different fields—life, health, accident, theft, riot, fire and in many other fields of life. Recently, they have begun to operate the pension schemes and mutual funds also. Insurance business consists of spreading risks over time and sharing them between persons and organisations. The major part of insurance business is life insurance. Its operation depends on the law of mortality. The distinction between life insurance business and general insurance business is that in the case of the former the claim is fixed and certain, but in the case of the latter, the claim is uncertain, *that is*, the amount of claim is variable and is ascertainable only sometime after the event. Pension business is a special form of life insurance. In this scheme, the customer makes regular contributions to a certain pension plan for a given period and gets monthly/quarterly/half-yearly/annually a pension amount till death and a lump-sum amount on death as per the pension plan.

4.4 STRUCTURE OF INSURANCE BUSINESS IN INDIA

Various insurance companies operate at present in India. Insurance business in India may basically be divided into two categories: (1) life insurance business and (2) non-life insurance business. In both categories, we have public sector company/companies and private sector companies. The structure of insurance business in India has been shown in Figure 4.1.

Let us discuss the major companies or players operating in different fields of insurance business in India.

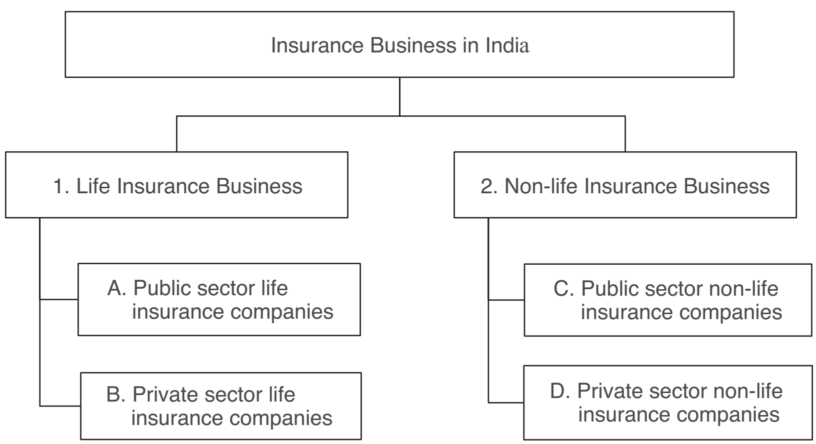


Figure 4.1 Structure of insurance business in India

4.4.1 Public Sector Life Insurance Companies

In this category, we have only one company, namely, Life Insurance Corporation of India (LICI).

4.4.2 Private Sector Life Insurance Companies

Before the adoption of the liberalisation policy in 1991, life insurance business in India was a state monopoly. The Life Insurance Corporation of India (LICI) enjoyed this monopoly position. However, after 1991, many private companies have been allowed to do life insurance business in India.

Important companies in this field are as follows:

- Aviva Life Insurance Company of India Pvt. Ltd.
- ICICI Prudential Life Insurance Company Ltd.
- OM Kotak Mahindra Life Insurance Company Ltd.
- Allianz Bajaj Life Insurance Company Ltd.
- Birla Sun Life Insurance Company Ltd.
- ING Vaisya Life Insurance Company Ltd.
- Met Life Insurance Company Ltd.
- AMP Life Insurance Company Ltd.
- HDFC Standard Life Insurance Company Ltd.
- Max New York Life Insurance Company Ltd.
- SBI Life Insurance Company Ltd.
- Tata AIG Life Insurance Company Ltd.

4.4.3 Public Sector Non-Life Insurance (General Insurance) Companies/Reinsurance Company

In this category, we have the following companies.

- General Insurance Corporation of India (GICI): From 2002, it has been working exclusively as a re-insurance company. The GICI had four subsidiaries up to the year 2002.
  - (i) The National Insurance Company Ltd.
  - (ii) The New India Assurance Company Ltd.
  - (iii) The Oriental Fire and General Insurance Company Ltd.
  - (iv) The United India Insurance Company Ltd.

However, after 2002 the four erstwhile subsidiaries are now carrying on general insurance business as independent companies. Two other general insurance companies in the public sector are:

- Employees State Insurance Corporation
- Agricultural Insurance Corporation

4.4.4 Private Sector Non-Life Insurance (General Insurance) Companies

In this category, the major companies are as follows:

- Bajaj Allianz General Insurance Company Ltd.
- HDFC-Chubb General Insurance Company Ltd.
- Cholamandalam MS General Insurance Company Ltd.
- ICICI Lombard General Insurance Company Ltd.
- IFFCO Tokyo General Insurance Company Ltd.
- Royal Sundaram Allianz Insurance Company Ltd.
- Reliance General Insurance Company Ltd.
- Tata AIG General Insurance Company Ltd.

For carrying out some reforms in the insurance sector, the Government of India appointed a committee headed by former Finance Secretary and RBI Governor R.N. Malhotra. The committee, known as Malhotra Committee (1993), recommended the liberalisation of the insurance industry. Following that recommendation, the Government of India opened the insurance sector to the private capital. Hence, today many private companies are operating in both life insurance business and general insurance business in India.

4.5 A BRIEF HISTORY OF INSURANCE BUSINESS IN INDIA

The systematic life insurance business in India started first in the year 1818. In that year, the Oriental Life Insurance Company was established in Kolkata. In the other hand, the general insurance business was started much later in the year 1850. In that year, the Triton Insurance Company Ltd. was established by the British in Kolkata. It was the first general insurance company in India. During that period, insurance was done mainly for transportation of goods on ships.

Though life insurance business in India started as early as in 1818, there was no specific law to regulate and control this business for a long period. Only in 1912, the Indian Life Assurance Companies Act was enacted. It was the first statute to regulate the life insurance business in India. In 1928, the government enacted the Indian Insurance Companies Act. Its objective was to enable the government to collect data on both life and non-life insurance businesses. In 1938, a considerable improvement in terms of legislation took place in the field of insurance business. The earlier legislations were consolidated and amended by the Insurance Act, 1938. Its objective was to protect the interests of the insuring persons.

In the case of general insurance business also, the second important company came up only after a period of 57 years. In 1907, the Indian Mercantile Insurance Ltd. was set up to conduct all classes of general insurance business. In order to ensure fair conduct and sound business practices, the General Insurance Council, a wing of the Insurance Association of India, framed a code of conduct in the business of general insurance.

In 1956, the Government of India took over 245 Indian and foreign life insurance companies and provident societies. Taking them together, the government established Life Insurance

Corporation of India (LICI) under the public sector by an Act of Parliament, namely, Life Insurance Corporation Act, 1956. Thus, the life insurance business in India was nationalised in the year 1956. Similarly, in the field of general insurance, the government enacted the General Insurance Business (Nationalisation) Act, 1972 and nationalised the general insurance business in India with effect from 1 January 1973. In this scheme, 107 general insurers were amalgamated and grouped into four companies. These four companies are the National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Fire and General Insurance Company Ltd. and the United India Insurance Company Ltd. The General Insurance of India (GICI) was registered as a government holding company in the same year.

Both the LICI and the GICI enjoyed monopoly right in conducting their business up to the year 1991. India adopted the policy of liberalisation in that year. The Government of India introduced a series of reforms in the financial sector. To examine the reforms in the insurance sector, it appointed Malhotra Committee in April 1993. As per the recommendation of this committee, the monopoly position in the Indian insurance market was broken and it was made competitive by opening up the market to both domestic and foreign companies. As a result, there are so many private companies, both Indian and foreign, operating in life and non-life insurance businesses. The LICI is still, however, the single nationalised company in the field of life insurance business. Further, as per recommendations of the Malhotra Committee, the GICI now ceases to be the holding company regulating its subsidiaries. Its four subsidiaries now function as independent companies on their own. The GICI at present functions exclusively as a re-insurance company. Its four former subsidiaries now carry out general insurance business. This has been effective after the enactment of General Insurance Business (Nationalisation) Amendment Act, 2002 following the recommendations of the Malhotra Committee (1993).

4.6 LIFE INSURANCE CORPORATION OF INDIA (LICI)

The Life Insurance Corporation of India (LICI) was set up under the LIC Act, 1956. In that year, the life insurance business was nationalised. The Government of India took over the assets and liabilities of 245 private insurance companies engaged in the conduct of life insurance business in India. In order to implement the second 5-year plan, the Government of India felt the necessity of mobilising resources. In addition, it felt the necessity to stop various illegal and corrupt practices of private life insurance companies. To achieve these twin goals, the Government of India promulgated an ordinance on 12 January 1956 and nationalised the life insurance business in India. On 1 September 1956, the Life Insurance Corporation of India was formed as an autonomous organisation. It is a statutory corporation.

4.6.1 Main Objectives of Establishing LICI

The main objectives of establishing the Life Insurance Corporation of India may be summarised as follows:

- To remove undesirable competition among various private life insurance companies

- To mobilise small savings of the people through insurance-linked savings schemes
- To spread life insurance and provide life insurance protection to the masses at reasonable cost
- To conduct business with maximum economy and to raise efficiency through amalgamation of many private companies
- To invest the funds to serve the best interest of both the policy holders and the nation
- To act as trustee of the policy holders and protect their individual and collective interest
- To innovate and adapt to meet the changing life insurance needs of the community
- To stop the wastage and misuse of insurance funds and so on

4.6.2 Financial Resources of LICI

The amount of paid-up capital of the LICI was ₹5 crore. The entire amount has been provided by the Government of India. In the year 1956, the LICI received the monopoly right of conducting life insurance business in India. In addition, it was also authorised to run life insurance business in some foreign countries, such as, Malayasia, Hong Kong, Singapore and so on. However, at present, the LICI does not enjoy monopoly in life insurance. In the new industrial policy of 1991, the government has opened the insurance sector and, as a result, many indigenous and foreign companies have come into existence and are still making a foray into the insurance sector in India. The LICI is, however, the only nationalised company operating in the life insurance business in the country.

4.6.3 Management and Organisation of LICI

The LICI was formed as a wholly owned government corporation. Its initial capital of ₹5 crore was exclusively provided by the Government of India. The LICI is managed by an autonomous board of directors consisting of 15 directors appointed by the Government of India. The Union Government has given some special powers to the board to conduct business on commercial basis. However, the government gives some general instructions to the board in the matter of management of the LICI.

The Chairman and the Managing Director are full time chief executives of the corporation. The board appoints an executive committee that look into the affairs of the corporation.

The organisational structure of the LICI has been built upon the basis of some regional or zonal divisions. The central office or the head office of the LICI is in Mumbai. It has eight zonal offices at Mumbai, Kolkata, Delhi, Patna, Chennai, Hyderabad, Kanpur and Bhopal. They operate through more than 100 divisional offices in important cities and more than 2000 branch offices. With about 12 lakh agents, the LICI has the largest field organisation in the country. It has foreign offices in the United Kingdom, Mauritius, Fiji and so on.

4.6.4 Functions and Investment Policy of LICI

The main function of the LICI is to run life insurance business. It insures the life of its customers or policy holders. During the insured period, if the policy holder dies, the corporation pays the insured amount to the nominee of the policy holder. If the policy holder remains alive, the corporation pays him/her a specified amount on specified date. In exchange, the LICI takes premium from the policy holder. The fund collected in the form of premium is invested in shares and debentures of different public and private enterprises. The LICI provides long-term finance to small-, medium- and large-scale industries. Further, it takes the responsibility of selling shares and debentures of different industrial units. It has also contributed to the initial capital of different development financial institutions, such as State Financial Corporations (SFCs), National Industrial Development Corporation (NIDC), Unit Trust of India (UTI) and so on. The LICI supplies funds to the corporate enterprises in three forms:

(i) Subscription to shares and bonds of development financial institutions
(ii) Direct lending to different industries
(iii) Purchase of securities of joint stock companies from the industrial securities market

In 2000–2001, the LICI sanctioned financial assistance in the tune of ₹10,867 crore whereas actual disbursement was ₹7,095 crore. In 2013–2014, the LICI sanctioned financial assistance to the amount of ₹34,212 crore whereas actual disbursement was ₹30,378 crore. These amounts were roughly one-third of total assistance sanctioned and disbursed by all financial institutions taken together. This information indicates that the LICI has emerged as the most important financial institution in the country. This assistance has been provided in the following forms:

- Term loans
- Underwriting and direct subscriptions in the forms of equity and preference shares and debentures
- Resource support to financial institutions

The LICI has tried to earn sustained and guaranteed income for its policy holders. Hence, it has preferred investment in debentures over equity shares. Again, the LICI has sanctioned financial assistance mainly to the public sector units. Out of the total investments of ₹1,39,059 crore made by the LICI up to March 2000, the public sector received the major share. It obtained ₹1,17,088 crore (84.2 per cent) whereas private sector got ₹19,844 crore (14.3 per cent). The balance (only 1.5 per cent or ₹2,127 crore in absolute terms) went to co-operative sector and joint sector. Thus, the major beneficiary of investments made by the LICI is the public sector.

We may summarise the functions of the LICI in the following manner:

1. Direct assistance to industries
   - The LICI provides finance to industries directly. This is done by purchasing shares and debentures and also by underwriting shares and debentures.
   - It grants term loans for setting up industrial estates.
   - It provides resource to financial institutions which, in turn, give finance to industries.
2. The LICI provides insurance cover to numerous policy holders.
3. It collects small savings of the people in the form of premium and again invests that sum in other fields.
4. The LICI provides finance for housing through HUDCO (Housing Urban Development Corporation), housing boards, housing co-operatives and so on.

5. It provides necessary service to all the policy holders, for example, settlement of claim, loans to policy holders and so on.
6. The LICI has established four major subsidiaries:
   - LIC Housing Finance Ltd (LIC HFL)
   - LIC Mutual Fund (LIC MF)
   - LIC (Nepal) Ltd.
   - LIC (international) E.C. Bahrain

The LICI has introduced Group Insurance Scheme for office employees. It has introduced a large variety of life insurance policies, such as, Jeevan Shree, Jeevan Asha, Jeevan Sneha, Jeevan Suraksha, Jeevan Mitra, Jeevan Sanchay, Bima Nivesh, Children's Money Bank, and so on.

4.6.5 An Evaluation of the Functions and Investments Policy of LICI

Various functions of the LICI have significantly helped the industrial sector of Indian economy in the following major ways:

First, the LICI has provided financial assistance to the state electricity boards and power corporation for power generation projects. It has also allocated funds for the development of roads, railways and air transport. The LICI has thus significantly helped in the development of infrastructure of the country.

Second, the LICI has helped in mobilising savings and channelising those savings to productive activities. It has thus helped in capital formation.

Third, the LICI has invested money in the capital market in debentures and shares of central and state government securities. On the one hand, it has helped the government to pursue its various developmental activities and on the other hand, it has contributed to the development of the capital market of India. The LICI has also helped in the establishment of various development financial institutions, such as, SFCs, NIDC, UTI and so on. All these have provided indirect help to the corporate sector.

Fourth, the LICI has evolved as a major financial institution to provide mortgage loans for housing.

Most importantly, as we have already mentioned, the main function of the LICI is to provide industrial finance. This is done mainly in three forms: (i) subscription to shares and bonds of various development financial institutions, (ii) direct finance to industries in the form of loans, and (iii) subscription to the shares and debentures of industrial units.

All these have gone a long way in the development of the industrial sector in particular and of the Indian economy in general. However, if we take a close look at the forms of financing made by the LICI, we get two major features:

First, there was a phenomenal increase in the subscription to shares and bonds of development financial institutions (DFIs) and direct lending to the industry. **Second**, there was a decrease in the purchase of industrial securities made by the LICI. The capital market activity of the LICI in terms of security purchase has declined after mid-1980s. This has serious implications for the financial system in India and for the interest of policy holders. Let us explain our viewpoint.

An efficient financial system must have the ability to discharge the two-fold functions of collection and channelisation of savings simultaneously. If we judge in this light, then the DFIs in India played a rather limited role, and the system of industrial financing in India could not grow *pari passu* with the growth of the industry. This is because the DFIs are merely distributive agencies. They passed on the funds obtained from the RBI and the government to the industrial sector and practically did nothing to mobilise them. Further, most of the funds provided to industrial units by the DFIs are in the form of loans. Hence, reliance on them created a heavy dose of debt in the financial structure of the joint stock companies. This has made the capital structure of these industrial concerns lopsided, jeopardising their very future. So, it may be stated that the LICI be permitted to follow an independent investment policy commensurate with the requirements of the emerging financial system in India.

Further, the passive investment policy followed by the LICI is also detrimental to the interest of its policy holders. Though the yield on the LICI investments somewhat rose over the years, it is considerably lower as compared to the yields or returns from other investments. Many allege that the LIC policy holders have not received a fair deal. They argue that the policy holders pay high premium rates but receive low bonus rates. It is alleged that the LICI has misused its monopoly position for a fairly long period. Many argue that high premium rates of the LICI are not related to the actual mortality rates. Although mortality rates have gone down over the years, the rates of premium have not been reduced. The LICI, as the monopolist in life insurance business till 1990s, has thus exploited its customers. Again, the LICI has to follow a pattern of investment stipulated by the Government of India. It has to provide funds to the priority sectors and to the government. This has led to a lower rate of return from investments on the life insurance policies. Due to its low returns, the LICI in recent years is at a disadvantage while competing with other saving agencies. In the era of liberalisation, it should be allowed to invest the funds of its policy holders in such a way that their interests are primarily served, that is, the policy holders get an equitable return compared to returns from investments in other sectors.

4.6.6 Recommendations of Malhotra Committee

The Government of India has adopted the policy of liberalisation in its New Industrial Policy, 1991. Various economic reforms have taken place since then. There have been various reforms in the financial sector also. As a part of financial sector reforms, the issue of reforms in insurance sector also came up. There have been some allegations against the Life Insurance Corporation of India. For example, it has been alleged that the LICI has not been permitted to follow an independent investment policy. Further, the yields on investments on life insurance policies are considerably low. It is alleged that the LICI has misused its monopoly position till recently and exploited its customers. In this context, the Government of India appointed Malhotra Committee in April 1993 to examine the issue of insurance sector reforms. The Committee submitted its report in January, 1994. In this report, the Malhotra Committee made some suggestions. The major recommendations of this Committee in relation to LICI may be summarised as follows:

- The Malhotra Committee recommended a modification in the existing pattern of investments of the LICI. According to the Committee, there is a need for reducing directed investment. Otherwise the returns on investment of the LICI will continue to be low.
- The role of branches as the single point of service and contract for consumers should be strengthened. This will raise the quality and the efficiency of service.
- Computerisation for handling business at all levels and the development of an effective management information system should be completed within 12–18 months.
- The LICI ownership pattern should be changed so that the shareholding of the government is reduced to 50 per cent.
- The initial paid-up capital of the LICI was ₹5 crore. This was contributed entirely by the Government of India. This capital should be raised to ₹200 crore. The government would hold 50 per cent thereof and the remainder would be held by the public, including the employees for whom a suitable proportion may be reserved.
- All provisions of the Insurance Act, 1938 should apply to the LICI and the special treatment meted out to it under the Act should be ceased.

Most importantly, the Malhotra Committee recommended that the insurance sector should be opened up to the private companies also. However, no single company whether Indian or foreign, should be allowed to transact both life and general insurance business. The entry of foreign companies should be permitted on selective basis and they should be required to float an Indian company in a joint venture with an Indian partner.

Thus, the Malhotra Committee recommended the liberalisation of the insurance industry. It argued that the insurance sector should be opened up to competition for the following reasons:

- Competition would result in better customer service and help improve the variety and prices of insurance products.
- The entry of new companies into the insurance sector would speed up the spread of both life and general insurances.
- The nationalised insurance sector is financially strong. It has also built up a large infrastructure in terms of professional talent, marketing and servicing. Hence, it is in a position to force competition from private sector.
- In the era of liberalisation, there is a growing competition within the banking sector. There is little reason for keeping insurance as a monopoly. Hence, the private sector should also be allowed to enter the insurance business.

For all these reasons, the Malhotra committee has recommended the liberalisation of the insurance industry. However, with proposal of libralisation of the insurance sector and the entry of private sector, the need for greater regulation has arisen. The Malhotra Committee recommended the following regulations on the insurance sector:

- The office of the Controller of Insurance should be restored to its full functions as stipulated.
- The legislation and government notification exempting the LICI and the GICI from several provisions of the Insurance Act should be withdrawn.
- Steps should be taken for the establishment of a strong and effective Insurance Regulatory Authority (IRA) as a statutory autonomous board. Some of the main functions of the IRA would be as follows:
  - Consumer protection
  - Monitoring the performance and quality of insurance
  - Ensuring compliance with the prescribed norms and pattern of investments
  - Ensuring transparency of balance sheets of insurance companies
  - Detecting badly managed, unhealthy or failing insurers and to take corrective action and so on.

4.6.7 Follow-Up Actions

Most of the recommendations of the Malhotra Committee have been accepted by the Government of India. The recommendations regarding revised investment norms have been implemented with effect from 1 April 1995. Following the recommendations of the Malhotra Committee, the Government of India approved the setting up of an interim IRA (Insurance Regulatory Authority) on 23 January 1996. The enactment of a comprehensive legislation was then pending. Finally, in 1999, Insurance Regulatory and Development Authority Act was passed. As a result, the Insurance Regulatory and Development Authority (IRDA) was established in 1999. It would work to protect the interests of the policy holders and to regulate, promote and ensure orderly growth of the insurance industry. It may be expected that all these measures would bring more prosperity to the LICI.

4.6.8 Concluding Remarks

So far, the LICI has played a vital role in mobilising small savings of the middle-class and lower middle-class families and in channeling those funds to the industrial sector. Excluding the initial years of the LICI, its efficiency and scope of activities has increased over the years. It has entered in the financing of socially oriented schemes such as housing, other schemes of state government, statutory authorities, co-operatives, electricity boards and so on. The LICI has diversified its activities considerably in the recent past. It has established (i) LIC Housing Finance Ltd (LIC HFL), (ii) LIC Mutual fund (LIC MF), (iii) Jeevan Bima Sahayog Asset Management Company (JBS AMC) Ltd. and (iv) LIC (International) E.C. Bahrain—a joint venture off-shore company.

However, it must be admitted that there is further scope to expand life insurance business in India. The activities of the LICI are generally confined to urban areas and among the service holders. Its activities have not expanded considerably in rural areas. So, there is further scope of expanding life insurance business in India. Another point may be mentioned in this connection. Up to 1991, the LICI has enjoyed monopoly. But now, many new companies, both domestic and foreign, have entered into the insurance business. In the coming days, more companies are expected to join this sector. As a result, competition in life insurance business will increase day-by-day. In this new environment of increased competition, the LICI will have to prove its efficiency by reducing cost on one hand and raising the quality of service on the other. Only then it will continue to hold the prime position in the life insurance business in India.

4.7 GENERAL INSURANCE CORPORATION OF INDIA (GICI)

The general insurance business was nationalised by the Government of India in 1971. A government company known as General Insurance Corporation of India (GICI) was formed by the central government in November 1972. This Corporation was given the right of doing general insurance business and of regulating it.

4.7.1 Organisational Set-up of GICI

Before nationalisation in 1971, there were 107 companies (both Indian and non-Indian) doing general insurance business in India. In 1971, the business of these organisations was nationalised and it was vested in the hands of the General Insurance Corporation of India (GICI) in November 1972. The GICI was registered as a company under the Companies Act, 1956. Up to the year 2002, it had four subsidiaries which were as follows:

(i) The National Insurance Company Ltd., Kolkata,
(ii) The New India Assurance Company Ltd., Mumbai,
(iii) The Oriental Fire and General Insurance Company Ltd., New Delhi.
(iv) The United India Insurance Company Ltd., Chennai.

In the year 2002, the Government of India enacted the General Insurance Business (Nationalisation) Amendment Act, 2002. By this Act, GICI was delinked from its four subsidiaries. It was stated that the GICI would undertake only refinance business and cease to carry out general insurance business. The four former subsidiaries would carry on general insurance business. The GICI now acts exclusively as a re-insurer company.

Before 2002, all the four subsidiaries of the GICI operated all over the country competing with one another and involved in various segments of general insurance business. They operated on all-India basis through regional, divisional and branch offices. In 1973, it had 799 offices. In March 1998, the network of GICI consisted of 4208 offices.

4.7.2 Financial Resources of GICI

The amount of authorised capital of GICI was ₹75 crore on 31 March 1990. This capital was divided into 75 lakh shares of ₹100 each. The amount of paid-up capital of the GICI was ₹64.5 crore. This capital was divided into 64.5 lakh shares of ₹100 each.

4.7.3 Objectives of GICI

The objectives of the GICI are as follows:

- To maximise investment income of the corporation
- To ensure safety and liquidity of funds of customers
- To deploy financial resources as per national objective and priorities

4.7.4 Investment Policy of GICI

According to the government guidelines, 70 per cent of the fund collected by the GICI is to be invested in socially oriented industries. The major beneficiaries were the central and state governments, housing and urban development corporations, local governments and so on.

4.7.5 Functions of GICI

The main function of the General Insurance Corporation of India is to insure and re-insure the air travel of different aviation companies. In addition, the corporation also does crop insurance on behalf of the government. The four subsidiary companies of the corporation run general insurance business all over India. For this purpose, these subsidiaries have their offices in different places of India. The subsidiary companies run general insurance business in foreign countries also.

The main source of income of the GICI is the premium paid by its policy holders. The gross direct premium income of the general insurance industry was ₹8759 crore in 1998–1999. The GICI provides finance to different industrial units out of this premium income. The investment policy of the GICI and its subsidiaries is defined in the Insurance Act, 1938 and the guidelines issued by the government from time to time. Investments are made with a view to maximising the investment income, ensuring safety and liquidity of funds and consistently following national priorities. During 1999–2000, the GICI and its subsidiaries sanctioned financial assistance to the tune of ₹2142 crore. The actual disbursement in that year was ₹1968 crore. In the year 2012–2013 financial assistance sanctioned and disbursed by the GICI alone both stood at ₹1766 crore.

Before becoming a re-insurer company, the scope of activities of the GICI considerably increased. For example, it managed Comprehensive Crop Insurance Scheme introduced by central government in 1985. It also operated cattle and livestock insurance scheme. The GICI met the requirements of industrial, manufacturing, commercial, services, household and agricultural sectors through a wide range of products, granting insurance coverage. Rural insurance and agricultural insurance schemes were developed so that even the poor could avail of the insurance coverage at affordable cost. The GICI promoted personal insurance cover in the fields of livestock, poultry, sericulture, pisciculture, horticulture, pump sets and personal accidents.

The GICI also introduced new policies, such as, Personal Accident Policy for visitors in bank premises, mediclaim, Householders' Comprehensive Insurance Policy, Professional

Indemnity Insurance, Rejection Insurance on Marine Products, and so on. Other activities of the GICI included GIC Mutual fund, GIC Griha Vitta Ltd., Loss Prevention Association of India Ltd. and the National Insurance Academy.

We may summarise the functions of the GICI in the following manner:

- The GICI has carried general insurance business up to the year 2002. After that it acts as a re-insurer.
- It has assisted and advised the companies to conduct general insurance business.
- It has encouraged competition among companies to render efficient services.
- It has participated in consortium financing with other financial institutions by providing term loans and by underwriting of shares.
- The GICI has developed non-traditional business and tried to spread general insurance to rural areas.
- It has introduced new schemes like cattle insurance, agriculture pump set insurance, Janata Personal Accident Insurance and so on.
- The GICI set up the Loss Prevention Association of India in 1978. It has provided advisory and consultancy services to industrial organisations. It has also provided information on loss prevention by means of technical manuals and brochures.

4.7.6 Some Reforms: Recommendations of the Malhotra Committee

India has adopted the policy of liberalisation since 1991. There have been various economic reforms. As a part of financial sector reforms, the monopolistic insurance market in India is sought to be made competitive by opening up the insurance sector to the domestic as well as foreign companies. To examine the issue of insurance sector reforms, the Government of India appointed a committee in April 1993 known as the Malhotra Committee. The Committee submitted its report in January 1994. The **major recommendations of the Committee** regarding the insurance sector in general and the GICI in particular were as follows:

- The GICI should cease to be the holding company. Its four subsidiaries should function as independent companies on their own. The GICI should function exclusively as a re-insurance company.
- The private sector should be allowed entry in insurance business, but no single company, whether Indian or foreign, should be allowed to transact both life and general insurance business, and the number of new entrants should be controlled. The minimum paid-up capital for a new entrant should be ₹100 crore.
- The entry of foreign companies should be done on selective basis and they should be required to float an Indian company in a joint venture with an Indian partner.
- The capital of the GICI should be raised to ₹200 crore. Fifty (50) per cent of this amount should be held by the government and the remainder should be held by the public at large including GICI employees for whom a suitable proportion may be reserved.
- The capital of each of the GICI subsidiaries (₹40 crore) was held by the GICI. The government should acquire this capital of each subsidiary from GICI. Further, the

capital of each subsidiary should be raised to ₹100 crore and its holding distribution should be similar to that of GICI.

- Regulatory, prudential norms and conditions should be finalised to ensure level-playing fields among insurer companies. Further, these norms should ensure that insurers do not neglect the small man or the rural business.
- The LICI and the GICI should operate as board-run enterprises.
- The office of the Controller of Insurance should be restored to its full functions. Steps should be taken for establishing a strong and effective Insurance Regulatory Authority (IRA) in the form of a statutory autonomous board on the lines of the SEBI. The private sector should be allowed entry only after the IRA starts functioning.

The Malhotra Committee proposed the following modified investment pattern for GICI:

(i) In central government securities, not less than 20 per cent.
(ii) In state government securities and government-guaranteed securities inclusive of (i), not less than 35 per cent.
(iii) In 'approved investment' including (ii), not less than 55 per cent.

4.7.7 Follow-up Actions Taken by the Government

The Malhotra Committee proposed far-reaching changes in the investment patterns and organisation structure of the GICI. The Government of India has implemented most of the major recommendations of the Malhotra Committee. The general insurance business has been opened to the private capital. The GICI does no longer enjoy monopoly in general insurance business. Many domestic–foreign joint ventures have now been operating in this sector. The recommendations regarding revised investment norms have been implemented with effect from 1 April 1995. A statutory Insurance Regulatory Authority (IRA) has been set up. The Insurance Regulatory and Development Authority Act (IRDA) was enacted in 1999. Its objective is to protect the interest of the insurance policy holders and to regulate, promote and ensure orderly growth of the insurance industry. The GICI has been designated as the Indian Re-insurer to function exclusively as a re-insurance company. It has been delinked from its four subsidiaries. These subsidiaries now run general insurance business. The GICI is no longer a general insurance company and has ceased to be a holding company of its subsidiaries. The ownership of the subsidiaries has been vested with the Government of India. The GICI provides general insurance direct to the general insurance companies in the Indian market, that is, it works as a re-insurer in India. It is also operative in countries in Afro-Asian region. It is also operating with some general insurance business in SAARC countries, Southeast Asia, Middle East and Africa.

4.7.8 Conclusion

The GICI has so far played an important role in providing finance to the government and semi-government enterprises with the recent reforms, the GICI may be expected to perform even better role in providing finance to the industrial units and better service to its policy holders. However, the GICI has enjoyed monopoly position in general insurance business in India for a fairly long period. But after the financial reforms, many domestic and foreign companies are making a foray into the insurance sector. So, competition in insurance business will continue to increase day-by-day. The GICI will have to prove its efficiency in the new era of liberalisation and increased competition.

4.8 A BRIEF NOTE ON MUTUAL FUNDS

4.8.1 The Concept

A mutual fund is a financial institution that raises money from the savers through sale of its units to the public and invests these collected funds in private and government securities. Simply speaking, a mutual fund collects the savings from small investors, invests them in government and other corporate securities and earns income through interest, dividends and capital gains.

A mutual fund works on the principle of 'small drops of water make a big ocean'. The small saving of a small saver is not enough for investments. But if the savings of a large number of small savers are pooled together, it makes a large fund. This fund can be invested in different types of shares and bonds. Thus it can reduce risk by diversification and can enjoy the economies of large-scale investment. Hence, a mutual fund is nothing but a form of collective investment through an investment company or a trust. These mutual funds are called Unit Trusts in the United Kingdom and Investment Companies in the United States. They pool funds by selling their own shares (units) and reduce risks by diversification. In India, the premier mutual fund is the Unit Trust of India (UTI).

4.8.2 Objectives of Mutual Funds

The main objectives of mutual funds can be stated as follows:

- To provide lower income groups or small investors a decent investment scheme
- To provide a good return to the investors from an indirect investment in equity
- To provide the knowledge of investment in equity market with the help of an expert team
- To provide a moderately risky investment mode to general investors who may not like to take high risk of making investment directly in share market.

4.8.3 Importance/Functions of Mutual Funds

The Importance of mutual funds in an economy is significant. It can be understood from the functions or services performed by mutual funds. The important functions of a mutual fund may be summarised as follows:

- Mutual funds channelise savings for investment.
- They offer wide portfolio investment.

- Mutual funds render expertise investment service at low cost.
- They provide better yields of investment.
- Investments in mutual funds offer tax benefits.
- Some mutual funds allow the investors to exchange their units of one scheme for another scheme. They thus provide flexible investment schedule.
- Mutual funds supply a large amount of funds to the corporate sector. They thus promote industrial development.

Thus, mutual funds play a vital role in the development of capital and money markets. Hence, they help in the overall economic development of an economy.

4.9 UNIT TRUST OF INDIA (UTI)

The Unit Trust of India (UTI) was set up in February 1964. It is the first mutual fund in India. Mutual funds are a very important form of non-bank financial intermediaries for promoting as well as mobilising small savings. They also act as important investment institutions, especially for the corporate sector. Mutual funds have become an important medium for mobilising savings of the community, particularly of the middle class and small investors. The UTI has also become a very important mutual fund in doing functions such as mobilising small savings and making investment in corporate sector. The UTI sells its units of ₹10 each to the investors. Though a certain minimum number of units under each scheme are to be purchased, one can participate in any scheme with a very small amount of savings.

4.9.1 Purpose of the UTI

The main purpose of setting up of the UTI is to mobilise small savings of the investors and to channelise them to the industrial sector. It also helps the small investors to get dividend taking minimum risks. The UTI sells its units to the small investors and, thereby, collects small savings of the investors. This money is then invested in different industrial units. Unit holders are given dividends by the UTI on the units purchased by them. Thus the main purposes of the UTI are to provide some benefits to the investors. The main benefits are (i) diversified portfolio and, hence, reduced risk of investment, (ii) professional management at negligible cost and (iii) high liquidity of investment. A small investor cannot have diversified portfolio and, hence, cannot avert risk if he directly invests in the shares and debentures of companies. Again, he cannot get the benefits of professional management with his small resources to invest because that will not be economic. Further, the investor in the UTI can enjoy high degree of liquidity of his investment. Most of the schemes of the UTI are open-ended schemes. This means that UTI is always ready to repurchase (redemption) its units. It enables the investor to liquidate his/her investment. This redemption feature of units provides high degree of liquidity to the investors.

4.9.2 Financial Resources

In the mutual funds industry in India, the UTI occupies the top-most and dominating position. Initially, it was a 50 per cent subsidiary of the RBI. Later, it was made a 50 per cent subsidiary of the IDBI. The rest of the share capital has been subscribed by the LICI, the SBI, other scheduled commercial banks, the IFCI and the ICICI (The ICICI, now a private sector bank, was then a development financial institution).

4.9.3 Benefits of Investment in UTI

The units of the UTI have several advantages. In brief, they are as follows:

- Investment in units is quite safe since the risk is spread through diversification of portfolio.
- The unit holders receive a steady income.
- Dividend incomes from the UTI enjoy certain tax concessions.
- The units are highly liquid as they can be sold back to the UTI any time.

4.9.4 Investment Policy of the UTI

The UTI invests part of its resources to fixed income-bearing securities and part of its funds to variable income-bearing securities. The main objective of the UTI is to maximise the return from units, maintaining the security of capital of the investors. The trust has invested in securities of 300 sound concerns that distribute regular dividends. The UTI has invested 80 per cent of its resources in the form of deposits with banks and investment in government securities.

4.9.5 Actual Investments by the UTI

The UTI is free in the investments of its funds. It is not constrained such as the LICI and commercial banks to invest specified minimum proportions of their funds in government and other approved securities. Thus, at the end of March 1995, out of total investible fund of ₹63,000 crore with UTI, about 80 per cent of it was invested in corporate equities and debentures, term loans and special deposits. Its investment in government securities at the end of June 1995 was about ₹10,000 crore.

The UTI disbursed financial assistance to the tune of ₹5070 crore in 1999–2000. However, it declined to ₹4600 crore in 2000–2001. The major part of this assistance is in the form of underwriting and direct subscription to equity of preference shares and debentures.

4.9.6 Evaluation of the Performance of the UTI

The operation of the UTI up to 1998 was very satisfactory. Its performance was acclaimed as a landmark in the development of India's capital market. It has been very successful to mobilise country's savings for investment in trade and industry. Out of various schemes of the UTI, Unit Scheme 1964, popularly known as US-64, was the most prestigious and most successful scheme up to the year 1991. It was the flagship scheme of the UTI launched in 1964. US-64 was the first scheme in India to build up the largest customer base in the world. Over the years, the UTI almost alone set the Indian mutual fund industry on a firm footing.

However, with liberalisation scheme in 1991, stock market expectations grew high. The UTI started investing more into equities. It turned the assured income-oriented US-64 scheme into a high-risk equity-oriented scheme. The stock market crash brought a doom for the scheme in 1998. There was a widespread panic among the people. They started to redeem their units in large numbers. To save the US-64 scheme from disaster, the Government of India appointed an expert committee under the chairmanship of Deepak Parekh. This committee is known as Parekh Committee. In October 1998, there was a scam centering the UTI. The main reason behind it was corruption among UTI officials. All these led to a panic among the unit holders. In this backdrop, the Parekh Committee was set up to rehabilitate the UTI. The Committee was asked to undertake a comprehensive review of the functioning of the UTI and to make recommendations to restore investors' confidence. The Committee made a number of recommendations. Important among them are: (i) conversion of US-64 scheme into a NAV (Net Asset Value) driven scheme over a 3-year period, (ii) fiscal incentives to investors in US-64 scheme, (iii) revamping of dividend distribution policy, and so on. Accordingly, the UTI gave an assurance of 20 per cent dividend for the year 1998–99. Further the Union Budget of 1999–2000 announced a number of concessions. Moreover, in order to save US-64 from disaster, a corpus of ₹3000 crore was sanctioned to the UTI.

For all these measures, the situation somewhat improved but only very temporarily. In July 2001, the scheme of US-64 lost confidence of the investors. This was mainly due to heavy investments in highly volatile IT stocks and dismal state of the equity market. The UTI had to reduce the dividend rate for the year 2000–2001. It also suspended sales and repurchases of US-64 for a period of 6 months from July 2001 to December 2001. All these led to a serious crisis of confidence among the investors. Net resource mobilisation by the UTI drastically declined in 2000–2001 and it turned to a highly negative figure in the next year, 2001–2002.

To come out of this problem, the UTI submitted a reform package to the Government of India. The Cabinet Committee on Economic Affairs (CCEA) in its meeting held on 31 August 2002 approved this package. As per this package, the UTI was divided into two parts: UTI-I and UTI-II. In UTI-I, the value of units was to be supported by the Government of India whereas in UTI-II, the value of the units was to be market-determined. The UTI-I comprised of assured returns schemes. In this part, there were US-64, 21 other assured returns schemes and Special Unit Scheme 1999. For US-64, assured repurchase prices were announced. In the UTI-II, there were all NAV-based schemes. It was to be managed by a professional chairman and Board of Trustees. The UTI-II was not to be subject to any redemption guarantees or assured return schemes. Hence, transaction in this part was to be based on market perception of the fund managers and the management. In spite of these measures taken, it may be admitted that the investors' confidence in the UTI has not recovered fully since 2001.

SUMMARY

S.1 Meaning of Insurance and its Importance

Insurance is a contract wherein the insurer agrees to pay to the insured, a certain sum upon a given contingency against the payment of some premium by the insured.

Insurance companies mobilise savings through premiums of insurance and channelise the pooled fund to productive investment. Further, insurance facilities help trade, commerce and industry by reducing insurable risk.

S.2 Nature of Insurance Companies

Insurance companies offer insurance service. They are basically financial intermediaries as they collect huge funds of premiums from the insured persons and invest those funds in different companies. They are basically of two types: life insurance companies and general insurance companies. Life insurance companies insure life of their customers while general insurance companies insure different assets of their customers.

S.3 Structure of Insurance Business in India

The insurance business in India may broadly be divided into two categories: life insurance business and non-life or general insurance business. Both the categories have public sector companies and private sector companies.

S.4 A Brief History of Insurance Business in India

The systematic life insurance business in India was started in the year 1818 when the Oriental Life Insurance Company was established in Kolkata. The general insurance business was started in the year 1850 when the Triton Insurance Company Ltd. was established by the British in Kolkata. The life insurance business was nationalised by the Government of India in 1956. In that year, 245 Indian and foreign life insurance and provident fund societies were taken together and the Life Insurance Corporation of India was established under the public sector. The general insurance business was nationalised in India in 1973. In that year, 107 general insurers were amalgamated and grouped into four companies: The National Insurance Company Ltd., The New India Assurance Company Ltd., The Oriental Fire and General Insurance Company Ltd. and The United India Insurance Company Ltd. The General Insurance Corporation of India (GICI) was registered as a government holding company in the same year. After the adoption of the policy of liberalisation and economic reforms in 1991, both life insurance business and general insurance business have been opened to the private sector. As a result, many private companies, both Indian and foreign, have now been operating in these fields.

S.5 Life Insurance Corporation of India

The Life Insurance Corporation of India (LICI) was set up in the year 1956 taking over 245 private life insurance companies. The main objectives of the LICI were: (i) to mobilise small savings, (ii) to stop various illegal and corrupt practices of private life insurance companies, (iii) to provide life insurance protection to the masses, (iv) to invest the mobilised funds in industrial sector, and (v) to stop wastages and misuse of insurance fund.

The management of the LICI is entrusted with an autonomous board consisting of 15 members. The government has given some special powers to the board. The central office of the LICI is in Mumbai. It has several zonal offices which operate through more than 100 divisional offices in important cities and more than 2000 branch offices. With about 12 lakh agents, the LICI has the largest field organisation in the country.

The main functions of the LICI are: (i) to run life insurance business, (ii) to invest the collected fund in shares and debentures of different public and private enterprises and (iii) to provide initial capital to different development financial institutions (DFIs).

Various functions of the LICI have significantly helped the industrial sector of India in the following ways:

- The LICI has helped in the development of infrastructure of the country.
- It has helped in mobilising savings and channelising them to productive activities.
- The investment made by LICI in the capital market and financial assistance given by it to set up various development financial institutions have contributed to the development of capital market of India.
- It has provided mortgage loans for housing.
- The LICI has provided industrial finance in three forms: (i) subscription to shares and bonds of various development financial institutions, (ii) direct finance to industrial units in the form of loans and (iii) subscriptions to the shares and debentures of industrial units.

Over the years up to mid-1990s, the LICI had to follow an investment policy as directed by the government. As a result, returns from investments in LICI had been lower. This hampered the interest of its policy holders. As the monopolist in life insurance business till mid-1990s, it exploited its customers. In this context, the Malhotra Committee, 1993, made some recommendations. The major recommendations are as follows:

- The insurance sector should be opened up to the private companies also in order to increase efficiency in this sector.
- Directed investment, that is, pattern of investment stipulated by the government should be reduced.
- The shareholding of the government in LICI should be reduced to 50 per cent.
- The special treatment given to the LICI should be stopped.
- To regulate the private companies in the insurance sector, a strong and effective Insurance Regulatory Authority (IRA) should be set up.

Most of the recommendations of the Malhotra Committee have been accepted by the government. The recommendations regarding revised investment norms have been implemented with effect from 1 April 1995. The government passed the Insurance Regulatory and Development Authority Act (IRDA) in 1999 and a statutory Insurance Regulatory Authority (IRA) was set up. With these measures, it may be expected that the LICI would prosper more in the future. The LICI enjoyed monopoly until mid-1990s, but in the recent past, many private insurance companies have entered into the insurance business. In the new era of increased competition, the LICI will have to increase its efficiency.

S.6 General Insurance Corporation of India (GICI)

The general insurance business was nationalised in 1971 and a government company known as General Insurance Corporation of India (GICI) was formed in November 1972. This corporation was given the right of doing general insurance business. Up to the year 2002, it had four subsidiaries. They were as follows:

(i) The National Insurance Company Ltd.

(ii) The New India Assurance Company Ltd.

(iii) The Oriental Fire and General Insurance Company Ltd.

(iv) The United India Insurance Company Ltd.

In the year 2002, the GICI was delinked from its four subsidiaries and was empowered to carry out only re-insurance business. Thus, the GICI now acts exclusively as a re-insurer company. The four former subsidiaries independently carry on general insurance business.

The main function of the GICI is to insure and re-insure the air travel of different aviation companies. It also does crop insurance on behalf of the government. The main source of income of the GICI is the premium paid by its policy holders. Out of this premium income, the corporation provides finance to different industrial units, central and state governments and development financial institutions. More than 60 per cent of total investment made by the GICI has gone to socially oriented sectors. Before becoming a re-insurer company, the scope of activities of the GICI increased to a great extent. It conducted Crop Insurance Scheme of the government, operated Cattle and Livestock Insurance Scheme, promoted personal insurance cover in the field of livestock, poultry, sericulture, pisciculture, horticulture, pump sets and personal accidents. Other activities of the GICI included conduction of GIC Mutual Fund, GIC Griha Vitta Ltd., Loss Prevention Association of India Ltd. and the National Insurance Academy.

Since 1991, there have been various economic reforms in India. As a part of financial sector reforms, the insurance sector was sought to be made competitive by opening it to the domestic as well as foreign companies. To examine the issue of insurance sector reforms, Malhotra Committee was appointed in April 1993. The major recommendations of this Committee regarding the GICI may the summarised as follows:

- The four subsidiaries of GICI should act as independent general insurance companies. The GICI should function exclusively as a re-insurance company.
- Private capital, both domestic and foreign, should be allowed entry in insurance business, subject to some stipulations.
- The LICI and the GICI should operate as board-run enterprises.
- A strong and effective Insurance Regulatory Authority (IRA) should be established.
- Investment norms should ensure equal competition among the insurance companies and also ensure that insurer does not neglect the small investors or the rural business community.

Most of these recommendations have been accepted. The recommendation regarding revised investment norms have been implemented with effect from 1 April 1995. The Insurance Regulatory and Development Authority Act (IRDA) was enacted in 1999 and a statutory Insurance Regulatory Authority (IRA) was set up. Its objective is to protect the interest of the insurance policy holders and to regulate, promote and ensure orderly growth of the insurance industry. With these reforms, it may be expected that the GICI would play an even better role in future in providing finance to the industrial sector and better service to its policy holders.

S.7 A Brief Note on Mutual Funds

A mutual fund is a financial institution that raises money from the savers through the sale of its units to the public and invests the pooled fund in private and government securities. The main objective of a mutual fund is to provide an opportunity to lower income groups or small investors a decent investment scheme. The main function of the mutual funds is to collect savings of small savers and invest the pooled amount in a diversified portfolio. In India, the premier mutual fund is the Unit Trust of India (UTI).

S.8 Unit Trust of India (UTI)

The Unit Trust of India (UTI) was set up in 1964. It is the first and premier mutual fund in India. The main purpose of setting up of the UTI is to mobilise small savings of the investors and to channelise them to the industrial sector. It also helps the small investors to get dividend taking minimum risks. The UTI sells its units to the small investors and thereby collects the small savings of the investors. This money is then invested in different industrial units. Unit holders are given dividends by the UTI on the units purchased by them.

The units of the UTI have several advantages:

- They are safe since their risk is diversified.
- The unit holders receive a steady income.
- Dividend incomes from the UTI enjoy certain tax concessions.
- The units are highly liquid as they can be sold back to the UTI any time.

The UTI invests part of its resources to fixed income-bearing securities and part of its fund to variable income-bearing securities. The main objective of the Trust is to maximise income maintaining the safety of capital. The operation of the UTI up to 1998 was very satisfactory. It has been very successful in mobilising community's savings for investment in trade and industry. Out of various schemes of the UTI, Unit Scheme 1964, popularly called US-64, was the most successful scheme. However, in October 1998, there was a scam centering the UTI. A panic spread among the unit holders. The UTI gave an assurance of dividend of 20 per cent during 1998–99. The Parekh Committee was set up to rehabilitate the UTI. Following the recommendations of the Committee, the situation improved for the time being. However, US-64 came under serious crisis again in the middle of 2001. This led to serious loss of investors' confidence in the UTI. The Government of India adopted some measures. It divided the UTI into two sections: UTI-I and UTI-II. In UTI-I, value of the units will be supported by the Government of India. But in UTI-II, value of the units will be market-determined. Since 2001, investors' confidence in the UTI has not recovered fully.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. Define insurance.
2. What are the two types of insurance?
3. Give the names of two private sector life insurance companies.
4. Mention the names of two public sector general insurance companies.
5. Give the names of two non-life insurance companies in India.
6. When was the LICI established?
7. In which year was the GICI set up?
8. In which year was the life insurance business nationalised?
9. When was general insurance business nationalised in India?
10. What is a mutual fund?
11. Name the premier mutual fund in India.
12. Give the full forms of GICI and UTI.
13. In which year was the IRDA Act enacted?
14. What are the full forms of IRDA and IDA?
15. What are the two parts of the UTI at present?
16. Mention two objectives of the LICI.
17. What is the main purpose of a mutual fund?
18. What are the main benefits of holding units of the UTI?
19. Why was the Deepak Parekh Committee formed?
20. What was the purpose of forming Malhotra Committee?

B. Medium Answer-Type Questions (4–5 marks each)

1. Discuss the meaning and importance of insurance.
2. Write a note on the nature of insurance companies in India.
3. Discuss the structure of insurance business in India.
4. Write down a brief history of the insurance business in India.
5. What were the main objectives of establishing Life Insurance Corporation of India?
6. Discuss the organisational set up of the General Insurance Corporation of India.
7. Write a short note on mutual funds.
8. Mention the benefits of investment in the Unit Trust of India.
9. Make a brief evaluation of the performance of the Unit Trust of India.
10. Briefly mention the management and organisational set-up of the Life Insurance Corporation of India.

C. Long Answer-Type Questions (10 marks each)

1. Discuss the functions and investment policy of LICI. **(Section 4.6.4)**
2. Discuss the major recommendations of the Malhotra Committee in connection with the insurance sector of India. **(Sections 4.6.6 & 4.6.7)**
3. Analyse the major functions of the General Insurance Corporation of India. **(Section 4.7.5)**
4. What is a mutual fund? What are its objectives? Briefly mention the major functions of mutual funds. **(Section 4.8)**
5. Explain the purpose for which the Unit Trust of India was set up and review its progress. **(Sections 4.9.1 & 4.9.6)**
6. Briefly mention the major recommendations of the Malhotra Committee in connection with the general insurance business in India. How far were those recommendations accepted? **(Sections 4.7.6 & 4.7.7)**

UNIT

5

INTEREST RATE STRUCTURE

UNIT OUTLINE

SUBJECT MATTER OF THE UNIT

Interest is the price for the use of capital. In the present chapter, we shall consider the concept of interest. We shall discuss topics such as the definition of interest, difference between gross interest and net interest, difference between real rate of interest and nominal rate of interest, differences in rates of interest, relationship between interest rate and economic progress, and term structure of interest rates in India.

5.1 MEANING OF INTEREST RATE

In an economy there are two types of economic units. One may be called surplus spending units, and the other may be called deficit spending units. Surplus spending units earn more than they spend. They have surplus funds at their disposal. On the other hand, deficit spending units spend more than they earn. They need funds to cover their deficits. The surplus spending units would like to give their surplus as loans in the loan market. They are lenders in the loan market. Deficit spending units need to borrow to meet their deficits.

In the loan market, lending and borrowing are done. *Interest is the price paid for borrowed funds. It is generally expressed as a rate per cent per period of time. It is then called the rate of interest. Usually the period is taken as 1 year*. If a borrower takes a loan of ₹100, for example, in any year and if he has to repay ₹110 after 1 year, then 10 per cent would be the yearly rate of interest. It is obvious that interest is cost to the borrower and return to the lender. Interest affects, among other things, lending and borrowing, saving and investment.

In theoretical analysis, we assume that all borrowing and lending are done under essentially similar conditions in an integrated market. Hence there is only one rate of interest which is the equilibrium rate in the loan market. In actual situation, however, there is a variety of loan contracts and instruments in the loan market which is segmented; thus, instead of one rate of interest we get different rates of interest in different segments of the loan market. We shall explain why interest rate differentials arise and the factors responsible for this difference. *When different interest rates are taken into account, we get an interest rate structure* and not an absolute rate of interest. This interest rate structure is the subject matter of this chapter.

5.2 GROSS INTEREST AND NET INTEREST

Gross interest refers to the additional amount of money collected by the lender from the borrower over and above the principal sum. For example, if a principal sum of ₹1000 is lent for 1 year at the rate of interest of 10 per cent, then ₹100 will be the total interest or gross interest. *On the other hand, the extra amount to be paid only for the use of money capital is called the net interest. Gross interest has within it net interest and several other factors*. These other factors are explained as follows:

First, when the lender gives a certain amount of money as loan to the borrower, he has to take some amount of risk. He will lose his money if the borrower does not return the money. This may happen if the borrower dies in the meantime or if the borrower becomes bankrupt. The borrower may also not return the money wilfully. For all these reasons, the lender takes some risks while giving the loan. As a reward for this risk-taking, the lender charges an extra amount other than the net interest to be payable on riskless lending (for example, lending to the government). This extra amount may be called risk premium. It is added with net interest. Thus gross interest includes risk premium.

Second, the lender also incurs some additional expenses in the process of giving loans or for the collection of interest and principal sum. For example, the lender needs to prepare the necessary financial papers for arranging the loan. He may have to engage individuals for the collection of the principal sum or periodic interest payments made by the borrowers. These costs are also added to the net interest in order to form gross interest.

Thus, gross interest is net interest plus these various expenses. The interest collected from the borrowers is actually the gross interest. If we deduct from the gross interest the risk premium and other administrative expenses of the lender, we get net interest.

5.3 NOMINAL AND REAL INTEREST RATE

Interest is paid in terms of money and not in terms of goods and services. *The nominal interest rate measures the yield in rupees per year per rupee invested*. If the nominal rate of interest is 10 per cent, for example, it means that if one rupee is invested for 1 year, the yield will be ₹0.10. But the value of money may not remain constant, particularly when the price level is changing. During a period of inflation when the general price level is rising, the real value of money or the purchasing power of money in terms of goods and services decreases. Nominal interest rate or interest rate in terms of money does not measure what a lender really earns in terms of goods and services. Suppose a lender lends ₹100 at the rate of interest of 10 per cent per annum, then the lender will get back ₹110 after 1 year. But the prices of goods and services may increase during the year and the lender may not be able to purchase the same quantity of goods and services that he could purchase if he had ₹110 at the beginning of the year.

We then need another concept which measures the return on investments in terms of real goods and services rather than the return in terms of money. This alternative concept is the *real interest rate. The real interest rate measures the quantity of goods we get in the next period for goods foregone in the present period. The real interest rate is obtained by correcting the nominal interest rate for the rate of inflation.*

The nominal interest rate is the interest rate on money in terms of money. These interest rates are reported in financial newspapers. They give return in rupee per rupee of investment. In contrast, the real interest rate is corrected for inflation and is calculated as the nominal interest rate minus the rate of inflation. For example, if the nominal rate of interest is 10 per cent and the rate of inflation is 4 per cent, then the real interest rate is 10 per cent – 4 per cent = 6 per cent.

Let us take a simple example. Suppose in an economy there is only one product, bread, produced by the firms. Further suppose that the price of one loaf of bread is Re. 1 in period 1 and that the rate of inflation is 4 per cent. This means that in period 2, the price of one loaf will be ₹1.04. Now if the nominal rate of interest is 10 per cent it means that if ₹100 is lent in period 1 it will accumulate to ₹110 in period 2. In period 1, the value of ₹100 in terms of bread is 100 loaves of bread. In period 2, when the price of one loaf of bread is ₹1.04, ₹100 will be worth of (110/1.04) loaves of bread. Now 110 ÷ 1.04 = 105.769, which is approximately equal to 106. Thus in monetary terms, the rate of return is 10 per cent, i.e. the nominal rate of interest. But in terms of bread, the rate of return is 6 per cent (from 100 loaves in period 1 to 106 loaves in period 2). This 6 per cent is the real rate of interest which is approximately equal to the difference between the nominal rate of interest and the rate of inflation. Thus, the real rate of interest is the rate of return on investment in terms of goods earned per year on goods invested.

The result of the above example can be generalised in terms of an algebraic analysis. Let i be the nominal rate interest, r be the real rate of interest and π be the rate of inflation. If one rupee is lent at present, it will become $(1 + i)$ after 1 year. If the rate of inflation is π, $(1 + \pi)$ rupees will be required to purchase goods which are worth one rupee after 1 year. Instead of buying one unit of goods at present, we can purchase $(1 + r)$ units of goods after 1 year where $(1 + r) = (1 + i)/(1 + \pi)$.

$$
\begin{aligned}
\text{Now, } (1 + r) &= (1 + i)\,(1 + \pi)^{-1} \\
&= (1 + i)\,(1 - \pi + \pi^2 - \pi^3 + \ldots\infty) \\
&= (1 + i)\,(1 - \pi) \text{ [Neglecting terms } \pi^2, \pi^3\ldots \text{ for small values of } i \text{ and } \pi] \\
&= 1 + i - \pi - i \times \pi \\
&= 1 + i - \pi \text{ [Neglecting } i \times \pi]
\end{aligned}
$$

$$\therefore 1 + r = 1 + i - \pi$$

$$\text{Or, } r = i - \pi$$

This shows that *the real rate of interest is equal to the difference between the nominal rate of interest and the rate of inflation.* The nominal rate of interest cannot be negative but if the rate of inflation is greater than the nominal rate of interest, the real rate of interest can be negative. The nominal rate of interest is fixed by contract during the period of giving loans. But the real rate of interest varies with the rate of inflation.

5.4 DIFFERENTIAL INTEREST RATE

Theoretically, it is assumed that all borrowing and lending are done at a uniform rate of interest. But in the real world the loan market is not integrated. Rather, the loan market is highly segregated. There are different segments in the loan market with different characteristics. Accordingly there is a wide variety of interest rates in the loan market. For example, on the basis of the periods of maturity of different financial instruments, interest rates are broadly classified as short-term, medium-term and long-term rates. In case of short-term rate, the maturity period of the financial instrument is less than 1 year; medium-term rates are applicable when the maturity period is between 1 and 5 years; and if the maturity period is greater than 5 years, the corresponding rates are called long-term rates. For example, consider the call money market where loans are given for 1 day. The rate at which call loans are given is called the call money rate. It is a short-term rate. Again, when the government borrows for a short period by issuing Treasury bills, the rate applicable is called Treasury bill rate. It is also a short-term rate. Similarly, the bazar bill rate of the commercial bill market is also a short-term rate. If the government borrows from public for a period of less than 5 years, the coupon rate for that bond will be an example of medium-term rate of interest. If any company issues debentures of maturity period of more than 5 years the coupon rate of that debenture is a long-term rate.

Interest rates can be classified as administered interest rates and market-determined interest rates. Administered rates are those rates which are determined by the authority. These rates are fixed by the authority and can be changed by the authority only. On the other hand, market-determined interest rates are determined in the market by the forces of demand and supply. They are flexible, changing with the changing conditions of demand and supply. Deposit rates on post office deposits in India are determined by the Government of India. They are examples of administered rates of interest. Before 1991, deposit and lending rates of banks were administratively determined. But now they are market-determined. Similarly, inter-bank call money rates, bazar bill rate, rates on corporate securities, are also market-determined rates.

In a country such as India, there is an unregulated credit market in which there are many private credit agencies whose forms of organisation and methods of working are not standardised. Instead, there is a great diversity in their organisations, methods, functional areas of operation, sources of funds, effective rates of interest charged on their loans, and so on. Their common characteristic is that they are not regulated by any authority. The credit markets in which they operate are unorganised or segmented and not integrated with one another. They are also not linked with the organised sector of the credit market. The rates of interest charged by these credit agencies in the unregulated sector differ over a wide range. Examples of such credit agencies are finance companies, hire purchase finance companies, chit funds, *nidhis*, indigenous bankers, village money lenders, and so on. The mode of operation of these agencies and the cost of funds lent by them vary greatly over a wide range. In certain cases the effective rate of interest may be as high as 100 per cent per year or even more.

5.5 CAUSES OF VARIATION OF INTEREST RATE

In the loan market, we find different rates of interest. It is usually seen that the village money lenders charge a very high rate of interest from the peasants. Again, when an individual takes loan from banks, the rate of interest is relatively low. When the government borrows funds from public, the government also gives a lower rate of interest. Now, what are the reasons for differences in interest rates? Differences in rates of interest may arise due to several factors. These factors are discussed as follows:

5.5.1 Differences in the Amount of Risks Involved

A loan involves two kinds of 'promises to pay' of the borrower: (i) the promise to pay the principal at maturity, and (ii) the promise to pay the interest due on the loan as specified in the loan contract. Both the promises to pay relate to the future. Therefore, there is a risk that either one or both the promises to pay may not be fulfilled in full. This risk is called the 'risk of default'. Normally the risk of default is taken to be nil for government debt. But all loans to private parties involve some risk of default. To guard against risk of default, the lender keeps some collateral security from the borrower. But due to several reasons, the security may be inadequate or legally defective. There are also unsecured loans. Hence, some amount of risk is present in case of lending to private parties. The greater the amount of risk, the higher will be the rate of interest. On the other hand, the lower the amount of risk the lower will be the rate of interest. When the government takes loan, the risk of default is nil. Hence, the government can take loan at a lower rate of interest. But when a private individual takes loan or a private company takes loan, there is greater risk involved. For this reason, the rate of interest is higher.

5.5.2 Differences in the Liquidity of Debt

Liquidity of an asset refers to the degree of ease and certainty with which it can be converted into cash quickly without any loss. Cash is the most liquid asset. When a borrower takes loan, he has to keep some collateral security. The property or asset which is kept as security may vary in terms of liquidity. Other things remaining the same, creditors prefer more liquid to less liquid assets. This means that other things remaining the same, a lender would be willing to charge a lower rate of interest on more liquid debt than on a less liquid debt. For non-money financial assets, the two main determinants of liquidity are their (i) marketability, and (ii) term to maturity. Bonds, shares, gold, and so on, can be easily sold in the market. They have higher marketability and they are more liquid. On the other hand, real estate assets such as land, buildings cannot be easily sold. They are less liquid. For this reason if real estates are kept as collateral security, the rate of interest is relatively high but if gold or government bonds are kept as collateral security, the rate of interest is relatively low.

5.5.3 Differences in Term of Maturity

In case of non-marketable securities, the longer the term to maturity the less will be their liquidity because a longer waiting period is required for their conversion into cash. Other things remaining the same, rates of interest differ according to term to maturity or time length of debt. Generally, the rate of interest is lower for a short-term period. On the other hand, the rate of interest is higher for a long-term period. There is a greater amount of risk in the long period and for this reason also the rate of interest is higher for longer periods of time. The variation in the interest rate according to the maturity period of debt is known as term structure of interest rate.

5.5.4 Differences in Lender's Cost of Servicing Loans

The rate of interest will be high if the expenditures associated with the arrangement of loan are also high. On the other hand, the rate of interest will be low if the administrative expenses for loan arrangement are also low. Lenders incur several expenses in servicing loans. For example, they make appraisal of loan applications for any project by scrutinising the project plan. The use of loan and security against it needs to be supervised during the currency of loan. In case of default or accumulation of overdue, special measures need to be taken for the recovery of the maximum amount due. Some of these costs are fixed as per loan transaction, whatever be the size of loan.

5.5.5 Differences in Lending Practices and Extra-Loan Services

It is seen that private finance companies are in a position to charge higher rates of interest from their borrowers who are eligible to borrow from commercial banks at lower rates of interest. And yet finance companies are expanding their businesses. This is due to two reasons. One is the informal lending practices followed by the finance companies. When taking loans from commercial banks, several formalities need to be followed. To avoid these formalities, some borrowers may borrow from finance companies even at higher rates of interest rather than taking loans from commercial banks.

Another reason is that some finance companies provide a package of services along with the loan at a small charge. For example, they may arrange for the delivery of goods from the manufacturer or dealer and arrange for insurance and other services.

5.5.6 Differences in Monopoly Gains

The rate of interest will also be higher if there are imperfections in the loan market. On the other hand, if the loan market is perfectly competitive the rate of interest will be relatively lower. Rates of interest charged by private moneylenders, indigenous bankers, finance companies, and so on, are high because they enjoy an element of monopolistic or exploitative gain. Interest rates are relatively high in those areas where there are no facilities of institutional loans. On the other hand, in those areas where there are facilities of institutional loans the rate of interest is relatively low.

One of the reasons for imperfection is the lack of mobility of capital from one area to another area. If there is high rate of interest in a particular area but if the supply of capital to that area does not increase, then the rate of interest continues to be higher in that area. On the other hand, if capital is perfectly mobile, then the rate of interest will tend to be equal in all areas. Thus differences in rate of interest may be found due to immobility of capital.

5.5.7 Differences in the Purpose of the Loan

If the borrower takes the loan for consumption purpose, the rate of interest is relatively high. On the other hand, if the borrower takes a loan for production purpose, the rate of interest is relatively low. When an individual takes a loan for meeting consumption expenditure, he has an urgent necessity for the loan. He is in duress and is prepared to pay even higher rates of interest. In rural areas, poor peasants or landless workers need to take loans for subsistence or for meeting social obligations. The rate of interest on such loans is relatively high. On the other hand, when funds are borrowed to use them in the production process, there is no such urgency; then loans will not be taken if the rate of interest is very high. It is for this reason that the rate of interest for production loan is relatively low.

5.5.8 Differences in the Financial Position and Goodwill of the Borrowers

The rate of interest also depends on the financial position and goodwill of the borrower. If the borrower has a good reputation in the market and if he has a sound financial status, he can get loans at lower rates of interest because there is less risk involved in providing loans to him. For this reason, reputed companies can borrow at lower rates of interest in the market. But the poor peasants or the poor artisans cannot collect funds at low rates of interest.

5.5.9 Government's Policy

It is found that lending rates of banks are not the same for all borrowers. Under the policy directives of the RBI, credit is given to the borrowers of priority sectors and weaker sections at concessional rates under the Differential Rate of Interest Scheme. Thus interest rate differential arises as a result of the deliberate policy followed by the RBI.

5.6 INTEREST RATE AND ECONOMIC PROGRESS

By economic progress, we mean continuous increase in the national income and per capita income of the country. We shall now consider the relation between rate of interest and economic progress. In particular, we shall consider whether the rate of interest increases or decreases with economic progress. Some economists argue that as economic progress takes place, the rate of interest decreases. From experience, it is found that the rate of interest prevailing in developed countries is comparatively low whereas the rate of interest prevailing in the less developed countries is comparatively high. Hence it can be argued that the rate of interest decreases along with economic progress.

Why the rate of interest decreases with economic progress can be explained as follows: we know that during economic progress national income increases and per capita income also increases. When income increases, the total saving of the economy also increases. Now the supply of loans comes from saving, and hence if saving increases supply of loan also increases. As the supply of loan increases, the supply curve shifts to the right. The demand curve remaining the same, the equilibrium rate of interest decreases. But this may not always be true. This is so because along with economic progress not only the supply of loan increases but also the demand for loan increases. Hence, both the supply curve and the demand curve for loans shift in the rightward direction. Hence the equilibrium rate of interest may increase, decrease or remain the same. The effect of economic progress on rate of interest, therefore, depends on the relative importance of demand and supply factors. However, from experience it has been found that there is a tendency for the rate of interest to drop with economic progress.

5.6.1 Can the Rate of Interest Fall to Zero?

Even if there is a tendency for the rate of interest to decrease with economic progress, it should be noted that the nominal rate of interest can never drop to zero. This is so because with economic progress the demand for loans may increase. The demand for loan curve may shift to right and in that case the rate of interest may increase rather than decrease.

Moreover, people lend money only to get the rate of interest. If the rate of interest is zero, nobody will be willing to lend money. In that case the loan market will cease to exist. Just as a commodity whose cost of production is not zero, cannot have a zero price, similarly the rate of interest, which is a price, cannot be zero because the loan money has an opportunity cost. When the lender lends money, he loses an opportunity to utilise the money for his own purpose. Thus, the supply or the use of loanable funds has a cost. Because of this cost the lender demands interest. As long as this opportunity cost prevails, the rate of interest can never be zero.

Theoretically it can be said that when the demand for loans and supply of loans are zero, the rate of interest can be zero. But in reality demand for loans and the supply of loans can never be zero. Therefore the rate of interest can never be zero. Even if the nominal rate of interest cannot be zero or negative, it is not true about real rate of interest. The real rate of interest may be zero or negative if the rate of inflation is equal to or greater than the nominal rate of interest.

5.7 TERM STRUCTURE OF INTEREST RATES

In different theories of interest rate determination, it is assumed that the loan market is homogenous and integrated. There is only one rate of interest in the market. However, in practice there is a variety of interest rates in any financial system. From the general theory of interest rate determination, we do not get answers to the following two questions:

(i) What is it that determines the difference between short-term and long-term rates of interest?

(ii) What is it that determines the general structure of interest rates?

Regarding the second question, we have already discussed different determinants of the general structure of interest rates such as differences in risk, differences in the liquidity of the debt, differences in costs of servicing of loans and so on. Let us now consider answer to the first question. This leads us to theories of term structure of interest rates. The term structure of interest rates refers to the relationship between different rates when all the investment characteristics (such as default risk, marketability and liquidity of assets) except the length of time to maturity of the financial claims are held constant. There are three theories to explain this relationship. They are: (i) Expectations Theory, (ii) Liquidity Premium Theory, and (iii) Market Segmentation Theory. Let us discuss these theories one by one.

5.7.1 Expectations Theory

This theory is based on the following assumptions:

- There is perfect competition in financial markets.
- The investors are rational. They try to maximise the yield of their holding period.
- Investors have a perfect foresight and all the investors hold uniform expectations about the future level and changes of short-term interest rates.
- There are no transaction costs.
- Securities of different maturities are perfect substitutes for each other.

With the help of these assumptions, it is argued that today's long-term rate is the unbiased arithmetic mean of short-term rates during the period of long-term loan. Consider the following example. Suppose that the maturity period of a long-period security is 3 years. The short-term rate of interest in the first year when the security is issued is 4 per cent, and that the expected short-term rate in the second year is 5 per cent and 6 per cent in the third year. Then the long-term rate will be the simple average of 4, 5 and 6 per cent, which is equal to 5 per cent. If the long-term rate of interest is an average of short-term rates of interest, then it is obvious that if the short-term interest rates rise, the average will also rise and the long-term rate of interest will also rise. Similarly, if short-term rates are expected to decrease in future years, the long-term rate of interest will also decrease. If no changes in future short-term rates are expected, the long rate and the short rate will be equal to each other. Thus the long-term rate always moves in the same direction in which short-term rates move. However, the fluctuations in the long-term rate will be lower than the fluctuations in the short-term rates.

This theory suffers from certain **limitations**. These are as follows:

- This theory is based on some unrealistic assumptions. It cannot explain rates structure in informal and rural markets where there is no trading of securities in the manner assumed by it. It is also not relevant for interest rates on bank deposits where there is no buying and selling of securities.
- While this theory explains the long-term rate in terms of expected short-term rates, it does not explain how short-term rates themselves are determined. This model does not give any account of how expectations of future short rates are formed.
- This theory assumes that all the lenders and borrowers have the same expectations. This assumption is also not realistic.

5.7.2 Liquidity Premium Theory

This theory is associated with J.R. Hicks. It is regarded as an extension of the pure expectation theory and it is sometimes called biased expectations theory. We know that there are two characteristics of investment. One is return and the other is risk. The choice of securities of the investor depends on the preference pattern of the investor between risk and return. The expectations theory ignores risk and assumes that investors try to maximise return. In the segmentation theory (to be considered later), it is assumed that investors ignore return and try to minimise risk. In the liquidity premium theory, it is assumed that investors are risk-return traders. They do not maximise return ignoring risk. Similarly they do not minimise risk ignoring return.

There are two types of return on any investment. One is return of interest income and the other is capital gain or loss. It is assumed in this theory that for short-term securities interest income is more variable than long-term securities. Variability is measured by variance, which is a measure of risk. Thus, income risk is higher for short-term securities than for long-term securities. Again, the variance of return of capital value is greater for long-term securities than for short-term securities. Thus capital risk is higher for long-term securities than for short-term securities. If it is assumed that stability of capital is valued more highly than the stability of interest, long-term securities have a net risk disadvantage. This means that long-term securities, on balance, are more risky than short-term securities. Investors will accept this additional risk only if long-term securities offer higher yields. Because of higher risk on long-term securities, other things being equal, the investors prefer to lend in short-term securities. Borrowers, on the other hand, prefer to borrow long. Due to this psychological disinclination to hold long-term securities, a positive liquidity or risk premium must be offered to induce investors to purchase long-term securities. This premium is over and above the average of the current and expected short rates.

The liquidity premium theory highlights the preference for liquidity and the desire to minimise the sum of income risk and capital risk as additional factors determining the term structure of interest rates. It is more realistic because it incorporates the complexity of forces such as lenders' and borrowers' preferences and differences in risk-return attributes of securities of different maturities.

5.7.3 Market Segmentation Theory

This theory was developed by Culbertson. In this theory, it is assumed that short-term and long-term rates are determined in separate or segmented markets. Some investors prefer short-term securities. They invest in short-term securities. Again, there are some investors who prefer long-term securities. As a result, securities of different maturities are not perfect substitutes of each other. Such an argument implies that lenders and borrowers are interested in securities of different maturities. Since the capital market is divided into a number of segments, the demand and supply of funds of each segment determines the rate of interest in that segment. Thus even if short-term rates are higher, those who prefer long-term securities will not shift from long-term securities to short-term securities in order to enjoy higher rate in the short run. Thus even if short-term rate of interest increases it will not influence long-term rates of interest.

In such segmented markets, the term structure of interest rates is determined exclusively by the supply of and demand for securities. If the demand for long-term capital is greater than the supply of long-term capital while the supply of short-term capital is greater than its demand, then the long rates would be greater than short rates and *vice versa* in the opposite case. Thus this theory stresses on the maturity structure of debt as an important factor determining the term structure of interest rates.

This theory is based on institutional practices followed by commercial banks and insurance companies and investment trusts. While commercial banks mostly deal in short-term securities, insurance companies and investment trusts mostly deal in long-term securities. This theory is, however, not free from limitation as it overlooks the fact that there is considerable degree of overlapping among different markets. Same institutions operate in different markets dealing in securities of different maturities.

5.8 INTEREST RATES IN INDIA

So far we have discussed theoretical aspects of interest rates. We shall now consider actual level and structure of interest rates in India. The period after 1950 in India can be divided into three phases of interest rate policy. The first phase was the decade 1950–1960 when the rates of interest were more or less free from control and were determined by market forces. The second phase was a long period of 25 years from 1961 to 1985. In this period almost all rates of interest were administered or regulated by some authority. The third phase began in 1985 and is still progressing. This third phase is the phase of deregulation of interest rates. It began in 1985 and received a big push in 1991 when the new economic policy was adopted.

5.8.1 The System of Administered Interest Rates

During the period 1961–1985, most of the rates of interest in the organised sector were not determined by market forces. Rather they were determined by monetary authorities.

- Deposit and lending rates of commercial and co-operative banks were fixed by the RBI. The RBI fixed different deposit rates and lending rates for different types of banks.
- The controller of capital issues fixed the ceiling on coupon rates on industrial debentures and preference shares issued by firms.
- The Indian Banks Association had been fixing the ceiling on call rates from 1973 to 1988.
- The Government of India fixed the rates on Treasury bills and long-term government bonds.
- The government also fixed the interest rates on long-term loans of term-lending institutions.
- The RBI fixed different interest rates on loans to different categories of borrowers or on loans for different purposes.
- The RBI also fixed interest rates on different financial instruments such as commercial bills.
- Co-operative societies were required to accept deposits at higher rates and to lend at lower rates than the rates of commercial banks.

Thus the ruling level and structure of interest rates in India during the period was predominantly an administered one. However, the direct regulation of interest rates in India was not a unique system. It is also quite common in other countries, including the US, UK, Japan, and Australia. The controls in India, however, had been far more pervasive and direct than in other countries of the world.

5.8.1.1 Reasons for Regulation

The **reasons for the regulation of interest rates** can be stated as follows:

- In the first place, it was thought that unless regulated, the rates of interest would be much higher than desirable and they would fluctuate widely and create instability in the financial system.
- It has been argued that a low rate of interest would encourage investment and would lead to higher rate of fixed capital formation.
- It was argued that government's need for funds to expand the public sector could be met easily if the rate of interest was kept low.
- It has been pointed out that in a planned economy there are certain priorities fixed by the authority and to fulfil these plan priorities and provide finance to the priority sectors such regulation is required.

For controlling deposit and lending rates of banks following reasons were mentioned:

- To avoid unhealthy competition for borrowing and deposit accounts.
- To maintain a kind of uniformity of interest rates on these accounts of all types of banks.
- To keep deposit rates in alignment with the lending rates of banks.
- To help mobilisation of deposits.
- To lengthen the maturity structure of deposits.
- To enable the authorities to avoid frequent changes in the bank's rate.
- It was believed that effectiveness of monetary policy would be higher when interest rates were administered than when interest rates were market-determined.

5.8.1.2 Effects of Regulation

The system of administered rates of interest had some effects on interest rates and credit control mechanism. These are as follows:

- Interest rates are normally expected to be well aligned with one another so that differences among them can be wiped out through arbitraging. In India, this alignment is comparatively low.
- Increase in interest rates during the period 1961–1985 was the result of periodic mark-ups. But we do not know how the authorities have determined the extent of change in the rate of interest. It appears that decisions in most cases are ad-hoc and haphazard.
- If the rates of interest are market-determined, the market mechanism can work freely which ensures optimum allocation of resources. But this cannot be obtained if the interest rates are administered.
- The administered interest rate system has prevented the growth of a competitive, dynamic and efficient financial system.

Chakravarty Committee (1985) appointed by the RBI to review the working of the monetary system in India pointed out the major deficiencies of the system of administered interest rates as follows:

- The system had grown to be unduly complex, and it contained features which had reduced the ability of the monetary system to promote the effective use of credit.
- The low yields on Treasury bills and government securities had resulted in the high level of monetisation of public debt and consequent monetary expansion.
- The captive market for government securities had adversely affected the growth of capital market.
- Concessional rates of interest had allowed projects of doubtful viability to be undertaken.
- Quantitative credit controls had come under severe stress in the absence of support from any price rationing mechanism.
- The system had lacked the flexibility necessary for augmenting the pool of financial savings.

For these deficiencies, the Chakravarty Committee strongly recommended for the elimination of the system of administered interest rates at least partially.

5.8.2 Deregulation of Interest Rates

The Chakravarty Committee recommended that the system of administered rates of interest should be abolished as far as possible. It had, however recommended that the ceiling on interest rates on bank loans and call loans should be abolished, and that the interest rates on Treasury bills, government securities and bank deposits should be appropriately raised. In accordance with the recommendations of the Chakravarty Committee, several measures have been adopted. The process started in 1985 and it gathered momentum after 1991 when financial sector reforms were introduced following the recommendations of Narasimham Committee. Following measures were adopted in the process of deregulation:

- The bank rate has been activated and most of the money market rates have been deregulated.
- The ceiling on call rate was withdrawn with effect from 1 May 1989.
- The interest rates on Treasury bills, certificates of deposits and commercial papers are allowed to be flexible, variable and market-determined.
- The deposit and lending rates of commercial banks, RRBs and co-operative banks have been freed.
- Interest rates on public deposits accepted by all non-banking companies have been partially deregulated.
- The coupon rates on government-dated securities have been made market-related.
- The interest rates on convertible, non-convertible and other types of debentures have been made free.
- The term lending institutions can now charge interest rates freely without any interference from the government.

5.8.3 Features and Trends of Interest Rates in India

If we observe the data on different rates of interest prevailing in India since 1951, we find that the interest rates were quite stable during the first decade of economic planning (1951–1961). During the next decade (1961–1971), they increased relatively faster. The fastest increase has occurred after 1970.

Wherever interest rates changed, they generally changed in the upward direction; the movements in the downward direction have been relatively less in number except in the case of call rate which is very much volatile. The call rate has increased the most among all the rates. On the other hand, the Treasury bill rate is the classic example of administered interest rates; it increased the least and remained remarkably stable. It remained constant from 1974–1975 to 1991–1992 in spite of so many significant changes in the financial markets and in the economy as a whole. The bank rate has shown similar stability and stagnancy. Interest rates on industrial debentures and bank finance have been higher than all the other interest rates.

If we consider the fluctuations or variability of different interest rates, we find that the amplitude of fluctuations has been different in the case of different interest rates. The variability has been small in the case of Treasury bill rate and government bond yield. The variability has been very high in the case of call rate, debenture yield and SBI advance rate in the ascending order. The bank rate and bank deposit rate have had the middle-order degree of fluctuations.

It has been found in India that the increase in the rates of interest have taken place along with the increase in money supply and prices. This cannot be explained by the Keynesian theory because in the Keynesian theory the rate of interest decreases as money supply increases. According to Professor Bhole, this upward movement of rates of interest along with rise in money supply and prices can be explained in terms of Wicksell's theory of cumulative process. According to him, the natural rate of interest in India has been quite high because of the high rate of planned investment and because of a considerable degree of technological advancement. But the market rate of interest has been kept at a low level because of the mistaken notion of keeping the cost of investment low. Since market rate is lower than the natural rate there is an excess of investment over saving which caused an upward movement of prices. Over the period, there was an attempt to adjust the market rate to the natural rate. Hence both prices and nominal rates have moved in the same direction.

Although the general level of interest rates has gone up, the cost of funds for some borrowers has been lower due to the introduction of differential interest policy adopted by the authorities. Loans to certain priority sectors such as small industries, exports, agriculture have been provided at low interest rates. At the same time, the rates of interest on government securities such as Treasury bills and government bonds have also been kept low in comparison with other rates of interest in order to keep the cost of borrowing of the government low.

Another feature of interest rates in India is the existence of a very high rate of interest in the unorganised sector. The bazar bill rate which belongs to the unorganised sector of the Indian money market is the highest among all interest rates. Interest rates charged by village money lenders are also quite high. However, it is seen that interest rates in the informal sector has decreased over the years.

5.8.4 Interest Rates in India—A Comparison with International Rates

In a study, Professor Bhole has made a comparison between interest rates in India and interest rates in international centres. His findings are as follows:

- The short-term rates in India have usually been higher than similar rates in other countries, especially Germany and Japan.
- The long-term rate of interest in India was mostly lower than similar rates in other countries until 1985. Thereafter, the long-term rate in India has been mostly higher than in other countries.
- While both the short-term and long-term interest rates abroad have somewhat eased, they have somewhat hardened in India since 1990.
- Both the short-term and long-term interest rates abroad have fluctuated more than that in India. The flexibility and volatility of all interest rates in other countries have been far

greater than that in India. The short-term interest rate has been more volatile than the long-term interest rate in all countries including India.

5.8.5 Appropriate Interest Rate Policy

The deregulation of interest rates after 1991 and abolition of ceiling on interest rates have led to increase in interest rates in the 1990s. This has been criticised by some quarters. There has been a constant demand for the lowering of rates of interest in India for encouraging private investment. What should be the appropriate interest rate policy in India in this context?

According to Professor Bhole, the demand for cheap money policy in India is not convincing. Even if the nominal rates of interest are very high the real rates of interest are very low (sometimes even negative) because of the high rate of inflation. Moreover, low rate of interest may not always be in the interest of business and industry. It reduces willingness and capacity of banks to lend funds to industry and business. In a situation of low interest rates, banks prefer to invest in risk-free government securities. Low rate of interest also discourages desire to save.

Again, there are also problems associated with high interest rates. High interest rates may bring in more foreign capital which could end up in building up a debt trap, increasing money supply and increasing inflation. Higher rates of interest also increase the cost of servicing of government debts. Therefore, there is a real dilemma before the policy makers of country: neither an unreasonably high rate of interest nor a low rate of interest is conducive to growth, stability and social justice. The authorities have to try to achieve an appropriate level of interest rates through a system of 'flexibly regulated' interest rates.

SUMMARY

S.1 Meaning of Interest Rate

Interest is the price paid for borrowed funds. It is generally expressed as a rate per cent per period of time. Usually the period is taken as 1 year. In the loan market, there is a variety of loan contracts and we get different rates of interest. When different rates of interest are taken into account, we get an interest rate structure.

S.2 Gross Interest and Net Interest

Gross interest refers to the additional amount of money collected by the lender from the borrower over and above the principal sum. On the other hand, the extra amount to be paid only for use of money capital is called net interest. Gross interest is equal to net interest plus other factors such as risk premium and administrative expenses of lenders.

S.3 Nominal and Real Interest Rate

The nominal interest rate measures the yield in rupees per year per rupee invested. The real interest rate measures the quantity of goods we get in the next period for goods foregone in the present period. The real rate of interest is equal to the nominal rate of interest minus the rate of inflation.

S.4 Differential Interest Rate

In the real world, the loan market is highly segregated. There are different segments in the loan market with different characteristics. Accordingly, there is a wide variety of interest rates in the loan market. Interest rate differences arise due to differences in maturity period of loans. Accordingly, we get short-term, medium-term and long-term rates of interest. Interest rates also vary between the organised sector and the unorganised sector.

S.5 Causes of Variation of Interest Rates

Differences in interest rates may arise due to several factors such as differences in the amount of risks involved, differences in the liquidity of debt, differences in term to maturity, differences in lender's cost of servicing loans, differences in lending practices and extra-loan services, differences on monopoly gains, differences in the purpose of the loan, differences in the financial position and goodwill of the borrowers and government's policy.

S.6 Interest Rate and Economic Progress

By economic progress, we mean continuous increase in the national income and per capita income of the country. Some economists argue that as economic progress takes place, the rate of interest decreases. From experience, it is found that the rate of interest prevailing in developed countries is comparatively low while the rate of interest prevailing in the less developed countries is comparatively high. Even if the nominal rate of interest decreases with economic progress it cannot drop to zero or negative. However, the real rate of interest can be zero or negative.

S.7 Term Structure of Interest Rates

Term structure of interest rates refers to the relationship between different rates when all investment characteristics except the length of time to maturity of the financial claims are held constant. There are three main theories to explain this relationship. They are: (i) Expectations Theory, (ii) Liquidity Premium Theory, and (iii) Market Segmentation Theory.

S.8 Interest Rates in India

The period after 1950 in India can be divided into three phases of interest rate policy. The first phase was the decade 1950–1960 when the rates of interest were more or less free from control and were determined by market forces. The second phase was a long period of 25 years from 1961 to 1985. In this period almost all rates were administered or regulated by some authority. The third phase is the post -1985 period. It is the phase of deregulation of interest rates. Several reasons were given for regulation of interest rates in the second phase. There were certain evil effects of regulation on the economy as a result of which Chakravarty

Committee recommended the elimination of the system of administered interest rates. Several measures were adopted in the process of deregulation of interest rates after 1991.

The level of all interest rates in India significantly increased during 1951–1997, but the extent of increase differs for different rates and in different periods of time. The interest rates have increased along with the increase in prices and money supply. This cannot be explained with the help of classical and Keynesian theories of interest rates. Wicksell's theory of cumulative process perhaps explains better the secular movement of interest rates *vis-a-vis* money supply and prices. The cost of funds for many borrowers has been much lower due to the policy of concessional interest rates of the government. Another feature of interest rates in India is the existence of very high interest rates in the unorganised sector. The flexibility and variability of interest rates abroad have been far greater than in India.

The demand for cheap money policy in India is not very convincing. At the same time, interest rates cannot be allowed to attain an unduly high level. There is a need to evolve a 'flexibly regulated' system of interest rates to achieve an appropriate level of interest rates in India.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. What is interest?
2. What is gross interest?
3. What is net interest?
4. What is risk premium?
5. Define nominal interest rate.
6. Define real interest rate.
7. What is the relation between nominal interest rate and real interest rate?
8. What is Treasury bill rate?
9. What is call money rate?
10. What do you understand by administered interest rate?
11. What is risk of default?
12. What is liquidity of an asset?
13. What are the determinants of liquidity?
14. What do you mean by cost of servicing of debt?
15. Why do private finance companies charge higher rates of interest?
16. What is differential rate of interest scheme?
17. Give one reason why the nominal rate of interest cannot fall to zero.
18. Can the real rate of interest be zero or negative?
19. What do you mean by term structure of interest rates?

20. What are the three theories to explain the term structure of interest rates?
21. How is the long-term rate obtained from short-term rates in the expectations theory?
22. Who is the proponent of the liquidity premium theory?
23. Who is the proponent of the market segmentation theory?
24. What was the period of administered interest rates in India?
25. Who fixed the ceiling on call rates in the call money market?
26. Who fixed the ceiling on coupon rates on industrial debentures and preference shares issued by firms?
27. Give two reasons for regulation of interest rates in India.
28. Mention two effects of regulation of interest rates in India.
29. Give two deficiencies of the system of administered interest rates introduced in India.
30. What was the main recommendation of the Chakravarty Committee?
31. Name two measures adopted in the process of deregulation of interest rates in India.
32. What should be the appropriate interest rate policy for India?

B. Medium Answer-Type Questions (4–5 marks each)

1. Distinguish between gross interest and net interest.
2. Distinguish between nominal interest rate and real interest rate.
3. Prove mathematically that real rate of interest is equal to the difference between nominal rate of interest and rate of inflation.
4. Show how the rate of interest varies according to the degree of risk.
5. Show how the rate of interest varies according to the maturity period of loan.
6. What is the relation between interest rate and economic progress?
7. Can the real rate of interest fall to zero? Give reasons.
8. Can the nominal rate of interest drop to zero? Give reasons.
9. State the assumptions of the expectations theory of term structure of interest rates.
10. Briefly describe the system of administered interest rates that prevailed in India during 1961–1985.
11. State the reasons for the regulation of interest rates in India.
12. State the effects of regulation of interest rates in India.
13. What are the major deficiencies of the system of administered interest rates in India?
14. State the measures adopted in the process of deregulation of interest rates in India.
15. Write a short note on the appropriate interest rate policy for India.

C. Long Answer-Type Questions (10 marks each)

1. Define nominal interest rate and real interest rate. Show the relation between them. **(Section 5.3)**
2. Give a brief account of different interest rates prevailing in the loan market of India. **(Section 5.4)**

3. Explain why differences in interest rates arise in the different segments of the loan market. **(Section 5.5)**

4. Write a note on the relation between interest rate and economic progress. **(Section 5.6)**

5. Give a brief account of expectations theory of term structure of interest rates. What are its limitations? **(Section 5.7.1)**

6. Explain the liquidity premium theory of term structure of interest rates. **(Section 5.7.2)**

7. Write a short note on market segmentation theory of term structure of interest rates. **(Section 5.7.3)**

8. Describe the system of administered interest rates that prevailed in India during 1961–1985. **(Section 5.8.1)**

9. Describe the features and trends of interest rates in India since 1951. **(Section 5.8.3)**

10. Make a comparison between interest rates in India and other international centres. **(Section 5.8.4)**

11. Write a note on what should be the appropriate interest rate policy in India. **(Section 5.8.5)**

MODULE 2

Financial Market Operations

UNIT

6

FINANCIAL MARKETS IN INDIA: AN OVERVIEW

UNIT OUTLINE

SUBJECT MATTER OF THE UNIT

In this introductory chapter, we have tried to give a snap-shot view of different financial markets operating in India. In particular, we have very briefly discussed the types, functions and importance of financial markets. We have also touched upon the recent reforms introduced in Indian money and capital markets. In all the discussions, we have tried to give only a bird's eye view on the concerned topics, as these topics will be discussed at length in the subsequent units of the present book. We have, however, discussed about unregulated credit market in India in some details as this topic will not be covered in the latter units of the book.

6.1 INTRODUCTION

Financial system of an economy is a set of institutional arrangements through which financial surpluses in the economy is transferred from surplus spending units to deficit spending units. Any financial system has three main components. They are: (i) financial assets, (ii) financial markets, and (iii) financial institutions. In this unit, we shall try to present an overview of financial markets in India.

6.2 CLASSIFICATION OF FINANCIAL MARKETS

Markets dealing in various financial assets and instruments, such as, currency, deposits, bills, shares, bonds and so on are called financial markets. The financial system of a country operates through financial markets and financial institutions. Financial markets are theoretically very much similar to the ordinary markets for goods and services.

Financial markets may be classified from different angles. For example, we may make the functional classification of financial markets. This classification is made on the basis of the term of credit. On this basis, financial markets are divided into two categories: markets for short-term credit and markets for long-term credit. Here, short term means a period less than 1 year and long term means a period of 1 year or more. The first category is called money market dealing in short-term credit. The second category is called capital market dealing in long-term credit. We may also make an institutional classification of financial markets. This classification takes into account whether financial markets are organised or unorganised. It also tells us whether the markets deal in new securities or in old or existing securities. If the financial market deals in new securities, we call it primary market. In this case, financial assets are introduced for the first time in the market. On the other hand, if the financial market deals in existing or old financial assets, we call it secondary market. Lastly, there may be sectoral classification of financial markets. The sectoral classification tells us about the sector in which the market is dealing in credit. If the market deals in credit arrangements for agricultural sector, we may call it financial market for agricultural sector. Similarly, we may have financial

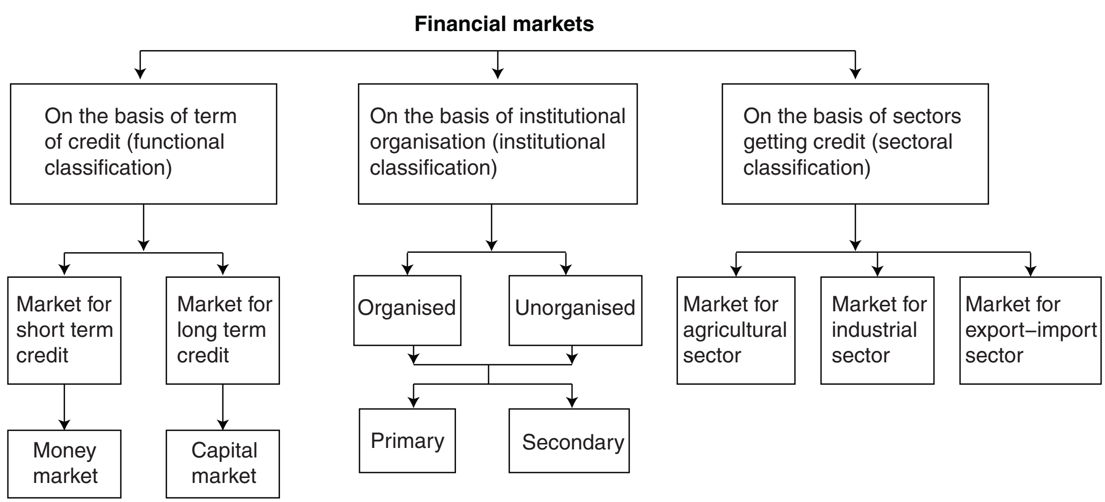


Figure 6.1 Classification of financial markets

market for industrial sector or financial market for export–import sector. In Figure 6.1, we have shown the classification of financial markets.

6.2.1 Money Market and Capital Market

Money market is a market for short-term financial assets which are close substitutes of money and which have a maturity period of less than 1 year. Commercial banks generally play a dominant role in money market. The main instruments in money market are: (i) call/notice money, (ii) treasury bills, (iii) commercial bills, (iv) commercial papers (CPs), and (v) certificates of deposits. In Unit 7, we shall discuss about money market in detail.

On the other hand, capital market is the market in which medium-term and long-term securities are traded. Here the financial assets have a maturity period of 1 year and above. The capital market may be divided into three submarkets: (i) industrial/private securities market, (ii) government securities market, and (iii) long-term loans market. The main instruments of capital market are shares, debentures, government bonds/securities, and so on. While central bank and commercial banks are the major institutions in the money market, development banks, mutual funds and insurance companies are major institutions in the capital market.

6.2.2 Organised and Unorganised Financial Markets

Financial markets are basically divided into money market and capital market. Both the money market and the capital market have organised and unorganised parts. The organised sector of the money market is the sector which is under the control and supervision of the Reserve Bank of India and the government. In this sector, the mode and rules of operations are more or less standardised. The members of organised money market are organised banking sector, co-operative sector banks, and the organised money market has **submarkets** such as call money market, bill market and short-term loan market. On the other hand, unorganised sector of the money market is the sector which is not under the direct control and supervision of the Reserve Bank of India and the government. Hence it is called unregulated credit market. The unorganised sector comprises indigenous bankers, money lenders, finance brokers, chit funds, and so on.

Similarly, the capital market has organised and unorganised components. The main players of the capital market are banks, development financial institutions, and non-bank financial companies. The capital market, whose constituents or sub-markets are well developed, is called organised capital market. On the other hand, the capital market whose constituents or sub-markets are not so developed is called unorganised capital market.

6.2.3 Primary Security Market and Secondary Security Market

The term security in business finance means any financial instrument. So, the market for any financial instrument may be called security market. Security market may broadly be divided into two parts: (i) government security market, and (ii) private/industrial security market. The private or industrial securities market may again be divided into primary market and secondary market. The primary security market is the market where new securities are traded for the first time. Thus, the market that deals in new securities which were previously not available to the investors and are offered to them for the first time is called primary security market. It is also known as the new issue market or the initial public offer (IPO) market. On the other hand, the market in which old and existing securities are traded is known as secondary security market. It is also known as stock market or stock exchange.

6.3 STRUCTURE OF INDIAN FINANCIAL MARKETS

Indian financial markets can broadly be divided into two parts: money market and capital market or security market. Money market is the market for short-term loans or financial assets having a maturity period of less than 1 year. On the other hand, capital market is the market for medium-term and long-term financial assets having a maturity period of 1 year and above. The main players of money market are Reserve Bank of India and commercial banks. The different sub-markets of the money market are call money market, treasury bill market, commercial bill market or discount market, market for commercial papers (CPs) and market for certificates of deposits (CDs). Commercial banks can be divided into nationalised banks and non-nationalised/private sector banks. Non-nationalised banks have two categories: private sector Indian banks and private sector foreign banks. The main components of capital market or security market are gilt-edged or government securities market, industrial or private securities market. The main players in the capital market are: banks, development financial institutions (DFIs) or non-bank financial intermediaries (NBFIs) or development banks and non-bank financial companies (NBFCs). We will briefly discuss about them as follows.

We shall first consider the components of Indian money market. The main components of Indian money market are as follows:

- Call/notice money market
- Treasury bill market
- Commercial bill market

In addition, there are two important instruments in Indian money market. They are as follows:

- Commercial papers
- Certificates of deposits

We will briefly discuss about them.

Call/notice money market: Call money refers to extremely short-period loans, say, 1–14 days. The market for such extremely short-period loans is referred to as call money market. In this market, the day-to-day surplus funds, mostly of banks are traded. Hence, it is also called inter-bank call money market. If the period of loan is just for 1 day, it is called call money. If the period of loan is 2-14 days, it is called notice money.

Treasury bill market: A Treasury bill is a promissory note issued by the government for a period less than 1 year. It represents short-term loan of the government. The market that deals in Treasury bills is known as Treasury bill market.

Commercial bill market: A commercial bill or a bill of exchange is created when goods are sold on credit. The creditor draws a bill on the buyer for the due amount and the buyer endorses it. Thus, a commercial bill or bill of exchange is created. The market dealing in commercial bills or the bills of exchange is called commercial bill market, or simply, bill market.

Commercial papers (CPs): Commercial paper, as a money market instrument was launched on 1 January 1990. Any person, bank, company or corporate body can issue commercial papers (CPs). The maturity period of CPs is between 15 days and 1 year. So it is a money market instrument. The major holders of CPs are banks. The market for commercial papers in India has become fairly popular in recent years.

Let us consider the elements of Indian capital market. Indian capital market has five main components or elements. They are as follows:

(i) **Banks**: It includes commercial banks including State Bank of India and its subsidiaries, NABARD, RRBs, and EXIM Bank.

(ii) Medium-term and long-term Gilt-edged or Government securities market.

(iii) **Industrial/private securities market**: It has two parts: new issue market or primary market and secondary market or stock market (or, stock exchange).

(iv) **Development financial institutions** such as Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), Industrial Investment Bank of India (IIBI), Small Industries Development Bank of India (SIDBI), National Industrial Development Corporation (NIDC), State Industrial Development Corporation (SIDC), and so on.

(v) **Non-bank financial companies**, such as, merchant banks, mutual funds, leasing companies, credit rating agencies, housing finance companies, hire-purchase and consumer finance companies, venture capital funds, and so on.

We will now briefly discuss about them.

Banks: In the category of banks in the capital market, we have commercial banks, co-operative banks, National Bank for Agriculture and Rural Development (NABARD) and regional rural banks (RRBs). The last two banks have been set up for the development of agricultural and rural sector in India. Commercial banks can again be divided into nationalised and non-nationalised or private sector banks. In the category of private sector banks, we have both Indian and foreign banks. Co-operative banks are organised on the basis of the principle of co-operation. It should be noted that commercial banks are included in both money market and capital market. This is because commercial banks provide short-term as well as medium-term and long-term loans. Hence, commercial banks are players in both money market and capital market.

Government securities market: Government securities market or gilt-edged securities market is a market where government securities are traded. Short-term government securities are traded in the money market while medium-term and long-term government securities are traded in the capital market.

Industrial securities market: Industrial securities market or private securities market has two parts: primary market and secondary market. In the primary market, only new securities are traded. Here, only those securities are traded which are issued to the public for the first time. Hence, it is also called **New Issue Market** or **Initial Public Offer (IPO) Market.**

Secondary market: Secondary market deals in already existing securities; it is also called stock exchange or stock market.

Development Financial Institutions (DFIs): Development financial institutions are special purpose development institutions created to supply finance to specific categories of industries. In this group, we have Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), Small Industries Development Bank of India (SIDBI), Industrial Investment Bank of India (IIBI), Life Insurance Corporation of India (LICI), General Insurance Corporation of India (GICI), National Industrial Development Corporation (NIDC), National Small-scale Industries Corporation (NSIC) Limited and so on.

Non-banking financial companies (NBFCs): There are so many non-banking financial companies operating in the capital market of India. Their names suggest the nature and the field of their activities. The main non-banking financial companies in India are merchant banks, mutual funds, leasing companies, credit rating agencies, housing finance companies, venture capital funds and so on.

Merchant banks: These are financial institutions which undertake various types of financial activities, such as giving advice to business enterprises on financial matters and corporate mergers, underwriting new issues, forming of loan syndication to provide large volume of credit, project counselling, providing advisory service to non-resident Indians and so on.

Mutual funds: These are investment companies which seek to mobilise savings of small savers, by selling units of small denominations and channelise those savings to productive investment. The Unit Trust of India (UTI) is the premier mutual fund in India.

Leasing Companies: They provide costly equipment to the business firms on lease. Such companies in India include many private sector non-banking financial companies, some private sector manufacturing companies, Infrastructure Leasing and Financial Services Ltd. (IL&FS), Industrial Reconstruction Bank of India (IRBI), capital market subsidiaries of leading nationalised banks, IFCI, LICI, Housing Development and Finance Corporation (HDFC), State Industrial Investment Corporations (SIICs), and so on.

Credit rating agencies: Simply speaking, these agencies rate or assess the ability of the borrower company to repay its debt. They thus provide useful information to the investors. Some of the important credit rating agencies in India are Credit Rating Information Services of India Limited (CRISIL), Investment Information and Credit Rating Agency of India Limited (IICRA), Credit Analysis and Research in Equity Limited (CARE), Onida Individual Credit Rating Agency of India Limited (ONICRA), now named as ONICRA Limited and so on.

Housing finance companies: They provide finance for house building. Some important institutions in this field are Housing Development and Finance Corporation (HDFC), Housing and

Urban Development Corporation of India Limited (HUDCO), State Housing Finance Societies (SHFSs), National Housing Bank (NHB), and some nationalised banks.

Hire-purchase and consumer finance companies: They mainly provide finance to business firms to purchase equipment and to households to purchase durable consumer goods on hire-purchase basis. Some of the important companies in this field in India are Commercial Credit Corporation Limited, Motor and General Finance Limited, and Investments Supply Limited.

Venture capital funds: They provide initial capital or fund (seed capital) for the risky operation of a firm. Important companies in this field are Risk Capital and Technology Finance Corporation Limited (RCTC), Technology Development and Information Company of India Limited (TDICI), Gujarat Venture Finance Limited, Andhra Pradesh Industrial Development Corporation Venture Capital Ltd., and so on. Further, commercial banks, such as Canara Bank, Grindlays Bank, Central Bank of India and the State Bank of India have opened venture capital companies under their respective banks.

In Figure 6.2 on the next page we have shown the structure of organised financial markets in India.

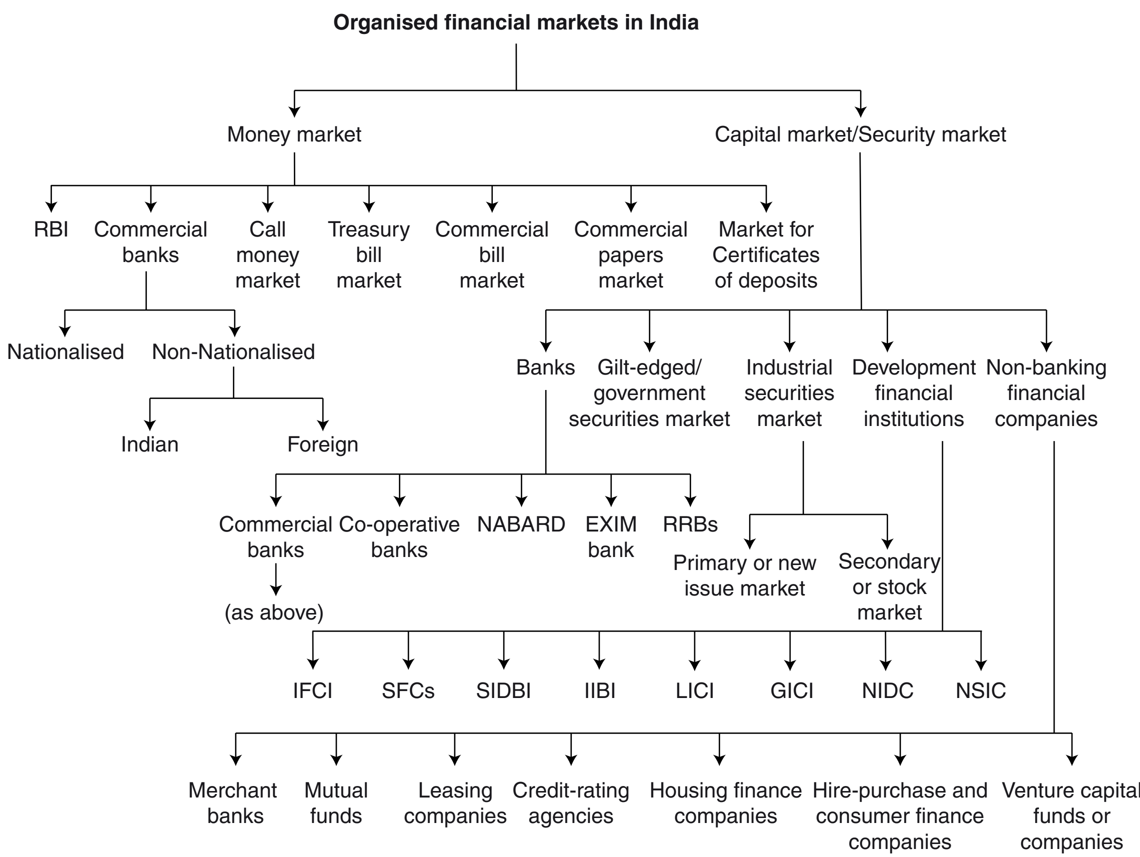


Figure 6.2 Organised Financial Markets in India

6.4 FUNCTIONS OF FINANCIAL MARKETS

Financial markets of an economy perform some important functions and thus help in economic development of the country. The important functions of financial markets may be summarised as follows:

(i) ***Provision of finance***: The main function of financial markets is to provide finance for agriculture, industry and trade. While the money market provides short-term finance, the capital market provides medium-term and long-term finance.

(ii) ***Supply of funds to the government***: Money market supplies short-term funds to the government on the basis of Treasury bills. Capital market also provides much needed funds to the government and autonomous bodies.

(iii) ***Mobilisation of savings***: Financial markets help in the mobilisation of savings. Banks and other financial institutions induce people to save more and collect those savings through their branches.

(iv) ***Channelising savings to productive investment***: Another important function of financial markets is to channelise mobilised savings to most productive investment. Financial markets thus try to ensure optimum use of financial resources.

(v) ***Encouraging savings***: Financial markets, especially capital market, open new opportunities for investment through various kinds of securities. It encourages people to save more.

(vi) ***Finance to targeted groups***: Development financial institutions of the capital market provide finance to some targeted groups including small and cottage industries.

(vii) ***Increasing financial mobility***: Financial markets facilitate the transfer of funds from one sector to another and from one region to another. They, thus, help in financial mobility which is essential for economic development of a country.

(viii) ***Providing information to investors***: Credit rating agencies of the capital market provide important information to investors. Their ratings act as a guidance to investors while taking investment decisions.

(ix) ***Helping the monetary policy***: Commercial banks grant credit to different sectors of the economy as per directives of the central bank. They, thus, help in the implementation of monetary policy of the central bank and the government.

(x) ***Serving corporate sector***: Merchant banks provide some essential services to the corporate sector. Some of these services are giving advice on financial alternatives, corporate mergers and takeovers, underwriting new issues, loan syndication, and so on.

Thus, financial markets perform so many important functions in a country. They encourage and mobilise savings, transfer those savings to productive investment, increase financial mobility, provide funds to the government, help in implementing monetary policy of the central bank, and so on. These are very helpful for economic development of a country.

6.5 MAJOR REFORMS IN FINANCIAL MARKETS OF INDIA

In 1991, the government of India adopted a new economic policy consisting of a series of economic reforms. This policy has three main components: liberalisation, privatisation and globalisation, or LPG, in short. Liberalisation means reduction in government control on economic activities. Privatisation simply refers to selling of a part or whole of a public sector unit to the private capital whereas globalisation refers to integration of domestic economy with the world economy. In order to execute these three schemes, the Government of India introduced a series of reforms in different sectors of the economy. In this section, we shall give a brief outline of reforms in the financial markets of India. In particular, we shall consider reforms in money market and in capital market.

6.5.1 Recent Reforms in the Money Market of India

From mid-1980s, the Government of India has introduced a series of reforms in the money market. We give a brief outline of these reforms below:

Introduction of market rate of interest: Following the recommendations of the Narasimham Committee (1991), interest rates have largely been deregulated. The system of administered interest rates in India is gradually disappearing. Interest rates are now largely determined by the market forces of demand and supply.

Reforms in the call money market: The Discount and Finance House of India (DFHI) Limited was set up in 1988. It has met the need for a discount house in India. Discounting of bills has now become relatively easier. As a result, the number of participants in the call money market has increased.

Introduction of innovative instruments: In recent years, many innovative instruments have been introduced in the Indian money market. As a result, the Indian money market has become diversified. The volume of transaction has also increased.

Reforms in the bill market: From May 1990, more than 25 financial institutions have been permitted to rediscount commercial bills.

Entry of private and foreign banks: As per recommendation of the Narasimham Committee (1991), private and foreign banks are being allowed to enter the Indian money market.

Entry of money market mutual funds (MMMFs): In recent years, some private sector mutual funds and some commercial banks have been allowed to deal in money market instruments.

Setting up of credit rating agencies: In order to provide credit information to the investors, some credit rating agencies have been set up.

Setting up of STCI: In order to create a secondary market in government securities, the RBI set up Securities Trading Corporation of India (STCI) in May 1994. It has extended the Treasury bill market and the call money market.

***Adoption of suitable monetary policy*:** Following the recommendations of Narasimham Committee, the RBI has reduced the Statutory Liquidity Ratio (SLR) to 25 per cent. The Cash Reserve Ratio (CRR) has also been reduced.

***Setting up of CCIL*:** In April 2001, the Government of India has established the Clearing Corporation of India Limited (CCIL). It clears all transactions in government securities.

***Introduction of electronic transactions*:** In order to make money market transactions transparent and efficient, the electronic transactions system has been introduced in recent years.

***Introduction of banking ombudsman scheme*:** On 14 June 1995, the RBI has introduced banking ombudsman scheme. It redresses customers' complaints and grievances on any banking transaction.

As a result of these reforms, Indian money market has become more organised and developed than before. However, it may be admitted that there is much left to be done. Particularly, the unorganised sector of the Indian money market should be integrated with the organised sector. That will make Indian money market more vibrant and developed.

6.5.2 Recent Reforms in the Capital Market of India

Since 1991, the Government of India has introduced a series of reforms in different sectors of the economy. As a part of the financial sector reforms, there were many reforms in the capital market also. Most of these reforms were executed by the Securities and Exchange Board of India (SEBI). It has been given the power to regulate stock exchanges. Further, SEBI has been allowed to issue regulation and to file suit against erring companies without prior approval of the central government. Various reforms introduced in the Indian capital market may be discussed under two headings: primary market reforms and secondary market reforms.

6.5.2.1 Primary Market Reforms

Important reforms in the primary market in recent years are as follows:

- SEBI has brought merchant banking under its regulatory framework.
- SEBI has advised stock exchanges to amend the listing agreement. A listed company should show variations between financial projections and actuals in the offer documents. Then the shareholders will be able to compare between promises and performance.
- In order to reduce the cost of new issue, SEBI has made underwriting by the issuing company optional.
- SEBI has stopped the practice of making preferential allotment of shares unrelated to the prevailing market prices. It has issued new guidelines in this regard.
- SEBI has introduced regulations regarding substantial acquisition of shares and takeovers.
- SEBI has also brought the UTI under its regulatory jurisdiction.

6.5.2.2 Secondary Market Reforms

In this sector, important reforms are as follows:

- SEBI has greatly simplified the procedure for placing securities for transfer by institutions.
- Stock exchanges are allowed to introduce carry forward system only with prior permission of the SEBI.
- To protect market intermediaries and consequently investors from default and other risks, SEBI has announced capital adequacy norms.
- SEBI has introduced insurance for all member brokers of stock exchanges against risk.
- SEBI has mentioned certain norms and codes of conduct for merchant bankers, brokers, underwriters and share transfer agents. These norms specify a high degree of responsibility towards investors. SEBI can take action against the erring intermediaries.

Thus, SEBI has introduced a series of reforms in recent years in the capital market of India. The objective is to ensure a fair, transparent and strong regulatory framework for efficient working of the capital market and for protecting the interests of the investors.

6.6 ROLE OF FINANCIAL MARKETS IN ECONOMIC DEVELOPMENT

Financial markets play a crucial role in the process of economic development of a country. Without a developed financial system or financial market the process of economic development of any country is bound to be halted. Both money market and capital market perform some very important functions and thus help in economic development of a country. Some of these functions of money market needed for economic development are as follows:

- Mobilisation of savings
- Provision of funds in productive investment
- Use of surplus funds
- Assistance to government to mobilise funds
- Increase in financial mobility
- Economy in the use of cash

Capital market in an economy also performs some important functions and thus helps in economic development of the economy. In fact, without a developed capital market, economic development of an economy is not possible. Some of the important functions of the capital market which are helpful for economic development are mentioned as follows:

- Provision of medium-term and long-term finance for agriculture, trade and industry.
- Mobilisation of small savings of the public and channelising them into proper investment.
- Provision of funds to the government and autonomous bodies.
- Bringing new opportunities for investment and thus encouraging savings.
- Assurance of funds to corporate bodies through underwriting of shares.
- Provision of finance to some targeted groups including small and cottage industries through development banks.

- Provision of important information to investors through credit rating agencies.
- Provision of some special services to the corporate sector through merchant banks.

Thus, both money market and capital market perform some useful functions which are of great help for economic development of a country.

6.7 UNREGULATED CREDIT MARKET IN INDIA

In terms of control or regulation by the monetary authority or the Reserve Bank of India, the financial market of India can basically be divided into two categories. They are: regulated credit market and unregulated credit market. Financial institutions such as IFCI, SFCs, SIDBI, SIDCs, NSIC, NIDC, NABARD, RRBs, EXIM Bank, LICI, GICI and some others together form the regulated credit market of India. The RBI or the monetary authority and the Government of India can regulate the activities of such institutions in one way or the other. On the other hand, there is a large segment of credit market of India which is not regulated by any financial authority. This is called unregulated credit market. This is one of the major defects of Indian finance market. There are different types of unregulated credit agencies. They are not linked with the organised sector of the credit market. Their forms of organisation and methods of working are not standardised. Instead, there is a great diversity in their organisation, methods, functional areas of operation, sources of funds, effective rates of interest charged on their loans and so on. Hence, they are also called unorganised credit market. Their common features are: (a) they are not regulated, as the term 'unregulated' suggests, by any authority, and (b) they operate in segmented credit market. Hence, the rate of interest charged by them varies widely.

Unregulated credit agencies are both competitive and complementary to banks. In attracting loanable funds from surplus units, they compete with banks and other financial institutions of the organised sector. In supplying credit, they often act in a complementary manner with regulated financial institutions as they provide credit for such users who cannot be accommodated by banks and organised financial institutions. However, due to incomplete information, it is very difficult to make a proper evaluation of the activities of unregulated credit market in India.

6.8 TYPES OF UNREGULATED CREDIT AGENCIES

In India, there are several types of unregulated credit agencies. The following five categories may be mentioned:

(i) Indigenous bankers
(ii) Finance brokers
(iii) Money lenders
(iv) Para-banking institutions
(v) Other lenders

Let us consider them one by one.

6.8.1 Indigenous Bankers

Indigenous bankers are individuals or private firms who operate like banks as such and receive deposits and give loans. Their activities are not regulated and so they form a part of the unorganised credit market of India. Indigenous bankers lend money, act as money changers and finance the internal trade of India by means of *hundis* or internal bills of exchange. There are mainly three types of indigenous bankers in India. They are as follows:

(i) Those whose main business is banking.
(ii) Those who combine their banking business with trading and commission agency business.
(iii) Those who are mainly traders and commission agents but who do a little banking business too.

The majority of the indigenous bankers belong to the second group.

Indigenous banking in India dates back to ancient ages. Until the middle of the nineteenth century, indigenous financial agencies had the main role in Indian banking system. They supplied credit even to the government in addition to traders and producers. With the arrival of the British, indigenous banking was started to be replaced by European modern banks. After independence, rapid growth of commercial and co-operative banks substantially reduced the area of operation of indigenous banking. Nonetheless, indigenous bankers, particularly as family concerns, survived in many areas. They are present even in the modern period. According to an estimate of the Banking Commission of 1972, there were about 2000–2500 indigenous bankers in India at that time. According to the estimate of Timberg and Aiyar conducted in 1980[1], there were about 20,000 indigenous bankers in India. They have further estimated that in the late 1970s, the total credit granted by these bankers was about ₹1500 crore. This amount was about 10 per cent of the total commercial bank credit in the year 1977–1978. By and large, indigenous bankers are urban. Their business, besides being hereditary, is confined to a few castes and communities.

Indigenous bankers are heterogeneous. The Banking Commission (1972) had grouped them under four sub-groups: (i) Gujarati Shroffs, (ii) Shikarpuri or Multani Shroffs, (iii) Chettiars of the South, and (iv) Marwari Kayas of Assam. Of these four types, the Gujarati Shroffs are the most important. They are active in Gujarat, Mumbai and Kolkata. The Shikarpuris or the Multanis are operative mainly in the city area of Mumbai. The Chettiars operate mainly in South India and the Marwari Kayas are operative in the tea gardens of Assam and Eastern India. We briefly discuss about them one by one.

Gujarati Shroffs: The Gujarati Shroffs are the most important among the four main types of indigenous bankers. They are of two types: (i) pure bankers, and (ii) bankers and commission agents. The function of pure bankers is like those of commercial banks. Like commercial banks, they accept deposits, make loans and provide means of remittance and collection of money. They accept both current and fixed deposits and pay interest even on current deposits. Some indigenous bankers also offer cheque facility to their current account

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[1]Timberg, T. and Aiyar, C. V., 'Informal Credit Markets in India', *Economic and Political Weekly*, Annual Number, 1980.

depositors. However, these cheques have only a limited local circulation and commercial banks do not accept them. Indigenous bankers also advance money on call and for short periods on personal credit or on securities. Generally this is done by issuing *darshani hundis* drawn on their firms or other Shroffs at other centres. Sometimes, advance is given by discounting *muddati hundis* and commercial papers of various kinds, out-of-station current cheques and post-dated cheques.

The Gujarati Shroffs arrange for the remittance of funds by using *darshani hundis*. They also collect *hundis* for their clients. Some big Shroffs have rural centres. In addition, Shroffs have arrangements of mutual accommodation for acceptance and payments of *hundis* at various places both within and outside the state boundaries. As a result, these Shroffs have been able to conduct commission agency work and exchange works. This also helps them raise and lend funds in the most profitable manner and direct surplus funds to those places where they are needed.

Sources of working capital of the Gujarati Shroffs are their own funds, deposits from the public and inter-firm borrowings. They do not generally borrow from commercial banks to finance their banking operations. They have developed their own call-money market. In this market, short term surplus funds are borrowed and lent. This is a very distinctive feature of the banking operations of the Gujarati Shroffs.

Shikarpuri or Multani Shroffs: In terms of importance, the Shikarpuri or Multani Shroffs are second to the Gujarati Shroffs as indigenous bankers. They mainly operate in Mumbai and South India. According to the estimate of Banking Commission (1972), there were about 400 Multani Shroffs. However, Timberg and Aiyar put this number at 1200 for the year 1980. To provide credit, the Shikarpuri Shroffs mainly rely on their own funds and borrowing from commercial banks. Generally they do not rely on deposits from the public as the source of their funds. This distinguishes the Shikarpuri financiers from the Gujarati Shroffs. Since 1970, banks have reduced loans to the Shikarpuris. Hence, the Shikarpuri Shroffs now rely largely on their own funds. As a result, the Shikarpuri credit business has not grown very much. The cost of their credit to their borrowers has also considerably increased.

The Shikarpuri Shroffs previously used to lend mainly by Multani *hundis*. These *hundis* were actually 90-day term notes. Previously, they borrowed from commercial banks by getting these *hundis* rediscounted. However, gradually this rediscounting facility from banks decreased over time. Hence, the Shikarpuri Shroffs moved more and more towards lending against demand promissory notes and giving instalment credit. The main borrowers of the Shikarpuri Shroffs are traders and small manufacturers. Other less important borrowers are transport operators and small exporters. The clientele of the Shikarpuri Shroffs is of various types. They are not limited to a few communities as in the case of the Gujarati Shroffs.

Chettiars of the South: The Chettiars are active mostly in South India. They are most organised among the indigenous bankers. They operate in the same way as the Gujarati Shroffs. However, reliable estimates on the amount of their business are not available. In recent years, banking operations of the Chettiars have decreased in importance. They have now concentrated on hire-purchase business.

Marwari Kayas: The Marwari Kayas operate mostly in the tea gardens of Assam. The tea gardens take short-term loans from the Kayas. For their loan operations, the Marwari Kayas get credit facilities from commercial banks. About 75 per cent of their funds come from commercial banks and about 25 per cent of their funds come from their own resources and deposits collected from the public. Due to the branch expansion of commercial banks in recent years, activities of the Marwari Kayas have been adversely affected.

6.8.1.1 An Evaluation of the Activities of Indigenous Bankers

In spite of stiff competiton from commercial banks, indigenous bankers have survived in the Indian credit market. This is due to some factors favourable to them. These factors operate both on the demand side and on the supply side. We sum up those factors below. Among these factors, the first three operate from the demand side whereas last factor operates from the supply side.

(i) Small traders and manufacturers in urban areas widely use the credits given by indigenous bankers. This is particularly true for metropolitan cities. Commercial banks cannot fully satisfy the credit needs of this segment of borrowers.

(ii) Indigenous bankers very often provide credit in the form of clean advances. Small borrowers badly need such credit. Commercial banks do not offer them such risk capital.

(iii) To get loans from commercial banks, many formalities are to be fulfilled. On the other hand, services offered by indigenous bankers are prompt, flexible and informal. Borrowers feel comfortable in such a system.

(iv) Indigenous bankers enjoy a certain cost advantage over commercial banks. Their operating and establishment costs are much lower than those of commercial banks. Their information costs are also lower as they know their borrowers well who are invariably local people. Hence, indigenous bankers face less default. Commercial banks do not generally enjoy such benefits.

However, indigenous banking system in India has some limitations. They are as follows:

- The rate of interest charged by indigenous bankers is much higher than the rate charged by commercial banks.
- The indigenous credit market is not only local but also highly segmented. Funds in this market do not easily move from one place to another or from one segment to another. As a result, credit does not flow to the most eligible user.
- Indigenous banking is almost totally unsupervised and unregulated. This reduces the effectiveness of monetary policy of the Reserve Bank of India.
- Indigenous bankers have very little regard about the end-use of credit. They provide credit for highly speculative activities. This can again reduce the effectiveness of selective credit control measures adopted by the Reserve Bank of India.

In spite of these limitations, indigenous bankers play a vital role in the credit market of India. In fact, they are the main source of credit to the small and marginal farmers and village artisans in rural India. Commercial banks have not been able to become effective competitors, particularly in the field of rural credit.

6.8.1.2 Reforms Suggested by the Banking Commission (1972)

We know that the indigenous banking system in India has some limitations. In this context, many feel that there should be some reforms in this system. They argue that the indigenous banking system should be integrated with the organised banking system rather than replaced totally by commercial banks. In spite of the considerable expansion of commercial banks in India in recent years, they have not been able to meet the credit needs of small borrowers. This is mainly due to their high cost of servicing small loans, high risks and many formalities. As a result, indigenous bankers have been able to flourish by providing credit to small borrowers. This has been possible due to their prompt, flexible and informal mode of operation. In the near future, the same conditions are likely to persist. Hence, indigenous bankers have still a role to play. So, the best course of action would be to reform the indigenous banking system and thus to remove its defects. This requires two lines of reforms. One is to establish a direct link of indigenous bankers with the Reserve Bank of India. The other is the indirect control of the activities of indigenous bankers by the Reserve Bank of India through commercial banks.

The Banking Commission of 1972 considered both the possibilities. In its view, the direct link of indigenous banking system with the RBI was neither necessary nor practicable. It was considered impracticable because refinancing of indigenous bankers by the RBI would involve much labour compared to the amounts of expected refinance. This is because *hundis* of indigenous bankers are for small amounts and the day-to-day turnover in them would be large. Detailed supervision and inspection of indigenous bankers would also require large and costly inspection machinery.

Hence, the Banking Commission favoured indirect control over indigenous bankers by the RBI through commercial banks. This requires that commercial banks offer steady and uninterrupted accommodation to the indigenous bankers through the discounting of *hundis*. However, at present, this assistance is highly irregular. The Banking Commission suggested that the flow of funds from commercial banks to the indigenous banks should be made regular. It also recommended that commercial banks should offer their discounting facilities only to those indigenous bankers who maintain accounts properly and get them audited and submit their summary to the RBI. Further, commercial banks should properly evaluate the financial statements of indigenous bankers while granting loans to them. The RBI should give guidelines to commercial banks for their dealings with indigenous bankers. The RBI should also indicate periodically the spread (i.e., difference) between the rate of interest charged by indigenous bankers from their borrowers and the rate of interest paid by them to commercial banks.

Unfortunately, no action has so far been taken on these lines. If these reforms are materialised, activities of indigenous bankers will increase and they will be able to supplement commercial banks. We know that after the nationalisation of major commercial banks in India, there has been a tremendous expansion of branches of commercial banks in all parts of the country. Still, because of the flexibility and informality in the operations of indigenous bankers, they continue to play a prominent role in the Indian credit market. The Banking Commission (1972) too hoped that indigenous bankers would play a very useful role in the future development of the country. If the above reforms are undertaken, this hope is likely to be fulfilled.

6.8.2 Finance Brokers

Finance brokers are found in all major urban markets. They are especially active in cloth markets in Mumbai, Kanpur, Delhi, in jute market in Kolkata, in grain market and in some other commodity markets in different cities of India. There are both full-time and part-time brokers.

As the very name suggests, finance brokers act as middlemen between the borrowers and the lenders. Such lenders may be commercial financiers such as Shikarpuri bankers or non-commercial lenders with surplus funds. Finance brokers help the lenders with their intimate knowledge of the credit worthiness of the borrowers. They also keep a close watch over the state of business of their borrowing customers. This is because their own standing depends on the accuracy of their reports.

There are big and small brokers. There are brokers who work in the inter-corporate call money market in Mumbai and Kolkata, where call loans for a day or so are arranged among corporate firms. Such deals involve big sums. Very often these big brokers are stock brokers. They also act as brokers of company deposits. Smaller brokers arrange intra-market and inter-market credit for proprietary firms and partnerships. They cover a wide range. On the one hand, there are brokers who handle more than ₹1 crore a year and on the other hand, there are brokers who handle as little as ₹5000–25,000 at a time between lenders and borrowers.

Brokers also syndicate loans among Shikarpuri bankers. In this case, a large loan is broken up into smaller amounts and sold to a group of bankers. In large cities, Gujarati Shroffs also use brokers. However, brokers' role is not as crucial for them as it is for Shikarpuris.

6.8.3 Money Lenders

The main distinction between a money lender and an indigenous banker is that the money lender lends his own fund. He does not accept deposits from the public. But the indigenous bankers accept deposits from the public and also give loans. Moreover, a money lender conducts his transactions in cash. But most of the transactions of an indigenous banker are done by short-term credit instruments such as *hundis* and commercial bills. Money lenders are of different categories. Broadly they are of three types:

(i) Professional money lenders: Their main activity is money lending.
(ii) Itinerant money lenders such as Pathans and Kabulis
(iii) Non-professional money lenders: Money lending is not their main activity.

The methods of operation of money lenders are also not uniform. Their activities are generally localised either in rural areas or in urban areas. The main features of money lenders as a source of credit are as follows:

- Money lenders do not generally receive deposits from the public. Their funds are mostly their own. They rarely borrow from bank or other financial institutions to conduct their lending business.
- Money lenders usually lend money to poor borrowers such as agricultural and landless labourers, marginal and small farmers, artisans, factory and mine workers and small

traders. These borrowers fail to get loans from formal sources as they cannot fulfil their formalities. As a result their bargaining power is negligible.

- Money lenders charge usurious (very high) rate of interest. They also indulge in various malpractices, such as frequent compounding of interest, false manipulations of loan records, extra imposition in the form of *begar* (unpaid labour), interlocking of markets, and so on.
- Money lenders' activities are unregulated. Hence, borrowers are exposed to worst kind of exploitation. Money lenders grant loans for both production and consumption. More often than not, borrowers find it difficult to repay consumption loans along with exceptionally high interest. They lose the security to the money lender. Thus, poor borrowers lose their land, cattle, crops, houses and ornaments against paltry amount.
- Money lenders' credit has the merit of being prompt, flexible and informal. Such loans can be easily renewed following timely payment. Transaction cost is also low. Yet, these benefits are quite small when considered against high exploitation.

So long as institutional loans are inadequate in India, there is no escape from such exploitative credit. Money lenders' credit has to be accepted as a necessary evil. In the past, several legislative measures have been adopted to restrict their exploitation. But most of these measures have not been implemented. To curb the activities of money lenders, supply of institutional credit is to be increased. There should be prompt and informal issue of institutional credit. At this point, institutional sources are in a disadvantageous position. They have to observe so many procedures; their transaction costs are also high. Hence, small borrowers always prefer to take loans from money lenders, rather than from institutional sources such as commercial banks, regional rural banks (RRBs) or co-operative banks.

6.8.4 Para-Banking Institutions

Para-banking institutions include loan or finance companies, chit funds and *nidhis*. Loan companies are found in all parts of the country. However, their exact number is not known. In addition, a large number of partnership firms and individuals are engaged in lending business. Loan companies try to attract fixed deposits from the public, mainly by offering high rates of interest, along with prizes, gifts, and so on. Services of agents are also used to solicit deposits. A part of the fund is kept as fixed deposits in banks and the rest is given as loans and advances to wholesale traders, retailers, small-scale industries and self-employed persons. Persons who cannot get adequate or any credit from institutional sources take loans from loan companies. The loans are generally unsecured. The effective rate of interest is very high. Yet, their business is increasing because of the easy availability of such loans.

In the case of chit funds, members make regular periodical subscription to the fund. The collected fund is given to some members of the fund and selected in an agreed manner. Each member is assured of his turn before another member gets it for the second time. A major part of this chit fund business is conducted in Kerala and Tamil Nadu. One important feature of chit funds is that they do not discount *hundis*. There are allegations of corruption about chit funds.

Nidhis are also found in South India, particularly in Tamil Nadu. They act as mutual benefit funds and so deal only with their members. The major source of their funds is long-term deposits from members. Loans granted by *nidhis* are also long-term loans given for house construction, repairs and so on. Sometimes, *nidhis* also get loans from banks; however, such loans are not on a regular basis but at the time of financial crisis.

6.8.5 Other Lenders

Some borrowings and lendings take place simply on the basis of personal contact. The borrowers or borrowing firms may collect funds from relatives, friends and other known persons. Reasonable faith in the honesty and solvency of borrowers is the basis of these loans. Often the borrowers offer higher rate of interest than the rates charged or offered by banks.

6.9 UNREGULATED CREDIT MARKET AND EFFECTIVENESS OF CREDIT POLICY OF THE RBI

The unregulated credit market creates serious problems of credit control for the monetary authority or the Reserve Bank of India. Both credit allocation and aggregate amount of credit are affected. The unregulated credit market attracts a part of the loanable fund generated in the economy. The larger is this part, the greater would be the amount of funds outside the direct control of the monetary authorities. Allocation of such funds would also be entirely outside the control of the Reserve Bank of India. As a result, the effectiveness of the monetary policy of the RBI gets diminished.

However, some indirect influence of the policies adopted by the monetary authority cannot be ruled out. In a situation of tight monetary control when high cost of credit and low availability of funds prevail in the formal market, unsatisfied demand for funds is diverted to unregulated credit market. Supply of funds, if any, from the formal market to the unregulated market gets choked. Thus, conditions in the unregulated market also become tight. It raises cost of credit and reduces availability of credit in the unregulated credit market also. This reasoning is, however, not applicable irrespective of the type of monetary policy. If selective credit control is adopted, then loans rejected or curtailed in the formal market may be sanctioned at least partly in the unregulated market. As a result, the flow of credit may not decline as desired by the monetary authority. Further, suppose the RBI asks the banks not to provide credit for speculative activities. While this will be obeyed by commercial banks, unregulated credit agencies may continue to provide loans in such activities. Then the speculative activities of the economy could not be controlled and the objective of the credit policy of the RBI will be frustrated.

When the RBI was established in 1935, attempts were made to bring particularly the indigenous bankers under its orbit. The RBI issued a draft scheme for this purpose.

Participation of the indigenous bankers was necessary to implement the scheme. They would have been required to give up certain privileges against some compensating benefits. The indigenous bankers, with their age-old tradition of independence, declined to accept the scheme. In 1954, the Shroff Committee recommended that the RBI should take steps to encourage the rediscounting of *hundis* of the indigenous bankers through the scheduled banks. Similar proposal also came from the Bombay Shroffs Association. However, the RBI did not consider the proposal acceptable and nothing was done in this regard.

In order to make the credit policy of the RBI effective, the unorganised credit market should be brought under its control. Otherwise, the credit control policy of the RBI will not be successful. Further, as there is no control over the unregulated credit agencies either by the Government of India or by the RBI, these credit agencies often deal in black money. Hence, in order to curb black money, these credit agencies should be controlled. The Banking Commission of 1972 also stressed on the necessity of bringing these credit agencies into the organised part of the money market.

There were, however, some measures, though not very effective, undertaken by the government in order to control the activities of the unregulated credit agencies. We may briefly mention them as follows:

- The Banking Companies Act of 1949 imposed some controls on indigenous banks. However, these controls were applicable only to those indigenous banks which were joint stock companies. Most of the indigenous banks are not joint stock companies. Hence, this Act is not very effective.
- The government passed the Banking Laws (Miscellaneous Provisions) Act in 1963. It empowered the RBI to inspect the accounts of the non-banking financial institutions. This Act was supposed to be applicable to all types of non-banking financial institutions. However, in practice, the RBI exercised control only on those non-banking financial institutions which were registered as joint stock companies. Further, the RBI could not exert any control on the rates of interest charged by these financial institutions.
- The Prize Chits and Money Circulation Schemes Banning Act was passed in the year 1978. The Act imposed some restrictions and regulations on the activities of chit funds. But again, the provisions of this Act are applicable only to those chit fund companies which are registered as joint stock companies. Hence, other chit funds which are not joint stock companies remain outside the control of this Act.

Thus, till today, the unregulated credit agencies are not controlled by the RBI. Their activities are not very often in line with the credit policy of the RBI. It reduces the effectiveness of the monetary policy of the RBI. To increase the effectiveness of the credit policy of the RBI, activities of these unregulated credit agencies should be brought under effective control of the RBI. Further, these credit agencies often deal in black money. Their activities help to generate and propagate black money in the economy. Hence, in order to curb black money, activities of these credit agencies should be controlled.

SUMMARY

S.1 Classification of Financial Markets

Financial markets may be classified from different angles. On the basis of term of credit, financial markets are divided into money market and capital market. The former is the market for short-term securities having maturity period of less than 1 year whereas the latter deals in medium-term and long-term securities having maturity period of 1 year or above. On the basis of institutional organisation, financial markets are classified as primary market and secondary market. In the first market, only new issues are traded whereas in the second market, old and existing issues are traded. Again, on the basis of sectors getting credit, we may classify financial markets as market for agricultural sector or market for industrial sector or market for export–import sector.

S.2 Money Market and Capital Market

Money market is the market for short-term credit. Here short term refers to a period less than 1 year. On the other hand, capital market is the market for medium- and long-term credit. Here medium term or long term refers to a period of 1 year or above.

S.3 Organised and Unorganised Financial Markets

Organised financial market is the market which is under the control or supervision of the Reserve Bank of India, whereas unorganised financial market is not under the control of the Reserve Bank of India.

S.4 Primary Security Market and Secondary Security Market

The primary security market is the market where new securities are traded for the first time. It is also known as the new issue market or the initial public offer (IPO). On the other hand, the market in which old and existing securities are traded is called secondary security market. It is also known as stock market or stock exchange.

S.5 Structure of Indian Financial Markets

Indian Financial markets have two broad components: money market and capital market or security market. The main components of money market are Treasury bill market, commercial bill market or discount market, markets for commercial papers (CPs) and certificates of deposits. The main players in the money market are commercial banks which can be divided into public sector banks and private sector banks. Private sector banks again have two categories: private sector Indian banks and foreign banks. The main components of capital market or security market are banks, gilt-edged or government securities market, industrial securities market, development financial institutions (DFIs) or development banks or non-banks financial intermediaries (NBFIs) and non-banking financial companies (NBFCs). Industrial or private securities market has two parts: primary market or new issue market which is also called initial public offer (IPO) and secondary market or stock market (or stock exchange). The main development banks are IFCI, SFCs, IIBI, SIDBI, NIDC, SIDC, and so on. Important non-banking financial companies are merchant banks, mutual funds, leasing companies, credit rating agencies, housing finance companies, hire-purchase and consumer finance companies, venture capital funds, and so on.

S.6 Functions of Financial Markets

The main functions of financial markets are provision of finance, supply of funds to the government, mobilisation of savings, channelising savings to productive investment, encouragement to savings, finance to targeted groups, provision of investment information to investors, increasing financial mobility, serving corporate sector and so on.

S.7 Major Reforms in Financial Markets of India

From mid-1980s, the Government of India has introduced a series of reforms in the financial sector. The main reforms in the money market are: introduction of market-determined rate of interest, reforms in the call money market, introduction of innovative instruments, permission to many institutions to rediscount commercial bills, entry of private and foreign banks, entry of money market mutual funds (MMMFs), setting up of credit rating agencies, setting up of Securities Trading Corporation of India (STCI), reforms in monetary policy, setting up of Clearing Corporation of India Limited (CCIL), introduction of electronic transactions, introduction of banking ombudsman scheme, and so on. The main reforms introduced in Indian capital market in recent years are: statutory status to SEBI, bringing merchant banks under the regulatory framework of SEBI, simplification of issue procedures, simplification in listing agreements, bringing UTI under the control of SEBI, introduction of certain norms and codes of conduct for merchant bankers, brokers, underwriters and share-transfer agents, introduction of risk management system for mutual funds, introduction of trading in government securities on stock exchanges, and so on. These reforms have made the working of Indian financial market fair, transparent and stable.

S.8 Role of Financial Markets in Economic Development

Both money market and capital market perform some important functions. These functions play a vital role in the process of economic development of India. These are very helpful in promoting economic development of the country.

S.9 Unregulated Credit Market in India

There is a large unorganised sector in the credit market of India. Many credit agencies operate in this market. They are not regulated by any authority and are not linked with the organised sector of the credit market. The rate of interest charged by them varies widely. In India, there are mainly five types of unregulated credit agencies. They are: (i) indigenous bankers, (ii) finance brokers, (iii) money lenders, (iv) para-banking institutions, and (v) other lenders.

S.10 Indigenous Bankers

Indigenous bankers are private firms or individuals who receive deposits and give loans. Their activities are not regulated and so they belong to the unorganised segment of the money market. The system of indigenous banking dates back to ancient times. Indigenous bankers are of different kinds. Following the Banking Commission of 1972, we may classify them under four categories: (i) Gujarati Shroffs, (ii) Multani or Shikarpuri Shroffs, (iii) Chettiars of the South, and (iv) Marwari Kayas. Among them, Gujarati Shroffs are the most important. They are of two types: (a) pure bankers, and (b) bankers and commission agents.

Pure bankers accept deposits, make loans and provide means of remittance and collection of money. The commission agents arrange for the remittance of funds. Many Gujarati Shroffs combine banking with commission agency or trade in commodities. The working capital of Gujarati Shroffs comes from their own funds, deposits from the public and inter-firm borrowings. They hardly borrow from commercial banks. The Gujarati Shroffs have developed their own call money market.

Next to Gujarati Shroffs, the most important are Shikarpuri Shroffs or Multani Shroffs. They are active mainly in Mumbai and South India. They are very much dependent on credit from commercial banks and their own funds. The main borrowers of the Shikarpuris are traders and small manufacturers.

The Chettiars operate mostly in South India. They function in the same way as Gujarati Shroffs. In recent years, their banking operations have decreased.

The Marwari Kayas are active mostly in the tea gardens of Assam. They get credit facilities from commercial banks and provide short-term loans to the tea gardens. The activities of the Marwari Kayas have been adversely affected in recent years due to the branch expansion of commercial banks.

Indigenous bankers occupy a very important place in the money market of India. Their credit procedure is simple, quick and flexible. Hence, in spite of the competition from commercial banks, these indigenous bankers still survive.

In the urban areas, the services of indigenous bankers are widely used by small traders and small manufacturers. Further, their operating costs and establishment costs are also lower than those of commercial banks. However, indigenous bankers have a number of limitations. They are unorganised and do not have any contact with other sections of the banking sector. As many of them act as traders too, trade risk is mixed with banking business. They do not care for the purposes of credit. In many cases, they do not give receipts and charge disproportionate interest. To regulate the activities of indigenous bankers, the Banking Commission of 1972 favoured indirect control of the Reserve Bank of India over their business through the mediator of commercial banks. It recommended that the flow of funds from commercial banks to the indigenous bankers should be made regular. Unfortunately, no action has so far been taken on these lines. If these reforms are undertaken, then the indigenous bankers will be able to supplement commercial banks and will play a prominent positive role in the Indian credit market.

S.11 Finance Brokers

Finance Brokers act as middlemen between the borrowers and the lenders. Such lenders may be commercial financiers like Shikarpuri bankers or non-commercial lenders with surplus funds. Finance brokers help the lenders with their intimate knowledge of the credit worthiness of the borrowers. They also keep a close watch over the state of business of their borrowing clients, for their own standing depends on the accuracy of their reports.

S.12 Money Lenders

Money lenders are broadly of three types:

(i) Professional money lenders whose main activity is to lend money
(ii) Itinerant money lenders such as Pathans and Kabulis
(iii) Non-professional money lenders whose main source of income is not money lending.

Money lenders as a source of credit have some features.

- Money lenders generally rely on their own funds to run credit operations.
- They usually lend money to poor borrowers such as agricultural labourers small and marginal farmers, artisans, factory and mine workers and small traders.
- They charge a very high rate of interest.
- As money lenders' credit is both unsupervised and unregulated, borrowers are worst exploited.

However, money lenders' credit is prompt, informal and flexible. So long institutional credit is inadequate in India, money lenders' credit is to be accepted as a necessary evil.

S.13 Para-Banking Lenders

Para-banking lenders or unregulated non-bank financial intermediaries include loan or finance companies, chit funds and *nidhis*. Loan companies are found in all parts of the country. They collect fixed deposits from the public mainly by offering high rates of interest. A part of the funds is kept as fixed deposits in banks and the rest is used to make loans and advances to wholesale traders, retailers, small-scale industries and self-employed persons. The effective rate of interest charged on loans is very high. In the case of chit funds, the members make regular periodical subscription to the funds. The periodic collection is given to some member of the fund. Each member is assured of his turn before another member gets it for the second time. There are allegations of corruption about chit funds. *Nidhis* act as mutual benefit funds and so deal only with their members. They collect funds from the members and provide long-term credit to them for house construction, repairs and so on.

S.14 Other Lenders

Some borrowings and lendings take place simply on the basis of personal contact. We group the providers of such credit under the heading of other lenders.

S.15 Unregulated Credit Market and Effectiveness of the Credit Policy of the RBI

The unregulated credit market is beyond the control of the Reserve Bank of India. Hence, the effectiveness of the credit policy of the RBI is reduced due to the existence of unregulated credit market. In a situation of tight monetary policy, these unregulated credit agencies may increase their lending. This may frustrate the objective of the monetary policy of the RBI. Again, the unregulated credit agencies, while issuing credit, do not consider the purpose of credit. Hence, in a situation when the RBI asks commercial banks not to grant credit in speculative activities, the unregulated credit agencies may grant such loans. In that case also, the effectiveness of credit control policy of the RBI will be diminished. To increase the effectiveness of the credit control policy of the RBI, the unregulated credit market should also be brought under the control of the RBI.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. What is financial system?
2. What are the main components of a financial system?
3. What is a financial market?
4. What is money market?
5. What is capital market?
6. What is meant by primary market?
7. What do you mean by secondary market?
8. What is initial public offer?
9. What do you mean by new issue market?
10. What is stock exchange?
11. What is call money?
12. What do you mean by development financial institutions (DFIs)?
13. Give the full forms of DFHI, MMMFs, CCIL and IPO.
14. When was the report of Narasimham Committee published?
15. What is unregulated credit market?
16. What are the different categories of unregulated credit agencies in India?
17. What is a *hundi*?

B. Medium Answer-Type Questions (4–5 marks each)

1. Make a classification of financial markets.
2. Briefly distinguish between money market and capital market.
3. Distinguish between organised financial market and unorganised financial market.

4. Distinguish between primary security market and secondary security market.
5. Describe the recent reforms introduced in the money market of India.
6. Describe the reforms introduced in the capital market of India in recent years.
7. Mention the main features of money lenders as a source of credit in the Indian credit market.
8. Write a note on finance brokers operating in the unregulated credit market of India.
9. Briefly describe the activities of money lenders operating in the unorganised credit market in India.
10. Give a brief description of para-banking institutions which operate in the unregulated credit market of India.

C. Long Answer-Type Questions (10 marks each)

1. Briefly describe the structure of Indian financial markets. **(Section 6.3)**
2. Discuss the major functions of financial markets in India. **(Section 6.4)**
3. Write a brief description of the major reforms in Indian financial markets in recent years. **(Section 6.5)**
4. Briefly describe different types of unregulated credit agencies operative in the unorganised credit sector of India. **(Section 6.8)**
5. Make an evaluation of the activities of different types of indigenous bankers in India. What measures would you suggest to improve their activities? **(Sections 6.8.1 & 6.8.2)**
6. Discuss the activities of different types of indigenous bankers in India. **(Section 6.8.1)**
7. Discuss the role of financial markets in economic development of India. **(Section 6.6)**
8. Write a note on the effectiveness of credit policy of the RBI in the presence of unregulated credit agencies. Suggest some measures to improve the effectiveness of the credit policy of the RBI. **(Section 6.9)**

UNIT

7

MONEY MARKET

UNIT OUTLINE

SUBJECT MATTER OF THE UNIT

Financial markets of an economy have two major components. One is money market and the other is capital market. In the present unit, we shall consider different aspects of money market. In particular, we will take up features, objectives, and functions of money market. To understand the functioning of money market, we should analyse the operations of various money market instruments. So, we shall discuss about various money market instruments. Further, we shall consider features and structure of Indian money market. Recent reforms and trends in Indian money market will also be discussed in the present unit.

7.1 CONCEPT OF MONEY MARKET

Financial markets of an economy may broadly be divided into two major parts. One is money market and the other is capital market. Money market is the market for short-term loan or financial assets having a maturity period of less than 1 year. It is the centre for dealing in short-term funds. It meets the short-term requirements of borrowers for funds and provides opportunity to lenders for short-term outlets of their surplus funds. In particular, money market meets the working capital needs of business firms. It does not refer to a particular place; it includes all individuals, institutions and intermediaries dealing in short-term funds. Transactions between borrowers and lenders may take place through telephone, telegraph, mail and agent. No personal contact or presence of the two parties is essential for negotiations in a money market. However, a geographical name may be given to a money market according to its location. For example, London money market operates from Lambert Street, while New York money market operates from Wall Street. In India, Mumbai money market operates from Dalal Street. Kolkata money market operates from Lyons range, and so on. Following Crowther, we may define money market as follows:

'The money market is a collective name given to the various firms and institutions that deal in various grades of near money[1]*'.*

Near money refers to short-term funds or financial assets with very high degree of liquidity, that is, which can easily be converted into cash.

7.1.1 General Features of Money Market

Money markets of developed and underdeveloped countries have different features. However, as money markets, they share some common features too. To clarify the concept or definition of money market, we may mention some general features of money market. The following are the **general features of money market**:

- Money market is purely a market for short-term funds or financial assets called near money.
- Money market deals in financial assets having a maturity period of less than one year only.
- It deals in only those assets which can be converted into cash readily without loss and with minimum transaction cost.
- Generally transactions in money market take place through phone, that is, oral communication. Relevant documents and written communications can be exchanged subsequently. There is no formal place of money market such as stock exchange or stock market as in the case of a capital market.
- Transactions have to be conducted without the help of brokers.
- Money market is not a single homogeneous market. It consists of several sub-markets, such as, call money market, commercial bill market, Treasury bill market, market for commercial papers (CPs), and so on. Each sub-market specialises in a particular type of short-term asset.

[1]Geoffrey Crowther, *An Outline of Money*, T. Nelson Sons Limited, London, 1941.

- The main players of the money market are the central bank, commercial banks, discount houses and acceptance houses. Commercial banks generally play a dominant role in the money market.

7.2 ORGANISED AND UNORGANISED MONEY MARKETS

Money market is the market which provides short-term finance to the business firms and individuals, where short-term refers to a period of less than one year. Now, according to the strength and stability, the money market may be divided into two sectors: organised sector and unorganised sector. The members of organised sector are commercial banks, co-operative sector banks, and sub-markets such as call money market, bill market, and short-term loan market. The unorganised sector comprises indigenous bankers, money lenders, finance brokers, *nidhi*s, chit funds, and so on. The organised sector has a definite or specific set of rules of operation. However, the unorganised sector has no definite set of rules of functioning. Further, the organised sector of money market of a country is under the direct control and supervision of the central bank of that country. But the unorganised sector of the money market is not under the direct control and supervision of the central bank. The formal distinctions between organised and unorganised money markets may be presented in terms of Table 7.1.

Table 7.1 Organised and unorganised money markets

Organised	Unorganised
1. Organised money market is that part of money market which is under specific rules and regulations.	1. Unorganised money market is that part of money market which is not governed by specific rules and regulations.
2. The main players are commercial banks, discount houses, co-operative banks, bill markets, and so on.	2. The main players are village money lenders, businessmen, indigenous bankers, *nidhi*s, chit funds, and so on.
3. The rate of interest is relatively low.	3. The rate of interest is relatively very high.
4. It is under the direct control and supervision of the central bank.	4. It is not under the direct control and supervision of the central bank.
5. The main instruments are call money, Treasury bills, commercial bills, and so on.	5. The main instruments are *darshani* hundis (sight bills) and *muddati* hundis (usance or time bills).
6. There are specific rules for security and hypothecation against credit.	6. There is no specific rule for security and hypothecation against credit. It varies from region to region and from creditor to creditor.
7. Small as well as large corporate houses and the government are generally the customers of credit.	7. Small businessmen and consumers are generally the customers of credit.
8. Personal acquaintance does not influence the terms of credit.	8. Personal acquaintance or past performance to repay debt may influence the terms of present credit.

7.3 CHARACTERISTICS OF AN ORGANISED OR DEVELOPED MONEY MARKET

An organised or developed money market has strong banking system, proper credit instruments, a number of sub-markets, ample resources, active secondary market, large supply of and demand for funds. Prof. S.N. Sen has mentioned certain essential features of a developed money market[2]. They are described in the following sub-sections.

7.3.1 Presence of a Highly Organised Banking System

A well-developed money market should have a highly organised banking system. In money market, commercial banks serve as the vital link between the central bank and various segments of the money market. Hence, in a developed money market, commercial banking system should be highly organised. In an underdeveloped money market, commercial banking system is not fully developed.

7.3.2 Effective and Strong Central Bank

The central bank of a country enables the commercial banks and other financial institutions to convert their assets into cash in time of financial crisis. For example, through its open market operations, the central bank absorbs surplus cash of the individuals during lean seasons (off-seasons) and provides additional liquidity (cash) during busy seasons. In a developed money market, the central bank is the strong leader, guide and controller of the money market. In an underdeveloped money market, the power of the central bank to influence the money market is limited. There is a huge unorganised money market which is beyond the control of the central bank. Hence in an underdeveloped money market the policies of the central bank are not as effective as in a developed money market.

7.3.3 Availability of Proper Credit Instruments

In a developed money market, there should be various types of credit instruments. Readily acceptable and negotiable securities, such as, bills of exchange, Treasury bills and so on, should be available. There should be sufficient number of dealers in the money market in order to transact these securities. In an underdeveloped money market, proper credit instruments and sufficient dealers to deal in these instruments are both absent.

7.3.4 Existence of Sub-Markets

The number of sub-markets determines the degree of development of a money market. The larger the number of sub-markets, the more developed will be the money market. Several sub-markets together make a coherent and well-composed money market. In an underdeveloped money market, several sub-markets, particularly the bill markets, are absent. Even if sub-markets exist, there is no coordination among them. As a result, different interest rates prevail in the sub-markets and they are not linked with one another.

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[2]Sen, S. N., *Central Banking in Underdeveloped Money Markets*, Bookland Private Limited Calcutta, 1951.

7.3.5 Ample Resources

In a developed money market, there should be sufficient funds to finance transactions in the sub-markets. These funds may come from within the country and also from foreign countries. The money markets of London, New York, Zurich, Paris, etc. attract funds from all over the world. Underdeveloped money markets do not have this power. They can attract a very negligible amount or cannot even attract any amount of foreign funds. As such, they are starved of funds.

7.3.6 Existence of Secondary Market

A developed money market should have an active secondary market in order to transact the money market instruments. In a developed money market, the secondary market is very active and powerful. In an underdeveloped money market, secondary market is not so active and strong.

7.3.7 Large Demand for and Supply of Funds

In a developed money market, there should be a large demand for and supply of short-term funds. It implies that there should be large volume of domestic and foreign trade. In an underdeveloped money market, the volume of both demand for and supply of short-term funds is relatively very small.

The money markets of London, New York, Paris, Zurich, etc. satisfy the above-mentioned requirements of a developed money market. Hence, they are regarded as developed money markets. If one or more of the above requirements are absent, the money market is said to be an underdeveloped money market. Money markets of the Asian countries (except those of Japan) and those of the African countries are, on the whole, underdeveloped. As it were, money markets of less developed countries are underdeveloped.

7.4 OBJECTIVES OF A MONEY MARKET

A money market has some important objectives. We briefly mention them as follows:

- To provide an opportunity to employ short-term surplus funds of surplus-spending units.
- To provide a way for overcoming short-term deficits of deficit-spending units.
- To assist the central bank to influence and regulate liquidity in the economy through its activities in the market.
- To provide a reasonable access to users of short-term funds to meet their requirements quickly, adequately and at reasonable rates.

7.5 FUNCTIONS OF MONEY MARKET

We know that a money market is for short-term loans or financial assets having a maturity period of less than 1 year. In any country, money market performs some important functions and thus helps in economic development of the country. Following functions of money market will explain its role and importance in economic development of a country.

7.5.1 Provision of Short-term Funds

Money market helps business firms to continue their production in an uninterrupted manner. It provides short-term funds to the public and private organisations. It thus finances their working capital requirements and helps to continue their activities without any interruption.

7.5.2 Use of Surplus Funds

Money market gives an opportunity to the holders of short-term surplus funds to utilise those funds. It provides an opportunity to banks and other financial institutions to use their surplus funds profitably for a short period.

7.5.3 Less Dependence of Banks on Central Bank

In a developed money market, commercial banks can call back some of their loans from the money market in the hour of need for cash. Hence, their dependence on central bank for cash decreases. Commercial banks can then concentrate on their lending policy more independently. The central bank also feels free while executing its monetary policy. All these indirectly help in economic development of a country.

7.5.4 Helpful for Government

Money market helps the government to borrow short-term funds at low interest rates on the basis of Treasury bills. Thus, the government can meet the short-term need for cash through the money market. This helps the government to implement its short-term economic policies more successfully.

7.5.5 Helpful for Monetary Policy

A well-developed money market helps in the successful implementation of the monetary policy of the central bank. If the money market is developed, monetary policy of the central bank becomes more effective. Specially, the policy of open market operations becomes very successful. Hence, the central bank can help in the economic development of a country through its successful monetary policy.

7.5.6 Financial Mobility

The money market increases financial mobility of a country by facilitating the transfer of funds from one sector to another. This mobility is very important for the development of trade and industry of an economy.

7.5.7 Liquidity and Safety

Money market promotes liquidity and safety of financial assets. On the one hand, it encourages savings and on the other hand it encourages investment. It thus promotes economic development of a country.

7.5.8 Equilibrium Between Demand for and Supply of Funds

Money market brings equilibrium between demand for and supply of loanable funds. This is done by channelising savings into productive investment. Money market, thus, helps in rational allocation of resources and promotes economic development.

7.5.9 Economy in the Use of Cash

Money market deals in near-money assets and not in money proper. It thus helps in economising the use of cash in transaction of goods and services. This raises the volume of transactions and increases the financial mobility in the economy. This again helps in economic development in various ways.

7.5.10 Increase in Savings and Investment

Money market helps in the mobilisation of saving. It channelises that saving into productive investment. It thus fosters economic development of a country. It also helps in the expansion of industry and trade of the country.

Thus, a developed money market performs so many important functions. It provides funds, utilises surplus funds, helps government to collect funds, helps in implementing monetary policy of the central bank, raises financial mobility in the economy, promotes mobility and safety of funds and so on. Thus the importance of money market in an economy is enormous. In a less developed economy, saving is low and even that low or insufficient saving is often spent in unproductive consumption. A developed money market can remove both evils. It can encourage and mobilise saving on the one hand and can channelise that saving to productive investment on the other. By all these functions, money market of a country helps industry and trade and, thus, fosters economic growth of the country. For steady economic growth of an economy, a well-organised money market in the economy is utmost necessary. If a country does not have a developed money market, its growth process is likely to face many obstacles. In that case, the growth process is bound to be slow or it may even be halted.

7.6 FEATURES/DEFICIENCIES OF INDIAN MONEY MARKET

India is a less developed or developing economy. Hence, Indian money market is an underdeveloped money market. In an underdeveloped money market, banking system is unorganised, monetary policy of the central bank is not so effective, there is lack of proper credit instruments, funds are insufficient, secondary market is not so active and strong and so on. Indian money market has similar features/characteristics. So it is an underdeveloped money market. This will be clear if we consider the main features/characteristics of Indian money market. The main features or deficiencies of Indian money market may be summarised as follows:

7.6.1 Existence of a Large Unorganised Sector

Indian money market has both organised and unorganised sectors. This unorganised sector is quite large. It is spread both in rural and urban areas. The organised sector consists of the banking sector and the non-bank financial intermediaries. The unorganised sector consists of indigenous bankers, money lenders, finance brokers, *nidhis*, chit funds, and so on Their main customers are small traders and entrepreneurs, small, medium and marginal farmers, artisans and so on They charge a very high rate of interest (usurious rate of interest) and follow their own rules of banking and finance. They remain completely disintegrated from each other. Each member of the unorganised money market has his own mode of functioning. Hence, the unorganised sector has no specific rule of operation. It varies from region to region and from creditor to creditor. In a word, the activities of the unorganised financial sector of India are not standardised.

7.6.2 Absence of Integration

The Indian money market is divided into several sections. Each section is loosely connected with other sections. The organised and the unorganised sections of the money market do not have any interaction between them. They remain completely aloof from each other.

7.6.3 Diversity in Rates of Interest

In Indian money market, there is wide diversity in the rates of interest. The main reason behind this is the immobility of funds from one region to another. Further, the rates of interest also differ between different regions or centres. This leads to fluctuations in security prices, because the main determinant of security price is the rate of interest. If the rate of interest fluctuates, security prices must fluctuate.

7.6.4 Seasonal Variations in Demand for Funds

The demand for money in Indian money market is of seasonal character. In India, the period from October to March is the busy season whereas the period from April to September is the lean season. During the busy season from October to March demand for money is high and hence the rate of interest is relatively high during this season. During the lean season from April to September, demand for money is low and hence the rate of interest is relatively low during this season. Thus, there are seasonal fluctuations in the rate of interest in Indian money market.

7.6.5 Underdeveloped Bill Market

The bill market in India is quite underdeveloped. This market has two parts: Treasury bill market and commercial bill market. In the Treasury bill market, government securities and semi-government securities are transacted. Treasury bills represent short-term borrowings of the government. In the commercial bill market, commercial bills or bills of exchange are transacted. In India, both the bill markets are not so developed. The Treasury bill market is narrow and underdeveloped. The commercial bill market is also not developed. The Reserve Bank of India introduced two bill market schemes to develop bill market in India—one in 1952 and other in 1970. Further, from May 1990, more than 25 financial institutions have been permitted to rediscount commercial bills. As a result, the volume of transaction of bills has increased in recent years. Even today, the bill market in India has not expanded up to the expectation.

7.6.6 Little Contact with Foreign Money Markets

Indian money market is almost detached from foreign money markets. It has very little contact with its foreign counterparts. As a result, it cannot attract much foreign funds. Developed money markets of the world can attract huge foreign funds.

7.6.7 Limited Number of Instruments

To meet the varied requirements of borrowers and lenders, there should be adequate supply of various kinds of money market instruments. But in Indian money market, the number of money market instruments such as commercial bills, Treasury bills, etc. is very much limited. As a result, the volume of transactions in the organised sector of Indian money market is low compared to that of developed money markets of the world.

7.6.8 Narrow Secondary Market

The secondary market in India is very limited in the case of money market instruments. Practically speaking, it is restricted to discounting of commercial bills and Treasury bills.

7.6.9 Limited Participants

The number of participants in the Indian money market is also very limited. Entry into the market is strictly regulated. In fact, there are a large number of borrowers and a few lenders. Hence, the market is not very active and broad. The organised sector of the Indian money market is passive and narrow. There are many rules and regulations in this sector. Small debtors cannot very often satisfy those formalities and requirements. On the other hand, the activities of the unorganised financial sector are prompt, informal and flexible. Hence, this sector still dominates in the Indian money market.

7.6.10 Ineffective Monetary Policy

Success of monetary policy requires presence of a developed money market. But Indian money market is underdeveloped. There is a vast unorganised sector which is beyond the supervision and control of the Reserve Bank of India. This reduces the effectiveness of monetary policy of the RBI. In a situation of tight monetary policy, the RBI wants to reduce the volume of credit. Now, suppose, the unregulated credit agencies continue to increase their lending. This may frustrate the objective of monetary policy of the RBI to reduce the volume of credit. Again, suppose, in a depressive situation, when the RBI tries to increase the volume of bank credit, these unregulated credit agencies may not increase their lending and advances. Then also, the objective of the monetary policy of the RBI may not be fulfilled. Further, the unregulated credit agencies, while issuing credit, do not consider the purpose of credit. Now, for example, in a situation, the RBI asks the commercial banks not to grant credit in speculative activities, but then, the unregulated credit agencies may grant such loans. In that case also, the effectiveness of credit control policy of the RBI will be reduced.

We see that the Indian money market has so many deficiencies. These deficiencies together imply that Indian money market is an underdeveloped money market. The RBI has adopted some measures in recent years to remove these limitations. For example, the RBI has offered rediscounting facilities to the indigenous bankers. Thus it has been slowly bringing them under the organised banking system. Similarly, by regulating the supply of money, the RBI has been trying to reduce the fluctuations in the rate of interest. Again, it has adopted some steps to develop the bill market in India. From 1990, a series of reforms has been introduced in the money market, specially after the publication of Narasimham Committee Report (1991). In recent years, the money market in India has been undergoing structural changes. Many steps have been taken to develop Indian money market. As a result of these measures, Indian money market has been able to remove some of its basic deficiencies. It may be said that the Indian money market has started its journey towards a developed money market. But, first of all, the unregulated or the unorganised sector of the money market should be brought under the direct control and supervision of the Reserve Bank of India. But the task is not so easy. Hence, it seems that the transformation of Indian money market to a developed one cannot be done overnight. It will require some time.

7.7 MONEY MARKET INSTRUMENTS

In the context of financial analysis, the word instrument refers to financial paper or financial security. It includes a wide range of financial assets including shares and debentures. Hence money market instruments refer to those financial papers or assets which are transacted in the money market. There are mainly five (05) instruments in the money market. They are as follows:

- Call money/Notice money
- Treasury bill
- Commercial bill
- Commercial papers (CPs)
- Certificates of deposits (CDs)

Let us discuss them one by one

7.7.1 Call Money/Notice Money

Call money/Notice money refers to extremely short-period loans, viz., 1-14 days. Technically, if the money is lent for 1 day, it is known as call money. If the money is lent for 2-14 days, it is called notice money. However, both types of money are popularly called call money. These loans are repayable on demand at the option of either the lender or the borrower. Hence it is called call money. The market for such extremely short-period loans, that is, for call money is called call money market. The participants in this call money market are mainly the banks. Banks with surplus funds lend to other deficit banks in the call money market. Although the borrowers and lenders are mainly the banks, some financial institutions such as LICI and UTI are sometimes allowed to provide such call loans in order to earn interest. As these call loans have very short maturity period, they are highly liquid and close to money. The rate of interest paid on call loans is known as call rate. It is highly unstable and very sensitive to changes in demand for and supply of call loans. In recent years, the size of call money market in India has expanded remarkably.

7.7.2 Treasury Bill

A Treasury bill is a promissory note issued by the government under discount for a specified period. The specified period is less than 1 year. The government promises to pay the specified amount to the bearer of the Treasury bill on the due date. As we have mentioned, Treasury bills are bought and sold on discounted basis. This implies that the price of the bill is below its face value by the amount of interest due on the bill.

A Treasury bill is purely a finance bill since it does not arise out of any trade transaction. The bill does not require any endorsement or acceptance since it is a claim against the government. Treasury bills represent short-term borrowing of the government. The important qualities of Treasury bills are high liquidity, no risk of default, assured yield, low-transaction cost, ready availability, and so on. On the basis of periodicity, Treasury bills may be divided into three main categories, namely, 91-day Treasury bills, 182-day Treasury bills and 364-day Treasury bills.

7.7.3 Commercial Bill

A commercial bill is a trade bill which arises out of a genuine trade transaction or commercial transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the due amount. The buyer accepts and endorses it; it implies that he agrees to pay the amount mentioned in the bill on a certain specified date. A commercial bill is also called a bill of exchange. Thus, a commercial bill or a bill of exchange is a written order from the creditor to the debtor, to pay a certain sum, to a certain person, after a certain period. It is self-liquidating and negotiable credit paper. Its maturity period is generally 91 days. Commercial bill is a very important credit paper for providing short-term finance to trade and industry. It can be resold any number of times. For all these reasons, banks prefer to invest in commercial bills.

7.7.4 Commercial Papers (CPs)

Commercial paper is a relatively new money market instrument in India. It was launched on 1 January 1990. Commercial paper is a credit paper. Any public sector or private sector company can issue commercial papers (CPs). The maturity period of CPs ranges between 15 days and 1 year. The CPs are issued at a discount to their face value. This means that the price of CP is below its face value by the amount of interest due on this credit paper. The discount rate is freely determined by the issuing company. Commercial papers (CPs) are freely transferable. However, commercial papers have few limitations also. Usually, CPs are unsecured instruments. This may act as a disincentive to the investors. Further, there is some restriction on the minimum size of investment in CPs. This minimum size is quite high to an individual and small investor. Hence, generally the individuals and the small companies cannot participate in the transactions of CPs. The major holders of CPs are banks.

Recently, the primary market for commercial papers has become fairly popular. Yet, a secondary market of CPs has not fully developed in India. With institutions such as Discount and Finance House of India (DFHI) and some agents dealing in CPs, it may be expected that the secondary market of CPs will grow in Indian money market in near future.

7.7.5 Certificates of Deposits (CDs)

Certificates of Deposits (CDs) are another type of credit instrument in the Indian money market. A certificate of deposit is a document of title to a time deposit. It is transferable from one party to another. CDs are short-term deposit instruments issued by banks and other financial institutions. They are generally issued to raise large sums of money. They are negotiable and bear specific face value and maturity. Due to their negotiable nature, CDs are also called Negotiable Certificates of Deposits. The subscribers of CDs may be individuals, corporate houses, trusts, associations and non-resident Indians (NRIs).

There are some advantages associated with CDs. CDs are negotiable or marketable short-term instruments. They can be sold and traded in the secondary market. The major merits of CDs are their liquidity and marketability. They are virtually riskless in terms of default of payment of interest and principal.

The RBI introduced the scheme of CDs in Indian money market in June 1989. We have already mentioned that CDs can be issued to individuals, corporations, companies, trusts, funds and associations. Initially, CDs were highly popular instruments in the primary market. It was mainly due to their higher interest rates compared to normal banking lending rates. However, after 1991, due to the adoption of liberalisation policy by the Government of India, banks are getting funds easily. Hence, interests on CDs have fallen and the market for CDs has not expanded much in the Indian money market. However, many think that there is a potential for the growth of primary and secondary markets for CDs in the Indian money market.

7.8 STRUCTURE OF INDIAN MONEY MARKET

The structure/composition of any financial market shows its different sectors and sub-sectors, players or organisations operating in those sub-sectors, financial instruments transacted in different sub-sectors and so on. Thus, while considering the structure/composition of Indian money market, we shall try to highlight the above-mentioned factors. The Indian money market is highly disintegrated and unorganised. In this market, there are mainly two sectors: unorganised sector and organised sector. The unorganised sector includes indigenous bankers, money lenders, finance brokers, private housing companies or *nidhi*s and various chit funds. The organised sector includes organised banking sectors, co-operative sector/banks and some sub-markets. Co-operative sector including co-operative banks may be included in the organised banking sector. However these co-operative banks are run on the basis of the principle of co-operation. Hence, we consider them as a separate group. The unorganised sector is out of the control and supervision of the Reserve Bank of India (RBI) whereas the organised sector is under the control and supervision of the RBI.

The organised banking sector of India includes the Reserve Bank of India (RBI), public sector banks and private sector banks. Public sector banks include both scheduled and non-scheduled banks. Scheduled banks are banks which are included in Schedule 2 of the Reserve Bank of

India. They are under the direct control of the RBI. Similarly, private sector banks include both Indian and foreign banks. Apart from them, there are some non-bank financial intermediaries in the Indian money market that also act as intermediaries between borrowers and lenders. Some of them provide short-term loans and, hence, are regarded as members of Indian money market.

The organised sector of Indian money market is not a single homogeneous market. Apart from organised banking sector including co-operative banks, it has a number of sub-markets. Important among them are call money market, bill market and acceptance market or short-term loan market. The bill market has again two components, namely—Treasury bill market and commercial bill market. The nature of credit paper traded in each sub-markets is indicated in their names.

In Figure 7.1, we have shown the structure of Indian money market. Two points may be mentioned in this context. First, in the structure of Indian money market, we see that India has an unorganised sector. In fact, this unorganised sector is quite large. It is outside the control and supervision of the RBI. This has greatly reduced the effectiveness of monetary policy of the RBI. We have analysed the case in details while discussing the topic under Section 6.9 of the previous unit (Unregulated credit market and effectiveness of the credit policy of the RBI).

Second, Indian money market has some sub-markets, namely, call money market, Treasury bill market, commercial bill market, market for commercial papers (CPs), market for certificates of deposits (CDs) and acceptance market or short-term loan market. Among

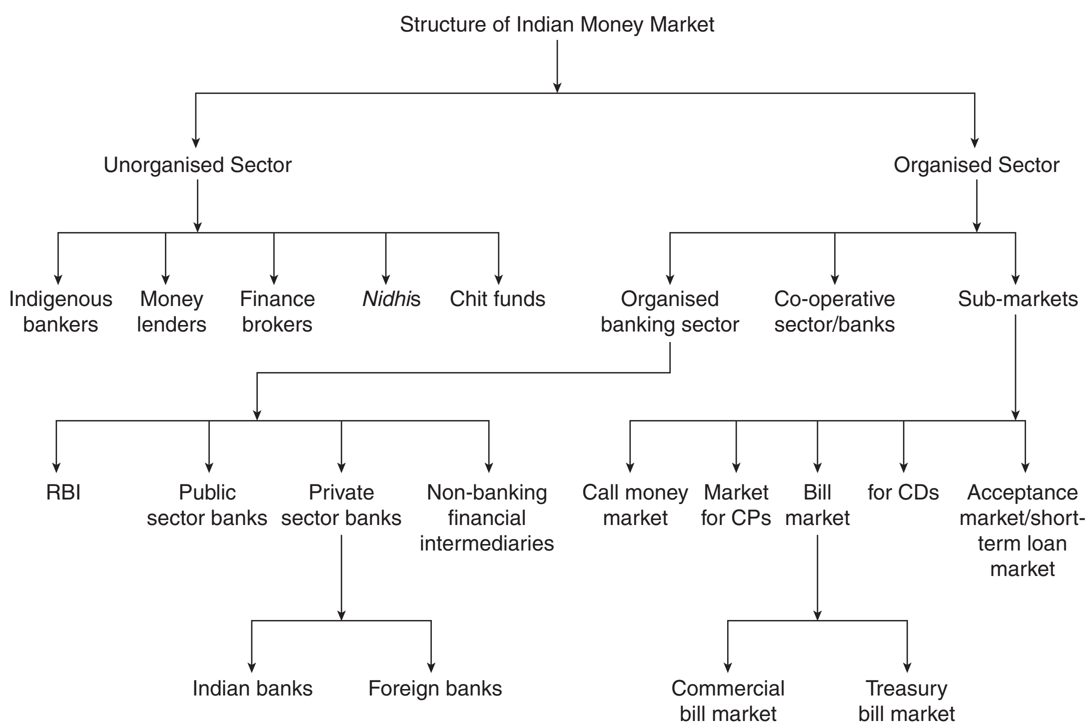


Figure 7.1 Structure of Indian Money Market

them, call money market, Treasury bill market and commercial bill market or simply bill market are the most important sub-markets in Indian money market. Hence, we have discussed these three markets separately in the subsequent sections (Sections 7.9, 7.10 and 7.11). After that, we shall make a brief discussion on acceptance houses and discount houses in India.

7.9 CALL MONEY MARKET

Call money refers to such loans which are repayable on demand at the option of either the lender or the borrower. Hence they are termed as call money, that is, money returned on call. The period of loan in the case of call money is extremely short, say, 1–14 days. The market for such extremely short-period loans is known as call money market. In the call money market of India, the day-to-day surplus funds, mostly of banks, are traded. Thus, the main participants in the call money market are banks. Hence, it is also called inter-bank call money market. It is also known as money at call and money at short notice.

Call money market is an important sub-market of Indian money market. Though the borrowers and the lenders in the call money market are mainly banks, some financial institutions having large funds at their disposal, such as LICI and UTI, are also allowed to operate in this market by the RBI. These loans are given mostly to the brokers and dealers in the stock exchange. Similarly, banks with surplus funds lend to other deficit banks in the call money market. Thus the call money market provides an equilibrating mechanism to even out short-term surpluses and deficits. Moreover, commercial banks can easily and quickly borrow from the call market to meet their statutory liquidity requirements. They can also increase their revenue by investing their surplus funds in the call money market for a short period when interests on call money are high.

The size of call money market in India has expanded remarkably in recent years. The rate of interest paid on call loan is known as call rate. It is highly unstable and very sensitive to changes in demand for and supply of call loans.

Participants in the call money market are scheduled commercial banks, foreign banks, co-operative banks, Discount and Finance House of India (DFHI), Life Insurance Corporation of India (LICI), Unit Trust of India (UTI) and Securities Trading Corporation of India (STCI). Call money markets in India are mainly located in big industrial and commercial centres such as Mumbai, Kolkata, Chennai, Delhi, Bangalore, Hyderabad, and Ahmadabad. Among them Mumbai and Kolkata call markets are important from the viewpoint of size of transactions. The lop-sided development of call money market in India indicates its lack of geographical integration.

7.9.1 Features of Call Money Market in India

We may briefly mention the main features of call money market in India as follows:

- The call market transaction is very short-term in nature. The repayment of loans varies from a period of few hours to 14 days. When the fund is borrowed for a day, it is known as call money. If the fund is borrowed for a period of 2–14 days, it is called notice money.

However, both types of loans are popularly called call money and hence the market for such short-period loans is called call money market.

- Interest rates in the call money market (called call rates) are market-determined, that is, determined by demand for and supply of call money.
- With effect from 6 August 2005, participation of non-bank financial institutions in the call money market has been debarred by the RBI. Hence, the call money market in India is now almost an inter-bank market. Institutions permitted to participate in the call/notice money market in India both as lenders and borrowers are as follows:
  - Scheduled commercial banks [excluding Regional Rural Banks (RRBs)]
  - Co-operative banks other than land development banks
  - Primary dealers (PDs)
- Call/notice loans are generally made on a clean basis. This means that no collateral is required.
- Call money market is a highly competitive and sensitive market.

7.9.2 Merits/Functions of Call/Notice Money Market

The main functions/merits of the call money market are as follows:

- The call money market enables participating banks to even out their day-to-day deficit and surplus of funds. It thus works as an equilibrating mechanism in the short-term loan market.
- As the call loans are repayable on demand, they are highly liquid.
- The call money market helps banks to economise their cash and yet improve their liquidity.
- In the call money market, banks are safe to get back their funds as these are repayable on demand.
- The call/notice money market is a good indicator of the liquidity position in the money market.

7.9.3 Limitations of Call Money Market

The main limitation of the call money market in India is that call rates are highly volatile in nature. When there is excess demand for call money, call rate becomes very high. In a situation of excess supply of call money, call rate becomes very low. The RBI has been attempting to stabilise call rate with repo and reverse repo instrument. But so far, these attempts have little success.

Another limitation of the call money market in India is that its development is lopsided. It indicates lack of geographical integration of the market.

7.10 TREASURY BILL MARKET IN INDIA

A bill of exchange or, simply, a bill is an unconditional order in writing to pay on demand or on a future date a sum to a person or to the bearer. The market in which the bills of exchange are transacted is known as bill market. Bill market in India may be divided into two parts, namely, Treasury bill market and commercial bill market. In other words, Treasury bill market is India in a component of bill market.

A Treasury bill is a promissory note issued by the government under discount for a period of less than 1 year. The government pays the promised amount to the bearer of the bill on the due date. The Treasury bill does not arise out of any trade transaction. Hence, it is purely a finance bill. The market that deals in Treasury bills is known as Treasury bill market. Treasury bills are claims against the Central Government of India. They represent short-term borrowings of the government. Treasury bills are issued by the Government of India through the RBI to commercial banks, mutual funds, financial institutions, non-bank public, primary dealers and so on. It helps the Government of India to collect short-term funds. Normally commercial banks are the main purchasers of Treasury bills. It may be mentioned that Treasury bills are bought and sold on discounted basis. This means that the price of the bill is below its face value by the amount of interest due on the bill. The important qualities of Treasury bills are higher liquidity, absence of risk of default, ready availability, assured yield, low transactions cost and so on.

In India, there are two types of Treasury bills. They are as follows:

(i) Ordinary or regular Treasury bills
(ii) *Ad hoc* Treasury bills, known as 'ad hocs'

Ordinary or regular Treasury bills are issued to the non-bank public, commercial banks, mutual funds and other financial institutions for meeting the financial requirements of the Central Government of India. They are freely marketable, can be bought and sold at any time and they have secondary market also. On the other hand, ad hocs are issued only in favour of the RBI. The central government can raise funds through these ad hocs on *ad hoc* basis, that is, on particular purpose. (*Ad hoc* is a Latin phrase which literally refers to 'for this particular purpose'.) Ad hoc Treasury bills are issued by the Government of India in order to raise funds for a particular purpose. Hence, such Treasury bills are called *ad hoc* Treasury bills or in short ad hocs.

On the basis of the period of maturity, Treasury bills in India may be classified into three main categories, namely, 91-day Treasury bills, 182-day Treasury bills and 364-day Treasury bills. India has experimented with all the three types of Treasury bills and also two special types of 14-day Treasury bills.

There are some benefits of investment in Treasury bills. In brief, they are as follows:

- There is no tax deduction at source.
- Treasury bills are negotiable instruments. One can easily transfer Treasury bills to others.
- There is no risk of default in investment in Treasury bills.
- Treasury bills are highly liquid money market instruments.
- Treasury bills provide better returns especially in the short run.
- Transactions related to Treasury bills are transparent.
- There are secondary markets for Treasury bills. It helps meet unplanned fund requirement and provides high degree of tradability of Treasury bills.

- Settlements relating to Treasury bills are simple. Hence, transaction cost associated with Treasury bill is minimum.

7.10.1 Benefits of Treasury Bill Market

There are some benefits of Treasury bill market. We may briefly mention them as follows:

- Treasury bill market gives an opportunity to invest short-term surpluses depending upon availability and requirement of the investors.
- Return on Treasury bills is much higher as compared to those on bank deposits.
- One can purchase Treasury bills of different maturities as per requirements so as to match with the respective outflow of funds.
- Due to the existence of a secondary market, Treasury bills enjoy high degree of tradability.
- The Treasury bill provides a highly liquid risk-free money market instrument to the investors.

7.10.2 Limitations of Treasury Bill Market in India

The Treasury bill market in India has two main limitations which are as follows:

- The Treasury bill market in India is narrow and underdeveloped. Hence, its impact on the Indian economy as a whole is negligible.
- Treasury bills are highly liquid. They can easily be converted into cash. Now if commercial banks hold large amount of such bills, their credit creation power will increase. If the RBI seeks to control credit and commercial banks continue to give more credit, it will reduce the effectiveness of monetary policy of the RBI. Hence, the RBI should be careful about it.

7.11 COMMERCIAL BILL MARKET

We have already mentioned that a bill is an unconditional order in writing to pay on demand or on a future date a sum to a person or to the bearer. The market trading in bills is the bill market. The bill market in India has two components: (i) Treasury bill market, and (ii) commercial bill market. In the previous section, we discussed about Treasury bill market. In the present section, we shall consider the commercial bill market which is a segment of bill market in India.

A commercial bill or a bill of exchange is a bill which arises out of a genuine trade transaction. When goods are sold on credit, the seller draws a bill on the buyer for the due amount and the buyer endorses it. Thus, a commercial bill or a bill of exchange (or, simply, a bill) is a written order from the creditor to the debtor, to pay a certain sum, to a certain person, after a certain period. It is a negotiable, self-liquidating instrument in the money market. Its maturity period is 91 days. The market in which commercial bills or the bills of exchange are transacted is called commercial bill market or simply bill market.

The commercial bill market is classified into two parts. One is the discount market and the other is the acceptance market. Discount market refers to the market where short-term genuine trade bills are discounted by financial intermediaries including commercial banks. As mentioned earlier, when there is a credit sale of goods, the seller draws a bill on the buyer who accepts it. It means that the buyer promises to pay the specified amount on the specified date. The seller has to wait till the maturity. But suppose that the seller requires money before the maturity of the bill. In that case, the presence of discount market enables him to get payment immediately. The seller can do so by getting the bill discounted by some financial intermediary. The financial intermediary purchases the bill at a discount. The rate of discount is actually the rate of interest charged by the financial intermediary. On maturity, the intermediary gets back the specified amount of the bill from the person who accepted or endorsed the bill. In India, commercial banks and Discount and Finance House of India (DFHI) generally discount such bills.

Let us briefly describe the acceptance market. This market consists of acceptance house which is a specialised firm or financial intermediary that accepts bills of exchange on behalf of debtors of the bills. These acceptance houses do so for a commission against these bills of exchange or commercial bills. They ensure that there will be no default on the bill of exchange on due date even if the original debtor is unable to pay. Such acceptance houses are found in developed countries. In India, the acceptance market has not yet developed. There is no specialised acceptance house in India to carry out acceptance services. Here commercial banks render such acceptance service.

There are various types of bills of exchange in the Indian money market. For example, there are demand bills which are to be paid on presentation. They are, so to say, sight bills. Again there are usance bills or time bills. Such bills are paid later on a specified date. Again there may be inland bills and foreign bills. There are also indigenous bills which are called *hundis*. They are usually written in one of the vernacular languages. The rate of discount on *hundis* is called '*bazar* bill rate'. It is not uniform as it differs among markets and even among bankers in the same city. *Hundis* are again basically of two types: *darshani hundis* and *muddati hundis. Darshani hundis* are actually sight bills which are to be paid on presentation. *Muddati hundis* are, in fact, usance or time bills which are paid later on a specified date.

Bills of exchange or commercial bills are a very important credit paper in Indian money market for providing short-term finance to trade and industry. They can be resold any number of times and also carry competitive rate of interest. Hence, banks prefer to invest in such bills. Yet, bill market in India is not well developed. Here, market for bills is limited. The RBI has introduced two bill market schemes to develop bill market in India—one in 1952 and the other in 1970. Further, from May 1990, more than 25 financial institutions have been allowed to rediscount commercial bills. As a result, the volume of transaction of bills has increased in recent years. Still it may be admitted that the commercial bill market in India has not grown up to the expectation. There are some reasons behind this slow growth of commercial bill market. We may briefly summarise them as follows:

- In India specialised discounting institutions are absent.

- There is a lack of well-developed and active market for commercial bills in India.
- People are unwilling to use commercial bills due to strict financial regulations.
- Banks and other financial intermediaries in India misuse the bill market.
- There are long administrative procedures in connection with the transactions of commercial bills.

Unless these problems are properly addressed by the RBI, the bill market is unlikely to develop in India in the near future.

7.12 ACCEPTANCE HOUSES

Acceptance houses are specialised firms or financial intermediaries which accept commercial bills or bills of exchange on behalf of debtors. They ensure that there will be no default on the bill on due date even if the original borrower is unable to pay. Acceptance houses do so for a commission against commercial bills. One problem associated with commercial bills is that the credit worthiness of the drawee of the bill (i.e., the debtor) may not be known to the bill market participants. Commercial bills may be drawn on relatively unknown companies. Thus, there may be an information gap about the credit worthiness of the drawee of the bill. It is a big hurdle in the development of a bill market. Acceptance houses have a big role to remove this problem. Their acceptance of a bill provides authenticity on the bill. As we have mentioned if an acceptance house accepts a bill, it implies that a guarantee is being given that no default will take place in respect of that bill.

It should be noted that the acceptance houses do not buy or discount any bill. They do not also lend money against a bill. They just provide a guarantee service for a commission — the guarantee of non-default of the bill on due date. Thus, their activity is basically a fee-based activity and not a fund-based activity. However, their provision of guarantee indirectly adds to the liquidity of the bill market and helps in the growth and expansion of the bill market.

Such acceptance houses are found in developed countries. For example, acceptance houses are present in London money market. The concept of acceptance actually originated in the United Kingdom. In the United States, acceptance services are provided by banks. In order to provide acceptance service (i.e., providing a guarantee service on a bill), acceptance houses or other institutions providing this service have to keep themselves informed about the credit worthiness of various drawees of commercial bills.

In India, the acceptance market is not at all developed as there are no specialised institutions for carrying out acceptance service in India. Here, acceptance services are rendered by commercial banks, especially in the field of international trade. Acceptance service is particularly important in the context of international transactions. In such transactions, it is more difficult for an exporter to know about the credit worthiness of the borrower. Hence, the exporter will be hesitant to export the good or service on credit. Now, if some agency provides the guarantee of non-default of the export bill, the exporter will be less hesitant to export the good or service. Acceptance service thus greatly helps in the expansion of foreign trade. As already mentioned, commercial banks in India provide acceptance service in such cases.

The Reserve Bank of India should adopt appropriate steps to develop acceptance market which comprises specialised acceptance houses. That will help in the expansion of trade and commerce of the country.

7.13 DISCOUNT HOUSES

Discount market consists of discount houses which are important institutions of the money market of any country. Discount houses are specialised dealers in performing the task of discounting and rediscounting the commercial bills. They also refinance money market instruments and thus provide adequate liquidity in the market.

When there is a credit sale of goods, the seller (say, A) draws a bill on the buyer (say, B). The buyer endorses it promising to pay the seller the specified amount on the specified date. Thus, a commercial bill is created. Here, A is the creditor and B is the debtor. In the absence of any discount market, A has to wait till the maturity of the bill. But if a discount market is present, the seller (A) can get payment by discounting the bill with some financial intermediary or discount house (say, C). The party C will then be creditor and claim the amount from B on maturity. C is said to have 'discounted' the bill, after keeping a margin. The discount market helps A to free his blocked fund. Now, suppose, C wants to get back his fund before the maturity of the bill, then C will have to get the bill rediscounted by some other party. If this process can be executed smoothly and repeatedly, it is said that a secondary bill market has developed. In the absence of a developed discounting bill market, a person's fund with a bill will remain blocked up to the maturity of the bill. Discount houses and financial intermediaries providing discounting facilities thus add liquidity to commercial bills. If a vibrant secondary market for commercial bills exists in an economy, the real sector of the economy can function more smoothly. Here lies the importance of discount house in a discount market. In India, commercial banks and Discount and Finance House of India (DFHI) generally discount such bills.

Discount houses in India did not exist before 1988 when Discount and Finance House of India (DFHI) was established. However, DFHI was set up merely for discounting bills. It was set up for creating a vibrant secondary market for all types of money market instruments including commercial bills or bills of exchange.

7.13.1 Discount and Finance House of India (DFHI)

The Discount and Finance House of India (DFHI) was set up in April 1988. It is jointly owned by the RBI, the public sector banks and all India financial institutions. The main objective behind its establishment was to meet the need for a discount house in India. Other main objectives were as follows:

- To balance the demand for and supply of short-term finance in the Indian money market.

- To promote secondary market in short-term money market instruments. This implies that the DFHI will be an active trader in money market instruments rather than simply an institution discounting bills.

The DFHI tries to develop and stabilise the money market by encouraging activity in the money market instruments and promoting secondary market in those instruments. It deals in call money market, Treasury bill market, commercial bill market, certificates of deposits, commercial papers, short-term loans and government securities. In a word, it has been trading actively in all the money market instruments. The DFHI also participates in repo operations. It is also engaged in buy-back operations in the government securities. Over the years, the business turnover of the DFHI has grown progressively.

The DFHI buys bills and other short-term credit instruments from banks and other financial institutions and invests their idle funds for short periods. Banks may also sell their short-term securities to the DFHI to get funds. Thus, the DFHI has helped corporate houses, banks and financial institutions to invest their short-term surpluses in money market instruments. The establishment of the DFHI is an important step towards the development of Indian money market.

7.13.2 Differences Between Acceptance Houses and Discount Houses

In the context of Indian money market, the roles of acceptance house and discount house are quite insignificant. In India, there is no specialised acceptance house. Here, acceptance activities are done mainly by commercial banks. Similarly discount market in India has not yet developed. Discounting activities in India are done by banks and financial intermediaries. However, from the conceptual point of view, there are some differences between acceptance house and discount house. We briefly summarise them as follows:

First, acceptance house accepts bills, that is, authenticates them as free from default risk. On the other hand, discount house discounts bill, that is, buys bills at a discount over their face values.

Second, the nature of activity of acceptance house is fee-based. Its service is provided for a commission. However, the nature of activity of a discount house is fund-based.

Thirdly, the source of income of the acceptance house is the fee or the commission for providing the guarantee of non-default. On the other hand, the source of income of the discount house is the discount, that is, the difference between the face value and the purchase price of a bill.

Fourth, acceptance house indirectly adds to the liquidity of the bill market. It makes a bill more tradable by putting a stamp of non-default on it. However, a discount house creates a secondary bill market by itself. It helps the creditor to free his blocked fund.

Finally, the activities of an acceptance house are not diversified. It just provides a guarantee service for a commission. It does not buy or discount the bill. Nor does it lend money against a bill. Such activities are done by a discount house. Hence the activities of a discount house are more diversified. Its basic purpose is to buy and sell some money market instrument in order to earn spreads, that is, differences between face value and purchase price of different bills.

7.14 RECENT REFORMS IN INDIAN MONEY MARKET

The Government of India adopted the policy of liberalisation in its industrial policy of 1991. Various economic reforms were introduced in different sectors of the economy. As a part of the financial sector reforms, many changes have been introduced and many steps have been adopted in Indian money market also in the recent past. Indian money market, as we know, is underdeveloped, narrow and disorganised. To make it developed, wide and organised, many steps have been taken by the Reserve Bank of India and the Government of India. Some of the major reforms introduced in Indian money market in recent years may be summarised as given in the following sub-sections.

7.14.1 Market-determined Rate of Interest

In order to examine all aspects relating to organisation, structure and functions of the financial system in India, Narasimham Committee was formed by the Indian government. The Committee submitted its report in November 1991. Following the recommendations of the Narasimham Committee, interest rates have been deregulated. Earlier, interest rates in India were largely administered interest rates. Since 1991, banking and other financial institutions have been instructed to adopt market-related rates of interest. Interest rates on domestic term deposits and bank loans have been decontrolled. Thus, the system of administered interest rate in India is gradually disappearing. Interest rate is now largely determined by the market, that is, by the forces of demand and supply.

7.14.2 Integration of Unorganised Sector With the Organised Sector

We know that Indian money market has a large unorganised sector. It consists of indigenous bankers, village money lenders, finance brokers and so on. They are not under the control and regulation of the RBI. This reduces the effectiveness of monetary policy of the RBI. To improve the situation, the activities of indigenous bankers and village money lenders are being brought under the control and regulation of the RBI. The RBI provides re-discounting facilities to them. Further, commercial banks have been asked by the RBI to open branches in rural areas. The Regional Rural Banks (RRBs) are opening branches in rural areas. All these have expanded the organised money market in India. These measures have also restricted the unlawful and undesirable activities of the indigenous bankers and village money lenders.

7.14.3 Reforms in the Call Money Market

To widen the call money market, the RBI has permitted some financial institutions in recent years to enter the call money market as lenders only. Further, the Discount and Finance House of India (DFHI) has been set up in 1988. It has somewhat met the need for a discount house in India. DFHI and the Securities Trading Corporation of India (STCI) have been permitted to operate both as lenders and borrowers in the call money market. Due to these reforms, the number of participants in the call money market has increased. It has expanded the call money market of India and made it more active and strong. Both the number of participants and the volume of transactions in the call money market have increased.

7.14.4 Innovative Instruments

Recently, many innovative instruments have been introduced in the Indian money market. Important among them are 91-day Treasury bills, 182-day Treasury bills, 364-day Treasury bills, certificates of deposits, commercial papers and so on. Investors can now choose securities from a wide range as per their requirements. As a result, the volume of transactions in the Indian money market has increased. Further, Indian money market has become diversified due to the introduction of various types of instruments. Again, the RBI has recently introduced some schemes for the development of secondary market in commercial papers and certificates of deposits.

7.14.5 Bill Market Schemes

The RBI introduced two bill market schemes, one in 1952 and other in 1970, in order to develop the bill market in India. Further, from May 1990, more than 25 financial institutions have been permitted to rediscount commercial bills. Again, the RBI has taken some measures to discourage cash credit and overdraft system of financing and to popularise bill financing. All these measures have tended to promote bill culture and expand bill market in India.

7.14.6 Entry of Private and Foreign Banks

One of the recommendations of Narasimham Committee (1991) was to allow entry of private and foreign banks into India. Following that recommendation, private and foreign banks have now been allowed to participate in the Indian money market. As per recommendation, both domestic and foreign banks are being treated at par. This step in Indian money market has made the market more competitive and efficient.

7.14.7 Establishment of Money Market Mutual Funds (MMMFs)

The RBI took initiatives to establish Money Market Mutual Funds (MMMFs) in April 1992. The objective is to provide additional short-term investment opportunities and to enable small investors to participate in money market. MMMFs are allowed to sell units to corporate houses and individuals. In recent years, some private sector mutual funds and subsidiaries of commercial banks have been permitted to deal in money market instruments. The objective is to expand the money market and also to develop secondary market for money market instruments.

7.14.8 Establishment of DFHI

In April 1988, the RBI established Discount and Finance House of India (DFHI) as a joint stock company. It is jointly owned by the RBI, some public sector banks and some all-India financial institutions. DFHI was established in India on the recommendation of Vaghul

Committee (1987). The objective is to meet the need for a discount house in India. DFHI buys bills and other short-term credit instruments from banks and other financial institutions and invests their idle funds for short periods. Banks may also sell their short-term securities to DFHI to get funds. The establishment of DFHI is an important step towards the development of Indian money market.

7.14.9 Setting up of Credit Rating Agencies

Credit rating agencies judge credit worthiness of a company seeking credit. They thus provide important guidance to the investors to take investment decisions. Since 1988, some credit rating agencies have been set up in India in order to provide credit information to the investors. Some important credit rating agencies in India are Credit Rating Information Services of India Ltd. (CRISIL), Investment Information and Credit Rating Agency of India Ltd. (IICRA), Credit Analysis and Research in Equity Limited (CARE), and Onida Individual Credit Rating Agency Ltd. (ONICRA, now named as ONICRA Ltd.).

7.14.10 Setting up of STCI

In May 1994, the RBI established Securities Trading Corporation of India (STCI).The main objective was to provide a secondary market in government securities. It has enlarged the Treasury bill market and the call money market. The STCI has provided an active secondary market for Treasury bills.

7.14.11 Adoption of Suitable Monetary Policy

We know that the RBI has some instruments at its disposal in order to regulate money supply in the economy. In recent years, the RBI has been adopting some policies in order to increase the resources in the money market. Following the recommendations of Narasimham Committee (1991), it has reduced the Statutory Liquidity Ratio (SLR) to 25 per cent. The Cash Reserve Ratio (CRR) has also been reduced. These measures have released more resources for the money market and thus made it more active and vibrant than before.

7.14.12 Liquidity Adjustment Facility (LAF)

Under LAF, the RBI periodically sets or resets its repo and reverse repo rates. Repo is the rate at which the RBI lends money to commercial banks. Reverse repo is the rate at which the RBI borrows money from the commercial banks. Repos are used to absorb liquidity at a given rate (floor). On the other hand, reverse repos are used for infusing liquidity at a given rate (ceiling). Thus, the LAF adjusts liquidity in the money market through absorption and/or rejection of financial resources. Through this LAF, the RBI continuously remains in touch with the money market.

7.14.13 Setting up of Clearing Corporation of India Limited (CCIL)

The CCIL was established in April 2001 by some commercial banks, financial intermediaries and primary dealers (PDs). It clears all transactions in government securities and also foreign exchange transactions.

7.14.14 Electronic Transactions

The Negotiated Dealing System (NDS) of the RBI, the CCIL, and so on, have introduced electronic transactions in the money market. The electronic dealing system has made money market transactions transparent and efficient. It has increased the confidence among players in the money market. Further, the electronic dealing system has greatly helped the RBI to act as the watchdog of the money market more efficiently.

7.14.15 Banking Ombudsman Scheme

The RBI introduced banking ombudsman scheme on 14 June 1995. Its main objective is to redress customers' complaints and grievances on any banking transactions.

7.14.16 Demonetisation of Large Denomination Notes

On 8 November 2016, the government demonetised 500-rupee and 1000-rupee notes. As per the announcement of the government, it has been done mainly to curb black money, to reduce the funds of terrorist organisations and to stop counterfeiting of currency notes of large denominations.

Comment: As a result of various reforms introduced in the Indian money market, the market has been able to remove some of its limitations and deficiencies. It is now more organised and developed than before. It now operates in a technology-oriented framework. Still, it has some weaknesses too. For example, the bill market in India is not developed. There is no specialised acceptance house to accept the bills. Discount houses are also not very important institutions in the context of the Indian money market. Different sections of the market are not integrated yet. Further, Indian money market has limited number of credit instruments. And above all, there is a large unorganised sector which remains outside the control and regulation of the RBI. To make the Indian money market more efficient and developed, this unorganised sector should be integrated with the organised sector. It may be admitted that there has been a considerable expansion of branch banking in rural areas. This has somewhat reduced the activities of village money lenders and indigenous bankers. Still, these institutions have not been able to become the effective substitutes of village money lenders. Still today, there is a vast unorganised credit market in both rural and urban areas. This has greatly reduced the effectiveness of monetary policy of the RBI. To make the money market strong and efficient, this unorganised sector of the Indian money market should be integrated with its organised sector.

7.15 RECENT TRENDS IN INDIAN MONEY MARKET

From the major steps and reforms adopted in Indian money market and their consequent impacts, we may trace out some major trends in this market. In this section, we shall consider the degree of integration among different sub-markets of Indian money market, its broadness, depth, liquidity, inclusiveness, efficiency and so on. Let us consider them one by one.

We first examine the broadness of Indian money market. By broadness of a financial market we mean the availability of various types of instruments with different features. A wide money market should offer the investors a wide choice of instruments. These instruments should be different in terms of risk, return, maturity, liquidity and so on. Then the investor will have greater opportunities to find a financial instrument as per his needs or preference. Until 1980s, there was a shortage of financial instruments in Indian money market. There were call money, Treasury bills, commercial bills and participation certificates. Thus, there was a lack of depth in Indian money market. The RBI set up a Working Group on the Money Market under the chairmanship of N. Vaghul in order to examine the widening and deepening of the Indian money market. Following the recommendations of Vaghul Committee (1987), the RBI introduced three major money market instruments in the Indian money market. They are certificates of deposits (CDs in 1989), commercial papers (CPs in 1990) and interbank participations certificates (in 1988). Thus, Indian money market now offers a wide range of instruments with varying degrees of risk and return. Some of these instruments have secondary markets as well. However, in the case of commercial bills, the secondary market is not at all strong. Any way, we may say that the width or broadness of Indian money market is gradually increasing.

Let us consider the depth of Indian money market. Depth of a financial market can be judged by its price fluctuations. If the market is deep enough, it can absorb shocks of large order without significant change in prices. If prices fluctuate widely, it implies that the market is unable to absorb shocks of large order. Another indicator of depth of a financial market is its turnover. A large turnover of a financial market indicates its greater depth. Now, coming to the case of Indian money market, we see from the available data that average turnover of all sub-markets except call money market has sharply increased in the recent years. Data also indicate that volatility of rates of interest in different sub-markets as measured by co-efficient of variation has decreased. All these data indicate that Indian money market has gained considerable depth in recent years.

Let us consider the liquidity of Indian money market. Liquidity of a financial market captures the marketability of its instruments. Until 1980s, there was no vibrant secondary market in most instruments of Indian money market. However, with the implementation of the recommendations of Vaghul Committee (1987) and Narasimham Committee (1991), many new instruments have been introduced in the Indian money market. Further, DFHI was established in 1988 in order to promote the development of secondary markets in different money market instruments. As a result, liquidity of Indian money market has somewhat increased. However, progress in this direction is quite slow.

Let us consider the degree of integration among different sub-markets of Indian money market. Integration reflects the easiness of shifting from one sub-market to another. If the sub-markets are well integrated, every arbitrage opportunity is utilised by market players. Then the rates of interest prevailing in different markets will be very close to each other. Hence, to judge the degree of integration of different sub-markets, we need to know how the rates of interest prevailing in different sub-markets are related. When they move, do they move together? To know the answer to this question, we have to consider correlation between different money market rates. Available data reveal that correlations among the various money market rates have increased very sharply in the recent past, as compared to the period 1993–2000. It strongly indicates that integration among different sub-markets of Indian money market has increased in recent years.

Let us consider the inclusiveness of Indian money market. The principle of inclusion indicates the ability of a market to be accessible to everyone. An inclusive market is accessible to all the major economic units, such as, households, large and small firms, and so on. Otherwise the market will not be able to realise its full potential. Coming to the context of Indian money market, we may mention that most of the instruments of this market are of very large denominations. This implies that most economic units, particularly medium and small investors cannot enter the Indian money market. The market suffers from lack of inclusion. To provide access to this market, MMMFs (Money Market Mutual Funds) have been introduced. But this scheme is yet to gain a considerable success. Further, due to non-accessibility to Indian money market, there is a vast unorganised money market. This segment's credit policy is prompt, informal and flexible. Small and medium borrowers, both in rural and urban areas, prefer to take loans from this unorganised sector. The monetary authority of India should seriously make attempt to improve the inclusivity of Indian money market.

Finally, we consider the efficiency of Indian money market. The volume of daily transactions in this market is huge. It is impossible to handle such enormous transactions efficiently without the application of technology. Negotiated Dealing System (NDS) provides that technological platform. The RBI introduced this system in 2002. Further, Clearing Corporation of India Ltd. (CCIL) was established in 2001. It provides electronic clearing services. The electronic dealing system, covering all deals in the money market, has been introduced in recent years. Hence, it may be said that the Indian money market now operates in a technology-guided framework.

*Comment***:** From the above discussion, we may say that the Indian money market is now quite wide, moderately deep, fairly liquid, reasonably integrated and is sufficiently technology-driven. The market, however, lacks inclusivity.

SUMMARY

S.1 Concept of Money Market

Money market is a market for short-term financial assets which are close substitutes of money and which have a maturity period of less than 1 year. According to Crowther, money market is the collective name given to the various firms and institutions that deal in the various grades of near money.

S.2 General Features of a Money Market

The general features of a money market are as follows:

- It is purely for short-term funds or financial assets called near money.

- It deals with financial assets having a maturity period of less than 1 year.
- Money market is not a single homogeneous market. It consists of several sub-markets.
- Transactions in money market are generally conducted without the help of brokers.
- Commercial banks generally play a dominant role in this market.

S.3 Organised and Unorganised Money Market

Any money market has two sectors: organised sector and unorganised sector. The members of organised sector of money market are organised banking sector, co-operative sector banks and sub-markets such as call money market, bill market and short-term loan market. The unorganised sector consists of indigenous bankers, money lenders, chit funds, and *nidhi*s. The organised sector is under the direct control and supervision of the central bank of the country. The unorganised sector is, however, outside the control of the central bank.

S.4 Characteristics of an Organised or Developed Money Market

The main characteristics or features of an organised or developed money market are as follows:

- Presence of a highly organised banking system
- Effective and strong central bank
- Availability of proper credit instruments
- Existence of sub-markets
- Ample resources
- Existence of secondary markets of credit instruments
- Large amount of demand for and supply of funds

S.5 Objectives of a Money Market

The main objectives of a money market are:

- To provide an opportunity to invest short-term surplus funds.
- To help overcome short-term deficits of deficit-spending units.
- To assist the central bank to regulate the supply of liquidity in the country.

S.6 Functions of Money Market

A money market performs the following important functions and thus helps in economic development of a country.

- Provision of funds
- Use of surplus funds
- Assistance to government to mobilise funds
- Increase in financial mobility
- Economy in the use of cash
- Mobilisation of savings
- Increase in investment

S.7 Features/Deficiencies of Indian Money Market

The main features or deficiencies of Indian money market are as follows:

- Existence of a large unorganised sector
- Absence of integration among different sections of the money market
- Diversity in money rates of interest
- Absence of bill market
- Seasonal stringency of funds
- Detachment from foreign money markets
- Limited number of credit instruments
- Limited secondary market of credit instruments
- Limited participants

These features indicate the underdeveloped nature of Indian money market.

S.8 Money Market Instruments

The main instruments in Indian money market are:

- Call/notice money
- Treasury bills
- Commercial bills
- Commercial papers (CPs)
- Certificates of deposits (CDs)

S.9 Structure/Composition of Indian Money Market

There are mainly two sectors in the Indian money market: organised sector and unorganised sector. In the unorganised sector, there are indigenous bankers, money lenders, finance brokers, chit funds, *nidhi*s, etc. The organised sector has three components: organised banking sector, co-operative banks and sub-markets. The organised banking sector includes Reserve Bank of India, public sector banks, private sector banks and non-bank financial intermediaries. In the category of sub-markets, we have call money market, Treasury bill market, commercial bill market and acceptance market or short-term loan market. The public sector banks can be scheduled banks or non-scheduled banks. On the other hand, private sector banks include both Indian banks and foreign banks.

S.10 Call Money Market

Call money refers to extremely short-period loans, say, 1–14 days. The market for such extremely short-period loans is referred to as call money market. In this market, the day-to-day surplus funds, mostly of banks, are traded. Hence, it is also called inter-bank call money market. Call money markets in India are mainly located in big industrial and commercial centres. Rate of interest paid on call loans is known as call rate. It is highly unstable and very sensitive to changes in demand for and supply of call loans. The main merits of call money market are as follows:

- It enables banks to even out their day-to-day deficit and surplus of funds.
- It helps banks in economising their cash and yet improving their liquidity.
- Call money has least risk of default.
- It is a good indicator of liquidity position in short-term loan market.

The main limitation of call money market is that the call rates are highly volatile in nature.

S.11 Treasury Bill Market

A Treasury bill is a promissory note issued by the government for a period less than 1 year. It represents short-term borrowing of the government. The market that deals in Treasury bills is known as Treasury bill market. In India, there are two types of Treasury bills: ordinary Treasury bills and *ad hoc* Treasury bills. On the basis of the period of maturity, Treasury bills are mainly of three categories: 91-day Treasury bills, 182-day Treasury bills and 364-day Treasury bills. The Government of India has experimented with all three types of Treasury bills and also two special types of 14-day Treasury bills.

The main benefits of Treasury bill market are as follows:

- It gives an opportunity to invest short-term surplus of the surplus units.
- Return on Treasury bills is much higher compared to those on bank deposits.
- Treasury bill market provides a highly liquid risk-free money market instrument.

The main limitations of Treasury bill market in India as follows:

- It is narrow and underdeveloped.
- If commercial banks hold large amount of Treasury bills which are highly liquid, their credit creation power will increase. This may reduce the effectiveness of monetary policy of the Reserve Bank of India.

S.12 Commercial Bill Market

A commercial bill or a bill of exchange is a bill which is created out of a genuine trade transaction when goods are sold on credit. The seller draws a bill on the buyer for the due amount and the buyer endorses it. Thus, a commercial bill or a bill of exchange is created. It is a negotiable, self-liquidating instrument in the money market having a maturity period of 91 days. The market in which commercial bills or the bills of exchange are transacted is called commercial bill market, or simply, bill market. The commercial bill market is classified into two parts: acceptance market and discount market. The former consists of acceptance houses whereas the latter consists of discount houses.

Bill market in India is underdeveloped. Here, market for bills is limited. The Reserve Bank of India has taken some measures to develop the bill market in India. Still, the market has not developed up to the desired level. The main reasons behind underdevelopment of bill market in India are:

- Reluctance of customers to use commercial bills due to strict financial regulations and long administrative procedures.
- Malpractices on the part of banks and other financial intermediaries in the bill market.

S.13 Acceptance Houses

Acceptance houses are specialised firms or financial intermediaries which accept commercial bills or bills of exchange on behalf of debtors. They ensure or provide a guarantee that there will be no default on the bill on due date even if the original debtor is unable to pay. They provide this guarantee of non-default for a commission against commercial bills. Acceptance houses neither buy nor discount any bill. Nor do they lend money against a bill. They just provide a guarantee of non-default of a bill for a commission. Such acceptance houses are found in developed countries such as the United Kingdom. In the United States, acceptance services are provided by banks. In India, there is no specialised institution providing acceptance service. Here, acceptance services are rendered by commercial banks, specially, in the field of international trade.

S.14 Discount Houses

Discount market consists of discount houses which are specialised dealers in discounting and rediscounting the commercial bills. They also refinance money market instruments. They thus provide adequate liquidity in bill market. In the absence of a developed discounting bill market, a person's fund with a bill remains blocked up till the maturity of the bill. Discount houses provide the opportunity to the creditor of a bill to get back his money before maturity, just by discounting the bill. In India, commercial banks and Discount and Finance House of India (DFHI) generally discount the bills.

S.15 Recent Reforms in Indian Money Market

Various reforms have been introduced recently in the Indian money market. We mention them as follows:

- Introduction of market-determined rate of interest
- Integration of unorganised sector with the organised sector
- Reforms in the call money market
- Introduction of innovative instruments
- Introduction of bill market schemes
- Permission for entry of private Indian and foreign banks into the money market
- Permission for entry of money market mutual funds (MMMFs) into the money market
- Establishment of Discount and Finance House of India (DFHI)
- Setting up of credit rating agencies
- Setting up of Securities Trading Corporation of India (STCI)
- Adoption of suitable monetary policy by the Reserve Bank of India
- Introduction of Liquidity Adjustment Facility (LAF)
- Establishment of Clearing Corporation of India Limited (CCIL)
- Introduction of electronic transactions
- Introduction of banking ombudsman scheme

- Demonetisation of 500-rupee and 1000-rupee notes in order to curb black money and funds of terrorist organisations.

As a result of these reforms, Indian money market has become more organised and developed. However, there is still a vast unorganised sector which should be integrated with the organised sector and brought under the control and regulation of the RBI.

S.16 Recent Trends in Indian Money Market

Due to the various reforms and steps adopted by the monetary authority in Indian money market, there have been some important changes or trends in the market. The Indian money market is now quite wide in the sense that investors can now choose suitable instruments from a wide range. The market is now moderately deep in the sense that it can absorb shocks of large magnitudes without considerable changes in prices of its instruments. Different sub-markets of Indian money market are reasonably integrated. The market is also sufficiently technology-driven. However, the Indian money market lacks inclusivity in the sense that the access of medium and small participants to this market is limited.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. What is money market?
2. Name the members of organised money market.
3. Mention the members of unorganised money market.
4. What is call money?
5. What is call money market?
6. What is notice money?
7. What is a Treasury bill?
8. Define Treasury bill market.
9. What is a commercial bill?
10. What is a commercial bill market?
11. What are commercial papers?
12. What is a certificate of deposit?
13. What is an acceptance house?
14. What is a discount house?
15. Give the full forms of DFHI and STCI.
16. What are the two components of bill market?
17. Give the full forms of MMMF and CCIL.
18. Mention two merits of call money market.
19. What do you mean by call rate?
20. What is the main limitation of call money market in India?

21. What is banking ombudsman scheme?
22. What are the full forms of SLR and CRR?
23. Give the full forms of CRISIL and IICRA.
24. What does a credit rating agency do?
25. What are the full forms of CARE and ONICRA?
26. What are the different types of Treasury bills introduced in the Indian money market?
27. What is the main difference between an acceptance house and a discount house?
28. Mention two benefits of investment in Treasury bills.
29. State one major limitation of Treasury bill market in India.
30. Mention two benefits of Treasury bill market.

B. Medium Answer-Type Questions (4–5 marks each)

1. Briefly state the general features of a money market.
2. Distinguish between organised and unorganised money market.
3. Clearly mention the objectives of a money market.
4. What is money market? What are the main instruments of a money market?
5. Briefly describe any one instrument of a money market.
6. Write a short note on commercial papers as an instrument in the Indian money market.
7. Discuss the merits of call money market. What is its main limitation?
8. Write a short note on Treasury bills.
9. Discuss the merits and demerits of Treasury bill market.
10. Give a brief description of commercial bills.
11. Mention the merits and demerits of commercial bill market.
12. Write a short note on bill market in India.
13. Describe the role of acceptance houses in a money market.
14. Evaluate the role of discount houses in a money market.
15. Write a short note on Discount and Finance House of India (DFHI).
16. Point out the main differences between an acceptance house and a discount house in a money market.
17. How can you judge the depth of the Indian money market?
18. Is Indian money market inclusive? Establish your answer.
19. How will you examine the degree of integration among different sub-markets of Indian money market?
20. How will you estimate the width or broadness of Indian money market?

C. Long Answer-Type Questions (10 marks each)

1. Discuss the major features of an organised or developed money market. **(Section 7.3)**
2. Examine the role or significance of money market in economic development of a country. **(Section 7.5)**

3. Discuss the importance of money market in an economy. **(Section 7.5)**
4. Discuss the major functions performed by the money market in a country. **(Section 7.5)**
5. Describe the main features of Indian money market. **(Section 7.6)**
6. Briefly discuss the major deficiencies or limitations of Indian money market. **(Section 7.6)**
7. Discuss the main instruments of a money market. **(Section 7.7)**
8. Briefly describe the structure of Indian money market. **(Section 7.8)**
9. Describe the composition of money market in India. **(Section 7.8)**
10. Discuss the features, merits and limitations of call money market in India. **(Section 7.9)**
11. What is a Treasury bill? Write a short note on Treasury bill market in India. **(Section 7.10)**
12. What is commercial bill market? Mention the merits and limitations of commercial bill market in India. **(Section 7.11)**
13. Give a brief account of various reforms introduced in the Indian money market in recent years. **(Section 7.14)**
14. Describe various measures adopted in recent years in order to develop the Indian money market. **(Sections 7.14 & 7.15)**
15. Give a brief description of an acceptance house and a discount house in money market. Point out the major differences between these two financial institutions. **(Section 7.12, 7.13 & 7.13.2)**

UNIT

8

CAPITAL MARKET

UNIT OUTLINE

SUBJECT MATTER OF THE UNIT

We know that any financial market has two major parts: money market and capital market. In the previous unit, we discussed various aspects of money market. In the present unit, we shall discuss various topics related to capital market. In particular, we shall consider the organisation and functions of capital market, difference between money market and

(*Contd.*)

capital market, difference between organised and unorganised capital market, features of Indian capital market, etc. Any capital market has two parts: primary market or new issue market and secondary market or stock exchange or share market. In the former, new issues of securities are traded whereas in the latter, old and existing securities are traded. In the present unit, we have discussed the functions, instruments and players in the new issue market. We have also considered the issue mechanism, that is, distribution methods of new issues followed by a new issue market. In the context of secondary or stock market, we have considered security trading and the role of depository system in security trading. Two important securities in a stock market are shares and bonds or debentures. We have discussed various types of shares and bonds, difference between shares and bonds, etc. We have also discussed the organisation, functions and functionaries of a stock market. Again, various functionaries of a stock exchange are often engaged in unfair and unhealthy practices. Hence, activities of stock exchanges are needed to be controlled. In India, Securities and Exchange Board of India (SEBI) has been set up for this purpose. Hence, we have analysed the objectives, organisation and functions of SEBI. Various reforms have been adopted in recent years in the Indian capital market. Those recent reforms have also been discussed in the present unit.

8.1 CONCEPT OF CAPITAL MARKET AND ITS ORGANISATION

Capital market is the market for medium-term and long-term financial assets. By medium term and long term, we mean a period of 1 year or more. Hence, capital market is a market which generally deals in financial assets having a maturity period of 1 year and above. Thus, while the money market deals in short-term securities having maturity period of less than 1 year, capital market deals in medium-term and long-term securities having maturity period of 1 year and above.

Capital market of a country may be divided into three sub-markets. They are as follows:

(i) Industrial/Private securities market
(ii) Government securities market
(iii) Long-term loans market

Let us briefly describe them one by one.

8.1.1 Industrial Securities Market

Industrial securities market is a market where industrial concerns or private entrepreneurs try to raise their capital or fund by issuing appropriate instruments. It is also known as private securities market. It can further be divided into two categories. They are (a) primary market or new issue market and (b) secondary market or stock exchange.

8.1.1.1 Primary Market or New Issue Market

It is that part of capital market where those securities are traded which are issued to the investors for the first time. Thus, primary market deals in new securities only. Hence, it is called new issue market. As the new issues are placed to the public for the first time, this market is also called initial public offer (IPO).

8.1.1.2 Secondary Market or Stock Exchange

Secondary market is that part of capital market which deals in already existing securities. This is also known as stock exchange or stock market. Thus, while primary market deals in new issues, secondary market trades in old or existing issues.

8.1.2 Government Securities Market

Government securities market is a market where government securities (that is, securities issued by government or PSUs) are traded. It is also known as gilt-edged securities market (Government securities or certificates have gilt edges and hence they are so called. However, this is only literary meaning. Technically gilt-edged securities imply those credit papers which are most reliable and bear least risk). Short-term government securities are traded in the money market whereas medium-term and long-term government securities are traded in the capital market.

8.1.3 Long-term Loans Market

Long-term loans market is the market where long-term loans are available. Development banks and commercial banks are important players in this market. They supply long-term loans to the corporate sector.

Long-term loans market may be classified into three sub-markets. They are as follows:

(i) Term loans market
(ii) Mortgage market
(iii) Financial guarantees market

We briefly describe them one by one.

8.1.3.1 Term Loans Market

It comprises industrial financial institutions both at the national and regional levels. They supply long-term and medium-term loans to the corporate sector directly as well as indirectly.

8.1.3.2 Mortgage Market

As the very name suggests, mortgage market supplies mortgage loan to individual customers. A mortgage loan is a loan against the security of immovable property such as land, building, plant, etc.

8.1.3.3 Financial Guarantees Market

This market provides finance against the guarantee of a reputed person or organisation in the financial circle.

Different elements or constituents of the capital market may be presented in Figure 8.1.

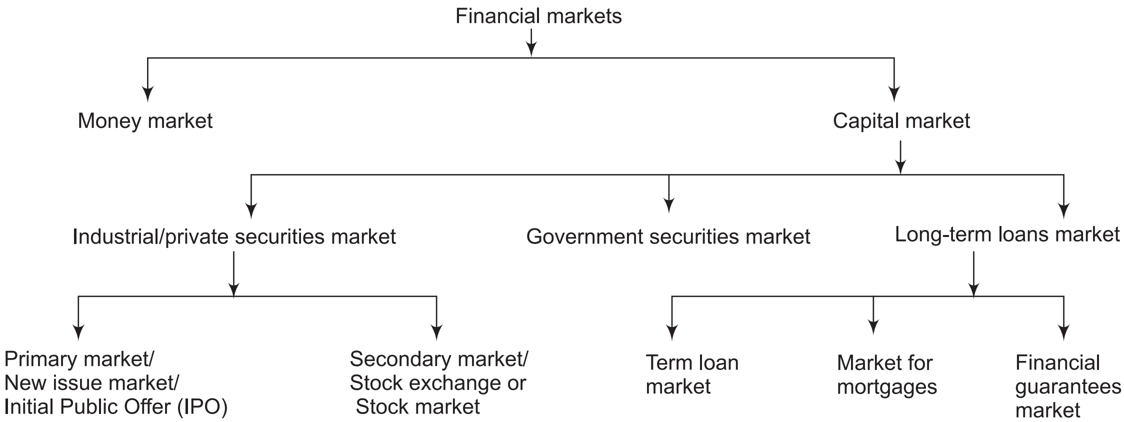


Figure 8.1 Different Elements of a Capital Market

8.2 ORGANISED CAPITAL MARKET AND UNORGANISED CAPITAL MARKET

Organised capital market is that capital market whose sub-markets or constituent institutions are developed and well organised. On the other hand, unorganised capital market is that capital market whose sub-markets or constituent institutions are not so developed or organised.

We know that a capital market is a market for medium-term and long-term financial assets. By medium term and long term, we mean a period of at least 1 year. Hence, a capital market deals in securities having maturity period of 1 year or more. The main constituents of a capital market are banks, security market, development financial institutions (DFIs) and non-bank financial companies. In developed or advanced countries, these sub-markets or institutions are also very developed and well organised. Hence, capital market in an advanced country is called organised capital market. On the other hand, in less developed or underdeveloped countries, the sub-markets and institutions of capital market are not so developed or organised. Hence, capital market in a less-developed country is regarded as an unorganised capital market.

There are some differences between an organised capital market and an unorganised capital market. The main differences between organised and unorganised capital market may be formally summarised in the form of Table 8.1 as follows.

Table 8.1 Differences between organised and unorganised capital market

Organised capital market	Unorganised capital market
1. Issue houses are developed. They are apt and quick in their activities and dealings with the customers.	1. Issue houses are not so developed. Their activities are not so quick and sometimes faulty also.
2. There are a large number of underwriting agencies.	2. The number of underwriting agencies is quite limited.
3. Investment trusts and insurance companies of the private sector are more important than those in the public sector.	3. Investment trusts and insurance companies are mainly in the public sector. Their role in the private sector is not so important.
4. Private sector financial institutions are more important than those of the public sector.	4. Public sector financial institutions are more important than those in private sector.
5. Financial institutions are more or less evenly distributed over the entire country. There is little regional discrepancy in terms of availability of financial services.	5. Financial institutions are concentrated mainly in large cities. This creates a financial dualism in unorganised capital market. There is regional discrepancy in terms of getting financial services.
6. Activities of non-bank financial companies are of various kinds. These activities are diversified. Further, these non-bank financial companies are spread over the entire economy.	6. Operations of non-bank financial companies are confined to some selected regions of the country. Their activities are not also diversified. Hence, people all over the country do not get services of non-bank financial companies.

8.3 DISTINCTION BETWEEN MONEY MARKET AND CAPITAL MARKET

Money market is the market for short-term loans or financial assets. Here short term refers to a period less than 1 year. Thus, money market mainly provides finance for meeting operating expenses or working capital requirements of business organisations. On the other hand, capital market is a market for medium-term and long-term financial assets. Here, medium term and long term refer to a period of 1 year or above. Hence, capital market deals in securities which have a maturity period of 1 year and above. It generally finances fixed capital requirements of business firms.

The main differences between money market and capital market may be summed up in Table 8.2 in the following manner.

Table 8.2 Differences between money market and capital market

Money market	Capital market
1. Money market is the market for short-term funds with maturity period of less than 1 year.	1. Capital market is the market for medium-term and long-term funds with maturity period of 1 year or above.
2. It supplies funds for current operations, working capital requirements of firms and short-term requirements of the government for funds.	2. It supplies funds for financing fixed capital requirement of firms as well as long-term requirement of the government for funds.
3. Main instruments of the money market are call money, treasury bills, commercial bills, commercial papers, certificates of deposits, etc.	3. Main instruments of the capital market are shares, debentures, government bonds/securities, etc.
4. Each single money market instrument is of large amount. For example, treasury bill is of a minimum amount of ₹1 lakh. A certificate of deposit or a commercial paper is of a minimum amount of ₹25 lakh.	4. Each single capital market instrument is of small amount. For example, value per share generally starts from ₹10 whereas the value of each debenture starts from ₹100.
5. In the money market, central bank and commercial banks are the major institutions.	5. In the capital market, development banks, mutual funds and insurance companies are the major institutions.
6. Money market instruments do not generally have secondary markets.	6. Capital market instruments generally have secondary markets.
7. In the money market, transactions mostly take place over phone and there is no formal market place.	7. In the capital market, transactions take place at a formal place, for example, stock exchange.
8. In the money market, transactions have to be conducted without the help of brokers.	8. In the capital market, transactions have to be conducted only through authorised dealers.

8.3.1 Inter-relationship between Money Market and Capital Market

Money market is the market for short-term loans or financial assets having a maturity period of less than 1 year. On the other hand, capital market is the market for medium-term and long-term financial assets having a maturity period of 1 year or more than 1 year.

Though there are important differences between money market and capital market, they are closely inter-related. Most financial institutions are active in both markets. Firms may borrow funds from the money market for a short period or from capital market for a long period. For example, if a firm requires working capital or funds for meeting operating expenses, it will approach the money market. On the other hand, if a firm has requirements for fixed capital, it will approach the capital market. Various factors may induce borrowers and lenders to go either to money market or to capital market. These factors reflect the interdependence of the two markets. They are mentioned as follows:

- Lenders may choose to invest their funds to one or both markets. That depends on the availability of funds, the rate of return, their investment policies, etc.

- Borrowers may obtain their funds from either or both markets according to their requirements. A firm may borrow short-term funds by selling commercial papers or get long-term funds by floating additional shares or bonds.
- Some financial institutions operate in both money and capital markets by buying and selling both short-term and long-term securities. For example, commercial banks provide both short-term and long-term credit. Hence, commercial banks are institutions of both money market and capital market.
- All long-term securities become short-term instruments at the time of maturity. So, some capital market instruments also become money market instruments at the time of maturity.
- Funds flow between the capital market and the money market. For example, suppose a bank received the proceeds of a long-term loan after maturity. Now, the bank gave credit to a firm out of that proceeds for a short period. In this case, funds flow from the capital market to the money market. In the opposite case, funds will flow from the money market to the capital market.
- Yields in the money market are related to yields in the capital market. For example, suppose there is a fall in the short-term interest rates in the money market. It shows a condition of easy credit in the money market. Thus, many borrowers will go to the money market. The demand for long-term credit in the capital market will decrease. In that case, there will likely be a fall in the long-term interest rates in the capital market. Thus, rates or yields in the two markets generally move in the same direction. However, short-term interest rates in money market are more sensitive than long-term interest rates in the capital market.

8.4 FUNCTIONS/IMPORTANCE OF CAPITAL MARKET

Capital market of a country performs some important functions and helps in the process of economic development of the country. We know that capital market is the market for medium-term and long-term financial assets. It deals in securities having a maturity period of 1 year and above. It supplies funds for financing fixed capital requirements of firms as well as long-term requirements of the government for funds. By its activities, the capital market of a country makes a considerable contribution towards the process of its economic development. This will be clear if we mention the major functions of the capital market of an economy. The important functions of the capital market may be summarised as follows:

- Trade and industry of a country require funds or liquidity for their expansion. Capital market provides medium-term and long-term funds for the development of trade and industry. It thus acts as a provider of liquidity.
- For economic development, small savings of the country should be mobilised first. Capital market mobilises small savings scattered over the country through its various institutions. It thus collects much needed funds required for the economic development of a country.

- Mere mobilisation of savings is not enough. The mobilised savings are to be properly invested. Capital market arranges proper investment of the funds collected from the savers. It thus makes an efficient allocation of resources. Capital market protects the interests of both the savers and the investors. It thus helps increase propensity to save of the savers and propensity to invest of the investors.
- Capital market helps in selling the securities of the government enterprises and autonomous bodies. It thus provides the much needed funds to the government and the autonomous bodies who are important agents in the process of economic development of a country.
- On the one hand, capital market opens new opportunities for investment and thus keeps the savings of the economy mobile. On the other hand, it encourages savings, raises the rate of savings and thus helps in the economic development of the country.
- Many financial institutions of the capital market underwrite shares of different corporate houses. When an industrial unit issues shares in the market, all the shares offered for sale may not be sold out. Under the circumstances, any financial institution may take the responsibility of purchasing all or a part of those unsold shares. This method of providing funds to an industrial unit is called **underwriting of shares.** It is one of the major functions of capital market. Through underwriting of shares, capital market assures supply of funds to corporate houses. It thus helps in the expansion and development of the industrial sector of an economy.
- In the capital market, some special purpose development financial institutions provide financial help to some targeted sectors. Some of them provide financial help to small and cottage industries. They thus help in the process of economic development of a country.
- Credit rating agencies of the capital market provide superior, low-cost information to the investors about their investment. These agencies ensure optimal uses of investible funds. By providing investment information, credit rating agencies increase propensity to invest of the investors and thus help in the economic development of a country.
- Merchant bankers of the capital market provide some important services to the corporate sector of an economy. Some of such essential services are: giving advice on financial alternatives, corporate mergers, underwriting new issues, loan syndication, etc. Merchant bankers thus help the corporate sector in proper utilisation of their funds.
- Some financial institutions of the capital market provide managerial and technical knowhow to industrial organisations. This service is also of great help for the expansion of the industrial sector of an economy.

Thus we see that the capital market of an economy performs some important functions. These functions strongly establish the importance of capital market in an economy. Without a developed capital market, economic development of a country is not possible. The process of economic development might be slow or may even be halted if the capital market is underdeveloped and unorganised. To remove the hurdles or obstacles to economic development of a country, its capital market should be properly developed. Hence, the importance of capital market in an economy in the process of its economic development is immense.

8.5 STRUCTURE OF INDIAN CAPITAL MARKET

The structure of any market shows its constituents or elements with which the market is organised. Hence, in this section, we shall discuss the constituents or elements of the capital market of India. The Indian capital market has five main constituents. They are as follows:

(i) Banks,
(ii) Gilt-edged or government securities market,
(iii) Industrial/Private securities market,
(iv) Development financial institutions,
(v) Non-bank financial companies.

We briefly describe them one by one.

8.5.1 Banks

Banks are very important players in the Indian capital market. They together provide a considerable amount of medium-term and long-term funds to the deficit spending units. Many of them also provide merchant banking services. Under the category of banks, we have commercial banks including the State Bank of India, co-operative banks, IDBI Bank (now a public sector bank), ICICI Bank (now a private sector bank), Regional Rural Banks (RRBs), etc. Again, commercial banks include both private and public sector banks and also scheduled and non-scheduled banks. Scheduled banks are those banks which are included in Schedule 2 of the Reserve Bank of India (RBI) Act, 1934. These banks have a paid-up capital and reserves of an aggregate value of not less than ₹5 lakh. On the other hand, banks which are not included in Schedule 2 of the RBI Act, 1934 are called non-scheduled banks. Role of banks, both private and public, and both scheduled and non-scheduled, is very important in the Indian capital market.

8.5.2 Gilt-edged Securities Market or Government Securities Market

In this market, government securities are transacted. In India, there are various kinds of government securities—both short term and long term. Short-term government securities are traded in the money market whereas medium-term and long-term government securities are traded in the capital market. Securities issued by the central, state and local governments and different government organizations are known as government securities or gilt-edged securities. Such securities are traded in government securities market.

8.5.3 Industrial/Private Security Market

Industrial security market is an important constituent of Indian capital market. It is a market where private industrial concerns or the private corporate sector raises funds or capital by issuing appropriate instruments. Industrial security market has two parts: (a) primary market or new issue market and (b) secondary market or stock exchange. In the primary market, only those securities are traded which are issued to the public or other institutions for the first time. Hence it is also called new issue market or initial public offer (IPO). In the secondary market, old or existing securities of industrial concerns are traded. Secondary market is also called stock market or stock exchange.

8.5.4 Development Financial Institutions (DFIs)

In order to provide finance to the industrial and agricultural sectors, different financial institutions have been set up both at national and state levels. These are called development financial institutions or DFIs. Some of such important institutions are Industrial Finance Corporation of India (IFCI), State Finance Corporations(SFCs), Small Industries Development Bank of India (SIDBI), Industrial Investment Bank of India (IIBI), National Industrial Development Corporation (NIDC), National Bank for Agriculture and Rural Development (NABARD), etc. These financial institutions constitute a very important part of the capital market in India.

8.5.5 Non-banking Financial Companies

Non-banking financial companies are also a very important part of Indian capital market. These companies also provide medium-term and long-term funds to the corporate sector.

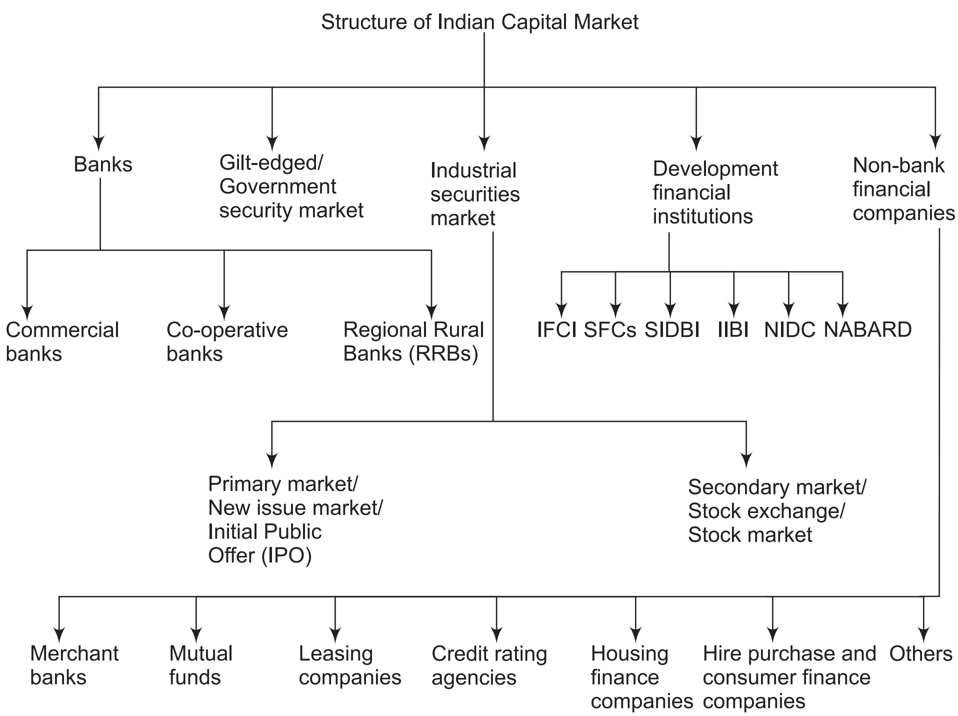


Figure 8.2 Structure of Indian Capital Market

They mobilise savings of the country and channelise them into productive investment. Non-banking financial companies thus play a vital role in the process of industrial development of India. Important institutions under this category are merchant banks, mutual funds, leasing companies, credit rating agencies, housing finance companies, hire purchase and consumer finance companies, etc. In Figure 8.2, we have shown the structure of Indian capital market indicating its important constituents.

8.6 FEATURES OF INDIAN CAPITAL MARKET

From the discussions on the structure and functions of Indian capital market, some basic features or characteristics of this market can be found. These features together imply that Indian capital market is an unorganised and underdeveloped capital market compared to those of western countries. The major characteristics or features of Indian capital market may be summed up as follows:

8.6.1 Unorganised Issue Houses and Underwriting Agencies

Issue house is a financial institution which is in the process of issuing securities at its disposal. Underwriting is an arrangement in which financial institutions provide guarantee to purchase a part or whole of unsold shares issued by a company. The agencies or institutions which provide such services are known as underwriting agencies or institutions. In Indian capital market, issue houses, underwriting agencies, etc. have not yet properly developed. Such institutions are quite common in western developed capital markets.

8.6.2 Setting Up of Public Sector Financial Institutions

In India, many public sector financial institutions have been set up in order to supply finance to specific sectors. These institutions have been established both at the state and national levels to provide finance mainly to the industrial sector. Some institutions have been set up to provide financial assistance mainly to small- and medium-scale industries. There are also some financial institutions to help agriculture and rural sector. Some of them help in the development of foreign trade. These institutions are together known as development financial institutions (DFIs). The importance of these public sector financial institutions is far greater than that of private financial institutions. Some important public sector financial institutions are Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), Small Industries Development Bank of India (SIDBI), Industrial Investment Bank of India (IIBI), National Industrial Development Corporation (NIDC), National Bank for Agriculture and Rural Development (NABARD), Life Insurance Corporation of India (LICI), General Insurance Corporation of India (GICI), Unit Trust of India (UTI), etc.

8.6.3 Limited Role of Investment Trusts and Insurance Companies

In developed capital market of western economies, investment trusts and insurance companies of the private sector play a vital role in providing finance to the industrial sector. In India, however, the importance of such institutions is relatively small. Hence, in India, the Life Insurance Corporation of India (LICI) and the Unit Trust of India (UTI) have been set up as public sector enterprises to meet the gap.

8.6.4 Developed Capital Market Only in Some Cities

In India, the organised capital market has grown up only in large cities. In Mumbai, Delhi, Kolkata, Chennai, Bengaluru and such other metro cities, there are many banks, stock exchanges or stock markets, government securities market, etc. In a word, all the constituents of a developed capital market are present in such cities. But these are absent in small towns and villages. Thus, the Indian capital market is highly unorganised.

8.6.5 Introduction of Newer Assets

In the Indian capital market, many new credit instruments and financial services have been introduced in recent years. After the adoption of liberalisation policy in 1991, the capital market of India has been growing and developing very fast. Various innovative credit instruments have come up in Indian capital market in the recent past. Examples of some of these innovative financial instruments are: zero coupon bonds, index-linked bonds, option bonds, easy exit bonds, retirement bonds, regular income bonds, infrastructure bonds, global depository receipt (GDR), secured premium notes (SPN), etc. we have briefly discussed about these innovative instruments in Unit-10.

8.6.6 Expansion of Non-Banking Financial Companies

In India, activities of non-banking financial companies are also expanding very fast in recent years. Some of such non-banking financial companies are: merchant banks, mutual funds, leasing companies, credit rating agencies, housing finance companies, hire-purchase and consumer finance companies, etc. These companies have introduced various types of financial services, such as, corporate and project counselling, loan syndication, issue management, underwriting, advice on mergers and takeovers, portfolio management, off-shore finance, factoring, forfaiting, etc. We have given a brief description of such products and services of financial institutions in Unit-10. It may however be repeated that the services of these newer companies and their products are available only in large cities of India. The vast rural sector and small towns are still out of the Indian capital market.

The above basic features of Indian capital market together imply its underdeveloped and unorganised character. In fact, the structure and the nature of the capital market of any country depend on the general economic condition of that country. Indian economy is still basically an underdeveloped economy. Hence, no wonder that its capital market is also underdeveloped and unorganised. However, in recent years, the Indian capital market has progressed too fast. Its activities have been growing at a very rapid rate especially after 1991when a series of reforms were introduced in the capital market. There have been reforms in both primary and secondary markets. In primary market, new issues are traded for the first time whereas in the secondary market, old or existing securities (shares and bonds) of corporate houses are traded. Further, activities of development financial institutions like IFCI, NABARD and SIDBI have also tremendously increased. These institutions are now more organised and developed. The scope of activities of non-bank financial companies has also increased manifolds. Stock exchanges (popularly known as stock markets or share markets) are now more organised and efficient. With the introduction of computerised trading, their activities have been quick and transparent. We may specially mention the development of four stock exchanges of India in this connection. These are National Stock Exchange (NSE), Calcutta Stock Exchange (CSE), Bombay Stock Exchange (BSE) and Over-the-counter Exchange of India (OTCEI). Most of the stock exchanges in India have introduced scripless trading or screen-based trading. In this trading system, securities cease to exist in physical form and exist only in electronic number. As the security certificates do not exist in material form in this system, it is known as dematerialisation or popularly de-mat or D-mat. Further, fifteen (15) regional stock exchanges have promoted Inter-connected Stock Exchange of India Limited (ISE). Its objective is to provide trading linkage or connectivity to all the participating exchanges to widen their market. It provides an opportunity to small traders to participate in a national market at low transaction costs.

Thus, there have been so many progressive changes in the Indian capital market. These changes have been pushing forward the capital market. As the Indian economy will grow and move towards economic development, its capital market is also expected to become gradually more developed, organised and diversified.

8.7 SECURITY AND SECURITY MARKET

8.7.1 Concept of Security

A security may be defined in two ways—from the viewpoint of the holder or investor and from the viewpoint of the issuer company. From the viewpoint of the holder, a security is a financial instrument or asset. Investment in it may give the holder some fixed or variable return after some period. From the issuer's viewpoint, a security is again a liability. Issue of it gives the issuer company the required finance on different alternative arrangements.

8.7.2 Types of Securities

Securities traditionally include equity or ordinary shares, preference shares, debentures or bonds, etc. They also include innovative financial instruments such as mutual fund schemes, convertibles, global depository receipts (GDRs), derivatives, etc. We briefly describe them one by one.

Equity/Ordinary shares bear the ownership right of the holder in the issuer company. They provide half-yearly or yearly dividend to the holder if the company earns a profit. These shares are transferable and so can be sold at any time. Issue of equity shares provides the company ownership capital.

Preference shares bear two types of preference over the equity shares. **First**, payment of dividend should first be made to the preference shareholders. **Second**, at the time of liquidation or closure, the company has to pay off first the preference shareholders.

Debentures or **bonds** are instruments of taking loan by the issuer company. There is periodic payment of interest to the bond holders. In India, government bonds are called 'gilt' securities or 'gilt-edged' securities.

Mutual fund schemes are run by mutual funds which collect savings by selling units. Funds are collected for any particular mutual fund scheme. This fund is then invested in a diversified portfolio. It thus spreads and minimises risk. Dividend is given to the unit holders in proportion to their contribution.

Convertibles are those bonds or preference shares which can be converted into equity shares either fully or partially. Again, this conversion may be optional or non-optional.

Global depository receipt (GDR) is a dollar-denominated instrument. It is traded on a stock exchange in Europe or the USA or both. It represents a certain number of equity shares. The shares are issued by a company to an intermediary called depository. The shares are registered in the name of the depository which subsequently issues the GDRs.

A derivative security is a security whose value depends upon the values of other basic factors backing the security. It is basically used as a risk management tool. Financial intermediaries buy derivatives in order to reduce risk.

In addition to the traditional and non-traditional securities, there are other securities, such as, commercial papers, treasury bills, certificates of deposits, floating rate notes, flip-flop notes, European Currency Unit (ECU) Bonds, American Depository Receipts (ADRs), loyalty coupons and various types of bonds and debentures. We have already discussed some of these financial instruments in previous units. We shall briefly discuss about the other financial instruments in the present and subsequent units.

8.7.3 Security Market

The term 'security' loosely includes a wide range of financial assets including equities or equity shares, preference shares and debentures of various kinds. Thus, security broadly means any financial instrument. The market which deals in securities is called security market. As the term security includes both short-term and long-term financial instruments, security market also includes those markets which trade in both short-term and long-term financial instruments. Now, money market deals in short-term credit instruments whereas capital market deals in medium-term and long-term credit instruments. Hence, security market includes both money market and capital market.

Security market may broadly be divided into two categories, namely, government security market and private or industrial security market. Government security market is also called gilt-edged securities market. It is a market where government securities are traded. On the other hand, industrial securities market is a market where industrial securities or private securities are traded. We shall briefly discuss about them one by one.

8.7.4 Government/Gilt-edged Securities Market

Government securities or Gilt-edged securities market, as the name suggests, is a market where government securities or gilt-edged securities are traded. In India, there are many kinds of government securities—both short-term and long-term. Short-term government securities are traded in the money market whereas long-term government securities are traded in the capital market. In India, securities issued by the central, state and local governments and different government organizations are traded in government securities market.

The major participants in government securities market in India are commercial banks. They hold a large portion of these securities in order to satisfy their Statutory Liquidity Ratio (SLR) requirements. As per RBI stipulations, commercial banks are required to keep a certain percentage of their deposits in the form of government securities. This percentage is known as SLR (Statutory Liquidity Ratio). In order to fulfil SLR requirement, commercial banks generally hold a large amount of government securities. The role of brokers in marketing government securities is practically very limited. Further, most of the institutional investors like to retain government securities until maturity. Hence the secondary market for government securities is narrow.

Government securities are of many forms. They may generally be divided into three categories. They are as follows:

(i) Stock certificates
(ii) Promissory notes
(iii) Bearer bonds

Short-term government securities, such as, treasury bills, are sold through auctions whereas long-term government securities are sold through the Public Debt Office of the RBI. Government securities are good sources of raising low-cost funds for the government exchequer. The government can easily raise funds by selling these securities. Further, government securities are highly liquid. So, they are suitable to the buyers of government securities also.

8.7.5 Private/Industrial Securities Market

Industrial or private securities market is simply the market for industrial securities. In this market, industrial securities are bought and sold. Industrial securities are mainly of three types. They are (i) equity or ordinary shares, (ii) preference shares and (iii) debentures or bonds. From the industrial securities market, private industrial concerns raise their capital or debt by issuing appropriate instruments. Industrial securities market may be divided into two sub-markets. They are as follows:

- Primary market or new issue market or initial public offer (IPO). In this market, new issues of shares and debentures are traded for the first time.
- Secondary market or stock market or stock exchange. In this market, old or existing securities (shares and bonds) of corporate houses are traded.

8.7.5.1 Primary Market

Primary market is a market where new issues are traded for the first time. Hence, it is called Initial Public Offer (IPO). In this market, borrowers exchange new financial securities for long-term funds. Hence, primary market helps in capital formation of an economy. In India, there are mainly, three ways by which a company may raise funds from a primary market. These are (i) Public issue, (ii) Rights issue and, (iii) Private placement.

Under **Public issue,** companies raise funds by sale of new securities to the public. In India, this method is quite common and often found. **Second,** when a company wants to raise additional capital, it may first offer securities to the existing shareholders on a pre-emptive basis. It is called **rights issue.** Similarly, there may be offer of securities to the employees, creditors, customers, etc. And lastly, when securities are sold privately to a group of investors for the first time, it is called **private placement** or simply, **placement**.

8.7.5.2 Secondary Market

Secondary market is the market where old and existing securities are traded. It is a market for secondary sale of securities. These securities have already passed through the new issue market. The secondary market is called stock market or stock exchange or share market. In this case, securities are generally quoted in the stock exchange which provides a continuous and regular market for buying and selling of securities. The stock market or the secondary market in India consists of all the stock exchanges recognised by the Government of India. The stock exchanges in India are guided and regulated by the Securities and Exchange Board of India (SEBI). Some principal stock exchanges in India are: Bombay Stock Exchange (BSE), National Stock Exchange (NSE), Calcutta Stock Exchange (CSE) and Over-the-Counter Exchange of India (OTCEI).

We have mentioned that industrial securities are mainly of two types: shares and bonds/ debentures. We shall now discuss about these two types of financial instruments.

8.7.6 Shares: Major Types

8.7.6.1 Share

A share is a part of owned capital of a company. The term 'ownership securities' represents shares. The total capital of a company is divided into a number of units of a fixed amount. These small units are called shares. The purchaser of a share of a company is the shareholder. He/She has then owned a part of ownership of the company and is entitled to get dividend if the company earns a profit and distributes that profit following certain procedures.

8.7.6.2 Share and Stock

It may be mentioned in this connection that there is a difference between share and stock of a company though we often use them interchangeably. For example, we say stock market or share market. The owned capital of a company is divided into a number of equal parts. Each part is known as a share. On the other hand, the issued capital of a company or a particular issue of securities (for example by a government) is called stock. It is in a consolidated form so that it can be held or transferred in any amounts. But shares in a company must be fixed for nominal amounts and they can be held or transferred in such units. A stock represents the total of fully paid shares of a member merged into one fund of equal value. It is expressed in monetary terms and not as a number of shares.

8.7.6.3 Par Value/Face Value/Nominal Value of Shares

In India, shares can have any par value (also called face value or nominal value) subject to the condition that it should not be less than Re. 1 and may be any multiple of Re. 1. Hence, different companies can issue shares of different par values. However, at any given time, there might be only one denomination of shares issued by the company.

8.7.6.4 Types of Shares

In India, companies generally issue two kinds of shares only: (i) equity or ordinary shares and (ii) preference shares.

Equity or ordinary shares are those shares whose dividend is not fixed and depends on the profits available and the policy of the board of directors on the distribution of profit. A profit-seeking organisation cannot exist without equity share capital.

Preference share is the share which enjoys certain preferences over other shares. It enjoys priority in payment of dividend and repayment of capital over ordinary share on liquidation or closure of the company. There are various types of preference shares depending on the various patterns of payment of dividend and the principal amount.

However, in India, some names of equity shares are in vogue on the basis of the behaviour of the shares in terms of changes in prices and returns. Some of them are mentioned as follows:

Growth stock: Equity shares which are expected to offer its investors sustained capital growth (that is, capital gains) are called growth stock.

Income stock: An equity share with good yield record or a fixed interest-bearing gilt-edged security is referred to as income stock in the share market.

Blue chip: The most attractive share with the highest status is referred to as the blue chip. Blue chip companies are well-known, stable and mature companies with a good track record. In contrast, securities which are not attractive among the investors are called **cats and dogs**.

Speculative stock: Securities which have unstable characteristics in respect of their prices and returns and which have been acquired by their buyers for speculative purposes and not for steady dividends are known as speculative stock.

Glamour stock: Stock which is held for wide popularity and which adds to the glamour of its purchaser is called glamour stock. It is not considered to be a good investment because this stock is generally overhyped and its price and return are highly unstable.

In this context of types of shares, we also like to mention the concept of bonus shares and rights shares or rights issue.

Bonus shares: Shares issued to existing shareholders as a result of capitalisation of reserves of a company are known as bonus shares.

Rights issue: Issue of securities offered to the existing shareholders/bond holders on a pre-emptive or priority basis is known as rights issue. Shares issued in such a manner are called rights shares. For example, preference shareholders may have a right of pre-emption of rights shares.

8.7.7 Preference Shares: Different Types

Shares enjoying some preference or benefits over other types of shares are called preference shares. Such shares enjoy two types of preference over equity or ordinary shares. **First,** payment of dividend should first be made to the preference shareholders. **Second,** at the time of liquidation or closure, the company has to pay off first the preference shareholders.

Preference shares may be of different types. We briefly mention them.

Cumulative Preference Shares: These shareholders have to be paid dividends for the past years in any current year. Suppose, the company did not pay dividends to them due to bad performance. When the company makes good profit, it will have to pay past dividends in addition to current year's dividends.

Non-Cumulative Preference Shares: These shareholders get only current year's dividend if the company is in a position to pay such dividend. No backlog dividend is payable to such type of shareholders.

Participating Preference Shares: These shareholders actually get a fixed amount of dividend as pre-declared and also a variable amount of dividend. The variable amount is determined at the time of distribution of residual profits to the equity shareholders.

Non-Participating Preference Shares: These shareholders get dividend at a pre-declared rate. Most of the preference shares are of this type.

Redeemable Preference Shares: The holders of these shares get back the principal amount of investment at the end of the redemption period. Redemption may take place at par, at a premium or at a discount.

Irredeemable Preference Shares: The holders of these shares do not get back the principal amount of investment any time during the operating life of the company. The amount of investment is actually made forever. The shareholders continue to get dividend at the end of each year. However, at present, no Indian company can make any fresh issue of such type of shares.

8.7.8 Difference between Ordinary or Equity Share and Preference Share

Equity or ordinary shares are those shares whose dividend is not fixed and whose dividend depends on the volume of profit available for distribution and the policy of the board of directors on the distribution of profit. On the other hand, preference share is the share which enjoys certain preferences over other types of shares. These shares enjoy priority in payment of dividend and repayment of capital (principal) over ordinary or equity shares.

There are some important differences between ordinary or equity shares of a company and its preference shares. We briefly mention them in Table 8.3 as follows:

Table 8.3 Differences between ordinary/equity share and preference share

Ordinary/Equity shares	Preference shares
1. Shareholders enjoy voting rights in the election of the members of the Board of Directors of the company.	1. Shareholders do not have any voting right.
2. Dividend is paid after the payment to preference shareholders.	2. Dividend is paid before the payment of dividend to equity/ordinary shareholders.
3. Rate of dividend is not fixed.	3. Rate of dividend is fixed or guaranteed.
4. At the time of liquidation or closure of the company, shareholders do not enjoy any preference regarding the refund of capital.	4. At the time of liquidation or closure of the company, preference shareholders get preference over equity or ordinary shareholders regarding the refund of capital.
5. Equity or ordinary shares do not impose any fixed burden on the company as the rate of dividend is not fixed.	5. Preference shares impose a permanent burden on the company to pay a fixed rate of dividend to such shareholders.

8.7.9 Bonds or Debentures and Their Types

Bonds or debentures are traditional borrowing instruments for a company and lending instruments for the investors. Bond holders are actually creditors of a company. Bonds yield periodical interests at a pre-determined fixed rate. They do not provide the holders any ownership right of the company. In other words, bonds/debentures are fixed-interest securities issued by the government and local bodies or corporate houses. They also mean a document by which a company or an organisation acknowledges a loan from the bond holders. As already mentioned, the debenture/bond holder is a creditor of the company; he is entitled to be paid his interest regardless of whether or not the company has made any profit, and the interest payment is to be made before any distribution of dividends.

Bonds/debentures are of different kinds. We mention some major types of bonds/debentures as follows:

Redeemable Debentures: These debentures are repaid by the company at the end of a specified period or by instalment. The period during which the value of the debenture is paid back is called redemption period.

Irredeemable Debentures: These debentures are not repayable during the lifetime of the company. Hence they will be repaid only when the company goes into liquidation.

Mortgage Bonds/Debentures: The secured bonds or debentures are known as mortgage bonds or debentures. The security may be some particular assets (legally called fixed charge) or it may be assets in general (legally called floating charge).

Simple or Naked Debentures: As opposed to mortgage debentures, simple or naked debentures are the debentures which have no security.

Registered Debentures: In the case of such debentures, the name, address and particulars of holdings of debenture holders are recorded in a register of the issuing company. Naturally, the transfer of such debentures requires the execution of a regular transfer deed.

Bearer Bonds/Debentures: Bearer bonds are a type of bonds which do not require a transfer deed because the holder has legal ownership. The company does not keep any record of such bond or debenture holders. Interest is paid on the production of coupons attached to the debentures. These debentures are transferable by mere delivery.

First Debentures: When a company issues a number of different types of debentures, those which have to be repaid before others are known as first debentures.

Second Debentures: Debentures which will be paid after the redemption of the first debentures are known as second debentures.

Convertible Bonds/Debentures: A bond or debenture that gives the investor the option to convert the bond into equity share at a fixed conversion price or as per a predetermined pricing formula is known as convertible bond or convertible debenture.

Junk Bonds: High-yielding bonds issued by low-rated companies are called junk bonds. These bonds carry low ratings with corresponding higher yields. Investment in junk bond is very risky since the company issuing junk bonds has little financial strength or stability.

Foreign Bonds: Bonds issued in domestic financial markets by foreign entities are known as foreign bonds. Such bonds are usually denominated in domestic currency, but occasionally denominated in another currency also.

Eurobonds: Bonds issued by parties outside their domestic financial markets are called Eurobonds. Such bonds may be issued in more than one currency.

Yankee Bonds and Samurai Bonds: Foreign bonds offered in US bond market are called Yankee bonds. Similarly, foreign bonds offered in Japanese bond market are called Samurai bonds. [Yankee means 'of America' or 'of the inhabitants of America' whereas Samurai refers to Japanese warrior.]

Further, there are many other types of bonds which have been introduced in Indian capital market in recent years. These bonds differ in terms of security, rate of return, marketability, liquidity, etc. To name a few, these bonds are zero interest bonds, deep discount bonds or zero coupon bonds, option bonds, bonds with warrants, easy exit bonds, retirement bonds, regular income bonds, etc. We have briefly discussed about some of them in the present unit under the topic 'Instruments of New Issue Market' and in Unit 10 under the heading 'Innovative Financial Instruments'.

8.7.10 Distinction between Shares and Bonds/Debentures

A share is a financial instrument in the capital market which indicates the share of ownership in a company. The purchase of share implies the purchase of a part of ownership of a company. Hence, shareholders of a company are the owners of the company. They get dividend if the company makes a profit. On the other hand, bond/debenture is a credit paper. Purchase of bonds of a company implies giving loan to the company. So, bondholders are the creditors of a company. They get interest generally at a predetermined rate.

The differences between shares and bonds may be summarised in terms of Table 8.4.

Table 8.4 Distinction between shares and bonds/debentures

Shares	Bonds
1. Shareholders are the owners of the company.	1. Bond holders are the creditors of the company.
2. Shareholders get a part of the company's profit. This is known as dividend.	2. Bond holders get interest from the company.
3. Shareholders get dividend only if the company earns a profit.	3. Bond holders get interest, no matter whether the company earns a profit or makes a loss.
4. Shareholders can participate in the annual general meeting of the company. Most of the shareholders can vote to elect the Board of Directors of the company.	4. Bond holders have no such powers. They cannot participate in the annual general meeting or in the voting to elect the Board of Directors of the company.
5. Apart from preference shares, amount collected from selling shares is not to be returned to the shareholders	5. The amount collected by the company by selling debentures or bonds is to be returned to the bond holders after a specified time period.
6. When a company is to be wound up, payments to shareholders will be made after paying the bond holders.	6. Payments to the bond holders are to be made first.
7. A new company can collect money only by selling shares. It cannot issue bonds.	7. When a company is established and has earned goodwill, it can issue bonds.
8. The rate of dividend enjoyed by shareholders is not constant. It may vary from year to year depending on the performance of the company.	8. The rate of interest paid to the bond holders is fixed. It is determined by the terms of contract when the bond is issued.

8.8 METHODS OF SECURITY TRADING

Having discussed about various types of securities and their market, we shall now consider the methods of security trading. Most of the security trading takes place in the secondary market. In the primary market or Initial Public Offer (IPO), only new securities are traded. In the secondary market, old and existing securities are traded. Secondary market is known as stock exchange or stock market (or share market). Here, buyers and sellers trade in securities among themselves with an active participation of their brokers.

There are basically two methods of security trading:

1. Scrip-based traditional trading
2. Scripless or paperless trading

Traditionally, equity shares and other securities were traded by mutual transfer of money (from buyer to seller) and security certificates (from seller to buyer). Hence, it is also known as physical trading. On the other hand, scripless or paperless trading means transfer of securities through electronic book entry. Here, trading in securities takes place in dematerialised form. Hence, this process of security trading is known as dematerialisation (or trading in demat form.).

8.8.1 Scrip-based Traditional Trading

The scrip-based traditional trading is normally made in four popular ways. These are as follows:

1. Spot trading
2. Cash-basis trading
3. Settlement trading
4. Options trading

Let us briefly discuss them one by one.

8.8.1.1 Spot Trading

Under this system, the seller of a security must deliver the security certificate within 48 hours to the buyer. The seller receives the selling price immediately after the delivery of the security. If the security certificate is delivered on some future date at price agreed at the time of contract, the trading is called forward trading. The contract of forward trading is called forward contract.

8.8.1.2 Cash-basis Trading

Under this system of security trading, actual delivery of security certificates and the payment of cash must take place before the next settlement date of cash transactions. At present, settlement takes place normally once in every week. These days are fixed for most stock exchanges, unless being holidays.

8.8.1.3 Settlement Trading

Under this security trading, a security can be purchased without having the requisite amount of money. Similarly, in this system, security can be sold without the securities to deliver. Suppose a person wants to buy a security. He expects its price to rise (bull). Then he can make a profit by selling the security. But he has no money to buy it. So he takes a loan and buys the security. If the price of the security rises, he will make a profit. But if the price falls, he suffers a loss equal to the loan and interest *minus* the sales proceeds. Such interest element on financing is known as '*badla*' in common local parlance.

8.8.1.4 Options Trading

This type of trading of security gives the buyer or the seller an option to buy or sell a security at a particular price by buying an option contract. Options are of two types: call option and put option. Call option is the option to buy and put option is the option to sell. A buyer of the call option or put option has to pay a premium to the option seller. The premium is called option premium.

If, on the final date of trading, the market price is higher than the option price of a call option, the buyer will exercise his option to purchase the security at the lower option price. In the opposite case, he will forego his option and the premium that he has paid is his loss. Similarly, the buyer of a put option will exercise his right to sell a security if its market price is lower than the option price on the final date of trading. In the opposite case, he will forego his option. Then the premium that he has paid is his loss.

8.8.2 Scripless or Paperless Trading/Dematerialisation (Demat)

When certificates of securities cease to exist in physical form and exist in electronic number, it is known as dematerialisation or demat in brief. In this trading, security certificate loses the paper form and there is no scrip of the certificate. Hence it is also called scripless or paperless trading. After dematerialisation, the securities lose the distinctive numbers and exist in electronic numbers. Hence, it is also called screen-based trading. Now, if any investor wishes to hold the securities in the physical or paper form, there is a reverse process of conversion of the paperless securities into scrip form. This is known as rematerialisation.

Dematerialisation of securities has certain distinct advantages for the investors. Briefly they are as follows:

1. Buyers of securities can avoid stamp duty at the time of buying the securities. They have to pay nominal settlement charges to the depository participants (DPs).
2. As there are electronic operations in the case of dematerialisation, it is trouble free.
3. Buyers of securities can avoid some risks, such as, bad deliveries, forged securities, loss of securities in transit, etc.

8.8.3 Physical Trading Versus De-mat Trading

De-mat security trading has some advantages over physical trading. They are as follows:

1. In de-mat trading, buyers can avoid stamp duty at the time of buying. They have only to pay nominal settlement charges to the depository participants (DPs). But in the case of physical trading, buyers of securities have to pay stamp duty.
2. In de-mat trading, buyers can avail the advantage of hassle-free operations. Physical trading in securities does not have this advantage.
3. In de-mat trading, buyers can avoid some risks, such as, bad deliveries, forged certificates, loss of certificates in transit, etc. Physical trading is not free from these risks.
4. In the case of de-mat trading of securities, buyers can save the postage expenses of sending the security certificates to the Registrar and Transfer Agents (R&T) for transfer. But in the case of physical trading, buyers have to bear these postal expenses.

Thus, de-mat trading of securities involves some cost-saving advantages over physical trading of securities. Hence, de-mat trading is becoming more and more popular to both buyers and sellers of securities.

8.9 DEPOSITORY SYSTEM

Depository system plays a vital role in the introduction of scripless trading of securities in the capital market of a country. Hence, we shall discuss different aspects of the depository system.

A depository can be defined as an institution which transfers the ownership of securities in electronic mode on behalf of its members. A depository is thus a nominee who keeps the scrips on behalf of the investors. It undertakes the role of a custodian. The depository system leads the capital market towards a scripless system of security trading through immobilisation and dematerialisation of security certificates. Immobilisation of security certificates means stopping of their physical movement. Dematerialisation means issue of one certificate number in favour of the depository nominee and not issuing the certificates in physical form.

8.9.1 Objectives of a Depository/Depository System

A depository or the depository system enables the capital market of a country to achieve the following objectives:

- To reduce the time for transfer of securities
- To avoid the risk of settlement of securities
- To enhance liquidity and efficiency
- To reduce cost of transaction for the investor
- To create a system for the central handling of all securities
- To promote the country's competitiveness by complying with global standards
- To introduce a scripless security trading

8.9.2 Activities of the Depository

The main activities of the depository may be summarised as follows:

- To accept deposit of securities for custody
- To make computerised book entry of deliveries of securities which are immobilised in its custody
- To create computerised book entry of pledges of securities in its custody
- To provide for withdrawal of securities
- To undertake corporate actions like distribution of dividend and interest
- To make redemption of securities on maturity

8.9.3 Interacting Institutions/Constituents in a Depository System

There are three institutions that interact with one another in a depository system. They are as follows:

(i) The Central Depository
(ii) Share Registrar and Transfer Agent
(iii) Clearing and Settlement Corporation

Central Depository: The central depository is the nominee who holds the securities on behalf of the investors and maintains records in an electronic mode.

Share Registrar and Transfer Agent (R&T): The registrar is an institution that controls the issuance of securities. The transfer agent is one who retains the names and addresses of registered security owners and re-registers traded securities in the names of new owners.

Clearing and Settlement Corporation: It is a centre to do trade matching, settle the funds and exchange securities.

8.9.4 Benefits of the Depository System

The Depository System provides many benefits. Those benefits may be discussed under the following three heads:

(i) Benefits to investors
(ii) Benefits to companies
(iii) Benefits to the capital market

We consider them one by one.

8.9.4.1 Benefits to Investors

- The depository system eliminates paper work, as the electronic book entry system does not need physical movement of security certificates for transfer purposes.
- The risk of bad deliveries, forged and misplaced, mutilated and lost share certificates will not exist.

- The electronic transaction will shorten settlement time. Hence, the investor can save time and increase the velocity of security movement.
- Investors will be able to change portfolio more frequently.
- The distribution of dividends, interest and other benefits will be speedier as the owner can be easily identified.
- The cost of transfer of security certificates is less as the transfers are exempt from stamp duty.
- Faster payment in the case of sale of securities is possible.

8.9.4.2 Benefits to Companies

- The companies will be able to know the participants of beneficial owners and their holdings periodically.
- At the time of declaration of dividends, bonus, etc., there will not be any rush for transfer-related activities for the companies.
- Complaints from the investors will be reduced significantly.
- Notices and annual reports can be sent without delay.

8.9.4.3 Benefits to the Capital Market

- Capital market will be more transparent. Trading, clearing and settlement mechanism will be highly automated and interlinked with the depositories among themselves.
- Capital market will be highly automated and efficient due to the use of computing and telecommunication technology.

  Due to the above two aspects, confidence of the investors will increase.
- Foreign investors will start participating in the capital market. This will result in a more buoyant capital market.
- The depository system will result in an increase in the volume of trade both by number and value.
- The depository system will attract more middle-income people into the capital market either through direct investment or through mutual funds.

8.9.5 Role of Depository Participants in Dematerialisation

In the system of dematerialisation, when an investor wishes to sell his securities held in physical form, he has to hand over the certificates to a depository participant (DP) either by himself or by his broker. With the DP, the holder-investor or his broker will then have a depository account. The depository system of Indian capital market has laid a great emphasis on the role played by depository participants (DPs) in dematerialisation. These DPs are scattered all over the country to meet the need of the investors and brokers. They act as a binding link between the central depository under this system and general investors along with the brokers. These depositories are trying to introduce a paperless regime in existence and trading of securities in the security market. The role of the DPs in introducing dematerialisation can be summarised as follows:

- To enter into an agreement with the central depository under this system for acting as its agents.
- To enter into agreement with the investors and brokers for availing depository services by them and issuing depository accounts to them.
- To act as an intermediary holder of the physical scrips received from the investors before sending them to the issuer company's share Registrar and Transfer Agent (R&T)
- To inform the issuer accordingly in case a beneficial owner or a transferee of any security seeks to have custody of such security.
- To furnish information about the details of securities held by the investors at the end of a certain period.
- To furnish information about the transfer of securities to the issuer's R&T (Registrar and Transfer Agent)
- To make appropriate entries in its record and inform the issuer's R&T the same if a holder seeks to opt out of the dematerialisation system and to have the scrips rematerialised in the physical scrip form.
- To indemnify the beneficial owner any loss which the person has suffered due to its negligence.

8.9.6 Role of National Securities Depository Limited (NSDL) in Dematerialisation

The Indian capital market took a major step in its rapid modernisation programme when the National Securities Depository Limited (NSDL) was set up. It was the first depository in India under the Depositories Act, 1996. There is only another depository, named Central Depository Services Ltd. (CDSL). However, it has much lesser connectivity with the stock exchanges and much lesser popularity among the depository participants than the NSDL.

The NSDL was promoted jointly by IDBI, UTI and NSE (National Stock Exchange) and commenced its operations in November 1996. Later, SBI also became a shareholder of it. The NSDL interacts with the investors and clearing members through market intermediaries or depository participants. It plays a vital role in introducing depository system. The main functions of the NSDL are as follows:

- To make agreement with companies regarding dematerialisation of their securities as the central depository.
- To enter into agreement with one or more participants to be acting as agents.
- To make liaison with depository participants (DPs).
- To try to set up a complete depository system in the country and to act as a central depository in this respect.
- To admit securities for dematerialisation by inserting holder's name as beneficial owner in its record.
- To fix up charges on transactions to the DPs.

- To act as a registered owner of the dematerialised securities for the purpose of effecting transfer of ownership on behalf of a beneficial owner.
- To spread the message of dematerialisation among the investors.
- To provide electronic depository facilities for securities traded in the equity and the debt markets.

As we have already stated, there is another central depository in the depository system of India, namely, Central Depository Services Ltd. (CDSL). However, it has lesser connectivity and popularity among the DPs. Up to September 1999, CSDL had only one exchange, the Bombay Stock Exchange, connected with it. At that time, 10 exchanges were linked up with the NSDL. They are Bangalore, Calcutta, Delhi, Madras, Ludhiana, Bombay, OTCEI (Over-the-Counter Exchange of India), National Stock Exchange (NSE) and Interconnected Stock Exchange (ISE) of India. Connectivity between the two depositories is mandatory under the Depositories Act. Investors can transfer securities from one depository to another as per the model adopted for inter-depository transfers. Similarly, a broker can transfer securities to the clients having accounts in any depository. This connectivity between the country's only two depositories—NSDL and CDSL—has been established on 20 September 1999. A suitable software has been developed for this purpose. It has greatly facilitated electronic transactions in the stock market of India.

8.10 PRIMARY MARKET/NEW-ISSUE MARKET/INITIAL PUBLIC OFFER (IPO)

8.10.1 Meaning of the Concept

The market that deals in new securities which were not previously available to the investors and which are offered to them for the first time is called primary market or new issue market. As securities are being offered for the first time to the potential buyers in the market, this primary market is also called Initial Public Offer (IPO). The new issue market helps companies raise fresh capital from the market. It includes all institutions dealing in new claim. Various forms of these new claims are equity shares, preference shares, debentures or bonds, rights issues and a variety of new and innovative financial instruments. Thus, there may be various types of financial instruments in the new issue market. All financial institutions which are somehow related to the activities in connection with a new issue are parts or players in the new issue market or the primary market.

8.10.2 Functions of Primary/New Issue Market

The new issue market or the primary market mobilises funds from the savers. Then it channelises them to borrowers for production purposes. The savers are individuals, commercial banks, insurance companies, etc. The users are corporate houses and the government. The main functions of the new issue market can be divided into three stages. They are as follows:

(i) Origination
(ii) Underwriting
(iii) Distribution of new issue

We briefly discuss them one by one in the following sub-sections.

8.10.2.1 Origination

Origination refers to the work of investigations, analysis and processing of new project proposals. It starts before an issue is actually offered in the market for sale. There are two aspects in the function of origination.

Study of the Project: A careful study of the technical, economic and financial viability of the project is done. If the results of the study in all the cases are affirmative or encouraging, only then the issue is marketed.

Advisory Services: These are intended to improve the quality of new issue and ensure its success. The advisory services include the following:

(i) Type of issue, *that is*, what kind of security is to be issued
(ii) Magnitude of the issue, *that is*, what amount of the issue is to be placed for sale
(iii) Time of floating the issue
(iv) Price of the issue, *that is*, whether it is to be issued at par or at a premium or at a discount
(v) Methods of issue, *that is,* how the issue is to be distributed among its potential buyers
(vi) Technique of selling the issue, *that is*, what selling strategies are to be adopted in order to sell the issue

Only correct decisions regarding these matters will ensure the success of new issue. In India, the origination function is done by merchant banks, all-India financial institutions and private firms.

8.10.2.2 Underwriting

Underwriting is an agreement whereby the underwriter promises to subscribe to a specified number of unsold securities (shares, debentures, etc.). If the issue (i.e., the security) is fully subscribed, the underwriter will have no liability of purchasing the issue. If a part of the issue remains unsold, the underwriter will buy the whole or a part of the unsold issue. Mere origination of the new issue does not guarantee the success of the issue. Hence, underwriting may be necessary for successful marketing of a new issue.

Forms/Types of Underwriting

There are three main types or forms of underwriting. The underwriting agreement may be any of the following three forms:

Standing Behind the Issue: Under this system, the underwriter guarantees the sale of a specified number of new security within a specified period. If the public and financial institutions do not subscribe to the full amount of the issue, the underwriter buys the balance amount of the issue.

Outright Purchase: In this method, the underwriter outright purchases the unsold securities and resells them to the potential investors.

Consortium Method: In this case, underwriting is jointly done by a group of underwriters. The underwriters form a syndicate or consortium for this purpose. This method is generally adopted for large amount of issues. In that case, an individual underwriter may be unwilling or unable to subscribe the entire unsold amount of the new issue.

Advantages of Underwriting

Underwriting is very significant to the issuing company. This underwriting service has the following advantages to the issuing company.

- The issuing company is relieved from the risk of finding buyers for the new issue.
- The company is assured of getting a certain minimum subscription within the required time period.
- The issuing company does not have to bear the difficulties of distribution of the security. The underwriter companies (or company) bear(s) the burden of distributing securities.
- Underwriters in many cases provide experts' advice to the issuing company with regard to timing, pricing, type and size of the issue. The issuing company does not have to decide on these matters and hence it can reduce expenses on these matters.
- When any new issue is underwritten by reputed underwriters, public confidence on the new issue rises. It then becomes easier for the issuing company to sell the issue.

8.10.2.3 Distribution

Distribution refers to selling of new securities to the ultimate investors. This service is performed by brokers and agents. Various methods are used to distribute the new issue. They are as follows:

- Public issues through prospectus
- Offer for sale
- Placement or Private placement
- Rights issues
- Book-building method or Tender method

We have briefly described these methods of distribution of new issues in the next sub-section.

8.10.3 Distribution/Issue Mechanism of an IPO

Distribution refers to the function of selling a new issue or an IPO to ultimate investors or buyers. This distribution service is performed by brokers and agents in the security market. Various methods are used to distribute securities in the new issue market. Important among them are **(1)** Public issue through prospectus, **(2)** Offer for sale, **(3)** Placement or private placement, **(4)** Rights issues, and **(5)** Book-building method/Tender method

We shall briefly describe these methods of distribution of new issues in the following sub-sections.

8.10.3.1 Public Issue through Prospectus

Under this method of distribution of new issues, the issuing company directly offers securities to the general public and financial institutions at a stated price through a document called prospectus. A prospectus is a document containing necessary and relevant information about the company seeking to raise fresh capital in the new issue market. The prospectus is prepared and made available by the issuing company to the potential buyers in the new issue market.

The method of public issues through prospectus has some major advantages. They are as follows:

- By this method, the issuing company can invite a large section of the investing public through advertisement.
- It is a direct method. No intermediaries are involved. Hence, there is no brokerage cost.
- Under this method, shares are allotted to a large number of investors without making any discrimination among them.
- This procedure helps in wide distribution of securities. It thus avoids concentration of shares in few hands.

The method of distribution of public issues through prospectus has some limitations also. Two major limitations of this method are as follows:

- The method of public issues through prospectus is an expensive method. The company has to incur expenses on printing of prospectus, advertisement, banks' commission, underwriting commission, etc.
- This method is suitable only for large issues. For small issues, expenditures on advertisement and printing of prospectus will be relatively high.

8.10.3.2 Offer for Sale

Offer for sale is a method of distribution of new issues among the potential buyers. This method consists of two stages. **First**, new issues are directly sold by the issuing company to the Issue Houses or security brokers at an agreed price. **Second**, the intermediaries (Issue Houses and security brokers) then resell them to the ultimate investors. They purchase the securities at a negotiated price and resell at a higher price. The difference between the sale price and the purchase price is called **spread** or the **turn** which is the earning of the intermediaries.

8.10.3.3 Placement/Private Placement Method

Under this method of distribution of new issues, the Issue Houses or brokers buy the securities outright from the issuing company. Their intention is to place the securities before their clients afterwards. Here the intermediaries (Issue houses) and the brokers act as almost wholesalers of securities selling them in retail to the public. In the process, they make their profits. Here, profit per unit of the issue is the difference between the selling price and the buying price.

The method of placement (also called private placement) for distribution of new issues has some advantages. They are as follows:

- The method is suitable when small companies issue their securities. However, for large companies issuing a large volume primary security or IPO, the placement method becomes unsuitable.
- By the placement method, issues can be floated at the right time when market conditions are favourable. This may not be possible in the case of selling issues through prospectus.

The placement method or the private placement method has **one major limitation**. Under this method, securities are not widely distributed among a large number of investors. Only a selected number of investors having personal contact with the Issue houses or brokers of securities are able to buy a large number of securities. They thus get majority holding in a company and may influence the policies of the company according to their own interests.

In India, the method of private placement or simply placement is used to a limited extent.

8.10.3.4 Rights Issues

The term 'right' in security market implies an option to buy certain securities at a certain privileged price within a certain period. Shares offered to the existing shareholders with this right are called rights shares or rights issues.

Rights shares are offered to the existing shareholders in a particular proportion to their existing shareholding. The rights themselves are transferable and saleable in the market.

The rights issue method of distribution of new issues has some advantages.

- The cost of issue is minimum. There is no cost for printing prospectus, giving advertisement, paying banks' commission or underwriters' fee, etc.
- This method ensures equitable distribution of shares to all existing shareholders. So, control of the company remains undisturbed.

Following the principle of rights issues, there may be some other methods of distribution of new issues. These are offer of shares to the employees, offer of shares to the creditors, offer of shares to the customers, issue of bonus shares, etc.

8.10.3.5 Book-Building Method/Tender Method

Book-building method or Tender method is one of the major methods of distribution of new issues of a company. Briefly speaking, under this method, the pricing of the issues is left to the investors. All the details including the reservation price or the minimum price are mentioned in the offer document. The investors have to quote the number of issues and price at which they wish to purchase them.

Let us slightly elaborate the process. Book-building method or Tender method is a process of marketing new issue of a company. Here, bids from investors are collected. The issue price is fixed after the closing date of bidding. The issuer company engages a lead merchant banker to act as a book-runner. It prepares and obtains a green signal for the draft of offer document (without mentioning price of the issue) to the Securities and Exchange Board of India (SEBI). A syndicate, comprising of capital market intermediaries, is appointed to underwrite the issue. It approaches investors and collects bids from them at different prices of the issue. The information is passed on to the book-runner. The book-runner builds an order book. It collects the bids from various investors. These bids show the demand for the shares of the company at various prices. Thereafter, price of the issue is fixed after careful analysis of the bids. This is, in brief, the book-building method or Tender Method of distribution of a new issue.

Steps adopted under book-building or Tender method The steps adopted under Book-building or Tender method for distribution of a new issue may be summed up as follows:

Step 1: Appointment of book-runners The issuer company first appoints a book-runner from one of the lead merchant bankers. He prepares the draft offer document (without mentioning price) and obtains a green signal from the SEBI (Securities and Exchange Board of India).

Step 2: Preparation of draft prospectus It contains all information except offer price and number of securities.

Step 3: Circulation of draft prospectus Draft prospectus is circulated among prospective investors by forming a syndicate. The syndicate comprising of capital market intermediaries is to underwrite the issue. One copy of the draft prospectus is filed with SEBI.

Step 4: Maintenance of the offer records Offers (bids) received from institutional investors and underwriters are recorded by the book-runner.

Step 5: Intimation about aggregate orders The underwriters and the institutional investors then give information about aggregate orders to the book-runner.

Step 6: Bid analysis After the closing date of bid offer, bid analysis is done by the book-runner. A final price of the issue is fixed after a careful analysis of bids given by the investors.

Step 7: Mandatory agreement An agreement is made between the underwriter and the issuer. It specifies the price and the number of securities to be underwritten by the underwriter.

Step 8: Filing with the Registrar of Companies (ROC) After the receipt of the acknowledgement from the SEBI, a copy of the prospectus is filed with the Registrar of Companies (ROC).

Step 9: Opening bank accounts The issuer company then opens two bank accounts for the collection of application money: one for the private placement portion and the other for the public subscription.

Step 10: Collection of complete applications The book-runner collects from the institutional investors and underwriters the application forms along with the application money.

Step 11: Allotment of securities Allotment of securities is finally done by the book-runner.

Step 12: Payment schedule and listing The book-runner prepares a payment schedule for the underwriters. Then the allotted shares are listed on a stock exchange for their trading.

This is, in brief, the steps involved in book-building method.

The Book-building method or the Tender method is, however, not very popular in India.

8.10.4 Instruments of New Issue Market

Traditionally, equity shares and preference shares are issued by companies as ownership capital. They also issue debentures and bonds as debt capital. So, these are the traditional instruments of new issue market. Apart from them, in recent years, various types of new instruments have been introduced in the new issue market. These instruments meet the varied needs of investors. These instruments differ in terms of security, rate of return, marketability, fluctuation in value, etc. We here mention some new important instruments of the new issue market.

Secured Premium Notes (SPN) with Detachable Warrants: The SPN is issued at a nominal value and does not carry any interest. It is redeemed by repayment in several instalments at a premium over the face value. The premium amount is distributed equally over the maturity period. The investor can dispose of the SPN on allotment at a premium. He can also convert the detachable warrant into equity shares within a notified period provided the SPN is fully paid up.

Equity Shares with Detachable Warrants: In this instrument, along with fully paid-up equity shares, detachable warrants are issued. The warrant holder can apply for a specified number of shares at a predetermined price. These warrants are registered separately with the stock exchange and are traded separately.

Preference Shares with Warrants: This instrument carries a certain number of warrants.

The warrant holders can apply for equity shares at a premium at any time in one or more stages between the third and fifth years from the date of allotment. The preference shares with warrants cannot be transferred or sold for a period of 3 years from the date of allotment (that is, lock-in period is 3 years).

Non-convertible Debentures with Detachable Equity Shares: The holder of this instrument is given an option to buy a specified number of equity shares from the company at a pre-determined price. There is a specific lock-in period after which the holder can exercise his option to apply for equity shares.

Fully Convertible Cumulative Preference Shares: This instrument has two parts: Part A and Part B. Part A is convertible into equity shares automatically on the date of allotment without any application by the allottee. Part B will be redeemed at par/converted into equity after a lock-in period, at the option of the investors.

Zero-Interest Fully Convertible Debentures (FCDs): No interest is paid to the holders of this instrument during the lock-in period. After a notified period, this debenture will be automatically and compulsorily converted into equity shares. Before this conversion, if the company issues rights shares, it will be available to the holders in the proportion decided by the company.

Fully Convertible Debentures with Interest: This instrument carries no interest for a specified period. After this period, option is given to apply for equity shares at a premium. Interest on the debentures is payable at a pre-determined rate from the date of first conversion to the final conversion and equity shares will be issued in lieu of interest amount.

Zero-Interest Bonds: These bonds do not carry any interest. They are sold at a discount from their eventual maturity value. They are converted into equity shares at par or at a premium on the expiry of the fixed period.

Deep Discount Bonds: These bonds are sold at a large discount to their nominal or face value. There are no interest payments on these bonds. The investors get the face value after the maturity period.

Option Bonds: Option bonds may be cumulative or non-cumulative as per the option of the bond holders. In the case of cumulative bonds, interest is accumulated and is payable on maturity only. In the case of non-cumulative bonds, the interest is paid periodically. The option is to be exercised by the investor at the time of investment.

Bonds with Warrants: A warrant entitles its holder to buy in future a number of equity shares at a pre-determined price. The warrants are usually attached to debentures or preference shares issued by companies as sweeteners to make issues more attractive.

In addition to the above, the Abid Hussain Committee has recommended the issue of the following instruments:

- Floating rate notes,
- Clip and strip bonds,
- Dual convertible bonds,
- Index rate notes,
- Dual option warrants,
- Commodity bonds,
- Industrial revenue bonds, etc.

In addition, the Pherwani Study Group has recommended the issue of some other new instruments. Some of them are as follows:

- Participating preference shares
- Participating debenture
- Convertible debenture with options
- Third party convertible debenture
- Convertible debentures redeemable at premium
- Debt for equity swap, etc.

Thus, various types of new issues have been introduced in the financial market of India in recent years. They have made the Indian capital market more diverse and varied. The main factors which provided a new impetus to the capital market are economic liberalisation, privatisation, globalisation (LPG), disinvestment in public sector, changes in the regulation of financial institutions, etc. adopted by the Government of India, particularly during 1990s. As there have been reforms in the financial sector, many new financial instruments have emerged in the Indian capital market.

8.10.5 Players in the New Issue Market

There are many players in the new issue market. Important among them are the following:

1. Merchant bankers
2. Registrars to the new issue
3. Collecting and co-ordinating bankers
4. Underwriters and brokers
5. Printers, advertising agencies and mailing agencies

We shall briefly discuss about them one by one.

8.10.5.1 Merchant Bankers

Merchant bankers perform a wide range of activities, such as, management of customer services, portfolio management, credit syndication, counselling, insurance, etc. Among them, the most important function of merchant bankers is issue management. The issue management function may be broadly divided into pre-issue management and post-issue management. The pre-issue management consists of three functions:

- Issue through prospectus, offer for sale and private placement (or simply, placement)
- Marketing and underwriting of new issue
- Pricing of new issue

The post-issue management consists of the following:

- Collection of application forms and statement of amount received from bankers
- Screening of applications
- Deciding allotment procedures
- Mailing of allotment letters, share certificates and refund orders, etc.

Thus, merchant banks are, in a word, the issue managers of a company issuing new securities.

8.10.5.2 Registrars to the New Issue

Registrars to the new issue of companies undertake the following major activities with new issue management:

- They draft application form for the new issue.
- They choose collection centres and collecting bankers.

- They assist in opening collection accounts with banks. They also lay down procedures for the operation of these activities.
- Registrars send various instructions to collecting bankers.

During the currency of new issue, registrars perform the following roles:

- Receive the collection figures every day.
- Tabulate and classify those data.
- Inform the merchant bank and the company about the progress of total subscriptions.
- Inform the stock exchange about the closure of issue(s).

Registrars perform the following pre-allotment works:

- They collect all application forms from the collecting bankers.
- Then they sort out valid applications eligible for allotment.
- Registrars finalise the allotment as per the basis approved by the stock exchange.

The most important work of the Registrar is the allotment of shares. These are done as per SEBI guidelines.

During the post-allotment stage also, Registrars perform the following activities:

- They write the letters of allotment and refund orders and mail them.
- Registrars submit all statements to the issuing company for their final approval.
- They arrange to pay the brokerage and underwriting commission and submit their relevant statements.
- They assist the issuing company to list the allotted shares on the stock exchange.

8.10.5.3 Collecting and Co-ordinating Bankers

Collecting bankers collect the subscriptions in cash, cheques, etc. Co-ordinating bankers collect information on subscriptions and co-ordinate the collection work. They inform these data to the registrars and merchant bankers. Collecting banker and co-ordinating banker may be the same bank or different banks.

8.10.5.4 Underwriters and Brokers

An underwriter helps in the issue of new security in three ways. They are as follows:

(i) **Standing behind the issue:** Under this method, the underwriter guarantees the sale of a specified number of shares within a specified period. If the public do not subscribe to the specified amount of issue, the underwriter buys the balance in the issue.

(ii) **Outright purchase:** In this method, the underwriter makes outright purchase of shares and resells them to the investors.

(iii) **Consortium method:** In this method, underwriting is jointly done by a group of underwriters. They form a syndicate for this purpose. This method is generally adopted for large issues.

Brokers along with the network of sub-brokers market the new issues. They send their own circulars and application forms to the clients and do follow-up works to market the securities.

8.10.5.5 Printers, Advertising Agencies and Mailing Agencies

There are some other organisations involved in the new issue market operations. Printers print various forms and other papers related to new issues.

Advertising agencies make advertisements to inform the prospective investors about the new issue.

Mailing agencies help the investors to send their application forms and subscriptions and to get the issue certificates and other relevant papers.

8.11 DIFFERENCE BETWEEN PRIMARY MARKET AND SECONDARY MARKET

Primary market for securities is the market in which new securities are traded. Hence, it is also known as new issue market or Initial Public Offer (IPO). On the other hand, secondary market for securities is the market in which existing old securities are traded. Secondary market is called the stock exchange or stock market or share market. There are many differences between the primary market and the secondary market. Those differences have been mentioned in Table 8.5 as follows:

Table 8.5 Differences between primary market and secondary market

Primary market	Secondary market
1. Primary market deals with the first (new) issue of securities.	1. Secondary market deals with subsequent trading of securities.
2. Primary market is necessary for creation and growth of new capital.	2. Secondary market is necessary to sustain the generated capital.
3. The issuer company is involved in the primary market.	3. The issuer company is not generally involved in the secondary market.
4. The case of new issue for a company is occasional. Hence, the amount of money involved in the primary market is much less compared to that in the secondary market.	4. Everyday trading of the same old and existing securities takes place, in some cases a number of times. Hence, the total amount of money involved in the secondary market is much higher than that in the primary market.
5. Primary market creates new capital.	5. Secondary market does not create any new capital.
6. Risk-reduction activities are not operative in the primary market.	6. Risk-reduction activities like speculation, futures, options, etc. are present in the secondary market.
7. The issuer company, the first subscribers, the bankers to the issue, the underwriters, etc. are involved in the primary market. They have the main roles to play.	7. The security traders, general public companies, government, foreign and domestic investors, banks, non-bank financial companies, brokers and their agents, mutual funds, clearing houses, etc. are involved in the secondary market.
8. Growth of primary market is necessary for the growth of the country.	8. Growth of secondary market is also necessary, but without the growth of primary market, growth of only secondary market is not good for the economy. Simultaneous growth of both primary and secondary markets is good for the economy.

8.12 STOCK EXCHANGE/STOCK MARKET/SHARE MARKET

Stock exchange or stock market is an institution where existing stocks and shares are traded. It is also known as secondary market. Though there is some theoretical difference between stocks and shares of a company, in general sense, shares and stocks are used interchangeably. Shares of a joint stock company are also called stocks. Hence, stock market or stock exchange is also known as share market. In a stock market, purchase and sale of existing securities of government, semi-government or other public bodies and also shares and debentures of the corporate sector are executed.

8.12.1 Organisation of Stock Exchange

Stock exchanges in India are organised either as voluntary non-profit making organisations or as public limited companies. They are to be registered with the central government and function within the purview of the Securities Contracts (Regulation) Act, 1956 (SCRA). This Act governs the organisation, management, membership and functioning of stock exchanges. Moreover, stock exchanges are governed by their own rules and by-laws. The Securities and Exchange Board of India (SEBI) overviews and governs the functioning of stock exchanges and their participants. A recognised stock exchange is managed by a governing body. This body consists of elected and nominated members. The executive director of a stock exchange is the chief executive of the exchange.

8.12.2 Listing of Securities

8.12.2.1 Meaning of Listing

To sell a share or any security in the secondary market or stock exchange, the share or the security is to be enlisted in a stock exchange. Listing of securities is the process whereby the securities (shares, debentures, bonds, units, etc.) are included in the official list of a recognised stock exchange for the purpose of trading. Every stock exchange maintains an official list of securities which can be purchased or sold on its floor. When a security is included in this list, it is said to be listed.

8.12.2.2 Procedure for Listing of Securities

A company which wants to enlist its securities in a recognised stock exchange must comply with some specific conditions. The Companies (Amendment) Act, 1988 stipulates that every company for selling its securities shall apply to the SEBI. Thus, listing has become compulsory in relation to any public issue of a security. The company concerned which wants to enlist its securities on a stock exchange has to apply in the prescribed form. Necessary documents and fee must be submitted along with the application. The company will have to submit the following documents:

- Certified copies of Memorandum and Articles of Association, Prospectus, Underwriting agreements, etc.

- Specimen copies of share and debenture certificates (security certificates).
- Particulars of dividends and bonuses paid during the last 10 years.
- Statement of arrear dividends and interest, if any.
- A brief history of the company mentioning its activities.
- Particulars regarding the capital structure of the company.
- Copies of balance sheets and audited accounts for the last 5 years.
- Particulars of shares and debentures for which enlisting is applied for.

The stock exchange authorities will scrutinise the application and the relevant documents. If they are satisfied, they will call upon the company to execute a listing agreement. This agreement contains a list of conditions and obligations which the company must observe. If the company fails to observe them, the stock exchange may suspend or withdraw the listing facility. Some of the important obligations of the listed company are mentioned below. The company must notify the following matters to the stock exchange:

- The date of Board meeting in which dividend, issue of rights or bonus shares will be discussed.
- Any change in the company's management.
- Any change in the company's capital structure.
- Any change in the company's nature of business.

Once listed, the shares of the company will be traded on the stock exchange. Securities become eligible for trading only through listing in the stock exchange or in the secondary market. The security will then be called listed security and the company will be called listed company.

8.12.2.3 Merits of Listing

Listing of securities is beneficial both to the company and the investors.

- Listing increases the goodwill and standing of the company. Transactions in listed securities are reported in newspapers. Hence, listed companies get wide publicity.
- Listing helps to diversify the shareholding. It becomes easier for the company to sell new securities.
- A listed company is treated as a widely held company. It enjoys certain advantages under the Income Tax Act.
- Listed companies have to submit quarterly financial results to the stock exchanges. These are also published in newspapers. So, investors get ready reports on the financial health of a company.
- Prices of listed securities are reported in newspapers. An investor can know the daily worth of his securities.
- Listing ensures marketability and liquidity of securities.
- Stock exchanges exercise regulation and control on listed companies. So, listing provides safeguards to investors regarding their holding of securities.

- A listed security carries a high collateral value for raising loans.

However, listing does not guarantee the financial soundness of a company. It merely indicates that the company was legally incorporated and was solvent when its securities were listed.

8.12.2.4 Demerits of Listing

There are some disadvantages or demerits of listing. In brief, they are as follows:

- Listing leads to speculation. It helps to manipulate the values of securities. This may be detrimental to the interests of the company.
- The stock market may not reflect the true picture of a listed company.
- The managerial personnel may themselves indulge in speculative activities with regard to listed securities. They may misuse the internal information available to them. This is called insider trading which is an illegal activity in India.
- Sometimes listed securities are subject to wide fluctuations in their values. During depression, values of listed securities fall very much. But unlisted securities are free from this difficulty. This may hamper the reputation of the listed company.
- To enlist securities, a company has to disclose vital information, such as, dividend and bonus rates, sales, remuneration of managers, etc. Thus, vital information is leaked out. Then trade unions may demand higher wages and bonus. Thus, listing may prove disadvantageous to a company.

8.12.3 Functions of Stock Exchange

Stock exchange or stock market occupies a pivotal position in the financial system of a country. It performs many important economic functions and provides invaluable services to investors, companies and to the country as a whole. In this way, the stock exchange helps the process of economic development of a country. The important functions of a stock market or stock exchange may be summarised as follows:

8.12.3.1 Provide Liquidity and Marketability of Securities

Stock exchanges provide liquidity to securities. They facilitate buying and selling of securities at listed prices. They thus provide marketability to the investors. Both buyers and sellers of securities can easily buy and sell them. Providing liquidity to the corporate sector, stock exchanges help in the economic development of a country.

8.12.3.2 Ensure Safety of Funds

Stock exchanges need to function under strict rules and regulations. Listed companies need to function by obeying some guidelines of the stock exchanges. All these are meant to ensure safety of investible funds of the investors. It raises the propensity to save and invest and thus is helpful for economic development.

8.12.3.3 Ensure Undisturbed Supply of Long-term Funds

Securities traded in the stock market are negotiable and transferable. When a security is transferred, one investor is replaced by another. But the company is not affected as it is assured of long-term capital. Hence, the activities of the company are not hampered—they continue to function as usual.

8.12.3.4 Ensure Flow of Capital of Profitable Ventures

Prices of stocks or shares of various companies are known from the stock exchanges. These prices indicate the performance and profitability of respective companies. Thus, stock prices give an idea to the investors about which shares are to be purchased and which are not to be purchased. Hence, stock exchanges ensure flow of capital to profitable ventures. They help the investors to utilise their funds in the optimum manner. Thus, stock exchanges ensure best use of surplus funds of an economy and make a positive contribution to the process of economic development of the economy.

8.12.3.5 Provide Motivation for Better Performance

In the stock market, prices of stocks or other securities of different companies are quoted. Public can know about the performance of various companies from those prices. Higher stock price of a company implies higher status and better performance of that company. This motivates companies to improve their performance. It again implies better allocation of resources and more efficient management of companies. Stock exchanges thus help in better performance of the industrial sector of an economy.

8.12.3.6 Mobilise Savings and Promote Investment

Stock exchanges help in the mobilisation of savings of the public and in channelling them into productive investment. Existence of stock exchange encourages the propensity to save and invest. Stock exchange thus helps in capital formation and promotes economic development of a country.

8.12.3.7 Reflect Business Cycles

Share market or stock exchange functions as an **economic barometer** of an economy. An idea on the course of business cycles can be obtained from the movement in share prices. Generally, rising trend in share prices indicates an upswing (boom like situation) in business cycle whereas a downward trend in share prices indicates a downswing (recession) in business cycle. Noticing the trends in shares prices, the government can take suitable measures to control business cycles or trade cycles. Stock exchanges thus help the government of a country to maintain economic stability of the country.

8.12.3.8 Mobilise Funds for Relatively Unknown Companies

When the share of a relatively unknown company is listed on a stock exchange, the company becomes familiar to the public. Its securities then become somewhat acceptable to them. Stock exchanges thus help in mobilising funds for relatively unknown companies also.

8.12.3.9 Other Functions or Services

Stock exchanges provide some other services as well, briefly mentioned as follows:

- Stock exchanges provide different kinds of securities with different maturities and yields. They help investors to reduce risk by diversification, *that is*, by holding different kinds of securities.
- Stock markets develop saving habits among the public. They help in capital formation in the economy.
- Stock exchanges guide the investors in choosing securities by providing information regarding them.
- Stock markets enable companies and the government of a country to raise funds without much difficulty. They provide a ready market for government and private securities.

Thus, we see that stock exchanges in an economy perform some important functions and provide some crucial services. Stock markets play a very important part in the capital market. They are, so to say, **the citadel of capital** and **fortress of finance.** Without a developed stock market, industrial growth of an economy is bound to be low mainly because of scarcity of capital. A developed stock market of a country removes various obstacles of industrial growth and ensures growth and expansion of the industrial sector of the country.

8.13 FUNCTIONARIES OF STOCK EXCHANGES

There are many types of functionaries in a stock exchange. They perform different roles in security trading on a stock exchange. We briefly describe below some major functionaries of a stock exchange.

8.13.1 Stockbroker or Broker

A broker or stockbroker in a stock exchange is a commission agent who transacts securities on behalf of his client who is not a member of the stock exchange. Thus, a non-member can buy and sell securities through a broker or stockbroker. The broker is a registered member of the stock exchange. The broker should register himself in order to trade in securities on a recognised stock exchange.

A broker need not always be an individual. Corporates and institutions can also become brokers. Brokers are selected and recognised by the selection committee on the basis of their qualification, experience, financial status, their performance in written test, interview, etc.

For membership, a broker has to officially apply to the SEBI through the stock exchange of which he wants to be a member. After scrutinising the application and considering other documents, if the Board is satisfied, it will grant a certificate to the stock broker. The concerned stock exchange is accordingly informed. The certified stockbroker has to abide by the prescribed code of conduct and pay the prescribed registration fee. He also has to maintain a security deposit with the stock exchange. He should not be convicted of a criminal offence or guilty of fraud. In the event of any breach of these conditions, his registration will be cancelled.

The stockbroker arranges the sale or purchase of securities on behalf of a non-member. The commission payable to the broker for his work is known as brokerage or brokerage fee. This brokerage is officially fixed by the stock exchange. For trading on behalf of the client, the broker first makes agreement with the client on a non-judicial stamp paper. He also takes information from the client on his income, employment, financial profile, identification proof, etc. The broker also obtains margin money from the client and utilises it for making payment or settlement in respect of that client. The broker then takes clear-cut and specific instructions from the client on the purchase/sale of securities. Then the broker tries to execute that instruction correctly and swiftly. This is the main function of the broker. While executing this function, the broker must be fair, prompt and careful. He shall neither indulge in manipulative, fraudulent or deceptive transactions nor disclose any financial information of his client to anybody else. The stockbroker shall not encourage purchase or sale of securities with the sole objective of getting brokerage or commission.

A broker performs an important job in the stock exchange. Without him, a non-member cannot buy or sell securities. A stockbroker or broker does this job on behalf of his client who is not a member of a stock exchange.

8.13.2 Sub-broker

A sub-broker is an agent of the stockbroker. He helps the investors to deal with the stockbroker. The sub-broker has a letter of recommendation from a stockbroker of a recognised stock exchange. By virtue of this recommendation letter, the sub-broker acts as an agent of the broker and helps the client/investor in the trading of securities through the stockbroker. A sub-broker is not a member of stock exchange; he is just an agent of the broker.

We know that a member of a stock exchange is known as its broker. A broker actually acts as an agent for the buyers and sellers of securities. In any transaction on the stock exchange, broker's presence is necessary. The general investors normally are not in a position to interact with the brokers directly as the number of brokers in a stock exchange is very limited. However, many sub-brokers or their agents are seen in the stock exchanges. Hence, very often, investors have to deal in securities through the sub-brokers. They have access to the brokers-appointed sub-brokers or agents appointed by the sub-brokers in the case of any trade in securities and through these middlemen their trade is authorised by any broker. The working procedure of a sub-broker is similar to that of the principal broker. The sub-broker, similar to the principal broker, buys or sells securities in a stock exchange on behalf of his client who is not a member of the stock exchange. Similar to the principal broker, the sub-broker also gets brokerage fee. However, the commission or brokerage of the sub-broker is relatively lower than that of the broker.

Like the broker, the sub-broker shall maintain fairness, integrity and promptness while conducting trading activities on behalf of his client. He must transact business strictly as per instructions from his client. He shall promptly inform his client about the execution or non-execution of the instruction(s) from him. Like the broker, the sub-broker shall not also disclose the financial details and other information of a confidential nature of his client to anybody else. He shall also not furnish any false or misleading information to the client in order to induce him to buy or sell any security. Similarly, he should not encourage his client to purchase/sell any security with the sole objective of obtaining more brokerage or commission. Similar to brokers, sub-brokers help their clients in performing trading activities in a stock exchange. However, their activities should be fair, efficient, prompt and careful.

8.13.3 Difference between Broker and Sub-broker

Both broker and sub-broker help in trading in a stock exchange their client who is not a member of the stock exchange. Their working procedures are also very much similar. There are, however, some differences between a broker and a sub-broker. In Table 8.6, we have mentioned the main differences between a broker and a sub-broker.

Table 8.6 Difference between broker and sub-broker

Broker	Sub-broker
1. Broker is a registered member of a stock exchange. He deals with securities on behalf of clients who are not members of the stock exchange.	1. Sub-broker is an agent of the broker. He is not a registered member of a stock exchange.
2. Broker acts as the principal dealer in the trading of securities of his client.	2. Sub-broker is not the principal dealer in securities. He only assists the broker in trading in securities of his client.
3. To be registered with SEBI, a broker has to apply through the stock exchange in which he wants to act as a broker.	3. A sub-broker has to get a certificate from the broker with whom he wants to work as an agent and that certificate is to be deposited with SEBI.
4. A broker has to pay relatively higher annual fees than the sub-broker.	4. A sub-broker has to pay relatively lower annual fees than the broker.
5. Commission or brokerage fee of the broker is relatively high.	5. Commission or brokerage fee of the sub-broker is relatively small.

8.13.4 Jobbers

Members of a stock exchange who stand ready to buy and sell shares in which they specialise are called jobbers. They are independent dealers in securities. They buy and sell securities on their own account. Jobbers can either deal with a broker or with another jobber. Unlike brokers, they do not work on commission basis, but work for making a profit. A jobber gives two quotations as dealer in securities. Normally he gives a lower quotation for buying. It is known as 'bid price', that is, the price at which he is willing to buy. He gives a higher quotation for selling. It is known as 'ask price', that is, the price at which he is willing to sell. The difference between the bid price and the ask price is known as the jobber's spread or, simply, the spread. It is the remuneration or profit of the jobber. Here profit is uncertain, it may be positive, zero or negative. A jobber is a dealer in his own right. He is a professional speculator and usually specialises in a limited number of shares. He plays a vital role in security trading in a stock exchange.

In this connection, it may be mentioned that a broker in a stock exchange trades in securities on behalf of his client. On the other hand, a jobber is an independent dealer in securities. **Tarawaniwalas** include both brokers and jobbers. A **tarawaniwala** deals in securities on his own like a jobber and as an agent on behalf of his client like a broker.

8.13.5 Difference between Broker and Jobber

There are some differences between a broker and a jobber. As functionaries of a stock market, their nature of business, remuneration, status, etc. are different. We have briefly mentioned those differences in Table 8.7.

Table 8.7 Difference between broker and jobber

Broker	Jobber
1. Broker is a registered member of a stock market. He trades in securities on behalf of his client who is not a member of the stock exchange.	1. A jobber is an independent dealer in securities in a stock market. He trades in securities in his own account.
2. A broker has direct contact with the investor.	2. A jobber does not have any direct contact with the investor.
3. A broker is a commission agent. He acts as an agent of the investor. In exchange of that service, he gets brokerage or commission.	3. In jobber's income, there is no commission or brokerage. The difference between buying price and selling price quoted by the jobber is jobber's income. The difference is called jobber's spread.
4. A broker makes transaction of securities on behalf of investors who are non-members of the stock exchange. Hence, he has a large number of customers (i.e. investors).	4. A jobber transacts securities with a broker and not with non-member investors. Number of brokers in a stock market is limited. Hence, a jobber has a limited number of customers (i.e., brokers).
5. A broker acts as an intermediary between a jobber and an investor in the stock exchange.	5. A jobber directly trades in securities with a broker. He is connected with the investor only through the broker. He has no direct link with the investor and is not an intermediary between the broker and the investor.

8.13.6 Consultants/Portfolio Consultants

The word portfolio actually means a particular combination of assets—physical or financial. In security analysis, however, portfolio is used to mean a particular combination of different kinds of financial assets or securities at any fixed amount of investment. A fixed amount of investment can be used to hold in different combinations of or a variety of financial assets. Each such combination is a portfolio. Now, holding of financial assets involves some risks as prices of financial assets or securities are subject to changes. A part of this risk can be reduced by portfolio diversification, that is, by holding a variety of assets. The particular combination of assets in a portfolio which maximises return on the one hand and minimises risk on the other is known as optimum portfolio. To determine this optimum portfolio which maximises expected return and minimises risk, there are some consultants who advise the investors on the desirable type of portfolio. These consultants are called portfolio consultants, or simply, consultants. Merchant banks in India perform this job. Again, investors get some information about the credit worthiness of a company or the attractiveness of a financial asset from credit rating agencies. Thus, credit rating agencies indirectly do the job of a portfolio consultant though they are not directly involved in this job. Consultants or portfolio consultants provide the advisory service on desirable portfolio for a fee. Credit rating agencies charge a fee on credit rating, not a fee on consultancy on this rating as they do not provide such consultancy service at all.

8.13.7 Institutional Investors

Mutual fund institutions such as Unit Trust of India and other financial institutions such as Life Insurance Corporation of India, banks in general, non-bank financial companies, etc. which invest in the security market as regular investors are called institutional investors. When foreign firms and institutions invest in a country's security market, they are known as foreign institutional investors (FIIs). The capacity of institutional trading (purchase and sale of securities) is huge in comparison to an individual investor's capacity. Hence, the security market is greatly influenced by the activities of institutional investors. Normally, the market values of the securities selected by the institutional investors for buying go up. In the opposite case, the market values of other securities selected by institutional investors for selling are seen to decrease. This is mainly due to the volume of institutional trade. These institutional investors trade in huge volume and very often their decisions of buying and selling of securities act as trend setters in the security market.

8.13.8 Non-Resident Indians (NRIs)

Loosely speaking, Indian citizens living abroad or Indians having dual or more citizenship, one of India and other(s) of foreign country or countries are called non-resident Indians (NRIs). They include the following:

- Indian citizens staying abroad for employment, business or for any other purpose for an indefinite period of time.
- Indian citizens working in foreign or international organisations.
- Officials of central and state governments posted to offices abroad.

NRIs make investment in different sectors of India through the stock exchanges. Hence, they are also functionaries in the stock markets of India. NRIs are allowed to invest in the following major fields:

- Investment in proprietorship/partnership concerns doing industrial/commercial activity on repatriation basis.
- Investment in companies within the limits stipulated by the Reserve Bank of India.
- Investment in priority sector with full repatriation benefits up to 100%.
- Investment in commercial paper issued by Indian companies on non-repatriation basis.

- Investment in mutual funds floated by private/public sector banks or other financial institutions located in India.

8.13.9 Different Types of Speculators in a Stock Exchange

8.13.9.1 Speculation and Speculator

The word speculation means the act of buying and selling of anything in expectation of making a profit from anticipated changes in its value. However, speculation is generally referred to in the context of financial security or foreign exchange. Hence, the word speculation in financial analysis means the acts of buying and selling of securities in expectation of earning a profit from anticipated changes in their values. Similarly, the word may be used in the context of foreign exchange. The person who attempts to make a profit merely out of an anticipated change in security prices is known as speculator in the security market or in the stock exchange. Similarly, there may be speculator in the foreign exchange market and for that matter in any market.

8.13.9.2 Types of Speculators on a Stock Exchange

Speculation in security market is a risky activity, incidental to change in price of the security under consideration. If the price of the security changes in the anticipated direction, the speculator will stand to gain or be able to avoid his loss. On the other hand, if the price of the security changes in opposite direction of the anticipation of the speculator, he incurs a loss. The activity of a speculator will then depend on his anticipation or expectation regarding change in security price, his attitude towards risk-bearing, information related to security price available to him, etc. On the basis of these factors, speculators are divided into different categories. We briefly mention them below.

Bull: A bull is a speculator in the stock market who expects a rise in the price of securities in the future. Hence, he is engaged in buying securities with an expectation to sell them at a higher price in future. A bull is known as ***Tejiwala*** in local parlance. The bull has no intention of taking delivery of securities but deals only in difference of prices. Sometimes bull speculators form a ring and try to raise the prices of securities by placing big purchase orders. As a bull tries to throw his victim up in the air, the bull speculators try to push the security prices up, and hence the term 'bull' is used.

Bear: A bear is a speculator in the stock market who expects a fall in the price of securities in the future. Hence, he agrees or makes contract to sell the securities on a fixed date. He may or may not possess such securities. If prices go down as per his expectation before the date of delivery, he will buy securities at a lower price and sell at a higher price. He will thus make a profit. A bear speculator is also called ***Mandiwala*** in common parlance. As a bear seeks to press its victim down to the ground, the bear speculator expects security prices to go down, and hence the term 'bear' comes.

Lame Duck: When a speculator is unable to meet his commitment, he is said to be a lame duck. For example, suppose, a bull speculator commits to sell a certain security at a pre-determined price on a fixed date. Now, it may be difficult for him to deliver the security if it is not available in the market at his expected price.

Stag: A share market investor who frequently buys and sells shares for speedy encashment of profit is called stag. A stag is a cautious speculator in the stock market. He applies for shares of new companies whose shares are more in demand. He expects to sell them at a premium. After getting the allotment, he waits for the price rise. As soon as price rises immediately after the issue of shares, he sells them. The difference between the price paid by the stag and the price at which he sells his allotment constitutes the profit of the stag speculator.

8.14 A BRIEF DESCRIPTION OF MAJOR STOCK EXCHANGES IN INDIA

Business in corporate stocks and shares started to increase in India in the early nineteenth century. It further increased with the expansion of activities of the East India Company. However, the main impetus to the business of stocks and shares came in 1856 when the Companies Act provided for limited liability of shareholders of joint stock companies. The Bombay Stock Exchange is the oldest stock exchange in India. It was established in 1875 and completed 125 years in 2000. The stock exchanges of Calcutta and Madras, the two older stock exchanges of the country started in 1908 and that of Delhi in 1947. As on 31 March 2004, there were 24 stock exchanges in India. Their nature of organisation varies. Some of them are public limited companies, some are companies limited by guarantee whereas others are voluntary non-profit making organisations. Only eight stock exchanges have been granted permanent recognition whereas the remaining exchanges have to renew it time to time.

To become a member of the stock exchange, one has to pay an entry fee and keep a security deposit with the concerned stock exchange. The amount of security deposit varies from exchange to exchange depending on their size. Similar to other countries, stock exchanges in India differ in size. The Canara Stock Exchange has less than 80 members whereas the National Stock Exchange (NSE) has more than 1000 members. Members also need to pay an annual subscription in addition to the entry fee and security deposit.

In India, stock exchanges are to be registered with the Central Government. They function within the purview of the Securities Contracts (Regulation) Act, 1956 (SCRA). This Act governs the organisation, management, membership and functioning of stock exchanges in India. Moreover, any stock exchange also follows its own rules and by-laws. The Securities and Exchange Board of India (SEBI) overviews, regulates and governs the stock exchanges and their participants and functionaries. A recognised stock exchange is managed by a governing body consisting of both the elected and the nominated members. The executive director of any stock exchange is the chief executive of that exchange.

In Table 8.8, we have given a brief description of some major stock exchanges in India.

Table 8.8 Description of some major stock exchanges in India (as on 31 March 2004)

Sl. No.	Name of the exchange and location	Type of association	Date of initial recognition	Recognition status
1.	The Bombay Stock Exchange, Mumbai	Voluntary non-profit-making association of persons	31.3.1957	Permanent
2.	The Ahmedabad Stock Exchange Association Ltd., Ahmedabad	Do	16.9.1957	Permanent
3.	The Calcutta Stock Exchange Ltd., Calcutta	Public limited company	10.10.1957	Permanent
4.	Madras Stock Exchange Ltd., Chennai	Do	15.10.1957	Permanent
5.	The Delhi Stock Exchange Association Ltd., New Delhi	Do	09.12.1957	Permanent
6.	The Hyderabad Stock Exchange, Hyderabad	Company limited by guarantee	29.09.1958	Permanent
7.	Over-the-Counter Exchange of India (OTCEI) Ltd., Mumbai	Public Limited Company	23.08.1994	Renewable after every 5 years
8.	National Stock Exchange, Mumbai	Do	26.04.1993	–
9.	Inter-connected Stock Exchange of India	Do	–	–

The stock exchanges in India can be grouped into four types:

(i) Regular stock exchanges (21)
(ii) Over-the-Counter Exchanges (01)
(iii) National Stock Exchange (01), and
(iv) Inter-connected Stock Exchange (01).

Figures in parenthesis indicate the number of stock exchanges in the relevant category, as on 31 March 2004.

Regular stock exchanges stand for big companies. All the major stock exchanges located in big cities such as Mumbai, Kolkata, Madras, Delhi, Ahmedabad, Hyderabad, Bangalore, etc. come under this category.

Over-the-Counter Exchange of India (OTCEI) provides computerised trading for smaller companies with a paid-up capital of ₹30 lakh to ₹25 crore. However, the upper limit has been removed later. We have described this exchange in a bit details in Section 8.14.3.

National Stock Exchange (NSE) was recognised in April 1993. It started operation initially only with government securities and money market instruments. However, equity trading was also started by the exchange from November 1994. This exchange provides a totally computerised trading. We have given a detailed description of this exchange in Section 8.14.4.

Inter-connected Stock Exchange of India Limited (ISE) has been promoted by 15 regional stock exchanges. Its objective is to provide trading linkage or connectivity to all the participating exchanges to expand their market. ISE has appointed about 500 dealers across 70 centres in the country. The dealers are given administrative support through regional offices in Delhi, Kolkata, Chennai and Nagpur. Thus, ISE is a national level exchange providing trading, clearing, settlement, risk management and surveillance support to the inter-connected market system. Its aim is to provide an opportunity to small traders to participate in a national market at low transaction costs.

8.14.1 Bombay Stock Exchange (BSE)

The Bombay Stock Exchange (BSE) was established in 1875 as a voluntary non-profit organisation in Mumbai (the-then Bombay). It is the oldest stock exchange in Asia which completed 125 years of its journey in stock trading in the year 2000. The BSE is a major and important stock exchange in India. It provides an efficient market mechanism to protect the interest of investors and to ensure redressal of their grievances. It also provides necessary informative inputs to the investing public.

8.14.1.1 Management

The BSE is managed by a Governing Board. This Board regulates the working of the Exchange and decides its policies. As per SEBI orders issued in March 2001, the Governing Board of the BSE presently comprises 10 directors. Among them, there are three government nominees, one RBI nominee, five public representatives and one executive director. The executive director acts as the Chief Executive Officer. He is responsible for the day-to-day administration of the exchange.

8.14.1.2 Functions

The members of the Bombay Stock Exchange can trade in the Exchange on behalf of outsiders. Only the shares of the listed companies can be traded at the Exchange.

To know the trends in stock prices, an index or average of stock prices is used. In Bombay Stock Exchange, this index is called SENSEX (Sensitive Index). This is actually a weighted average of stock prices of 30 companies listed on BSE. A rise in SENSEX indicates a buoyancy (bullish) condition in the stock market whereas a fall in SENSEX implies a sluggish (bearish) condition in the stock market. The SENSEX is so popular that it is quoted daily in major newspapers in the country and is broadcast daily in major TV channels and incessantly in some business channels.

The SEBI has permitted the BSE to extend its on-line trading. As per new arrangements, the members of the BSE are free to install their own trading terminals at any place in the country. In order to expand this on-line network to centres outside Mumbai, the BSE has admitted subsidiary companies as its members. These companies have been formed by 13 regional stock exchanges. The objective is to reach out to the investors in these centres and to provide them access to the trading facilities in all scrips listed on the BSE.

Similar to any important and developed stock exchange, the BSE also performs few important functions. In brief, they are as follows:

- The BSE has facilitated trading of securities listed on it. It thus provides liquidity to listed securities.
- The BSE operates following the rules and regulations formulated by the SEBI. It thus provides safety of funds to the investors.
- The BSE provides long-term funds to the industrial sector.
- It has helped companies and the government to sell their securities. This has been very helpful to the corporate sector and the government to raise funds.
- The BSE supplies different kinds of securities with different maturities and yields. It has thus helped investors reduce risk by portfolio diversification or asset diversification.
- The BSE guides the investors in choosing securities. It has thus helped in optimum use of investible funds.
- The BSE develops saving habits among the public.
- It has provided facilities of on-line trading in scrips. This has made security trading quick, efficient and transparent.
- The BSE provides wider scopes of investment through its BSE on-line trading (BOLT) network.
- The BSE provides trading facilities to its members on behalf of outsiders. This has expanded the volume of security trading on the Exchange manifolds.

For all these activities, the BSE has become one of the most important stock exchanges in India. It is the oldest stock exchange in the country. Hence, some of its activities and working procedures might have been back-dated and conservative. But the BSE, with the passage of time, has been able to shrug off the old practices and has modernised its activities. This has helped the BSE to serve its members in a better way.

8.14.2 Calcutta Stock Exchange (CSE)

Calcutta Stock Exchange (CSE) was established in 1908 as an Association. Later it was transformed into a joint stock company in 1923. Following the regulations provided in the Securities Contract (Regulation) Act of 1956 (SCRA), Calcutta Stock Exchange has been working as an approved stock exchange since 10 October 1957. This approval was to be renewed after every 5 years. It now operates as a public limited company and its approval is permanent. Whereas the Bombay Stock Exchange was the oldest stock exchange in India being established in 1875, the stock exchanges of Calcutta and Madras were established in 1908. Thus, Calcutta Stock Exchange is the second oldest stock exchange in the country.

Before the approval of the government in 1957, the Calcutta Stock Exchange had 300 shares and the face value of each share was equal to ₹1000. Each member of the stock exchange was distributed one share. On this basis, there were only 300 members of this stock exchange. However, after the approval of the government, this limit has been increased. Each share has now been divided into four parts. Thus, the face value of each share has been fixed at

₹250 and there are 1,200 shares. Hence, the maximum number of members of the Calcutta Stock Exchange can be equal to 1200. In order to become a member of the stock exchange, an individual has to purchase one share of Calcutta Stock Exchange. In addition, a member has to deposit an amount of ₹20,000 and an entry fee of ₹1000. For helping the transactions, each member is entitled to employ two clerks and some sub-agents.

Till the early 1980s, Calcutta Stock Exchange was the largest in the country in terms of the number of companies being listed. However, by late 1980s, its place was occupied by Bombay Stock Exchange (BSE). During late 1990s, the National Stock Exchange (NSE) became the largest stock exchange in India.

Calcutta Stock Exchange is managed by an Executive Committee. This Committee is formed by 16 elected members and 3 members nominated by the Central Government. The executive committee members elect one president. This committee also forms several sub-committees. At present, in Calcutta Stock Exchange, bonds and shares of more than 700 private companies are bought and sold. The Calcutta Stock Exchange (CSE) publishes a year-book each year. This year book gives an account of the companies whose shares are bought and sold in Calcutta Stock Exchange. In addition, the fluctuations in the prices of shares of different companies are reported in daily newspapers.

Like any developed stock exchange, the Calcutta Stock Exchange (CSE) also performs some important functions. Those functions may briefly be summarised as follows:

- The CSE supplies long-term capital to the industrial sector of the economy.
- The CSE allows trading in securities following SEBI stipulations. It thus ensures safety of funds of the investors.
- Securities listed on Calcutta Stock Exchange are easily tradable. The CSE thus gives liquidity to the listed securities.
- In the CSE, various types of securities with different maturities and yields are listed. Investors have the opportunity of selecting different securities from among them. The CSE thus helps investors to reduce risks by asset diversification.
- Securities issued by government and private concerns are traded in the CSE. It thus helps government and the corporate sector in collecting investible funds.
- The year book published by the CSE provides useful information on bonds and shares of different concerns to the members. Thus, CSE provides some guidance to the investors in choosing securities.

However, the Calcutta Stock Exchange is one of the oldest stock exchanges in the country. Naturally, some of its activities and procedures are old and conservative. These are needed to be modernised and made suitable for the present age. Some procedures are to be simplified and made effective. On-line scripless trading is to be encouraged. Latest software is to be installed in order to make quick and hassle-free trading of securities. All these measures will increase the speed of trading activities and the efficiency of the CSE. This will also make the transactions transparent and free from various types of frauds which are quite common in a stock exchange.

8.14.3 Over-the-Counter Exchange of India (OTCEI)

Over-the-Counter Exchange of India (OTCEI) was set up in October1990 with a paid-up capital of ₹4 crore. It was jointly set up by the UTI, ICICI, IDBI, SBI Capital Markets Limited, IFCI, LICI, GICI and its subsidiaries and Canbank Financial Services Limited. The term 'over-the-counter' implies trading of securities which are not listed on an organised stock exchange.

8.14.3.1 Objectives

The main objectives of the OTCEI are as follows:

- To offer small and medium companies an access to a nationwide market of securities.
- To provide a chance to small companies to raise finance at a lower cost.
- To provide a convenient investment avenue under the capital market segment for the investors.
- To develop a computerised, scripless stock exchange of international standard.

8.14.3.2 Listing

OTCEI offers for listing the companies which have an issued equity share capital between ₹30 lakh and ₹25 crore. The upper limit was, however, later removed. Companies listed on any other recognised stock exchange cannot generally list their shares simultaneously on the OTCEI. However, certain specific securities listed on other stock exchanges are allowed to be traded on OTCEI. Again, companies engaged in hire-purchase finance, leasing, etc. cannot list on the OTCEI. Before listing, the company should select one of the members of the OTCEI as its sponsor. A financial institution, mutual fund, scheduled bank, its subsidiary and merchant banker approved by the SEBI may be the sponsor. After getting the permission from the sponsor, the applicant company will be listed. The listed company is required to follow SEBI guidelines regarding pricing, underwriting, lock-in period, etc. of the securities.

8.14.3.3 Members

Banks and their subsidiaries, financial institutions, merchant banks, venture capital funds, non-banking financial intermediaries, mutual funds, etc. are eligible to be the members of the OTCEI. Eligibility criteria include sufficient resources for holding scrips, project appraisal and capability in all respects, having minimum issued capital as specified by the OTCEI, authorisation from SEBI, etc.

8.14.3.4 Dealers

Every investor can enter into transactions in a convenient manner. Hence, OTCEI has a group of persons at the counters locally situated across the country. These persons are called **dealers**. Normally, the individuals, partnership firms and corporate bodies are eligible to be the dealers. These dealers have to satisfy some conditions as specified by the OTCEI.

8.14.3.5 Trading Procedure

Trading in securities in OTCEI is undertaken through a network of members and dealers who are spread all over the country. Both members and dealers are required to have computers, telephones, telex, fax, etc. They operate at OTC counters that are linked to a centrally located OTCEI computer network. Investors who want to trade in OTCEI securities can make the trading through any OTC counter. There is a settlement bank which clears the payments among counters.

The intending trader has to approach his nearest OTC counter. If he is a buyer of shares, he has to see the best price of selling in the computer terminal. On the other hand, if he is a seller of shares, he has to see the best price of buying in the computer terminal. Then the trader has to ask the operator at the counter for dealing on his behalf. The deal gets automatically confirmed at the best price. Payment of money in the case of buying or delivery of scrips in the case of selling has to be made on the spot. In the case of scripless trading, a specific trading document printed out at the counter is regarded as the substitute of the share certificate. The trader gets the confirmation certificate with price and brokerage mentioned separately. Share certificates in the case of buying or money in the case of selling will be received by the trader within a week. In the case of a direct buying of shares from any company listed on OTCEI, the investor has to fill up a form. Allotment of shares is expected to be completed within 35 days and trading can begin immediately after that.

8.14.3.6 Concluding Remarks

The OTCEI is a technology-driven system in security trading. It offers a trading system equipped with electronic or computer network. Through this network, buyers and sellers over the world can trade in securities more efficiently and that too at a lower cost. Further, small and medium-sized companies are sometimes unable to meet the listing requirements of other stock exchanges. For example, sometimes the companies are required to have a minimum capital of ₹3 crore. However, these companies may be sponsored by any of the sponsors at the OTCEI, if they have an issued capital of ₹30 lakh or above. Thus, OTCEI provides an opportunity to small and medium-sized companies to raise funds at a lower cost. It must be admitted that OTCEI has opened a new dimension in the Indian capital market by introducing screen-based scripless trading and the system of sponsorship of companies. It has introduced trading of securities which are not listed on an organised stock exchange.

The main objective of the OTCEI is to offer small and medium companies an access to a nationwide market of securities. The OTCEI has been largely successful in fulfilling that objective.

8.14.4 National Stock Exchange (NSE)

The National Stock Exchange (NSE) or the National Stock Exchange of India Limited (NSEIL) was set up by the IDBI and some all-India financial institutions such as IFCI, ICICI, LICI, GICI, SBI Capital Markets Ltd., etc. It was established in November 1992 at Mumbai with a paid-up equity share capital of ₹25 crore. The Government of India accorded recognition to the NSE in the same year. The NSE started its operation in wholesale debt market in June 1994 and in equity market in November 1994. Any company having a minimum capital of ₹10 crore is entitled to be listed on NSE.

8.14.4.1 Objectives

The major objectives of the NSE may be summed up in the following manner:

- To establish a nationwide trading facility for the various financial instruments.
- To ensure equal access to the investors all over the country.
- To introduce shorter settlement cycle and book entry settlement system.
- To meet the current international standard in the securities market.
- To provide a fair, efficient and transparent securities market.

8.14.4.2 Management

The NSE is managed by a Board of Directors. The market operations are regulated by an Executive Committee. It includes representatives from the trading members. The day-to-day management is done under the supervision of the Managing Director of the NSE. He is supported by a team of professional staff.

8.14.4.3 Organisation and Membership

The NSE has two market segments. One is the Wholesale Debt Market (WDM) and the other is the Capital Market (CM). The terms of membership, trading rules and procedures are separate for the two market segments.

Individuals, registered firms, corporate bodies, subsidiaries of banks and other financial institutions are eligible to be trading members of the National Stock Exchange under the capital market segment. In the case of debt market segment, the applicant for membership must have a minimum net worth of ₹2 crore. In the case of capital market segment, this limit is ₹75 lakh for individuals and registered firms and ₹1 crore for corporate bodies.

8.14.4.4 Trading System

The trading system of the NSE, popularly called NEAT (National Exchange for Automated Trading) is based on software system. It is actually a fully automated screen-based security trading system. It enables the members from across the country to trade simultaneously with each other. A satellite network, owned, operated and managed by the NSE is used for the purpose. Thus, the traders no longer need to assemble on the floor of the stock exchange for trading of securities.

The trading system of the NSE is order-driven. The traders need not disclose their identity. The trading system operates on a price time priority. All orders received in the system are sorted with the best price order getting the first priority for matching. Thus, the best buy order matches the best sell order. This is automatically done by computers. Where an order does not find a match, it remains in the system and is displayed in the terminals till a fresh order comes.

Otherwise, this order is cancelled. The trading system has a greater flexibility in relation to the time-related, price-related or volume-related conditions. It also provides the complete market information on-line to all the concerned parties.

We know that to inform the investors about the trends in stock prices, an index or average is used. In National Stock Exchange, this index is called NIFTY or NIFTY fifty. This is actually a weighted average of stock prices of 50 companies listed on NSE (NIFTY means National Index of Fifty share prices). A rise in NIFTY implies a buoyancy (bullish) condition in the stock exchange. In the opposite case, a fall in NIFTY indicates a sluggish (bearish) condition in stock market. The NIFTY is very popular among the investors in the stock market. The value of NIFTY at the end of each trading day is quoted in major newspapers of our country and it is broadcast daily in major TV channels and incessantly in some business channels.

During the late 1990s, the National Stock Exchange (NSE) became the largest stock exchange in India in terms of the number of companies listed. The main objective of the NSE is to establish a nationwide trading facility for the various financial institutions. It has been largely successful to achieve this target. Within a very short period, the NSE has emerged as the most important stock exchange in India in terms of total turnover. The activities of the NSE have been expanding quite fast day-by-day.

8.15 CONTROL OF STOCK EXCHANGES

8.15.1 Need for Control of Stock Exchanges

For various reasons, activities of stock exchanges are required to be controlled. Stock exchanges in many cases are involved in some unscrupulous, unhealthy and illegal activities. Sometimes they divulge important information about a company to others for making illegal profits through security trading. This is known as insider trading which is illegal. Sometimes they are involved in unhealthy speculation. In many cases, they flout listing requirements. Sometimes they are involved in overtrading of securities. Hence, the activities of stock exchanges should be controlled. The reasons for the control of activities and operations of stock exchanges may briefly be mentioned as follows:

- To ensure uniformity in the rules, regulations and working of different stock exchanges in the country.
- To prevent unhealthy speculation on the part of the stock exchanges.
- To limit the number of stock exchanges in one region.
- To provide margin regulations in order to restrict overtrading in stock exchanges.
- To ensure proper listing requirements for various securities
- To prevent monopoly of business at the stock exchange by a few persons.

8.15.2 Methods of Control of Stock Exchanges

Stock exchanges are very often involved in many unhealthy and illegal activities. Hence, their activities are to be controlled and regulated. In India, the activities of stock exchanges are supervised, regulated and controlled by the Securities and Exchange Board of India (SEBI). This Board has been given some powers to do such jobs. Two Acts have been passed for this purpose. They are the Securities Contract (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992. The main provisions of these two Acts are as follows:

- The SEBI can grant or withdraw recognition to any stock exchange.
- It can approve the rules and by-laws of stock exchanges.
- The SEBI has been given the power to direct any stock exchange to make or amend rules and by-laws.
- The SEBI has the power to monitor the functioning of stock exchanges by calling for periodical returns and conducting enquiries whenever required.
- It can suspend business of a stock exchange due to its high irregularity in activities.
- The SEBI has the power to supersede the governing body of a stock exchange.
- It can regulate the procedures of listing of securities on a stock exchange.

Thus, the Securities and Exchange Board of India (SEBI) has been given strong statutory powers to exert controls on the activities of stock exchanges in India. As a result of these controls, unhealthy practices adopted by stock exchanges have been greatly reduced. The activities of stock exchanges in India are now transparent than before. Further, there has been a great deal of uniformity in rules and regulations and in operations of different stock exchanges in India. Again, due to the application of on-line scripless transactions and dematerialisation in security trading, activities of most of the stock exchanges in India have been efficient, quick and transparent.

8.16 SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

To regulate, supervise and control the activities of stock exchanges and to develop the Indian capital market, the Securities and Exchange Board of India (SEBI) was set up in April 1988. It was given statutory powers in 1992 through enactment of the Securities and Exchange Board of India Act 1992. In that year, the Bombay Stock Exchange witnessed a major stock exchange scam masterminded by Harshad Mehta. Many felt that to avert such scams, the SEBI should be given more powers. As a result, the Government of India brought in the SEBI Act, 1992 which conferred strong statutory powers to the SEBI.

8.16.1 Objectives of SEBI

The major objectives of SEBI may be summarised as follows:

- To protect the interests of general investors to ensure a steady flow of savings into the capital market.
- To ensure fair practices by companies which actually issue various securities and to stop unfair practices, such as cheating, frauds and malpractices by brokers, sub-brokers, etc. of stock exchanges.
- To promote efficient services by brokers, merchant bankers and other intermediaries in security trading.

- To stop insider trading in securities.
- To regulate substantial requisition of shares and takeover of companies.

8.16.2 Organisation of SEBI

The Securities and Exchange Board of India (SEBI) consists of the following members:

(i) A chairman
(ii) Two members nominated by the Central Government.
(iii) One member from the officials of the RBI.
(iv) Two other members appointed by the Central Government. They have experience or special knowledge on capital and money markets.

For day-to-day functions, the SEBI is divided into five departments. They are as follows:

(i) Investor grievances and guidance department
(ii) Issue management department
(iii) Secondary market policy department
(iv) Secondary market administration department
(v) Internal regulation department.

In addition, there are legal and investigation departments.

Each department is headed by an executive officer who has to inform the chairman on different matters. The chairman of the SEBI is the chief executive of the Board.

8.16.3 Functions of SEBI

As the capital market regulator of India, the Securities and Exchange Board of India (SEBI) performs many important functions. Some major functions of the SEBI may be summarised as follows:

- To protect the general investors from various dishonest practices of the company officials. For this purpose, the SEBI has formed Investors' Grievance and Guidance Division.
- To register and regulate the workings of stock brokers, sub-brokers, jobbers and other functionaries of the stock market.
- To register and regulate the workings of share transfer agents, merchant bankers, underwriters and other intermediaries associated with the securities market.
- To regulate, control and supervise the overall business of the stock exchanges.
- To register and regulate the workings of venture capital funds.
- To regulate and supervise the activities of mutual funds.
- To control and regulate the workings of depositories, custodian of securities and credit rating agencies.
- To promote and regulate Self-Regulatory Organisations (SROs).
- To prohibit and remove insider trading in securities.
- To promote investors' education for making suitable investment decisions.
- To impart training to the intermediaries in the securities market for their better functioning.

- To regulate substantial acquisition of shares and takeover of companies.
- To conduct enquiries, inspection and audit of the stock exchanges.
- To levy various fees and other charges for carrying out its operations.
- To publish useful information for all market participants.

The above-mentioned functions of the SEBI can be broadly grouped under two categories. They are regulatory functions and developmental functions. Regulatory functions seek to control and regulate the undesirable functions of various functionaries in the capital market. On the other hand, the objective of developmental functions is to promote the growth and development of the capital market including stock exchanges of India. These regulatory and developmental functions are shown in Table 8.9 in the following manner.

Table 8.9 Powers and functions of the SEBI

Regulatory	Developmental
1. Registration of brokers and sub-brokers. 2. Registration of various investment schemes including mutual funds. 3. Registration of stock exchanges and merchant banks. 4. Prohibition of fraudulent and unfair trade practices including insider trading. 5. Imposition of penalties for various malpractices.	1. Education of investors for making suitable investment decisions. 2. Training of intermediaries for their better working. 3. Publishing useful information for all market participants. 4. Promotion of fair practices and a code of conduct for all Self-Regulating Organisations (SROs) 5. Levying various fees for its operations.

The SEBI has so far issued various guidelines for performing its functions and fulfilling its objectives. These guidelines may be grouped under primary market guidelines and secondary market guidelines. Primary market guidelines cover the requirements as to the first issue by the new and existing companies. Secondary market guidelines cover the requirements as to subsequent issues by the existing and old companies.

8.17 CAPITAL MARKET REFORMS IN RECENT YEARS

To stop unscrupulous activities in the capital market and to increase its efficiency, various steps have been taken under the leadership of the SEBI. Many reform measures have been adopted in the capital market in recent years. Important among them are as follows:

- Repeal of Capital Issues (Control) Act, 1974.
- Abolition of the Office of Controller of Capital Issues
- Conferring statutory status on the SEBI.

In addition to them, there have been some other measures as well.

- The SEBI has been given the power to regulate stock exchanges. This power includes recognition of stock exchanges, framing of rules related to voting rights, delivery contracts, listing of securities, etc.

- SEBI has been allowed to issue regulation and file suit against erring companies without prior approval of the Central Government.

In 1991, the Government of India adopted the policy of liberalisation. Various reform measures have been introduced since then in different sectors of the economy. As a part of financial sector reforms, various reform measures have been introduced in the capital market of India. These measures may be discussed under two headings:

(a) Primary market reforms
(b) Secondary market reforms

We consider them one by one.

8.17.1 Primary Market Reforms

We know that primary market is the market in which securities are issued for the first time. Hence, primary market is also called the new issue market or Initial Public Offer (IPO). Important reforms in the primary market in recent years are as follows:

- SEBI has brought merchant banking under its regulatory framework. It has issued a code of conduct for merchant bankers.
- SEBI has brought the 'banker to the issue' under its purview for investors' protection.
- SEBI has stipulated that the disclosures made in the offer document would be treated as part of the offer document itself. This is for better accountability.
- SEBI has prescribed improved disclosure standards, introduction of prudential norms and simplification of issue procedures for the companies.
- SEBI has advised stock exchanges to amend the listing agreement. A listed company should furnish annual statement with stock exchanges. It should show variations between financial projections and projected utilisation of funds and actual figures in the offer documents. Then the shareholders will be able to compare between promises and performance.
- In order to reduce the cost of issue, SEBI has made underwriting by the issuing company optional.
- SEBI has stopped the practice of making preferential allotment of shares unrelated to the prevailing market prices. It has issued new guidelines in this regard.
- SEBI has introduced regulations regarding substantial acquisition of shares and takeovers. It stipulates that disclosures are mandatory for public offers that are to be made to the shareholders.
- In the case of B-group shares, SEBI has prohibited renewals. This is to settle transaction within 7 days.
- SEBI has also brought the Unit Trust of India (UTI) under its regulatory jurisdiction.
- SEBI has issued fresh guidelines for advertising by mutual funds.

In spite of these measures, there are flagrant breaches in issue procedures. There are so many malpractices inflicted by brokers, sub-brokers and other functionaries of stock exchanges. These misdeeds take place through collusion among unscrupulous promoters, corrupt officials of lead banks and dishonest officials of SEBI itself. To protect the investors' funds, to ensure fair practices by companies and to promote efficient services by brokers, merchant bankers and other intermediaries, SEBI should remain ever vigilant keeping a close look on the functioning of the new issue market.

8.17.2 Secondary market reforms

As we have already stated, secondary market is the market in which already existing or issued or outstanding securities are traded. Secondary market is also known as stock exchange or stock market (share market). Since 1991, the SEBI has taken a series of measures to control and regulate the secondary market or the stock exchange.

Some of the important measures may be summarised as follows:

- SEBI has greatly simplified the procedures for placing securities for transfer by institutions.
- Stock exchanges are allowed to introduce carry forward system only with the prior permission of the SEBI. This system has been subjected to effective monitoring and surveillance.
- To protect market intermediaries and consequently investors from default and other risks, SEBI has announced capital adequacy norms. It requires 3 per cent for individual members and 6 per cent for corporate members in their outstanding positions.
- SEBI has introduced insurance for all member-brokers of stock exchanges against risk. It thus protects them from an erosion of capital.
- SEBI has mentioned certain norms and codes of conduct for merchant bankers, brokers, underwriters and share transfer agents. These norms specify a high degree of responsibility towards investors. SEBI can take action against the erring intermediaries.

Thus, SEBI has taken a series of measures since 1991 to ensure a fair, transparent and strong regulatory framework for efficient working of the capital market and for protecting the interests of the investors. These measures have together helped to partly achieve the objectives. These steps were initially strongly resisted by the brokers in stock exchanges. However, the SEBI did not deviate from its goal in the face of that resistance. It is determined to put the Indian capital market on international standard. The SEBI has been trying to make our capital market healthy, fair, transparent and strong. It is heading in the right direction. However, it has miles to go to put Indian capital market at par with international standard.

SUMMARY

S.1 Concept of Capital Market and its Organisation

The market in which medium-term and long-term securities are traded is called capital market. It may be divided into three sub-markets, namely, (i) industrial/private securities market,

(ii) government securities market and (iii) long-term loan market. Industrial securities market can again be divided into two parts, namely, (a) primary market or new issue market and (b) secondary market or stock exchange or stock market. In the primary market, new issues are traded whereas in the stock exchange or stock market, old and existing securities are traded.

S.2 Organised Capital Market and Unorganised Capital Market

The main constituents of a capital market are banks, security market, development financial institutions and non-bank financial companies. If the constituents or sub-markets of a capital market are well-developed, it is called organised capital market. On the other hand, if the constituents or sub-markets of a capital market are not so developed, it is called unorganised capital market.

S.3 Distinction between Money Market and Capital Market

Money market is the market for short-term loans or financial assets having a maturity period of less than 1 year. On the other hand, capital market is the market for medium-term and long-term loans or financial assets having a maturity period of 1 year and above. The instruments of money market are call money, treasury bills, commercial bills, certificates of deposits, commercial papers, etc. On the other hand, instruments in capital market are shares, debentures, government bonds or securities, etc. While central banks and commercial banks are major institutions in the money market, development banks, insurance companies and non-bank financial companies are major institutions in the capital market.

S.4 Functions/Importance of Capital Market

Capital market in an economy performs some important functions and thus helps in economic development of the economy. The important functions of the capital market are as follows:
(i) It provides medium-term and long-term finance for trade and industry. (ii) It mobilises small savings of the public and channelises them into proper investment. (iii) Capital market also provides much-needed funds to the government and the autonomous bodies. (iv) It opens new opportunities for investment and thus encourages savings. (v) Through underwriting of shares, capital market assures supply of funds to the corporate sector. (vi) Development financial institutions provide finance to some targeted groups including small and cottage industries and also agriculture. (vii) Credit rating agencies of the capital market supply important information to the investors. (viii) Merchant banks provide some essential services to the corporate sector. All these are of great help for the economic development of a country.

S.5 Structure (Constituents/Elements) of Indian Capital Market

Indian capital market has five main constituents or elements. They are as follows:

(i) **Banks**: It includes commercial banks including State Bank of India, RRBs, EXIM Banks, etc.

(ii) **Medium-term and long-term Gilt-edged or Government securities market.**

(iii) **Industrial/Private Securities market:** It has two parts: new issue market or primary market and secondary market or stock market (stock exchange).

(iv) **Development Financial Institutions** such as IFCI, SFCs, IIBI, SIDBI, NIDC, SIDC, NABARD, etc.

(v) **Non-banking financial companies** such as merchant banks, mutual funds, leasing companies, credit rating agencies, housing finance companies, hire–purchase and consumer finance companies, etc.

S.6 Features of Indian Capital Market

The main features of Indian capital market are as follows: (i) Issue houses, underwriting agencies, etc., have not yet properly grown up. (ii) Many public sector institutions have been set up both at the national and state levels. (iii) Importance of investments trusts and insurance companies is relatively less compared to the capital market of developed economies. (iv) Organised capital market has grown up only in the large cities of India. (v) Capital market in India is growing very fast in recent years, especially during the post-liberalisation period, that is, after 1991. (vi) Many innovative credit instruments have come up in recent years. (vii) The activities of non-banking financial companies in India are also expanding very fast in recent years.

S.7 Security and Security Market

The term security broadly means any financial instrument, such as, equity or equity shares, preference shares, bonds or debentures, mutual fund schemes, global depository receipt, derivative security, etc. The market for any financial instrument may be called security market. It may broadly be divided into two parts: government security market and private security market. Government securities are traded in government security market whereas industrial securities or private securities are traded in private or industrial security market. The private or industrial securities market may again be divided into primary market or new issue market and secondary market or stock market (stock exchange).

S.8 Shares: Major Types

A share is a part of owned capital of a company. The purchaser of a share of a company is the shareholder who owns a part of the ownership of the company and is entitled to get dividend if the company earns a profit. Shares are basically of two types: equity or ordinary shares and preference shares. Equity or ordinary shares are those shares whose dividend is not fixed and depends on the profits available and the policy of the Board of Directors on the distribution of profit. On the other hand, shares enjoying some preference or benefits over other types of shares are called preference shares. Both equity/ordinary shares and preference shares have different types depending on their various types of returns.

S.9 Bonds or Debentures and Their Types

Bonds or debentures are traditional borrowing instruments for a company or organisation and lending instruments for the investors. Bond holders are actually creditors of a company. They get interest at a pre-determined rate. There are various kinds of bonds or debentures depending on the payment conditions of interest and repayment conditions of principal.

S.10 Distinction between Shares and Bonds

Shareholders are the owners of the company whereas bond holders are the creditors of the company. The formers get profit whereas the latters get interest. Shareholders get dividend only if the company earns a profit. But bondholders' interest is certain. When a company is to be wound up, bondholders are paid their money first, and then, if fund remains, shareholders are paid their principal. The rate of dividend paid to the shareholders is not fixed, but the rate of interest paid to the bondholders is fixed.

S.11 Methods of Security Trading

There are basically two methods of security trading: scrip-based traditional trading and scripless or paperless trading. The scrip-based traditional trading is normally made in four popular ways. They are spot trading, cash-basis trading, settlement trading and options trading. Under scripless or paperless trading, security certificates cease to exist in physical or paper form and exist in electronic number. It is known as dematerialisation or, in brief, demat. This trading process has certain advantages over scrip-based or paper-based trading. Hence, dematerialisation process of security trading is now very popular and most of the security trading centres are heading towards this direction.

S.12 Depository System

Depository system plays a vital role in the introduction of scripless trading of securities in the capital market. A depository is an institution which transfers the ownership of securities in electronic mode on behalf of its number. The main objective of the depository system is to introduce scripless security trading. Its other objectives are to reduce time for transfer of securities, to avoid the risk of settlement of securities, to reduce the cost of transaction for the investor, to hold securities centrally, etc.

Interacting institutions/constituents in a depository system are the central depository, Share Registrar and Transfer Agent, and Clearing and Settlement Corporation. Each institution has a specific job in the process of electronic transfer of securities from the seller to the buyer. The depository system is beneficial to investors, companies and to the capital market. For the investor, the system removes the risk of bad delivery and loss in transit of security certificate, reduces settlement time, makes quick distribution of dividends, profit, interest, etc., decreases cost of transfer of security certificates and so on. For the companies, the system helps to circulate notices and annual reports without delay, it informs the companies about the beneficial owners, eliminates risks for transfer-related activities, etc. As for the capital market, the depository system makes trading transparent, quick and efficient. It takes the capital market to a system of scripless, electronic transactions.

S.13 Primary Market and Secondary Market

Market for new securities is known as primary market whereas market for old and existing securities is known as secondary market. The primary market is also called new issue market or Initial Public Offer (IPO). The secondary market is called stock exchange or stock market (or share market).

S.14 Primary Market/New Issue Market/Initial Public Offer (IPO)

The market that deals in new securities which were not previously available to the investors and which are offered to them for the first time is called primary market or new issue market. It is also referred to as Initial Public Offer (IPO). The main functions of the new issue market can be divided into three stages, namely, **Origination**, **Underwriting** and **Distribution** of new issues. **Origination** refers to the work of investigation, analysis and processing of new project proposals. It starts before an issue is actually floated in the market for sale. **Underwriting** is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures. **Distribution** refers to selling of securities to the ultimate investors. Various methods are used to distribute new issues. Important among them are (i) Public issue through prospectus , (ii) Offer for sale, (iii) Placement/Private placement method, (iv) Rights issues and (v) Book building method/Tender method. Each method has some merits and demerits. Among these methods, the method of public issues through prospectus is most widely used in India.

S.15 Instruments of New Issue Market

Apart from traditional instruments such as equity and preference shares and bonds, various types of new instruments have been introduced in the new issue market in recent years. Some important new instruments in the new issue market are (i) Secured premium notes (SPN) with detachable warrants, (ii) Equity shares with detachable warrants, (iii) Preference shares with warrants, (iv) Non-convertible debentures with detachable equity shares,(v) Fully convertible cumulative preference shares, (vi) Zero interest fully convertible debentures (FCDs), (vii) Fully convertible debentures with interest, (viii) Zero interest bonds, (ix) Deep discount bonds, (x) Option bonds, (xi) Bonds with warrants, etc.

S.16 Players in the New Issue Market

Important players in the new issue market are as follows:

(i) Merchant bankers
(ii) Registrars
(iii) Collecting and co-ordinating bankers

(iv) Underwriters and brokers
(v) Printers, advertising agencies and mailing agencies

S.17 Listing of Securities—Procedures, Merits and Demerits

Listing of securities is the process whereby the securities (shares, debentures, bonds, units, etc.) are included in the official list of a recognised stock exchange for the purpose of trading. A company which wants to enlist its securities on a stock exchange has to apply in the prescribed form. Necessary documents and fees must be submitted along with application. The Board of Directors of the stock exchange will scrutinise the papers. Once the Board is satisfied, the security is listed and intimation is given to the company. The listed company has to fulfil its obligations under the agreement of listing.

There are some merits of listing. They are as follows:

- Listing increases the goodwill and standing of the company.
- It helps to diversify shareholding.
- A listed company enjoys certain income tax benefits.
- Investors get ready report on the financial health of a listed company.
- Listing ensures marketability and liquidity of securities.
- Listed companies are regulated and controlled by stock exchanges. This provides safeguards to investors regarding their holding of securities.

However, there are also some **demerits** of listing. They are as follows:

- Listing leads to speculation.
- The stock market may not reflect the true picture of a listed company.
- Officials may themselves indulge in speculative activities with regard to listed companies.
- Sometimes, market values of listed securities fluctuate widely.
- For listing, a company has to disclose its vital information. This may prove disadvantageous to the company.

S.18 Stock Exchange and its Functions

Stock exchange or share market is a market where existing or old stocks and shares are traded. It is also known as stock market or secondary market. The stock exchange of a country performs some important functions and makes great contribution to the process of economic development of that country. The main functions or services of stock exchanges are as follows:

- It provides liquidity and marketability of securities.
- It ensures safety of investible funds.
- It guarantees assured supply of long-term capital.
- Stock exchange ensures flow of capital to profitable ventures.
- It provides motivation for better performance by companies.
- Stock exchange mobilises savings and channelises them into productive investment.

- It functions as an economic barometer of the country.
- It helps relatively unknown companies in mobilising funds.
- Stock exchange helps investors reduce risk by asset diversification.
- It develops saving habits among the public.
- Stock exchange guides the investors in choosing right securities by supplying required information.
- It enables companies and the government to raise funds without much difficulty.

Performing these functions, stock exchange of an economy helps in the process of economic development of the economy.

S.19 Functionaries of Stock Exchanges

There are many types of functionaries in a stock exchange. They are as follows:

(i) Stockbroker or broker: A stockbroker or broker of a stock exchange is a commission agent who transacts securities on behalf of his client who is not a member of the stock exchange.

(ii) Sub-broker: A sub-broker is an agent of the stockbroker in a stock exchange. He helps the investors to deal with the stockbroker.

(iii) Jobber: A jobber is an independent dealer in securities in a stock market. He trades in securities on his own account.

(iv) Consultants/Portfolio Consultants: Financial organisations which offer consultancy service to the investors in stock exchange regarding desirable or optimum level of diversification in their asset portfolios are called portfolio consultants, or simply, consultants. In India, merchant banks perform the role of portfolio consultants to the investors.

(v) Institutional investors: Institutions which invest in security market as regular investors are called institutional investors. Foreign firms and institutions which are engaged in investment in a country's security market are called foreign institutional investors. The capacity of institutional investors is huge in comparison with an individual investor's capacity. Hence, their decisions of buying and selling of securities act as trendsetters in the security market.

(vi) Non-resident Indians: Indian citizens living abroad for the purpose of employment, business, education, etc. are called non-resident Indians (NRIs). They make various types of investment in Indian capital market, such as, investments in proprietorship or partnership concerns, in Indian companies, in commercial papers, in mutual funds, in priority sector, etc.

(vii) Different Types of Speculators: By speculation in security market, we mean the act of buying and selling of securities in expectation of earning a profit from anticipated changes in their values. A person engaged in speculation is called a speculator. Speculation is a risky activity incidental to change in the price of the security under consideration. There may be different types of speculators depending on their expectation regarding changes in security prices, their attitude towards risk bearing, etc. Generally, there are four types of speculators in a stock exchange. They are: bull, bear, lame duck and stag.

Bull: A **bull** is a speculator in the stock market who expects a rise in the price of securities in the future. Hence, he is engaged in buying securities with an expectation to sell them at a higher price in future. In common parlance, a bull is called ***Tejiwala***.

Bear: A bear is a speculator in the stock market who expects a fall in the price of securities in the future. Hence, he agrees or makes contract to sell the securities on a fixed date. A bear speculator is called ***mandiwala*** in common parlance.

Lame duck: When a speculator is unable to meet his commitment, he is said to be a lame duck.

Stag: A stag is a cautious speculator in the stock market who frequently buys and sells shares for speedy encashment of profit.

S.20 Stock Exchanges in India

In March 2004, there were 24 stock exchanges in India. Among them, Bombay Stock Exchange is the oldest in Asia. It was established in 1875. Some other stock exchanges in India are Calcutta Stock Exchange, Madras Stock Exchange Ltd., Hyderabad Stock Exchange, Bangalore Stock Exchange Ltd., etc. Three other important stock exchanges in India are National Stock Exchange (NSE), Over-the-Counter Exchange of India (OTCEI) and Inter-connected Stock Exchange (ISE).

S.21 Bombay Stock Exchange

The Bombay Stock Exchange (BSE) was set up in 1875 as a voluntary non-profit organisation. It is the oldest stock Exchange in Asia. A major and important stock exchange in India, the BSE is managed by a Governing Body. It has an Executive Director who acts as the Chief Executive Officer of the BSE. The members of the BSE can trade in the Exchange on behalf of outsiders. Only the shares of the listed companies can be traded at the Exchange. The SEBI has permitted the BSE to extend its on-line trading. The objective is to reach out to as many investors as possible. Like any developed and important stock exchange, the BSE also performs some important functions.

S.22 Calcutta Stock Exchange

Calcutta Stock Exchange was established in 1908 as an Association. Later it was transformed into a joint stock company in 1923. It has been working as an approved stock exchange since 10 October 1957. It now operates as a public limited company. Till the early 1980s, it was the largest stock exchange in the country in terms of the number of listed companies. However, by late 1980s, its place was occupied by the Bombay Stock Exchange. During late 1990s, the National Stock Exchange (NSE) became the largest stock exchange in India. The Calcutta Stock Exchange is managed by an Executive Committee. At present, in Calcutta Stock Exchange, bonds and shares of more than 700 private companies are traded. Being one of the oldest stock exchanges in the country, some of its activities and procedures are old and conservative. These are to be modernised and made suitable for the present age. Then the speed of activities and efficiency of the Calcutta Stock Exchange will increase.

S.23 Over-the-counter Exchange of India (OTCEI)

OTCEI was set up in October 1990. Its main objectives are to offer small and medium companies an access to a nationwide market of securities and to develop a computerised scripless stock exchange of international standard at a lower cost. OTCEI offers a trading system equipped with electronic or computer network. Through this network, domestic as well as foreign buyers and sellers can trade in securities more efficiently and economically. Small and medium-sized companies, who cannot list their securities on other stock exchanges, can raise finance at lower cost through OTCEI. This exchange has opened a new horizon in Indian capital market by introducing a screen-based on-line trading in securities.

S.24 National Stock Exchange (NSE)

The NSE was established in November 1992. Its main objectives are to establish a nationwide trading facility to ensure equal access to the investors all over the country, enable shorter settlement cycle, introduce current international standard in securities market and provide a fair, efficient and transparent securities market. The NSE is managed by a Board of Directors. The day-to-day management is done under the supervision of the Managing Director. The NSE has two market segments: one is the Wholesale Debt Market (WDM) and the other is the Capital Market. Terms of membership, trading rules and procedures all are different in the two segments. The NSE is a fully automated screen-based system of security trading. Within a short period, it has become the most important stock exchange in the country in terms of total turnover.

S.25 Regulation and Control of Stock Exchange

The activities of stock exchanges are to be regulated and controlled for many reasons. Some of them are to ensure uniformity in their activities, prevent their unhealthy and illegal practices, limit the number of stock exchanges in a region, control overtrading, ensure proper listing requirements, etc. In India, stock exchanges are regulated and controlled by the Securities and Exchange Board of India (SEBI). This Board has been given some statutory powers for this purpose.

S.26 Securities and Exchange Board of India (SEBI)

To regulate and develop the Indian capital market, the Securities and Exchange Board of India (SEBI) was set up in April 1988. It has three main objectives. Briefly they are (i) to protect the interests of investors, (ii) to ensure fair practices by companies issuing securities and (iii) to promote efficient services by brokers, merchant bankers and other intermediaries.

To achieve these objectives, the SEBI undertakes various functions. They may be divided into regulatory functions and developmental functions. Regulatory functions include (i) registration of brokers and sub-brokers, (ii) registration of various investment schemes, (iii) registration of stock exchanges and merchant banks, (iv) prohibition of fraudulent and unfair trade practices including insider trading, (v) imposition of penalties for various malpractices, etc. Developmental functions include (i) education of investors, (ii) training of intermediaries, (iii) promotion of fair practices, (iv) collection of various fees for its operations, (v) supply of useful information to all market participants, etc.

S.27 Recent Reforms in the Indian Capital Market

To increase the efficiency of the capital market and to control its unhealthy activities, various reforms have been introduced in this market. Important among them are as follows:

- Statutory status to SEBI to register and regulate new intermediaries
- Screen-based and scripless trading in National Stock Exchange
- Bringing merchant banking under the regulatory framework of SEBI
- Screen-based on-line trading of securities at OTCEI
- Simplification of issue procedures
- Simplification in listing agreements
- Making underwriting by the issuing company optional
- Bringing UTI under the jurisdiction and control of SEBI
- Introduction of certain norms and codes of conduct for merchant bankers, brokers, underwriters and share transfer agents
- Introduction of risk management system for mutual funds
- Introduction of trading in government securities on stock exchanges
- Improved accounting standards and disclosure practices
- Introduction of insurance against risk for all member brokers of stock exchanges
- Imposition of monetary penalties on erring companies by SEBI
- Regulation regarding substantial acquisition of shares and takeovers

These measures have made Indian capital market more transparent, fair and efficient.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. What is capital market?
2. Mention the names of sub-markets of a capital market.
3. What do you mean by primary market?
4. What are the alternative names of primary market?
5. Define secondary market.

6. What are the alternative names of secondary market?
7. What is new issue market?
8. What is an IPO?
9. What is gilt-edged security market?
10. What is a stock exchange?
11. What is the full form of IPO? What does it stand for?
12. What is stock market?
13. Give the full form of NABARD and RRBs.
14. What is EXIM Bank?
15. What are the full forms of SIDBI and IIBI?
16. Give the full forms of LICI and GICI.
17. What are the full forms of IDBI and NIDC?
18. What is a security?
19. Define security market.
20. What do you mean by primary or direct security?
21. What is meant by indirect or secondary security?
22. What are the major types of security markets?
23. What do you mean by organised capital market?
24. What is unorganised capital market?
25. What do you mean by underwriting?
26. What is meant by distribution in new issue market?
27. What is the full form of OTCEI?
28. Give the full forms of NSE and BSE.
29. What is the full form of SEBI?
30. What is the main objective of SEBI?
31. When was SEBI established? What is its main function?
32. What is screen-based trading?
33. What is meant by scripless trading?
34. What is meant by rematerialisation?
35. What do you mean by demat?
36. What is share market?
37. What do you mean by long-term loan market?
38. What are the major sub-markets of long-term loan market?
39. Mention one major distinction between organised and unorganised capital markets.
40. Distinguish between money market and capital market.
41. Mention one major function of capital market.
42. Mention one advantage of underwriting.
43. What do you mean by loan syndication?

44. Give the full forms of IPO and DFIs.
45. Mention two major features of Indian capital market.
46. Give the names of two innovative instruments in the Indian capital market in recent years.
47. What is a share?
48. What do you mean by equity share?
49. What is preference share?
50. What do you mean by convertibles?
51. What is a derivative security?
52. What do you mean by global depository receipt?
53. Give the full forms of ECU and ADRs.
54. What is the full form of GDRs?
55. What are the different categories of government securities?
56. What are the methods by which a company may raise funds from a primary market in India?
57. What do you mean by par value of an asset?
58. Distinguish between share and stock.
59. What is face value of an asset?
60. What do you mean by blue chip?
61. What do you mean by bonus share?
62. What is meant by rights issue?
63. What is glamour stock?
64. What is meant by speculative stock?
65. What do you mean by growth stock?
66. What is income stock?
67. What do you mean by cumulative preference share?
68. What is non-cumulative preference share?
69. What is meant by participating preference share?
70. What is non-participating preference share?
71. What is redeemable preference share?
72. What do you mean by irredeemable preference share?
73. What is bond?
74. Give the names of some different kinds of debentures.
75. What are redeemable debentures?
76. What is meant by irredeemable debenture?
77. What is mortgage bond?
78. What do you mean by simple or naked debentures?
79. What are bearer bonds?

80. What is first debenture and what is second debenture?
81. What is convertible bond or convertible debenture?
82. What are junk bonds?
83. What are Eurobonds?
84. What is meant by foreign bonds?
85. What are Yankee bonds and what are Samurai bonds?
86. Mention two major differences between shares and bonds.
87. What do you mean by spot trading?
88. What is cash-basis trading in the context of security trading?
89. What is meant by settlement trading?
90. What is options trading?
91. What is call option and what is put option?
92. What do you mean by paperless trading?
93. What is physical trading in security market?
94. Mention one advantage of demat trading over physical trading.
95. Mention two advantages of dematerialisation in security trading.
96. What is depository?
97. What is depository system?
98. Give the full forms of DPs and R&T.
99. Give the full forms of NSDL and CDSL.
100. What do you mean by origination in the context of new issues?
101. Mention the different types of underwriting agreement.
102. Give the names of various methods used to distribute securities in the new issue market.
103. What do you mean by public issue through prospectus?
104. What do you mean by placement or private placement method of distribution of new issues?
105. What is meant by rights issues?
106. What is Book-building method or Tender method of distribution of a new issue?
107. Give the full forms of ROC and SPN.
108. Mention the names of some instruments of new issue market.
109. What is the full form of LPG? When was it introduced in India?
110. Mention the names of some players in the new issue market.
111. What is merchant bank?
112. Mention two differences between primary market and secondary market.
113. What do you mean by listing of securities?
114. What is a listed company?
115. Mention two advantages/merits of listing of securities.

116. Mention two disadvantages/demerits of listing of securities.
117. Give the names of some functionaries of a stock exchange.
118. Who is a broker or stockbroker?
119. What is sub-broker?
120. What is jobber in a stock exchange?
121. What is ask price and what is bid price?
122. What do you mean by a portfolio?
123. What is meant by consultants or portfolio consultants?
124. What do you mean by portfolio diversification?
125. Who are institutional investors in capital market?
126. Give the full forms of FIIs and NRIs.
127. What is speculation?
128. Who is a speculator in a stock market?
129. What are the different types of speculators in a stock market?
130. What is bull and what is bear in a stock exchange?
131. Who is a lame duck in a stock market?
132. What is stag in a stock exchange?
133. What are the different types of stock exchanges in India?
134. Give the full forms of BOLT and SCRA.
135. Give the full form of ISE. What does it do?
136. What do you mean by insider trading?
137. Mention two major primary market reforms in Indian capital market in recent years.
138. Mention two recent secondary market reforms in the Indian capital market.
139. What is brokerage?
140. Give the full form of FCDs.

B. Medium Answer-Type Questions (4–5 marks each)

1. What is capital market? Briefly describe the organisation of capital market of an economy.
2. Distinguish between organised and unorganised capital market.
3. Distinguish between money market and capital market.
4. Discuss the inter-relationship between money market and capital market of an economy.
5. Briefly mention the important function of a capital market of any country.
6. What are the main constituents or elements of Indian capital market?
7. Bring out the major features of Indian capital market.
8. Is Indian capital market unorganised? Establish your opinion.
9. Write a short note on security market.

10. Describe the different sub-markets of a security market.
11. What is a share? Discuss its major types.
12. What is a preference share? What are its different types?
13. Make a distinction between ordinary share and preference share.
14. What are bonds or debentures? What are its different types?
15. Make a distinction between shares and bonds.
16. What are the various methods of security trading?
17. What is demat? Make a brief comparison between physical trading and demat trading.
18. What is depository system? Mention its major objectives.
19. Discuss the functions of the depository system in a financial market.
20. Briefly describe the interacting institution in a depository system.
21. Briefly analyse the benefits of depository system in the capital market of a country.
22. Evaluate the role of depository participants in the process of dematerialisation in Indian capital market.
33. Discuss the role of National Securities Depository Limited (NSDL) in the process of dematerialisation in security trading in India.
34. Distinguish between primary market and secondary market.
35. Discuss the main functions of primary or new issue market.
36. What is underwriting? Discuss the main benefits of underwriting.
37. Briefly describe the distribution or issue mechanism of an IPO.
38. Mention some major instruments of new issue market of India.
39. Briefly describe the Book-building or Tender method of distribution of a new issue.
40. Mention some major players operating in a new issue market.
41. What is stock exchange? Describe the organisation of a stock exchange.
42. What do you mean by listing of securities? Discuss the procedure for listing a security on a stock exchange.
43. Discuss the merits or advantages of listing a security on a stock exchange.
44. What are the demerits or disadvantages of listing securities on a stock exchange?
45. Give a brief description of major stock exchanges in India.
46. Write a short note on National Stock Exchange.
47. Briefly evaluate the role of Bombay Stock Exchange in Indian capital market.
48. Write a brief note on Calcutta Stock Exchange.
49. Discuss the role of OTCEI in expanding securities trading in Indian capital market.
50. Discuss the role of stock exchanges in the economic development of a country.
51. Briefly describe the major functions of a stock exchange in the capital market of a country.
52. Discuss the activities of a broker in the stock exchange.
53. Describe briefly the functions of a sub-broker in a stock exchange.

54. Distinguish between broker and sub-broker as functionaries of a stock exchange.
55. What is a jobber? What are its main functions?
56. Distinguish between a broker and a jobber as functionaries in a stock market.
57. Write a short note on portfolio consultants in a stock market.
58. Give a brief description of different types of speculators in a stock market.
59. Discuss the need for control of stock exchanges in any country.
60. Briefly describe the methods imposed by SEBI in order to control stock exchanges in India
61. Mention the main objectives of the Securities and Exchange Board of India (SEBI)
62. Briefly describe the organisational setup of the Securities and Exchange Board of India.
63. Briefly describe the major functions of SEBI.

C. Long Answer-Type Questions (10 marks each)

1. Carefully discuss the organisation of capital market of a country. **(Section 8.1)**
2. Analyse the importance or functions of capital market in an economy. **(Section 8.4)**
3. Discuss the role of capital market in the economic development of a country. **(Section 8.4)**
4. Briefly describe the structure of Indian capital market. **(Section 8.5)**
5. Discuss the main elements or constituents of the capital market of India. **(Section 8.5)**
6. Describe the main features of Indian capital market and indicate their implication. **(Section 8.6)**
7. What is security market? Describe the security market of India bringing out its various sub-categories. **(Sections 8.7, 8.7.1 & 8.7.2)**
8. Discuss the various methods of trading securities in Indian capital market. **(Section 8.8)**
9. What are the needs for control of activities of stock exchanges in India? Briefly describe the methods available for such control. **(Section 8.15.1 & 8.15.2)**
10. Discuss the major functions of Securities and Exchange Board of India (SEBI). **(Section 8.16.3)**
11. Briefly mention the major reforms introduced in the Indian capital market in recent years. **(Section 8.17)**

UNIT

9 INVESTORS' PROTECTION

UNIT OUTLINE

SUBJECT MATTER OF THE UNIT

This unit deals with investors' protection. It provides the meaning of investors' protection and discusses the investors' rights and obligations. It considers grievances of the investors concerning stock exchange dealings. There are grievance redressal cells in stock exchanges. We shall discuss about such cells in major stock exchanges. This unit also considers the role of **Securities and Exchange Board of India (**SEBI) in providing investors' protection. It also deals with role and functions of Company Law Board, the role of press and judiciary in investors' protection.

9.1 MEANING OF INVESTORS' PROTECTION

While investing his surplus funds, an investor has **three objectives:** (i) safety of invested funds, (ii) liquidity position of invested money, and (iii) a fair rate of return on invested money.

Investors' protection means ensuring that the investor can achieve these three objectives as far as possible. In the capital market of a country, there are many investors and they are not homogeneous. Investors may be large or small in number. They may be rich or poor. They may be expert or lay persons. All of them need not require equal degree of protection for their invested amount. **In general, the term investors' protection means protecting investors from various malpractices of companies, merchant bankers, depository participants and other intermediaries.** Thus, 'investors' protection' refers to the methods and measures adopted by SEBI, stock exchanges and the government to protect the interests of small investors. This is necessary to remove unfair and fraudulent trade practices and to make the system more investor friendly.

It should, however, be noted that there is always a risk element in investing in private securities. This risk factor should be taken into account by the investor while making investment and accordingly precaution should be taken to protect his interest. If the investor invests in any venture without a prior assessment of risk, he himself is to blame for the loss suffered by him. Market risk will always be present in any investment decision. Investors' protection is thus limited to protecting the interest of the investor against various types of frauds and malpractices.

9.2 IMPORTANCE OF INVESTORS' PROTECTION

Importance of investors' protection can be understood by considering the following points:

Creation of Proper Investment Climate: Protection of investors will create a proper, secured investment climate. This would help the corporate sector to raise funds from the capital market easily and efficiently.

Creating Discipline in the Market: If investors' protection is guaranteed, it will create an atmosphere of discipline in the activities of market players. All the market players then work within the ambit of regulations. Then the market operations become smooth and stable. The possibilities of scams, malpractices and so on become minimised. This brings discipline in the capital market.

Building up Investors' Confidence: There are many small investors in the capital market. Many of them do not have adequate knowledge about the functioning of the capital market. Many of them are tempted to invest their funds with the expectation of making a good fortune when the market tends to be bullish. All these investors receive a jolt when the market tends to be bearish. If these investors lose their confidence in the market, the market will also receive a serious jolt. This is neither desirable nor acceptable. Investors' protection measures try to build up confidence among the investors by creating a conducive atmosphere for investment.

Creating a Sense of Accountability: Strong investors' protection and disclosure norms create a sense of accountability to all the persons connected with the capital market. Since there exists a regulatory body to check compliance of all laid down guidelines, everybody related with the market remains cautious to avoid any sort of delinquency. This will also help them get a feeling of satisfaction when all the guidelines are followed.

Ensure Transparency in Dealings and Disclosures: Investors' protection measures and regulations try to bring transparency in the dealings of companies and various intermediaries connected with the capital market. Various disclosure norms prescribed by SEBI help maintain transparency in various areas.

Development of Capital Market: A good system of providing investors' protection will help create vibrant primary and secondary markets. Protected investors will find it secured to participate in dealings with both these types of capital market. Thus, customers' confidence would help develop these markets. Once markets get developed, they would again attract more and more investors. In this way, a well-developed capital market will come up if investors' protection is ensured.

Consciousness of Investors: As a part of the mechanism of providing investors' protection, measures are taken to educate the investors about nitty-gritty of different market formalities. Investors are also educated about their rights and obligations. It makes the investors really conscious about the grey areas where chances of getting duped exist. In this way, investors' consciousness increases and they themselves become their protectors.

From the above analysis, it can be said that provision of investors' protection is very important in an economy. It will build up investors' confidence and create discipline in the capital market. It will also help the growth of primary and secondary markets for securities.

9.3 MECHANISMS OF PROTECTING INVESTORS

We know that protecting the interests of the investors is very important for an economy. Now the question arises: **What are the mechanisms through which investors' interests can be protected? The mechanisms can be provided through passing a set of Acts and Regulations as well as through the setting up of certain regulatory bodies.** Let us now discuss different components of the mechanisms.

9.3.1 Different Acts

Several Acts have been passed by the Indian parliament to protect the interests of the investors. Some of these Acts are mentioned below:

9.3.1.1 The Companies Act 1956 as amended up to date

It is the basic Act governing the companies virtually in all its affairs. One of the basic objectives of this Act is to protect the interests of the shareholders. This Act is administered by the Department of Company Affairs of the Government of India.

9.3.1.2 Securities Contracts (Regulation) Act, 1956

The basic objective of this Act is to control the security market by curbing undesirable transactions or speculation in securities. Before the SEBI Act was passed in 1992, this Act was the instrument for regulating the stock exchanges. This Act is administered by the Department of Economic Affairs under the Ministry of Finance.

9.3.1.3 Depositories Act, 1996

This Act was passed to introduce dematerialised trading in the security market. It provides various regulations on depositories to protect the interests of investors in demat form.

9.3.1.4 SEBI Act, 1992

This Act empowers SEBI for protecting the investors' interests and for regulating the securities market, including the stock exchanges. SEBI has been given wide powers to regulate all market intermediaries. It has full autonomy and authority to regulate and develop an orderly security market.

9.3.2 Different Bodies

Apart from these Acts, several regulatory bodies have been set up to safeguard the interests of the investors. Some of these bodies can now be discussed:

9.3.2.1 Securities and Exchange Board of India (SEBI)

SEBI was initially established in 1988 on the basis of an administrative order. But after the SEBI Act was passed in 1992, it has been set up under the provisions of this Act. In the preamble of the SEBI Act, 1992, it is stated that the objective of SEBI is 'to protect the interest of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith and incidental thereto'. Direct mention of the words of 'investors' protection' in the preamble of SEBI Act shows that upholding the interests of the investors is the prime purpose of setting up of SEBI.

In order to ensure investors' protection, SEBI has formulated a number of rules, regulations and guidelines. Some of these are as follows:

- SEBI (Disclosure and Investor Protection) Guidelines, 2000
- SEBI (Prohibition of Insider Trading) Regulations, 1992
- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997
- SEBI (Buyback of Securities) Regulations, 1998
- SEBI (Employees Stock Option Scheme and Employees Stock Purchase Scheme) Guideline, 1999

In fact, SEBI tries to ensure investors' protection by the regulation and control over all the players in the capital market.

SEBI receives complaints from the investors directly and in the SEBI Act, there has been provision for setting up Securities Appellate Tribunal where investors can seek redressal of grievances against SEBI itself. The Government of India can also give directions to SEBI. Thus though SEBI has been given wide powers to protect the interests of investors, different regulatory organs have been placed over SEBI to keep a check on the unjust activities of SEBI. Thus, an apparently full proof system has been introduced to protect the interests of the investors.

9.3.2.2 Company Law Board

This Board was constituted by the Government of India in 1991 under the Companies Act, 1956. In securing investors' protection, Company Law Board acts as a vital part of the total mechanism. The member(s) of a company can complain to the Company Law Board that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to the member/members. The Company Law Board in that case may issue an order as it thinks fit, to solve the conflict. An appeal can be made to the High Court against the order of the Company Law Board. Thus, the judicial system of the country is also involved in protecting the interests of the investors.

9.3.2.3 Department of Company Affairs (DCA)

Department of Company Affairs of the Government of India also works as a supervisory body to protect the interests of the investors. Its main functions are managing, overseeing and regulating the issue of capital, defining the duties and responsibilities of promoters and directors, rights of shareholders, amalgamation and liquidation of companies, change in capital structure of companies and so on. It can carry out investigations in the affairs of a company to detect frauds or other types of irregularities.

9.3.2.4 Ministry of Finance

This is the supreme regulatory body reigning over all other regulatory bodies. It is concerned with formulating the broad policy framework and maintaining overall supervision and control.

9.3.2.5 Reserve Bank of India (RBI)

The RBI is the apex body in the banking sector. It is a regulating as well as promoting authority in the money and capital markets. The RBI helps in protecting the interests of the investors by the control of liquidity in the capital market, supervision and control of money market and control over foreign investment.

9.4 FORCES HAMPERING THE INTERESTS OF INVESTORS

In the previous section, we have seen the mechanism through which the interests of investors can be protected. The mechanism includes Acts, rules, regulations and setting up of regulatory bodies. Let us now consider the forces which hamper the interests of investors. These forces can be stated as follows:

9.4.1 Insider Trading

Insider trading means sale and purchase of securities by persons who hold price-sensitive information about the company due to their positions in the company. Securities include shares, debentures or derivatives like options and futures. Person involved in insider trading may be an employee of the company or a director of the company who has inside knowledge of information about the financial performance of the company. The person can use this information for the benefit of himself/herself or his/her associates to gain an advantage by dealing in the securities of the company in the market.

The main argument against insider trading is that insiders should not be permitted to get undue advantage over the uninformed traders. If people fear that insiders will regularly profit at their expense, they will not be interested in holding such securities at all. Thus in the presence of insider trading, interests of ordinary investors will suffer. Hence, insider trading should be banned to protect the interests of common investors. In fact, SEBI (Prohibition of Insider Trading) Regulations, 1992 were made to curb and prevent insider-trading in securities. The Regulations were amended in 2002 to make some changes.

9.4.2 Price Rigging

Price rigging means artificial manipulation of prices. Prices of securities are not always determined by the forces of demand and supply as it happens in a perfectly competitive market. Instead, in the stock market, it is often found that there are cartels that artificially rig up prices. When bulls or bears form cartel and try to purchase or sell on a very wide scale to influence prices, it is referred to as price rigging. Ordinary investors are misled by such price manipulation by the cartel and they ultimately suffer heavily.

9.4.3 Lack of Transparency

Lack of transparency is another evil that hampers the interests of investors. We know that investors invest their funds in securities to earn dividend and interest by purchasing shares and debentures of companies. In order to attract investors, some companies often manipulate their system of accounting and create a lofty image of the companies. These accounts do not represent true and fair view of their actual financial positions. These companies are not transparent in their disclosures. Ordinary investors are misled by this type of cosmetic accounting and they suffer from investing in these companies. Stock market dealings also do not appear to be transparent to thousands of small investors.

9.4.4 Excessive Speculation

Some amount of speculation must be present in the capital market. But excessive speculation is undesirable. It not only hampers the interests of common investors but also brings down debacle in stock exchanges. For example, in order to earn more and more profits, brokers may go on purchasing shares beyond their capacity and may not maintain their settlement promises. When market crashes due to non-settlement by the brokers and non-delivery of the scrips, many investors suffer due to no fault of their own.

9.5 GRIEVANCES CONCERNING STOCK EXCHANGE DEALINGS

Main grievances which the investors have concerning stock exchange dealings can be stated as follows:

Investors' Grievances: Investors' grievances may be related **to a company** such as non-receipt of securities sent for transfer, non-receipt of corporate benefits like dividends, interest, bonus issues or rights issues. Grievances may also be related **to the brokers** such as non-receipt of funds/securities on sale/purchase transaction, non-rectification of documents returned as bad delivery by the broker, and not issuing contract note by the broker.

Excessive Volatility: Volatility in the stock exchanges has increased very much over the years due to a number of factors such as: (i) liberalisation and globalisation of the Indian economy, (ii) Adoption of flexible interest rates, (iii) Introduction of new, innovative and hybrid financial instruments like derivatives, (iv) Technological advancement, and (v) Integration of the Indian stock market with the world stock market. Ordinary investors who do not have specialised knowledge fail to keep pace with the volatility of the stock market and their possibility of suffering losses has increased.

Prevalence of Various Unethical Practices/Malpractices: Different forms of malpractices are followed by companies, brokers, sub-brokers and other functionaries of stock exchanges. Some of the malpractices are: insider trading, false advertisements, mergers and acquisitions through unfair means, exaggerated prospectus at the time of new issue, entering into unofficial transactions even before issue opens up and so on. Majority of investors in corporate securities have serious grievances in this regard.

Not Conducive to Small Investors: In Indian stock exchanges, financial institutions like LICI, GIC, UTI dominate. Along with them, foreign institutional investors (FIIs) also play a major role. Institutional investors (domestic as well as foreign) take up about 75 per cent of the new issues which account for 60 per cent of the market's turnover. The ownership of equities by individuals or households is very small. The institutional investors dominate the market. When they start purchasing shares, the market becomes bullish. Again, when they start selling shares, the market becomes bearish. The interests of small investors are neglected by the actions of the institutional investors. That's why, it is said that stock exchanges in India are not conducive to small investors. This is a serious grievance of small investors.

Payment Crisis: The stock markets have witnessed sharp payment crisis due to indulgence of brokers in speculative transactions beyond their resources. As a result, investors do not get payment in time for the securities sold by them. The authorities have failed to make timely intervention. In many cases, the brokers have been declared defaulters and some of them have been directed not to carry on their businesses.

Oligopolistic Nature: Indian stock exchanges are not like perfectly competitive markets where free entry and free exit exist. The membership of stock markets is restricted. A handful of jobbers and brokers in many cases embarrass the common investors. Brokers make huge profits by trading on their own accounts, credit gains to their own books and debit losses to their clients' accounts. They delay payments of sale proceeds and deliveries of shares to their clients and speculate in shares without possessing them. In this way, the brokers dupe thousands of small investors. By putting barriers to entry, the stock market has become oligopolistic in nature.

Organisational and Structural Imbalances: Though there are many stock exchanges in India, only two of them, BSE and NSE hold the lion's share of the dealings in stock exchanges. Other stock exchanges are not so active. Even the brokers and investors are not familiar with all the stock exchanges. All the stock exchanges are urban oriented. Moreover, in the stock exchanges, large and well established investors get the best service. Small and individual investors and small companies do not get adequate attention.

Lack of Secondary Debt Market: Most of the securities traded in stock exchanges are equities. Debentures are not generally traded in stock exchanges. Hence, investors in debentures cannot get liquidity by selling their debentures in the stock exchanges. This is another point of grievances of investors in debentures.

In conclusion, it can be said that in the Indian economy, agriculture, small and cottage industry, activities in the informal unorganised sector occupy an important position so far as the source of national income and the source of employment are concerned. But, these sectors have no access to the stock exchanges. Hence, share market in India cannot be treated to be the barometer of the country's economy in the strict sense of the term.

9.6 SEBI GUIDELINES REGARDING RIGHTS AND RESPONSIBILITIES OF INVESTORS

SEBI has published detailed guidelines regarding rights and responsibilities of investors in shares. SEBI has brought out an information pamphlet titled 'A Quick Reference Guide for Investors' for the benefit of investors. Main features of this pamphlet are discussed in the following subsection.

9.6.1 Rights of Investors/Shareholders

As a shareholder the investor has the following rights:

- To receive share certificates on allotment or transfer as the case may be, in due time.
- To receive copies of the annual report, the balance sheet and the P and L A/C and auditor's report.

- To participate and vote in general meetings either personally or through proxies.
- To receive dividends in due time once approved in general meetings.
- To receive corporate benefits like rights shares, bonus shares and so on, once approved.
- To apply to Company Law Board to call or direct the annual general meeting.
- To inspect the minute books of the general meetings and to receive copies thereof.
- To proceed against the company by way of civil or criminal proceedings.
- To apply for the winding-up of the company.
- To receive the residual proceeds.

Apart from the above rights as an individual shareholder, the shareholder also enjoys the following rights as a group:

- To requisition an extraordinary general meeting.
- To demand a poll on any resolution.
- To apply to Company Law Board (CLB) for relief in cases of oppression and/or mismanagement.
- To apply to CLB to investigate the affairs of the company.

As a debenture holder, the investor has the following rights:

- To receive interest/redemption in due time.
- To receive a copy of the trust deed on request.
- To apply for winding up of the company if the company fails to pay its debt.
- To approach the debenture trustee with any grievance, if there is any.

It should be noted that the above mentioned rights are not necessarily absolute. These rights are subject to the rules of the company.

9.6.2 Responsibilities of Investors

According to SEBI guidelines, the **investors not only have rights, but also have responsibilities.** The responsibilities are as follows:

- To remain informed.
- To be vigilant.
- To participate or vote in general meetings.
- To exercise rights on his/her own or as a group.

9.7 GRIEVANCE REDRESSAL CELLS IN STOCK EXCHANGES

Grievance redressal refers to the process of looking into investors' complaints and giving solutions to the complaints. Grievance redressal cells have been set up in all the major stock exchanges of India.

The main objectives for setting up of grievance redressal cells are as follows:

- To receive written complaints from the investors or market participants.
- To call upon the defaulters in writing who have failed to redress the grievances of investors.

- To ask the aggrieved investors to appear before the grievance cell to explain their grievances.
- To advise the aggrieved investors to send complaints to SEBI.
- To appeal to the Securities Appellate Tribunal to deal with the investors' grievances in case the defaulter fails to redress the grievances of the aggrieved investors.
- To check unfair means, fraudulent activities, malpractices and other unethical activities of stock market operators.
- To protect the interests of investors.
- To exercise control over the activities of stock market operators.

The functions of grievance redressal cells are as follows:

Receiving and Recording Grievances: The grievance cells receive complaints of investors regarding different matters relating to functioning of stock exchanges. Once the complaints are received, they are properly recorded by the cells.

Call upon the Defaulters: The cells analyse the grievances and call upon the defaulters in writing within a specified time. The defaulters may also be called upon to explain to the cells about the steps taken for the redressal of complaints.

Calling upon Aggrieved Investors: The redressal cells may call the aggrieved investors to appear before them and explain their grievances along with evidences.

Appeal to the SAT: In case the defaulter party fails to redress the grievances of the aggrieved investor, the grievance cell appeals to the Securities Appellate Tribunal (SAT) to take up the grievances.

Build up Fair Picture of Stock Market: Grievance cells check unfair practices, malpractices and unethical activities of the stock market operators and thereby, try to build up a fair picture of the stock markets. In the process, the cells also attempt to reform the stock markets. In this way, they try to increase the confidence of the investors.

Publication of Different Information: Grievance cells publish different information regarding stock exchanges which are helpful to meet the queries of the investors. With the help of their information, the investors can know the grievance redressal procedure which they should follow.

9.7.1 Redressal Cell in Bombay Stock Exchange (BSE)

The Bombay Stock Exchange (BSE) has set up an Investors' Services Cell (ISC) to look after the grievances of the investors.

The ISC considers grievances of investors against listed companies of BSE and also against members of the exchange. The ISC also helps in the arbitration process between members and investors.

The grievances of investors against listed companies may be on: non-receipt of refund order, non-receipt of share certificate, non-receipt of certificate after splitting or after consolidation, non-receipt of duplicate securities, non-receipt of redemption proceeds of listed debentures, non-receipt of interest due on listed debentures and so on. This list is only illustrative and not exhaustive.

Whenever the ISC receives a complaint against any listed company, it immediately forwards the same to the respective company and directs it to solve the matter within 15 days. If the company fails to resolve the complaint within 15 days and if the total number of pending complaints against the company exceeds 25 and is pending for more than 45 days and after issue of show cause notice for 7 days, the scrip of the company is suspended for trading till grievances are resolved.

The grievances of investors against members of BSE may be about: non-receipt of delivery of shares, non-receipt of sale proceeds of shares, non-receipt of dividend, non- receipt of rights or bonus shares, disputes regarding rate differences, disputes regarding non-settlement of accounts and so on.

Whenever such a complaint is received by the ISC, it is forwarded to the concerned member to reply/settle the complaints within 7 days from the receipt of the letter. If no reply is received or, if the reply is unsatisfactory, the matter is placed before the **Investors' Grievance Redressal Committee (IGRC)** headed by a retired High Court judge. IGRC is constituted by the Governing Board of BSE to resolve the complaints of non-members against members through the process of reconciliation. The parties are heard by the IGRC and the matter is tried to be solved amicably. Otherwise it is referred for **arbitration** under the rules of the BSE.

The process of solving investors' complaints through the arbitration procedure can be stated as follows:

If the complaint is against an active member of BSE, it is considered by the Arbitration Committee set up with the approval of SEBI. On receiving the direction for arbitration from the IGRC, the applicant files relevant supporting documents. Copies of the documents are sent to the other party for giving the counter reply. Then, the matter is fixed for hearing before arbitrators. After hearing both the parties, the arbitrators declare the award.

If the applicant is not satisfied with the award, he can appeal against the award in the BSE within 15 days of the receipt of the award. The appeal bench of five arbitrators hears the matter and gives the award. If this award goes in favour of the applicant, the active member has to abide by the decision. If he fails to abide by the decision, the Disciplinary Action Committee (DAC) takes necessary action against him. The award becomes a decree after 3 months from the date on which it is given and can be executed as a court decree through a competent court of jurisdiction. The same can be challenged in the High Court of Mumbai.

Any complaint against a defaulter member of BSE can be directly filed before the Arbitration Committee. However, the same has to be filed within 6 months from the date of declaring the member as defaulter by the BSE. The rest of the process is the same as above.

An award obtained against a defaulter member is scrutinised by the Defaulter Committee (DC) which is a standing committee constituted by the BSE to ascertain its genuineness, the awarded amount or ₹10 lakh whichever is lower is paid to the applicant(s) from the Customers' Protection Fund (CPF) after the approval of the DC and the trustees of the CPF.

9.7.2 Redressal Cell in National Stock Exchange (NSE)

As in BSE, in National Stock Exchange (NSE) also, Investor Grievance Cell (IGC) has been established. This IGC looks after the grievances of the investors. The cell is manned by a team of professionals who are experienced in law, company affairs and capital markets. These professionals help to solve investors' grievances. Investors can lodge complaints with the IGC in prescribed forms or through e-mails. Whenever a complaint is received by the IGC, it is assigned a unique complaint number and it is put in a database for easy review and necessary action. If the complaint is lodged against a trading member (such as a broker), the member is intimated by the IGC about the complaint and a reply is expected within 21 days of intimation. If necessary, further clarifications are asked for and the issue is settled to the satisfaction of the parties involved. If all attempts to solve the problem amicably fail, then the matter is referred to **arbitration**.

Arbitration process is similar as in the case of BSE. When the claim amount is less than ₹25 lakh, a sole arbitrator is appointed by the NSE. If the claim amount exceeds ₹25 lakh, a panel of arbitrators consisting of three persons is appointed. The arbitrator/panel of arbitrators may arrange hearing of both sides, if necessary before giving the award. A party not satisfied with the award of arbitration may seek an appeal against the award in an appropriate court within a period of 90 days. If the time for making the application for appeal is expired or if the court refuses to admit the appeal, the award becomes binding on the accused party and it receives the status of the degree of a court which can be enforced by the code of criminal procedure.

An Investor Protection Fund (IPF) has been set up by the NSE to compensate investor claims which may arise due to non-settlement obligations by a trading member who has been declared defaulter. Thus, this fund is used to satisfy the claims of investors against trading members who have been declared as defaulters. The maximum amount of claim payable from the IPF is ₹5 lakh.

9.7.3 Redressal Cell in Over-the-Counter Exchange of India (OTCEI)

OTCEI is the first stock exchange in India to set up IGCs. In 1993, OTCEI established four IGCs in the four metro cities—Delhi, Kolkata, Chennai and Mumbai. The IGCs of OTCEI handle investors' grievances against brokers of the exchange or against companies listed in the exchange.

Whenever a complaint is received in any IGC, a unique reference number is allotted to it. An acknowledgement is issued to the aggrieved investor. The complaint is then forwarded to the broker or to the company as the case may be. They are given 21 days to redress the grievance from the receipt of the complaint. If the complaint remains unresolved after expiry of 30 days from the date of acknowledgement of the IGC, the investor may approach the OTCEI with the reference number allotted to his complaint.

The OTCEI has also set up an Investors' Compensation Fund (ICF) in 1995 to compensate the claims of investors against defaulter brokers or against loss of security.

9.8 REDRESSAL OF GRIEVANCES OF INVESTORS

We have considered the role of stock exchanges in the redressal of grievances of the investors. We have also considered the functioning of redressal cells of BSE, NSE and OTCEI in protecting the interests of the investors. Let us now consider the **role of other institutions in the redressal of grievances of investors.** Among the other institutions, we shall consider the role of SEBI, role of Company Law Board, role of judiciary (or, court) and the role of media in this context.

9.8.1 Role of SEBI

We know that one of the basic objectives of establishment of SEBI was to protect the interests of investors. Since its inception SEBI has taken a number of measures to safeguard the interests of investors. Let us discuss the **various measures adopted by SEBI to protect investors' interests.**

9.8.1.1 Direct Receipt and Disposal of Complaints from Investors

SEBI has formed a separate investor grievance and guidance division at head office. It has introduced an automated complaints handling system for dealing with investors' complaints. **The types of grievances for which an affected investor may approach SEBI are given below:**

Type-I Non-receipt of refund orders/allotment letters/stock invest

Type-II Non-receipt of dividend

Type-III Non-receipt of share certificates/bonus shares

Type-IV Non-receipt of debenture certificates/interest on debentures/redemption amount of debentures/interest on delayed payment of interest on debentures

Type-V Non-receipt of annual reports, letter of offer for rights, interest on delayed payment of refund offers

Type-VI Complaints relating to collective investment schemes

Type-VII Complaints related to brokers, sub-brokers, transfer agents, bankers to issue, underwriters, merchant bankers and other participants of the capital market

Type-VIII Complaints related to mutual funds, FIIs, portfolio managers, venture capital funds and custodians

Type-IX Complaints related to stock exchanges, clearing and settlement organisations and depositories

Type-X Complaints related to derivative exchanges

Type-XI Complaints related to corporation finance such as corporate governance, corporate restructuring, substantial acquisition and takeovers, buyback, delisting, compliance with listing conditions

SEBI has established a comprehensive investor grievance redressal mechanism. The investor grievance redressal and guidance division of the SEBI assist investors who prefer to make complaints to the SEBI against listed companies. A standardised complaint format is available at all SEBI offices and on the SEBI website for the convenience of the investors. Each complaint is taken up with the company and if the complaint is not resolved within a reasonable time, a periodical follow up is also made with the company. Errant companies are warned of stern action for their failure to redress grievances. Recalcitrant companies are referred for prosecution.

9.8.1.2 Investors' Education

Apart from the redressal of grievances of investors, **SEBI also tries to educate investors about the capital market.** It has prepared a booklet entitled, *A Quick Reference Guide for Investors* for the education of the investors. This book is distributed among the investors. SEBI also issues advertisements in national and regional newspapers to educate and caution investors about the risks associated with investments in collective investment schemes. SEBI also issues messages in the interest of investors on the national channel and regional channels of Doordarshan.

9.8.1.3 Registration and Regulation of Market Intermediaries

In the capital market, the investors have to deal with different market intermediaries like merchant bankers, underwriters, brokers and so on. In order to protect the interests of the investors, **SEBI has power to register and regulate all market intermediaries.** It has the power to penalise them in case of violations of the provisions of the Act, rules and regulations made thereunder. It can conduct enquiries, audits and inspection of all market intermediaries and adjudicate offences under the SEBI Act, 1992.

9.8.1.4 Introduction of Book Building Process

This is an important measure taken by SEBI. **Book building process in determining the prices of new issues has definite advantage compared to fixed price method.** In the fixed price method, it is the underwriters and issuers who decide the price of a new issue. But in the book building method, the price of a new issue is determined by the investors. It is a transparent and flexible pricing method based on the feedback from the investors. Moreover, in the fixed price method, investors have to pay at the time of application and these funds are locked up during the period from application to allotment. They have to sacrifice liquidity and cannot consider any other investment opportunity during this period. But in the book building method, investors do not have to commit their funds since they pay only at the end of the pricing process. Thus **by introducing the book building method, SEBI has been trying to safeguard the interests of the investors.**

9.8.1.5 Disclosure of Risk Factors

In order to make the investors aware about the risks involved in subscribing to a particular share, **SEBI has directed that all risk factors will have to be disclosed prominently in the**

prospectus, letter of offer and all issue-related advertisements. This has safeguarded the interests of investors.

9.8.1.6 Equal Distribution of Assets of Defaulting Borrowers

SEBI has directed that all the creditors of the defaulting brokers should be given equal priority in order to meet dues while distributing the assets of the broker. Earlier, in case of defaulting borrowers, small and ordinary investors were generally ignored and had to face a lot of trouble and hardships. The SEBI has directed that investor should be given equal priority with the stock exchanges to meet dues. This has protected the interests of small investors.

9.8.1.7 Ombudsman Scheme

The SEBI has set up a new institution in 2003 called the **'Ombudsman'** for the capital market. It is an office to redress the grievances of the investors against the intermediaries and the listed companies by mutual agreement or by award on adjudication. The powers and functions of the ombudsman as given in regulations 11 and 12 are as follows:

- To receive complaints against any intermediary or a listed company or both
- To consider such complaints and facilitate resolution thereof by amicable settlement
- To approve a friendly or amicable settlement of the dispute between the parties
- To adjudicate such complaints in the event of failure of settlement thereof by friendly or amicable settlement

Regulation 13 provides for the grounds under which a person may lodge a complaint either to the SEBI or to the ombudsman concerned. The ombudsman may award compensation, costs and interest. The award of ombudsman may be reviewed by the SEBI, if needed. Failure to obey the award of the ombudsman or order of the SEBI is liable for penalty under the SEBI Act. It is clear that the ombudsman scheme has protected the interests of investors.

The above mentioned measures are not exhaustive in nature. In spite of various efforts by SEBI, a lot remains to be done to protect the interest of small investors. Frauds and scams are a part of any system and cannot be eliminated altogether but it is for the regulatory authorities to ensure adequate checks and balances by not only framing guidelines on investor protection but imposing stricter enforcement and taking appropriate steps to create awareness among investors.

9.8.2 Role of Company Law Board

The Company Law Board (CLB) has been constituted by the Government of India in 1991. Under section 10E of the Companies Act, 1956, it is a quasi-judicial body. It has powers to overlook the working of companies within the Companies Act. The Company Law Board has framed Company Law Board Regulations, 1991 wherein all the procedures for filing the applications before the CLB have been prescribed.

The CLB shall consist of such number of members, not exceeding nine, as the Central Government deems fit, to be appointed by that government by notification in the official gazette. One of them shall be appointed by the central government as the chairman of the board. The Company Law Board shall exercise and discharge such powers and functions as may be conferred on it by the Companies Act or by any other law. The CLB has regional benches in Mumbai, Kolkata, Chennai and New Delhi. Every bench of the CLB shall have the powers which are vested in a court under the code of civil procedure, 1908 while trying a suit.

The Company Law Board performs a very important role in protecting the interests of investors. Some of these can be stated as follows:

Repayment of Deposits: If a company fails to repay any deposit in accordance with the terms and conditions of such deposit, the CLB may, on the application of the depositor, direct the company to make payment of such deposit or part thereof, forthwith or within such time and subject to such conditions as may be specified in the order.

Redemption of Redeemable Preference Shares: When a company is not in a position to redeem any preference share within the specified period and consent of the CLB, it issues further redeemable preference share equal to the amounts due (including the dividend).

Appeal against Refusal of Registration: If a company refuses to register the transfer of any share of a member or debenture of the company, an appeal can be made to the CLB against such refusal within two months of the receipt of the notice of such refusal.

Holding Enquiry against Managerial Personnel: The CLB can hold enquiry against such persons as has been referred to by central government to see whether or not such person is fit to hold the office of director or any other office connected with the conduct and management of the company. The CLB can also prevent change in board of directors which is likely to affect company prejudicially.

CLB as constituted under section 10E of the Companies Act stands dissolved after the formation of National Company Law Tribunal (NCLT) as per section 10FA of Companies (Amendment) Act, 2002. Power of the CLB in respect of repayment of fixed deposits, redemption of redeemable preference shares ordering investigations into the affairs of the company and so on, are transferred to the National Company Law Tribunal. All matters or proceedings or cases pending before the CLB on or before the NCLT shall stand transferred to the NCLT and the NCLT shall dispose of such cases in accordance with the provisions of the Companies (Second Amendment) Act, 2002.

9.8.3 Role of Judiciary (or, Court)

In the Indian democratic system, judiciary is regarded as the last resort for redressal of all grievances. But, Indian judiciary is overburdened with suits. Hence, various Acts formulated to monitor the operations of the capital market have provided an in-built system so that instances of referring to the courts to get justice are kept to the minimum. **Different Acts have enacted**

different situations when a reference should be sought from the court. Let us consider the role of the court under the provisions of different Acts guiding the securities market.

SEBI Act: Under the SEBI Act, the board of SEBI has the regulatory power to appoint adjudicating officer to hold enquiry to adjudicate under certain circumstances. Besides, the central government is empowered to establish Securities Appellate Tribunal (SAT) wherein appeal against the order of the board in certain circumstances can be made. Against the order of the SAT, no civil court shall have any jurisdiction to entertain any suit. An appeal can be made by an aggrieved party to the Supreme Court within 60 days from the date of communication of the decision/order of the SAT.

Securities Contracts (Regulation) Act, 1956: Under this Act, a person aggrieved by the action of any stock exchange can file an appeal to the SAT which is vested with the powers of civil court. Again, any person aggrieved by any decision or order of the SAT may file an appeal to the High Court within 60 days from the date of communication of the decision/order of the SAT.

The Companies Act: In 1991, the Company Law Board was established under section 10E of the Companies Act, 1956. It was a quasi-judicial body and with the establishment of CLB, the power of the court had been rested to the CLB. However, as a result of the enactment of Companies (Second Amendment) Act 2002, the CLB has been substituted by the National Company Law Tribunal (NCLT). The NCLT is vested with judicial powers. Any person aggrieved by any decision/order of the NCLT may file an appeal to the High Court within 60 days from the date of the order.

The NCLT, on the application of a company or any creditor or member of the company, may order a meeting of the creditors or of the members to be called, held and conducted in such manner as the NCLT directs. The NCLT has also been given the power of winding up of a company under certain conditions (known as compulsory winding up). When a company is being wound up voluntarily, a petition for its winding up may be presented to the NCLT by the official liquidator or by any person authorised to do so.

The above lists are not exhaustive, but merely illustrative. It only shows that the court has wide roles to play to protect the investors' interests in the capital market.

9.8.4 Role of the Media

In a modern economy the media have an important role to play in protecting the interests of the investors. **Media may be of two types—print media and electronic media.** Newspapers and journals are examples of print media while broadcasts in radio and telecasts in television channels and posting in websites are examples of electronic media. The basic objective of the media is to provide information to the investors about recent changes and developments that have taken place in stock markets within the country and in the international stock markets.

The media can play three types of roles in protecting the interests of the investors. These three roles are:

(i) **Investigative role**

(ii) **Advertising role**

(iii) **Advisory role**

Let us consider these roles one by one.

9.8.4.1 Investigative Role

The media can investigate to unearth frauds and scams as it happened in the case of Satyam scam in India or the case of Enron scam in the USA. Unearthing of frauds and scams makes the investors cautious and alert regarding purchase of shares and debentures of those companies which are involved in the scam. The media also highlight the failure of the role of regulatory authorities in performing their functions. This creates pressure on the regulatory bodies to become more vigilant in their functions. The media can also highlight the grievances of the investors in order to bring the same to the knowledge of the general public, government and various regulatory bodies.

9.8.4.2 Advertising Role

The main role of the media regarding advertising consists of the following:

- The companies are under statutory obligation to publish its prospectus, advertisement regarding new issues in a number of newspapers so that investors all over the country can be aware of the details of them. SEBI has also given guidelines on advertisements both pre-issue and post-issue.
- Newspapers and various financial journals are used for publication of annual results and financial accounts of different companies. All listed companies are required to announce their unaudited financial results on a half-yearly basis in at least one national and one regional English daily newspaper. Going through these results, investors can take their investment decisions.
- Financial newspapers publish stock indices particularly nifty and sensex on a daily basis in order to keep the investors aware of the stock market conditions and help them take decisions regarding purchase and sale of shares of different companies.
- Newspapers also notify government circulars, regulations and amendments made in various Acts.
- News regarding mergers, amalgamations and foreign collaborations can be obtained by the investors from newspapers.
- The press publishes the orders, directions, rules and regulations of the CLB in the interests of the investors.
- News regarding the disinvestment policy of the government and disinvestment programmes of the government are published in newspapers. This gives investors the opportunity to purchase the shares sold by the government.

- The press informs the investors regarding winding up of companies. It also publishes the government's notification granting reliefs to the investors in respect of corporate tax concessions, capital gains tax concessions and so on.
- The press publishes notices of annual general meetings, extraordinary general meetings of companies and circulars for the information of the investors.
- The press publishes the news of suspension of trading on stock exchanges or suspension of office bearers of stock exchanges, suspension and cancellation of certificate of registration of any broker, sub-broker, share transfer agent and the like by the SEBI for the interest of the investors.

9.8.4.3 Advisory Role

The press has a wide information base. It also has a network of communication with the best specialists and professionals and management stalwarts. So, the press is in a position to extend various suggestions and advices for ensuring better investor protection to the regulators.

Economists, share market analysts are invited to write in newspapers and magazines to offer advices to investors. They may also be invited by any business channel on television to give advice to investors regarding investment in securities.

The press arranges from time to time conferences of chambers of commerce and industries. Press conferences discuss different matters relating to the investors' protection. These conferences provide information to the investors regarding investment opportunities. Many newspapers, trade journals, financial periodicals publish various columns of specialist market analysts and share market specialists. In their analysis, they assess and appraise different risk factors of alternate investment options and suggest different beneficial investment options for various types of investors. These are very helpful to the investors.

Newspapers and TV channels explain market trends, highlight causes of fluctuations in share prices of any particular company and share market crash. They also give information to the investors regarding false promises made by any company or sponsor or a brokerage house. In this way, the media can provide useful advice to the investors for protecting their interests.

9.9 INSIDER TRADING

Insider trading may be defined as the sale or purchase of securities by persons who hold price sensitive information about the company. Insider transaction also includes those who receive confidential price sensitive information from insiders who have access to it.

Insider: As per Regulation 2(l) of SEBI Prohibition of Insider Trading Regulations 1992, **'Insider means any person who is or was connected with the company or is deemed to have been connected with the company and who is reasonably expected to have access to unpublished price sensitive information in respect of securities of the company or who has received or has had access to such unpublished price sensitive information'.**

Thus, insider is a person who is either a connected or deemed to be connected person and who is expected to have an access to unpublished price sensitive information. The insiders may be of two categories—primary insiders and secondary insiders. Primary insiders include directors of companies and stock exchanges, merchant bankers, registrars, brokers of the company, top executives, auditors, and bankers. Secondary insiders include dealers, agents and other employees having access to price sensitive information due to their proximity with the company.

9.9.1 Price Sensitive Information

Price sensitive information means any information which relates directly or indirectly to a company and which, if published, is likely to materially affect the prices of securities of the company. The following shall be deemed to be price sensitive information:

- Periodical financial results of the company
- Intended declaration of dividends (both interim and final)
- Issue of securities or buy-back of securities
- Any major expansion plans or execution of new projects
- Amalgamation, merger or takeovers
- Disposal of the whole or substantial part of the undertaking
- Significant changes in policies, plans or operations of the company
- Any other information as may affect the earnings of the company

Insider trading means the following three activities:

(i) Dealing in securities
(ii) Communicating information
(iii) Counselling others for trading

9.9.1.1 Dealing in Securities

Dealing in securities means purchase and sale of securities including agreement to purchase or sell. Dealing may be done by the insider himself or through agent. But, this dealing must be based on some price-sensitive information to which the insider has an access because of his position.

9.9.1.2 Communicating Information

Communicating information refers to any communication of price sensitive information which is not known to the public and which insider could have known because of his position. The person using the position to communicate the information is involved in insider trading and not the person receiving the information.

9.9.1.3 Counselling Others for Trading

Counselling others for trading involves the act of exhorting or advising others to trade on some sensitive information not made to public. The counsellor in possession of sensitive information not only communicates the information but also persuades the person to trade in the security. The person who is counselling is guilty of insider trading.

9.9.2 Argument against Insider Trading

The basic argument against insider trading is that insiders should not be permitted to get undue advantage over the uninformed traders. If people fear that insiders will regularly profit at their expense, they will not be interested in holding such securities at all. Thus in the presence of insider trading, interests of ordinary investors will suffer. Hence, insider trading should be banned to protect the interests of the common investors. Curbing insider trading will help protect and promote the interest and reputation of the company, besides helping maintenance of confidence in stock exchange operations and the financial system as a whole.

One argument in favour of insider trading states that such trading helps in the process of price discovery in the markets. Through insiders, the markets are made aware of developments within a company which otherwise they would not be aware of. But the problem is that insider trading appears to be always harmful to some investors and in the long run investor confidence is lost.

9.10 ROLE OF SEBI IN REMOVING INSIDER TRADING

To curb the practice of insider trading, SEBI has framed the SEBI (Prohibition of Insider Trading) Regulations, 1992 which has been amended in 2002. Under Chapter II Regulation 3–SEBI has dealt with prohibition on dealing, communicating or counselling on matters relating to insider trading. Regulation 4 makes an insider guilty of insider trading if he deals in securities in contravention of the provisions of Regulation 3. A penalty up to ₹5 lakh can be imposed on an insider who indulges in insider trading.

Chapter III of Insider Trading Regulations deals with investigation. SEBI may order investigation on the basis of complaints received from investors or intermediaries or any other person. It may also initiate investigations *suo-moto* upon knowledge or information in its possession to protect the interests of the investors in securities. Regulation 6 deals with the procedure for investigation. Investigation against an insider should be conducted by giving reasonable notice to the insider. The notice may also be waived by the Board if it is satisfied that there is no need of giving such notice in the interest of investors or in public interest.

Regulation 7 provides the **obligations of insider during the process of investigation**. When an investigation by SEBI has been ordered, the insider is under obligation (i) to produce to the investigating authority such books, accounts and other documents in his custody, and furnish the statements relating to transactions in the security market, and (ii) to allow investigating authority access to his premises and books, records, documents and so on, required for such investigation. It shall be the duty of every director, officer and employee of the insider to give to the investigating authority all assistance and co-operation in connection with the investigation.

Regulation 11 provides for **orders by the Board.** SEBI may, on the basis of investigation report initiate the following actions towards curbing insider trading: (i) Criminal prosecution against the insider, and/or (ii) Giving necessary directions to insiders for protecting the interest of investors, and for due compliance with the provisions of the SEBI Act, Rules and Regulations.

SEBI can give the following directions:

- It can direct the insider not to deal in securities in any particular manner.
- It can prohibit the insider from disposing of any of the securities acquired in violation of these regulations.
- It can restrain the insider to communicate or counsel any person to deal in securities.
- It can declare the transaction(s) in securities null and void.
- It can direct the person who acquired the securities in violation of these regulations to deliver the securities back to the seller.
- It can direct the person who acquired the securities in violation of these regulations to transfer an amount or proceeds equivalent to the cost price or market price of securities, whichever is higher, to the investor protection fund of a recognised stock exchange.

Regulation 12 provides for policy on disclosure and internal procedure for prevention of insider trading. Further, SEBI has directed all listed companies and organisations associated with securities markets to frame a code of internal procedures and conduct as near as possible to the model code specified in schedule I of the regulations.

SEBI has suggested that companies work out and initiate the following actions in order to prevent the insiders gaining access to unpublished information:

- Companies should initiate action to identify the types of information that could be considered to be price sensitive in relation to the business of the company and its subsidiaries.
- Corporates shall initiate action to identify the types of employees and officers who are likely to have access to such price sensitive information.
- Companies shall initiate action to identify the types of controls that are put in place in order to handle the price sensitive information, so as to publish such information wherever possible.
- A company may prescribe certain norms to be followed by all officers and employees of the company in dealing with the company's own shares. The norms may include the time periods during which time the company employees and officers are not to deal in the company's shares.
- Companies may strive to obtain declaration from employees and officers including transactions done by their relatives to purchase and sell the shares of the company.
- Companies may prescribe necessary procedure for handling information which is likely to affect the price of the securities of other companies in situations such as mergers, take-overs and so on.

Although SEBI has formulated very wide guidelines for prevention of insider trading and goes on revising them in the light of new experiences to make them investor friendly, much depends on the attitude of the regulatory body to implement the regulations in letter and spirit.

The occurrence of scams in the market simply points out the sorry state of the surveillance system of regulatory authority. So unless this deficiency in the monitoring system is removed, no amount of rules and regulations will be sufficient to eliminate the menace of insider trading from our security market.

SUMMARY

S.1 Meaning of Investors' Protection

While investing his surplus funds, an investor has three objectives: (i) safety of invested funds, (ii) liquidity position of invested money, and (iii) a fair rate of return on invested money. Investors' protection means ensuring that the investor can achieve these three objectives as far as possible. In general, investors' protection means protecting investors from various malpractices.

S.2 Importance of Investors' Protection

Importance of investors' protection can be understood by considering the following points: (i) creation of proper investment climate, (ii) creating discipline in the market, (iii) building up investors' confidence, (iv) creating a sense of responsibility, (v) ensuring transparency in dealings and disclosures, (vi) development of capital market, and (vii) consciousness of investors.

S.3 Mechanisms of Protecting Investors

The mechanisms through which investors' interests can be protected can be provided through passing a set of Acts and Regulations as well as through the setting up of certain regulatory bodies. Different Acts are: the Companies Act, 1956; Securities Contracts (Regulation) Act, 1956; Depositories Act, 1996; SEBI Act, 1992 and so on. Different bodies are: SEBI, Company Law Board, Department of Company Affairs, Ministry of Finance, RBI and so on.

S.4 Forces Hampering the Interests of Investors

Different forces which hamper the interests of investors are:

(i) Insider Trading
(ii) Price Rigging
(iii) Lack of Transparency
(iv) Excessive Speculation

S.5 Grievances Concerning Stock Exchange Dealings

Main grievances which the investors have concerning stock exchange dealings are as follows: (i) various grievances of investors related to companies, and brokers, (ii) excessive volatility, (iii) prevalence of various unethical practices, (iv) not conducive to small investors, (v) payment crisis, (vi) oligopolistic nature of market, (vii) organisational and structural imbalances, (viii) lack of secondary debt market.

S.5 SEBI Guidelines Regarding Rights and Responsibilities of Investors

SEBI has published detailed guidelines regarding rights and responsibilities of investors in shares and debentures. The rights are not necessarily absolute. Investors have also certain responsibilities.

S.6 Grievance Redressal Cells in Stock Exchanges

Grievance redressal refers to the process of looking into investors' complaints and giving solutions to the complaints. Grievance redressal cells have been set up in all the major stock exchanges of India. The functions of grievance redressal cells are as follows: (i) receiving and recording grievances, (ii) calling upon the defaulters, (iii) calling upon aggrieved investors, (iv) appealing to the Securities Appellate Tribunal, (v) building up fair picture of stock market, and (vi) publishing different information.

S.7 Redressal of Grievances of Investors

Apart from grievance redressal cells of stock exchanges, there are other institutions for the redressal of grievances of investors. Among these other institutions notable are: SEBI, Company Law Board, Judiciary (or, Court) and Media.

SEBI has taken a number of measures to safeguard the interests of investors. It has also established a comprehensive investor grievances redressal mechanism. SEBI also tries to educate investors about the capital market. SEBI has set up ombudsman for the capital market in 2003 to redress the grievances of the investors.

The Company Law Board has been constituted under the Companies Act 1956. It performs an important role in protecting the interests of investors. National Company Law Tribunal set up under Companies (Amendment) Act 2002 has replaced Company Law Board.

The Judiciary (or, the Court) also plays an important role in the redressal of grievances of investors. Different Acts have enacted different situations when a reference should be sought from the court.

Print and electronic media play three types of roles in protecting the interests of the investors. These three roles are: (i) investigative role, (ii) advertising role, and (iii) advisory role.

S.8 Insider Trading

Insider trading may be defined as the sale or purchase of securities by persons who hold price sensitive information about the company. An insider is a person who is connected with a company and who is reasonably expected to have access to unpublished price sensitive information in respect of securities of the company. Insiders may be of two categories—primary and secondary. Price sensitive information means any information which relates directly or indirectly to a company and which, if published, is likely to materially affect the prices of securities of the company. Insider trading means the following three activities: (i) dealing in securities, (ii) communicating information, and (iii) counselling others for trading.

The basic argument against insider trading is that insiders should not be permitted to get undue advantage over the uninformed traders. In the presence of insider trading, interests of ordinary investors will suffer.

S.9 Role of SEBI in Removing Insider Trading

To curb the practice of insider trading, SEBI has framed SEBI (Prohibition of Insider Trading) Regulations, 1992 which has been amended in 2002. SEBI has come out with the necessary directions regarding the prohibition of insider trading. SEBI even levies penalty up to ₹5 lakh on an insider who indulges in insider trading. It can also order investigation if circumstances exist for the suspicion of the occurrence of insider trading. SEBI is empowered to initiate actions towards curbing insider trading. In addition, SEBI has suggested companies to work out and initiate necessary actions to curb insider trading.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. What is investors' protection?
2. In which year was the SEBI Act passed?
3. In which year was the Company Law Board constituted?
4. What do you mean by insider trading?
5. Who is an insider?
6. What is price rigging?
7. Name two grievances of investors related to a company.
8. Name two stock exchanges of India which hold the lion's share of the dealings in stock exchanges.
9. State two rights of investors as shareholders of a company.
10. State two rights of debenture holders of a company.
11. Name two responsibilities of investors.
12. State two objectives of setting up of grievance redressal cells.
13. State two functions of grievance redressal cells.
14. What is the name of the grievance redressal cell of Bombay Stock Exchange?
15. State two functions of ombudsman.
16. What is price sensitive information?

B. Medium Answer-Type Questions (4–5 marks each)

1. Briefly discuss the functions of Grievance Redressal Cell of stock exchange in India.
2. Discuss in brief the role of stock exchanges in investors' protection.

3. State the role of court in investors' protection.
4. State the role of media in investors' protection.
5. Explain why investors' protection is important.
6. Write a short note on insider trading.
7. What are the grievances of investors against stock exchange dealings?
8. Discuss the SEBI guidelines regarding the rights and responsibilities of investors.
9. Discuss the objectives of grievance redressal cells in stock exchanges in India.
10. Write a short note on the grievance redressal cell of the Bombay Stock Exchange.
11. Write a short note on the grievance redressal cell in National Stock Exchange.
12. Discuss the role of SEBI in the redressal of grievances of investors.
13. Write a short note on the Ombudsman Scheme of SEBI.
14. Discuss the role of Company Law Board in investors' protection.
15. Discuss the role of SEBI in removing insider trading.

C. Long Answer-Type Questions **(10 marks each)**

1. Discuss the importance of investors' protection. **(Section 9.2)**
2. What are the mechanisms in India through which protection of investors is offered? **(Section 9.3)**
3. Discuss the forces hampering the interests of investors in the capital market of India. **(Section 9.4)**
4. State the main grievances of investors in relation to stock exchange dealings in India. **(Section 9.5)**
5. Discuss SEBI guidelines regarding rights and responsibilities of investors. **(Section 9.6)**
6. Discuss the objectives and functions of grievance redressal cells in stock exchanges. **(Section 9.7)**
7. Write a note on the grievance redressal cell in Bombay Stock Exchange. **(Section 9.7.1)**
8. Write a note on the grievance redressal cell in National Stock Exchange. **(Section 9.7.2)**
9. Discuss the role of SEBI in the redressal of grievances of investors. **(Section 9.8)**
10. Discuss the role of Company Law Board in the redressal of investors' grievances. **(Section 9.8.2)**
11. Discuss the role of court in the redressal of grievances of investors. **(Section 9.8.3)**
12. Discuss the role of press in the protection of interests of investors. **(Section 9.8.4)**
13. Define insider trading. Who is an insider? What is price sensitive information? State the basic argument against insider trading. **(Section 9.9)**
14. Discuss the role of SEBI in removing insider trading in Indian capital market. **(Section 9.10)**

UNIT

10 FINANCIAL SERVICES

UNIT OUTLINE

SUBJECT MATTER OF THE UNIT

In this unit, we shall discuss various aspects of financial services, such as, concept and activities of financial services, various kinds of financial products and services and so on. Some of these financial services are provided by merchant banks. We shall consider the functions of merchant banks, their difference with commercial banks, merchant banking in India, SEBI guidelines in respect of merchant banking, and so on. Credit rating is an important financial service provided by the credit rating agencies. Hence, we have considered the meaning of the concept of credit rating, its features, and types. Various

(*Contd.*)

merits and demerits of credit rating have also been discussed. A brief description of credit rating agencies in India and limitations of credit rating in India have also been given at the end of this unit.

10.1 CONCEPT OF FINANCIAL SERVICES

In a broad sense, the term financial services means 'mobilising and allocating savings'. It includes all activities involved in the transformation of savings into investment. The term 'financial service' can also be called 'financial intermediation'. It is a process by which funds are mobilised from a large number of savers and made them available to all those who need it and particularly to the investors of the industrial sector. Thus, financial services are very important for industrial development of an economy.

10.2 ACTIVITIES OF FINANCIAL SERVICES

Financial services cover a wide range of activities of financial intermediaries. These activities can broadly be divided into two categories. They are:

(i) Traditional activities
(ii) Modern activities

10.2.1 Traditional Activities

Traditional activities of financial intermediaries include those activities which are relatively old and which are being performed by them since their inceptions. These activities can again be divided under two heads, namely,

(i) Fund-based activities, and
(ii) Non-fund-based activities, or fee-based activities

We briefly mention them one by one.

10.2.1.1 Traditional Fund-Based Activities

Traditional financial services which come under fund-based activities are the following:

- Underwriting of or investment in shares, bonds, debentures and so on of new issues (activities in primary market).
- Investment in old and existing securities (secondary market activities).
- Participating in money market instruments like commercial papers and certificates of deposits, discounting of treasury and commercial bills and so on.
- Involving in equipment leasing, hire-purchase, venture capital, seed capital and so on.
- Dealing in foreign exchange market activities.

10.2.1.2 Traditional Non-Fund-Based or Fee-Based Activities

Non-fund-based or fee-based activities are, as the very name suggests, are those financial activities or intermediation which financial intermediaries provide in exchange of a commission or service charge or fee. Traditionally, financial intermediaries provide some non-fund based activities or fee based activities. Now-a-days, customers, whether individual or corporate, are not satisfied with mere provision of finance. They expect some other services from these financial companies. Hence, a wide variety of services have been provided by these companies. The major non-fund-based activities are the following:

- Management of pre-issue and post-issue activities on behalf of a company in accordance with rules and regulations.
- Arrangement for the placement of capital and debt instruments of the customer company to investment institutions.
- Arrangement of funds from financial institutions for the customer's project cost or working capital requirements.
- Assistance to the customer in the process of getting all government permissions and other clearances.
- Corporate counselling on various financial matters.
- Portfolio management, i.e., determination of optimum combination of financial assets.
- Arrangement of mergers and acquisitions on behalf of the clients.

10.2.2 Modern Activities

Modern activities of the financial intermediaries are those activities which have evolved after the spread of joint stock companies or the corporate sector in the world economy during the second half of the 20th century. So, these are relatively new or modern activities. Most of these activities are in the nature of non-fund-based activities or fee-based activities. Some of these major modern activities of the financial intermediaries may be mentioned as follows:

- Providing project advisory services. It ranges from the preparation of project report till the starting of the project. More specifically, it includes preparation of project report, raising of funds, obtaining government approval and so on.
- Acting as trustees to the debenture holders.
- Planning for mergers and acquisitions on behalf of customers and assisting for their smooth carry out.
- Guiding corporate customers in their capital restructuring.
- Suggesting suitable change in management structure of the corporate customer.
- Preparing appropriate schemes for sick units for their reconstruction.
- Providing advice to the investors on hedging of various risks associated with various financial instruments.
- Managing the portfolio of large public sector units.
- Undertaking risk management services of the customers like insurance services, buy-back options and so on.

- Advising the clients in selecting the best source(s) of funds.
- Guiding the clients in the minimisation of the cost of debt and in the determination of the optimum debt-equity ratio.
- Undertaking services relating to capital market. They mainly include the following services:
    - o Clearing services
    - o Registration and transfers
    - o Safe custody of securities
    - o Collection of income on securities

Thus, we see that financial services mean a wide range of activities – a variety of operations of different types. As already mentioned, most of these activities are non-fund-based or fee-based in nature.

10.3 NEW FINANCIAL PRODUCTS AND SERVICES

In today's free market concept, a financial service company or an intermediary has to play a dynamic role. The clients of such a company expect from it new products and services to meet their varied requirements. Hence, many new financial products and services have been emerging in the capital market. Some of them are mentioned below:

10.3.1 Merchant Banking

Merchant banking includes a wide range of activities. These are management of customers' securities, portfolio management, project counselling and appraisal, underwriting of shares and debentures and so on. Banks which provide such services are called merchant banks.

10.3.2 Loan Syndication

When a large corporate house or a government undertaking wants to borrow a huge amount, a single bank may not be able or willing to provide such a huge sum. Then a number of banks join together and form a syndicate to provide the loan. This act of providing a huge loan by forming a syndicate or consortium is called loan syndication. The risk of the loan is also shared among the syndicate members. In many cases, merchant banks perform this act of loan syndication.

10.3.3 Leasing and Hire Purchase

In countries like USA, UK and Japan, equipment leasing is very popular among financial intermediaries and corporate houses. There, about 25 per cent of plant and equipment are financed by leasing companies. Financial intermediaries which provide plants and equipment to the corporate houses are called leasing companies. In India also, many financial companies or intermediaries have started equipment leasing business and hire purchase business.

10.3.4 Mutual Funds

A mutual fund collects the savings of the public by selling units of small denominations and invests the pooled sum in a diversified portfolio. It thus spreads and minimises the risks. It provides investment opportunities for small investors who cannot participate in the equities of big companies.

10.3.5 Factoring

Factoring refers to an arrangement under which a financial intermediary takes the credit risk in the collection of book debts for its clients. The entire responsibility of collecting the book debts passes on to the financial intermediary called 'factor' in this arrangement. Hence, the whole arrangement is called factoring. The factor provides credit information, collects debts, monitors the sales ledger and provides finance against debt. The financial intermediary or the factor gets a fee or commission for such factoring.

10.3.6 Forfaiting

Forfaiting is a technique by which a financing agency discounts an export bill and pays ready cash to the exporter. The financing agency is called forfaitor and the arrangement is called forfaiting. Under this arrangement, the exporter is protected against the risk of non-payment of debts by the importers. The forfaitor (financial agency) undertakes the responsibility of collection of export bills. The exporter need not bother about it.

10.3.7 Venture Capital

Venture capital simply means initial funds for risky operations of a firm. Financial intermediaries provide venture capital in the form of equity participation. They provide finance not only for 'start-up capital' but also for 'development capital'.

10.3.8 Custodial Services

Under custodial services, financial intermediaries mainly provide services to their clients, particularly to foreign investors, for a fee. Custodial services include keeping of shares and debentures of the clients, collection of interest and dividend on behalf of them, reporting of matters of corporate developments to the clients and so on. These services are provided against a fee, i.e., custodial services are fee-based services.

10.3.9 Corporate Advisory Services/Corporate Counselling

Some financial intermediaries provide advisory services exclusively to their corporate customers. This service is also referred to as corporate counselling. New avenues of finance like Euro loans, Global Depository Receipts, American Depository Receipts (ADRs) and so on are available today to corporate customers mainly because of these corporate advisory services or corporate counselling. Hence, such services are very helpful to and popular among corporate customers. This service in many countries is mainly provided by merchant banks.

10.3.10 Securitisation

Securitisation is a technique by which a financial company converts its illiquid, non-negotiable and high value financial assets into small value, tradable and transferable securities. It helps the organisation to raise cash by issuing tradable securities. Securitisation thus increases the liquidity of various securities and it ultimately helps the industrial sector.

10.3.11 Derivative Security

A derivative security is a security whose value depends on the values of other basic assets backing the security. It is basically used as a risk management tool. Financial intermediaries can go for derivatives in order to reduce or hedge risk.

10.3.12 Line of Credit (LOC)

Line of credit (LOC) is an arrangement of a financial institution/bank of one country with another financial institution/bank/agent to support the import of goods and services. It enables the importers to import on deferred payment terms. This may be backed by a guarantee furnished by the institution/bank in the importing country. The LOC helps the exporters get payment immediately as soon as the goods are shipped. The payment is made from the pool account with the financing agency which does this job for a fee. The amount is debited from the account of the borrower agency/importer. The LOC saves a lot of time and money in transactions of goods and services as a source of foreign exchange.

10.3.13 Housing Finance

With the setting up of National Housing Bank (NHB) in 1988 by the RBI, housing finance has emerged as a fund-based financial service. Today, a number of financial institutions in the public, private and joint sectors have entered in the field of housing finance. Some of these institutions are Housing Development Finance Corporation (HDFC), Housing and Urban Development Corporation (HUDCO), Housing and Infrastructure Development Corporation (HIDCO), SBI Home Finance Limited (SBI HFL), LIC Housing Finance Limited (LIC HFL), ICICI Home Finance Company Limited (ICICI HFC), GIC Housing Finance Limited (GIC HFL), and State Housing Finance Societies (SHFSs).

10.3.14 Credit Cards

Credit cards are good substitutes for cash and cheques. The issuer company issues credit cards to its customers depending on their credibility. The card holder can purchase certain goods and services through these cards without any immediate cash payment. The use of this card is safe and convenient. The issuer company charges a fee for this service from its customers.

10.3.15 Bill Discounting

Bill discounting provides short-term trade finance. Discounting houses discount trade bills and thus provide liquidity to these bills. It helps in the expansion of trade and commerce in an economy. Discount market in India is, however, not so developed.

Thus, we see that various new financial services have been introduced in the financial market of India.

10.4 NEW/INNOVATIVE FINANCIAL INSTRUMENTS

10.4.1 Meaning of New Financial Instruments

A new financial instrument may be defined as one which possesses some new features compared to the features of presently available instruments. If defined in this manner, then very few instruments are completely new. Many instruments have just added new features to the conventional financial instruments to make them marketable. Equity shares, preference shares and debentures are conventional financial instruments. They may be partly convertible, fully convertible and non-convertible. When certain new features are added to these conventional financial instruments, they turn into new financial instruments. For example, if a warrant to the non-convertible portion of a debenture is added, the debenture becomes a new financial instrument (A warrant is a corporate-created option to purchase a stated number of securities at a specified price within a specified time).

10.4.2 Reasons for Emergence of New/Innovative Financial Instruments

After the introduction of new economic policy by the government of India, the Indian financial system has undergone a significant transformation. Various reforms have been introduced in the financial sector of India in the 1990s. Important among those reforms are deregulation of lending rates, entry of private sector institutional investors (both Indian and foreign), free pricing of equity shares, opening up of the banking sector to the private capital, allowing Indian companies to do business in foreign capital markets and so on. All these have made the Indian financial sector highly competitive. On the one hand, there has been a huge demand for funds from both corporate and financial institutions. So, there is an intense competition among them to capture a sizeable part of the investors' funds. On the other hand, investors have been growing more and more fastidious. Their needs continue to change over time. Hence, to meet the differing requirements of both issuers and investors, it has become imperative for issuers (borrowers) to innovate and design new financial instruments.

We may summarise the reasons for innovations in financial instruments in the following manner:

- Every product, including financial product, requires constant re-engineering. Further, the product is to be modified as per needs of the consumers. If there are repeated offerings of the same product, investment is not encouraged. Hence, it is necessary to make new designs of financial products.
- In recent years, interest rates have steadily declined world over, including India. This trend has forced the corporate sector to consider the introduction of new financial instruments.

- Investors do not want to be shackled with long-term instruments. They prefer instruments with varying maturity periods and various options. To meet these preferences of the investors, borrowers have felt the urgency to introduce innovative financial instruments.
- The traditional trend of collecting finance from financial institutions has changed. Now, companies prefer to collect finance from the capital market. To raise funds from capital market, companies are now compelled to offer newer attractive terms even on debt securities.
- Due to some scams in the capital market in recent years, investors have been hesitant to put their funds in the capital market. To remove this hesitation and diffidence among investors, attractive new financial instruments are needed to be introduced in the capital market.

As a result of the above-mentioned factors, many innovative financial instruments have been introduced in the Indian capital market in the post-reforms period. These instruments have been able to raise a considerable amount of funds from the market. Various RBI reports on currency and finance show that the amounts raised through these innovative instruments have steadily increased over the years in the recent past.

10.4.3 Major New/Innovative Financial Instruments

A host of new/innovative financial instruments have been introduced in the financial market of India in the recent past. We mention below some of those new major instruments:

Floating Rate Bonds: The interest rate on these bonds is linked to a benchmark/anchor rate and it is not fixed. It takes care of the falling market or provides a cushion in times of falling interest rates in the economy. In India, the SBI was the first to introduce this type of bond. Its term deposit rate serves as the anchor rate. The Treasury bill rates can also be the anchor rate.

Zero Interest Convertible Debentures/Bonds: These instruments do not carry any interest till the time of conversion. They are converted into equity shares of the issuing company after a certain period of time.

Zero Coupon Bonds or Deep Discount Bonds: In the case of such bonds, there will be no interest payments. Hence, they are sold at a large discount on their nominal/face value.

Index-Linked Bonds or Indexed Bonds: These are instruments having a fixed maturity. Their maturity value is linked to the price index as on the date of maturity. Hence, they are inflation free financial instruments.

Option Bonds: These bonds may be cumulative or non-cumulative as per option of the buyer at the time of investment. In the case of cumulative bonds, interest is paid on maturity. On the other hand, in the case of non-cumulative bonds, interest is paid periodically.

Medium-Term Debentures: As the name suggests, these debentures have a medium term maturity (normally, 1 to 3 years). These debentures are secured and negotiable. Hence, they are highly liquid.

Variable Rate Debentures: These are debt instruments and carry a compound rate of interest. This rate varies from time to time according to some pre-determined formula. Hence, they are called 'variable' rate debentures.

Convertible Bonds: A convertible bond can be converted into equity shares either fully or partially. This conversion may be optional (depending on the option to be exercised by the holder of the debenture) or non-optional (automatic). This is an innovative way of investment for the investors. Here, the investors get a fixed interest for the first few years before conversion. After that, they can become the equity shareholders at their own option. If the investors do not exercise their option in favour of conversion, they will get back the principal amount of investment on redemption.

Debentures with Call and Put Options: In the case of debentures with 'call' feature, the issuing company (the seller) has the option to redeem the debentures at a certain price before maturity. In the case of debentures with 'put' feature, the investor (the buyer) has the option to sell them before maturity.

Easy Exit Bond: As the name suggests, the bond allows the investor to encash the bond after a certain period. It thus makes exit easy for the investor and hence the name of the bond.

Retirement Bond: This type of bond gives the investor an assured monthly income for a fixed period after the expiry of the 'wait period' chosen by him. The longer the wait period, the higher will be the monthly income. Further, the investor gets a lump sum amount on maturity.

Regular Income Bond: This bond pays interest half yearly with the facility of early redemption. The investor is assured of regular and fixed income.

Infrastructure Bond: This bond is issued to raise funds for the development of infrastructure. It provides tax relief to the investors.

Convertible Bonds with a Premium Put: These are bonds issued at values with a put option. This means that the bond holder can redeem the bonds for more than their face value.

Debt with Equity Warrant: These are bonds issued with warrants for the purchase of shares. A warrant is a corporate-created option to purchase a stated number of shares at a specified price within a specified time. These warrants are separately tradable.

Dual Currency Bonds: These are bonds which are denominated and pay interest in one currency and are redeemable in another currency. Such bonds facilitate interest rate arbitrage between two markets.

Yankee Bonds and Samurai Bonds: If bonds are raised in the USA, they are called Yankee bonds. On the other hand, if bonds are raised in Japan, they are called Samurai bonds.

Flip-Flop Notes/Bonds: It is a kind of debt instrument which permits investors to switch between two types of securities. For example, it permits investors to switch over from a long-term bond to a short-term fixed rate note. Literally, the word 'flip-flop' means 'to make abrupt reversal of policies'. Flip-flop notes give the investor opportunity to switch over from one type of security to another type of security and hence the name of the instrument.

Floating Rate Notes: These are debt instruments which facilitate periodic interest rate adjustments. These are very much similar to floating rate bonds.

Loyalty Coupons: These are entitlements to the holder of debt instruments for two to three years to exchange them into equity shares at discounted prices. To get this facility, the original subscriber must hold the debt instruments for the said period.

Global Depository Receipt (GDR): A global depository receipt is a dollar-denominated instrument. It is traded on a stock exchange in Europe or the USA or both. It represents a certain number of equity shares. The shares are issued by a company to an intermediary called depository. The shares are registered in the name of the depository which subsequently issues the GDRs to the investors.

American Depository Receipts (ADRs): ADRs are negotiable instruments, denominated in dollars, and issued by US depository bank. A non-US company, which seeks to enlist in the US, deposits its shares with a bank and receives a receipt. This receipt enables the company to issue ADRs. These ADRs represent ownership of deposited shares. Hence, they serve as stock certificates and are used interchangeably with ADRs. As ADRs are listed on the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ) system, ADR issues offer access to the US institutional and retail markets.

Besides these instruments, there are some other innovative instruments. Some of them are Secured Premium Notes (SPNs), Non-convertible Debentures with Equity Warrants, Carrot and Stick Bonds, European Currency Unit (ECU) bonds and so on.

10.5 MERCHANT BANKING

10.5.1 Definition

Merchant banking may be defined as an institution which covers a wide range of activities, such as, management of customer services, portfolio management, credit syndication, counselling, and insurance. In India, many public and private sector banks are now engaged in merchant banking. Some of these banks are State Bank of India (SBI), Punjab National Bank (PNB), Bank of Maharashtra, ICICI Bank, Yes Bank, Axis Bank, Bank of America, and Deutsche Bank. Some

Indian financial intermediaries, public and private, also provide merchant banking services. Important among them are IFCI Financial Services Ltd., Bajaj Capital Ltd., Tata Capital Markets Ltd., Reliance Securities Limited, Kotak Mahindra Capital Company Ltd., and so on. Some foreign companies are also offering merchant banking services in India. Notable among them are Goldman Sachs (India) Securities Private Ltd., Citigroup Global Markets India Private Limited, Morgan Stanley India Company Private Limited, and Barclays Securities (India) Private Limited.

10.5.2 Origin of Merchant Banking

Merchant banks are in fact the first modern banks. They emerged in the middle ages from the Italian grain and cloth merchants. Merchant banking started in the 11th century in Europe, particularly in Italy, England and France. There, merchants of cereal crops and silk financed trades of various kinds and of various goods. Merchant banking in a developed form started in Britain in the 13th century when a few firms engaged themselves in foreign trade and finance. Based on this British model, the Dutch and the Scottish traders started merchant banking. Formal merchant bank in an institutional form in the UK came into existence in the early 19th century, the oldest being the Barings Bank.

Modern merchant banking originated through the entry of London merchants in financing foreign trade through acceptance of bills during the post-Industrial Revolution period. Later, the merchants assisted the governments of underdeveloped countries in raising long-term funds. As an example, we may mention the managing agency system in India which developed during the second half of the 19th century and early years of the 20th century. The merchants provided finance by floating bonds in the London money market. Later, these merchants extended their activities to domestic business also. They helped the business and corporate houses through syndication of long-term and short-term finance, underwriting of new issues, portfolio management and so on. During the post second world war period, there was a rapid growth of merchant banking. Many innovative instruments were introduced and various financial centres like Singapore, Hong Kong, Kuwait, Dubai and so on developed during this period. Today, most commercial banks are introducing merchant banking services. Thus, they are gradually transforming themselves into merchant banks.

10.5.3 Functions/Services of Merchant Banks

Merchant banks perform some important functions and thereby provide many essential services to the corporate sector of an economy. Due to rise in competition in the financial sector in recent years, they are now forced to perform a number of services both for the issuing companies (borrowers) as well as the investors (lenders). Today, the range of financial activities which comes under the purview of merchant banking is really very wide. Various functions performed by merchant banks of today may be classified under following four groups:

1. **Advisory Services:** It generally includes project counselling and corporate counselling.
2. **Market Operations:** It includes placement and distribution of different securities of the issuing companies, portfolio management of the issuing companies as well as of

institutional investors and so on.

3. **Management of Capital Issues:** It includes pre-issue activities as well as post-issue activities. The main pre-issue activities are preparation of prospectus, submission of draft offer documents to the SEBI and launching of the issue. The main post-issue activities are determination of basis of allotment (BOA), giving advertisement in newspapers regarding different aspects of the issue, and submission of post issue reports to the SEBI.
4. **Non-Fund-Based or Fee-Based Financial Services:** These services include a host of activities like venture capital financing, foreign currency financing, deferred payment guarantee, loan syndication, underwriting of public issue, advisory services relating to mergers and takeovers, investment services for non-resident Indians (NRIs), working capital finance, off-shore finance and so on.

Thus, merchant banks today perform a variety of services. Various functions and services of merchant banks may be summarised as follows:

Corporate Counselling: Merchant bankers give suggestions and opinions to the client corporates on various financial matters. They thus help corporate houses to solve their problems and to achieve better performance.

Project Counselling: Corporate counselling by merchant banks includes project counselling also. This project counselling again includes preparation of project reports, project finance and project appraisal. It also includes filling up of application forms with relevant information for obtaining funds from financial institutions.

Loan Syndication: When a large corporate house or a government department seeks a huge amount of loan, it may not be possible for a single merchant bank or financial institution to finance that loan. Merchant bankers form a syndicate or consortium for meeting such loan requirements of large volume of their clients. Loan syndication refers to assistance rendered by merchant banks to get mainly term-loans for projects. Such loans may be obtained from a single development finance institution or a syndicate or consortium of banks and/or financial institutions. Merchant bankers help corporate clients to raise syndicated loans from commercial banks and other financial institutions.

Issue Management: Issue management broadly involves marketing of corporate securities, such as, equity shares, preference shares, debentures or bonds and so on, by offering them to the public. Merchant bank acts as intermediary by transferring capital from its owners to its potential borrowers.

Underwriting of Public Issue: Merchant bankers underwrite public issue. Underwriting is an arrangement in which merchant banks provide guarantee to purchase unsold securities issued by a company. Thus, they reduce the risk of under-subscription borne by corporate houses. Further, issues backed by well-known underwriters generally receive a high premium from the public. This enables the issuing company to sell its securities quickly. Thus, through underwriting services, merchant bankers make raising funds relatively easy for the corporate houses.

Managers, Consultants or Advisers to the Issue: SEBI guidelines insist that all issues should be managed by at least one authorised merchant banker. The managers to the issue assist in the drafting of prospectus and application forms, completion of formalities under the Companies Act, transfer and listing of shares of the company on the stock exchange and so on.

Portfolio Management: Portfolio refers to a particular combination of different types of financial assets. Portfolio management refers to maintaining proper combination of different types of financial assets so that it gives maximum return with minimum risk. Merchant bankers provide portfolio management service to their clients.

Advisory Service Relating to Mergers and Takeovers: A merger is a combination of two or more companies into a single company in order to get some extra benefits. A takeover is the purchase of one company by another company. Merchant bankers are the middlemen in settling negotiations between the two or more parties in such cases. Being professional experts, they can safeguard the interests of the shareholders of both the companies.

Off-shore Finance: Merchant bankers help their clients in the following areas involving foreign currency:

- Long-term foreign currency loans
- Joint venture abroad
- Financing exports and imports
- Foreign collaboration arrangements.

Merchant banks render financial services, such as, appraisal, negotiations and compliance with procedural and legal aspects related to off-shore finance.

Non-Resident Investment: Merchant bankers provide advisory services to foreigners also. These services include identification of investment opportunities, selection of securities, investment management and so on. They also advise on purchase and sale of securities, securing necessary clearance from central bank for repatriation of interest and dividend.

Working Capital Finance: Merchant bankers assist their clients in raising working capital from the market. They advise on possible sources from where working capital can be obtained on better terms.

Deferred Payment Guarantee: When a company wants to purchase machinery on deferred payment, the merchant bank arranges the required deferred payment guarantee from banks in favour of the supplier of such machinery.

10.5.4 Merchant Banking in India

Before the enactment of Indian Companies Act, 1956, managing agents in India performed the functions of merchant banking. These agents even continued their activities up to 1970, though on a limited scale.

During the early years of the 19th century, with the development of the company form of organisation in India, there developed a particular system of their management. The companies gave the responsibilities of management to the managing agents for a remuneration. This system was known as Managing Agency System in Indian economic history. A managing agent was a person, firm or company in charge of the whole or a major part of the management of the company, enjoying its authority by virtue of an agreement with the company. The managing agents performed three main functions:

(i) Pioneering and promoting industrial enterprises
(ii) Arranging finance
(iii) Day-to-day management of the industries

In return, managing agents received:

(i) A fixed office allowance for their office expenses
(ii) A commission for rendering managerial services
(iii) A commission for rendering various subsidiary services

More specifically, managing agents acted as issue houses for securities, evaluated project reports, planned capital structure and in some cases provided venture capital to new firms. In a word, managing agents in India were merchant bankers of today. Few share broking firms also functioned as merchant bankers. According to a study of R. K. Nigam, there were as many as 3,944 managing agencies at work in India in 1954–55. However, the managing agents were involved in many corrupt and unhealthy practices specially after the second world war. To stop these activities, the Indian Companies Act, 1956 was passed as per recommendation of the Bhabha Committee (1951). Later, the Patel Committee in its report in 1966, recommended the discontinuation of the managing agency system in the major industries of India. Further, the number and the size of various issues in the primary market were growing rapidly. Hence, the need for specialised merchant banking services was felt in India. For all these factors, the managing agency system gradually disappeared from the scenario of Indian industries. In place of it, modern merchant banking was started.

The merchant banking services *par se* were initially started in India by foreign banks. The National Grindlays Bank started its merchant banking operations in 1967 and the Citibank in 1970. The year 1972 marked the beginning of specialised merchant banking in India. In that year, the Banking Commission recommended the setting up of merchant banking institutions by commercial banks and non-bank financial institutions.

The State Bank of India was the first Indian bank to set up its merchant banking division in 1972. Later, ICICI and then Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank and United Commercial Bank set up their merchant banking divisions. Some private sector merchant banks in India are Kotak Mahindra Capital Company, Karvy Consultants, Escorts

Financial Services Limited, Jardine Fleming India Limited, Bajaj Capital Ltd., Tata Capital Markets Ltd. and so on. After 1983–84, the merchant banking in India grew rapidly mainly due to the growth of new issues in the capital market and adoption of a liberalised policy by the government, particularly during the 1990s.

10.5.5 Distinction between Commercial Banks and Merchant Banks

Commercial banks are those financial institutions which accept deposits from the public that are withdrawable by cheques and which again lend money to the public. On the other hand, merchant banks are those financial institutions which cover a wide range of activities, such as, management of customer services, corporate counselling, project counselling, portfolio management, loan syndication and so on. So, commercial banks and merchant banks are not the same kind of banks. There are some important differences between commercial banks and merchant banks. Those differences may be summarised as follows:

- On the basis of nature of work, commercial banks and merchant banks are different. Commercial banks basically deal with credit and credit-related finance. Their activities are mainly confined to credit proposals, credit appraisal and loan sanctions. On the other hand, the area of activity of merchant-bankers is equity and equity-related finance.
- Commercial banks are governed by the banking regulations. They operate under the control of the Reserve Bank of India (RBI). On the other hand, merchant banks are governed by merchant banking rules. These rules are generally issued by the Ministry of Finance and SEBI.
- Small and big institutions of all types and all kinds of people are the clients of commercial banks. On the other hand, certain selected medium and big industrial companies or corporations and few medium and large savers and investors are the clients of merchant banks.
- Commercial banks and merchant banks are also different on their attitude towards risk. Commercial banks generally avoid risks. They study loan proposals in detail and consider the value of security offered against loans. On the other hand, merchant banks are not risk averters. They accept risks of business houses.
- Activities of commercial banks are asset-oriented while activities of merchant banks are management-oriented.
- Commercial banks can create credit and make a multiple expansion of credit. Merchant banks have no such power.
- Commercial banks are mainly engaged in money market. They mainly deal in short-term credit. Merchant banks are mainly engaged in capital market.
- Commercial banks have to maintain statutory liquidity ratio (SLR) and cash reserve ratio as per instructions of the RBI. However, merchant banks are not required to maintain any such ratio.
- The main sources of revenue of commercial banks are interest on loans provided by them and commission received by them for their services. However, in the case of merchant banks, their remuneration takes the form of fees.

- Commercial bankers are mainly financiers of business houses and firms. But merchant bankers are not only financiers but also advisers and helpers of management. They act as guides to the management. Their activities include project counselling, corporate counselling, loan syndication, portfolio management, underwriting of public issue, advice on mergers and takeovers, off-shore finance and so on. These activities have considerable impact on growth, stability and liquidity of money market. Thus, area and scope of activities of merchant banks are much wider than those of commercial banks. Commercial banks are also important players in the money market, but they act mainly as financiers or providers of liquidity in this market. Their range of service is much limited compared to that of merchant bankers.

Thus, we see that there are important differences in approach, attitude and areas of operations between commercial banks and merchant banks. However, both are essential for overall economic development of a country. One point may be mentioned in this connection. Mainly due to increased competition among commercial banks, most of them are introducing merchant banking activities while continuing with traditional commercial banking activities. Thus, commercial banks are gradually transforming themselves into commercial-cum-merchant banks in recent years.

10.6 SEBI GUIDELINES IN RESPECT OF MERCHANT BANKING

For smooth functioning of merchant banks and to control their activities, the government of India has given some powers to the SEBI. It has passed Securities and Exchange Board of India (Merchant Bankers) Rules, 1992 and Securities and Exchange Board of India (Merchant Bankers) Regulation, 1992. Being empowered by them, SEBI has issued some guidelines in respect of merchant banking. Any individual or organisation desiring to carry on merchant banking activities is required to register with SEBI. At present, a merchant banker must have a registration certificate from SEBI. Without it, nobody, person or organisation, can act as a merchant banker in India.

We mention below some of the relevant rules and regulations of SEBI in respect of merchant banking.

10.6.1 SEBI Regulations regarding Registration and Capital Adequacy Norms

To get registration certificate from SEBI, following conditions should be fulfilled:

- The organisation should be a corporate body other than a non-banking financial company.
- The applicant should run business connected with securities market only.
- The applicant should have qualification in finance, law or business management.
- To be a merchant banker, the applicant should have infrastructure like office space, equipment, and manpower.
- The applicant should have at least two employees with prior experience in merchant banking.
- No associate company of the applicant should be a registered merchant banker.

- The applicant should not be proved guilty of any offence or involved in any securities scam.
- The applicant should have a minimum net worth depending on the category for which the registration is applied for. SEBI has mentioned four categories of merchant banks and required limits of their net worth.

Subject to the fulfilment of above-mentioned conditions and the payment of registration fee, registration certificate is issued. It remains valid for 3 years from the date of issue. Three months before the expiry of the certificate, application for its renewal is to be done. Being satisfied, SEBI renews the registration certificate for a further period of 3 years.

10.6.2 SEBI Guidelines in Respect of Code of Conduct of Merchant Bankers

SEBI has issued a series of guidelines in respect of code of conduct of merchant bankers. We have briefly mentioned the major ones among them below:

- A merchant bank shall maintain integrity, dignity and fairness in the conduct of its business. It shall make all efforts to protect the interests of investors.
- A merchant banker shall fulfil its obligations towards investors in a prompt, ethical and professional manner. It shall try to provide the best possible service to the clients.
- A merchant banker shall try to provide adequate consideration to enquiries from investors, timely and appropriate redressal of their grievances and proper guidance in the event of non-redressal of grievances.
- A merchant banker shall try to provide true and adequate information and no misleading or exaggerated claim to the investors.
- A merchant banker shall see that copies of prospectus, offer document, letter of offer and so on, have been made available to the investor.
- A merchant banker shall not discriminate among its clients.
- A merchant banker shall not divulge any confidential information about his client to anybody else.
- A merchant bank shall not make any false statement or suppress any material fact in any document submitted to the SEBI.
- A merchant banker shall maintain an appropriate level of knowledge and competence in merchant banking. It must employ fit and efficient persons to undertake its jobs.
- A merchant banker shall develop its own internal code of conduct for its employees and officers in order to ensure its efficient and fair operations.
- A merchant banker shall ensure that good corporate policies and governance are in place.
- A merchant bank shall be responsible for the acts, errors or omissions of its employees and agents in respect of business.
- A merchant banker shall not be involved in price rigging or manipulation and in passing of unpublished price sensitive information in respect of securities to anybody in the security market.

- A merchant banker shall provide adequate freedom and powers to its compliance officers for their effective discharge of duties.

10.6.3 SEBI Guidelines in Respect of Maintenance of Books of Accounts, Records and Other Documents

SEBI has also issued some guidelines to the merchant banks for maintaining books of accounts, records and other documents. The main guidelines in this respect are as follows:

- The merchant banker shall have to preserve the books of accounts, records and other documents for a minimum period of 5 years. They include, (i) balance sheet, (ii) profit and loss account, (iii) audit report, and (iv) statement of financial position.
- Every merchant banker shall inform the SEBI about the place where the above mentioned books of accounts, records and documents are maintained.
- Whenever required by the SEBI, the merchant banker would submit the copies of the balance sheet, profit and loss account, and auditor's report for the last five accounting years.
- Every merchant bank shall submit to the SEBI half-yearly unaudited financial results whenever required by the Board.

Apart from these guidelines, the SEBI has issued some instructions to the merchant bankers on the appointment of lead merchant bankers. It has also imposed some restrictions on the acquisition of securities of bodies corporate of merchant banks.

10.7 CONCEPT OF CREDIT RATING

Credit rating is an important financial service provided by credit rating agencies. In a word, credit rating is the act of judging credit worthiness of a company seeking credit. More specifically, credit rating is the act of assigning values to credit instruments by estimating or assessing the ability of the borrower (issuer) company to repay its debt. It is expressed in terms of some predetermined symbols. In other words, credit rating is an assessment of the investment quality of a particular credit instrument issued by a company. Its objective is to inform the investors about the financial standing of a company. It thus seeks to provide guidance to the investors on investment. Credit rating is a fee-based activity, the fee being paid by the borrower company.

10.8 FEATURES OF CREDIT RATING

We may mention some features of credit rating or the major points related to the act of credit rating. That will help us understand the concept of credit rating.

- Credit rating is an assessment of the capacity of an issuer of debt instrument (i.e., borrower company) to repay the debt. This assessment is done by an independent agency called Credit Rating Agency. This credit rating agency collects the relevant data from the company which is to be rated or assessed. On the basis of these data, the rating agency assesses the capacity of the company to honour its debt obligations.

- The ratings are expressed in symbols or code numbers which can be easily understood even by the common people. Symbols like (A+, A, B+, B, …) or, (A, B, C, D, …) or (1, 2, 3, 4, …) and so on, may be used for rating. From these ratings, a company's financial standing or strength can be understood without going into the complicated detail of financial reports. In this connection, it may be mentioned that credit rating is only guidance to the investors. It is not a recommendation to purchase, sell or hold any security.
- Credit rating is generally done for a specific debt instrument. It is not generally done for the company as a whole. Hence, credit rating should not be taken as an indicator of the financial strength and status of the company concerned.
- Credit rating is done by specialised expert and accredited agencies. It is mainly confined to debt instruments. However, efforts have been made to rate equity shares also in occasional cases.
- Credit rating is not a one-time evaluation of credit risk. It is an on-going and continuous appraisal process.
- A credit rating does not create a fiduciary relationship between the credit rating agency (CRA) and the users of the rating.
- A credit rating does not imply that the credit rating agency performs an audit work of a company. Nor does it attest the genuineness of information provided by the borrower company.

In credit rating, although the whole organisation is not rated, it does reflect the strength, soundness of operations, quality of management, organisational behaviour and overall performance of the company being rated. Credit rating may be different for different instruments issued by the same company. This is due to the different nature of obligations of different instruments.

Usually, the credit rating agency (CRA) undertakes the job of rating an instrument on a request by the organisation issuing that instrument. However, once the agency has rated an instrument, it becomes an obligation on the part of the agency towards investors to announce periodic deterioration or improvement in the grade or rating of that instrument, whether the issuer company wants it or not. Unsolicited credit rating also exists in some countries.

While making ratings, the credit rating agencies consider various factors, such as, industry risk, market position, operating efficiency, track record, profitability, liquidity, asset quality and the like, of the borrower company. Credit rating is based on both information provided by the borrowing company and information collected by the credit rating agency independently. After the assignment of the job of assessment, ratings are continuously monitored by the credit rating agency (CRA). The rating activities may be changed, suspended and withdrawn by the agency at any time as a result of new information and/or other circumstances.

In the recent past, the practice of 'country rating' or 'sovereign rating' indicating credit worthiness of a country in the international capital market has been quite common. Two important institutions in this field are Standard and Poor's, and Moody's Investor Service, or Moody's in short. Some other important credit rating agencies in international field are

Fitch Rating (or, Fitch, in short), Egan-Jones Ratings Company, A. M. Best, Japan Credit Rating Agency Limited (JCR), Rating and Investment Information Inc (R&I) and so on. It should be noted that in the case of domestic borrowers, only the specific instruments are rated. However, in the case of country ratings, the whole country or the whole nation is rated. This is somewhat against the basic tenet of credit rating.

10.8.1 Types of Credit Rating

Basically, credit ratings may be divided into three categories on the basis of rating-related products and activities:

(i) Rating of financial products, i.e., ratings of bonds/debentures, commercial paper, bank loans, mutual fund debt schemes, Initial Public Offers (IPOs), various kinds of shares and so on.

(ii) Rating of countries or nations. It is called country rating or sovereign rating.

(iii) Rating of various companies/organisations, e.g., rating of chit funds, rating of corporate houses, rating of real estate builders and developers and so on. In this case, the ability of the company or the organisation to honour its commitments is assessed or rated.

10.8.2 Objectives of Credit Rating

The main objectives of credit rating may be summarised as follows:

- To provide information to the investors about various credit instruments of different companies.
- To help banks and other providers of credit know about the credit-worthiness of their customers.
- To ensure discipline and healthy growth of capital market.
- To provide some idea about the economic condition of a country in the case of country rating.
- To inform the investors about financial standing of various corporate houses and their credibility to raise fund from the market.
- To offer various kinds of advisory services like project counselling, corporate counselling and so on to the business firms.
- To provide information to the investors about the risks and expected returns involved in any investment.
- To provide investors with wider choice of various instruments depending upon their ability to bear risk and diversification plan.

10.9 METHODOLOGY OF CREDIT RATING

Following factors are considered while assessing the instruments of a company by credit rating agencies:

Business Risk Analysis: It includes industry's prospects for growth, its stability, the pattern of its business cycle, vulnerability to technological changes, labour issues and costs and so on.

Financial Analysis: Credit rating agency takes into account capital structure, liquidity position, profitability, cash-flow analysis and so on, of a company. The objective is to assess the financial risk of the company.

Management Evaluation: To rate a debt instrument of a company, the rating agency evaluates the strengths and weaknesses of the company.

Fundamental Analysis: It includes an analysis of liquidity management, profitability, financial position, interests and tax rates sensitivity of the company.

Business Environment Analysis: This includes regulatory environment, operating environment, political environment, financial environment and so on.

Geographical Analysis: While rating a debt instrument, the credit rating agency makes a geographical analysis also. This analysis is undertaken to determine locational advantages of the issuer company.

Rating is not generally based on any predetermined formula which mentions relevant variables and their weights. Further, the emphasis on different aspects varies from agency to agency. Broadly speaking, if the quality of assets of a company depreciates, the rating of a credit instrument of the company downgrades, and *vice versa*.

10.10 FUNCTIONS OF A CREDIT RATING AGENCY

A credit rating agency performs various important functions. In brief, they are as follows:

- A credit rating agency provides an unbiased opinion regarding the capability of a company to serve its debt obligations.
- Credit rating gives an indication of risk and return of a financial instrument.
- For credit rating, investors can easily understand the information about the investment. They need not go into details of the financial statements of the company.
- A credit rating agency provides quality and dependable information. It has trained and professional staff who can assess various financial information. Common public can then enter capital market, shedding off fear and hesitation. This helps capital market to expand.
- Credit rating motivates savers to invest in industry and trade through capital market.
- Credit rating helps the market regulators in promoting stability and efficiency in the securities market.
- Credit rating helps issuers of debt instruments to price their issue correctly and also to reach out to new investors.
- Credit rating helps investors to take a quick decision on investment. It thus saves investors' time. Further, it gives them better choice among available investment opportunities.
- Credit rating helps in the development of capital market. Proper credit rating raises confidence and interest of investors in the favourably rated instruments. More money flows into the capital market. As a result, capital market develops.

Apart from rating credit instruments, credit rating agencies of today are involved in some other activities. Those activities are very much similar to the activities of merchant bankers. Some of those activities unrelated to credit rating are as follows:

Company Research: In order to complement their credit rating activities, some Indian credit rating agencies have set up their research wings. These wings undertake research on the specific company, industry and the whole economy. They make the results of these researches to external subscribers for a fee. They also utilise these results in their credit rating activities.

Risk Consulting: Credit rating agencies provide consultancy service to financial institutions so that credit risk can be reduced.

Advisory Services: Credit rating agencies also provide many advisory services to the corporate houses. These services include project counselling, corporate counselling, bid process management, consultation of public-private partnership (PPP) and so on.

Knowledge Process Outsourcing (KPO): Some credit rating agencies have knowledge process outsourcing (KPO) wings. These wings provide manpower skills and other knowledge to their clients.

In a word, most credit rating agencies, apart from credit rating activities, perform some other activities which are unrelated to credit rating and which may better be described as merchant banking activities.

10.11 MERITS OF CREDIT RATING

From the functions of credit rating agencies, it may be understood that credit rating has so many benefits. Those benefits may be divided under three heads. They are: (i) Benefits to investors, (ii) Benefits to issuer company, and (iii) Benefits to financial intermediaries/capital market.

We shall consider these benefits one by one. It may be mentioned that some of the benefits may be overlapping, i.e., the same activity may be beneficial to more than one group, say, beneficial to both investors and borrowers.

10.11.1 Benefits of Credit Rating to Investors

Benefits of credit rating to investors may be summarised as follows:

Superior Information: Credit rating is done by an independent and professional firm. It offers a superior and more reliable source of information on credit risk. A rating firm has greater ability to assess risks than other firms. Again, due to professional attitude, it can provide unbiased opinion.

Information at Low Costs: Credit rating helps investors get information at a low cost. The collection, processing and analysis of relevant information are done by a specialised agency. This reduces cost of getting information.

Investors' Protection: Credit rating encourages greater information disclosure, better accounting standards and improved financial information. All these help in investors' protection.

Better Understanding of Investors: For credit rating, investors can easily understand the information regarding investment. They need not go into details of financial statements or understand those complicated financial instruments.

Motivation to Investors: Credit rating motivates savers to invest in industry and trade through capital market.

Quick Decision on Investment: Credit rating helps investors to take a quick decision on investment. It thus saves investors' time. Further, it gives them better choice among available investment opportunities.

10.11.2 Benefits of Credit Rating to Issuer Company

Credit rating is beneficial to the issuer (borrower) company also. We have mentioned some benefits of credit rating to the issuer company.

Healthy Discipline: Credit rating imposes a healthy discipline on borrower companies. Because of public exposure, companies try to have a good image.

Forewarns Risks: Credit rating acts as a guide to companies which get a lower rating. It forewarns the management of those companies about marketing risks and to be careful.

Helpful to Foreign Collaborators: Foreign collaborators always want to know the credit rating of the company while negotiating with it. Credit rating helps them know the relative credit standing of the company and take appropriate decision on collaboration.

Beneficial for the Industrial Sector: Relatively small and unknown companies can use their favourite ratings to bring confidence in investors. Further, companies with high credit rating can get funds at lower rates of interest. All these help in the industrial development of a country.

Unbiased Opinion: A credit rating agency provides an unbiased opinion regarding the capability of a company to serve its debt obligations. Thus, the company can know of its objective position or where it stands in respect of its financial standing.

Correct Pricing of Issues: Credit rating helps issuer of debt instruments to price their issues correctly. They can do so after knowing the rating of their instruments. This correct pricing of debt instruments helps them reach out to new investors.

10.11.3 Benefits of Credit Rating to Financial Intermediaries or to the Capital Market

Credit rating helps the financial intermediaries or the capital market as a whole. We here mention some of the benefits of credit rating to financial intermediaries or the capital market as a whole.

Proper Risk-Return Trade-off: If debt instruments are rated professionally, then a more rational risk-return trade-off would be established in the capital market. This will help the players of the capital market to perform their activities in a better way. For example, merchant banks will now be in a better position to take decision on underwriting an issue, loan syndication, corporate counselling and so on.

Expansion of Capital Market: Credit rating helps in the development of capital market. Proper credit rating raises confidence and interests among investors in the good-rated instruments. More money flows into the capital market. As a result, capital market expands.

Helpful to Players in Financial Markets: Proper credit rating helps merchant bankers, brokers, regulatory authorities and so on, in discharging their functions related to debt instruments.

Helpful to Market Regulators: Accurate credit rating helps the market regulators in promoting stability and efficiency in the security market.

We may conclude with one or two cautions on credit rating in this connection. We should keep in mind that credit rating guides the investors but it may also misguide the investors. That depends on the expertise and honesty of the officials of the credit rating agency. Too many variables are to be considered with their due weightage for proper credit rating. Hence, there is no magic formula to arrive at the correct credit rating number or code or symbol. The usefulness of credit rating depends upon the quality and standard of the credit rating agency, its independence from industrial units, its honesty and integrity, absence of the vested interest of the agency with the issuer of securities, the quality of its staff, correct information provided by the issuer company and so on. Only 'correct' credit rating helps the financial sector and ultimately the industrial sector of an economy, but 'rating correctly' is also a very difficult job. It demands a lot of things from the credit rating agency as well as from the company which is being rated.

10.12 DEMERITS OF CREDIT RATING

There are some problems related to credit rating. They indicate the demerits or disadvantages of credit rating. Some major problems associated with credit rating are mentioned below:

- Perfect credit rating is very difficult. A host of factors is to be considered for this job. Inexperienced and unskilled staff of a credit rating agency may not be able to do this. As a result, credit rating may not be perfect.
- There is no mathematical formula for credit rating. It involves a number of factors and assignment of proper weightage to those factors. Hence, some element of subjectivity creeps into this exercise. There is thus a scope for bias in all credit ratings.
- More often than not, companies provide false and misleading financial information to the credit rating agency. Rating based on these information will not be correct. Time factor greatly affects credit rating and sometimes gives misleading conclusions. A financially sound company may temporarily have adverse and difficult conditions. If rating is done at that time, the debt instruments of that company will be badly rated. But that does not reflect true financial capability of the company concerned.

- The staff and officials of the credit rating agency may be bribed by the company. Then the company's instruments will unduly get better ratings.
- The rating of an instrument of a company is not permanent. It is subject to changes. Investors may not be able to know the rating of different debt instruments each time they are investing.
- The number of rating companies is limited. Hence, they cannot reflect small but meaningful differences in the degree of risk associated with different credit instruments.
- Sometimes, companies give misleading advertisement about the rating symbols of their instruments. Suppose, for example, a company has received high rating for its debenture but low rating for its fixed deposits. Now, the company, while marketing its fixed deposits, may mention its high rating on debenture in the advertisement and conceal the low rating for fixed deposits. Common people will then be easily misguided.

Thus, while taking any investment decision, the credit rating assigned to any financial instrument should be judged carefully and cautiously. Otherwise, there is every possibility of being misled and making wrong investment decision. The investor should keep in mind that credit rating is generally done for a specific debt instrument. It is not generally done for the company as a whole. Hence, credit rating should not be taken as an indicator of the financial strength of the company. Further, it should also be borne in mind that a credit rating does not imply that the credit rating agency performs an audit work of a company, nor does it attest the genuineness of information provided by the issuer (borrower) company.

10.13 CREDIT RATING AGENCIES IN INDIA

Credit rating is not a very old practice. It started in the year 1988 when CRISIL (Credit Rating Information Services of India Limited) was set up. At present, there are four major credit rating agencies in India. They are:

(i) CRISIL (Credit Rating Information Services of India Limited) later renamed as CRISIL Ltd.
(ii) IICRA (Investment Information and Credit Rating Agency of India Limited)
(iii) CARE (Credit Analysis and Research in Equity of India Limited)
(iv) ONICRA (Onida Individual Credit Rating Agency of India Limited), now renamed as ONICRA Ltd.

We shall briefly discuss about these four credit rating agencies of India one by one.

10.13.1 CRISIL (Credit Rating Information Services of India Limited)

In January 1988, the Credit Rating Information Services of India Limited (CRISIL) was set up jointly by ICICI, UTI, LICI, GICI and the Asian Development Bank (ADB). It was the first credit rating agency in India. The main objective of CRISIL is to rate or assess, on request from companies, their debentures, fixed deposit schemes, short-term borrowing instruments and preference shares. The CRISIL ratings are now required by banks, UTI, merchant bankers and so on, when they provide financial assistance to various companies. The evaluation of the company is done by CRISIL on a confidential basis. Apart from credit rating, CRISIL provides corporate reports on public sector and private sector companies on regular basis. These reports contain information of their financial, business and technical aspects. CRISIL also undertakes industry studies on requests covering topics, such as, structure of industry, basis of competition and demand-supply estimates of products produced by various industries.

CRISIL constantly monitors the ratings assigned by it. The ratings may be upgraded, downgraded or withdrawn depending on new information or developments in the concerned company or in the concerned field of the industry. In 2003–04, the name of the company was changed from the Credit Rating Information Services of India Ltd. to 'CRISIL Ltd.' In recent years, CRISIL has won international recognition. It is one of the four international credit rating companies short-listed by the Asian Development Bank (ADB). CRISIL has set up an information company in collaboration with External Financial Limited of the United Kingdom. The name of this company is CRISIL Information Limited. It provides a wide range of information of the business world based on published data. Further, CRISIL has formed strategic alliance with Standard and Poor's Rating Services, a globally renowned rating agency from the USA. Clearly, the range as well as the quantum of activities of CRISIL as a credit rating agency has been expanding day-by-day.

10.13.1.1 Credit Rating Symbols Used by CRISIL

CRISIL uses the conventional rating symbols used in the USA. These symbols are widely accepted in many other countries. In the following two tables (Tables 10.1 and 10.2), we have shown rating symbols assigned by CRISIL to different types of credit instruments, and also the significance of those symbols. While Table 10.1 shows debenture rating symbols of CRISIL, Table 10.2 shows fixed deposit rating symbols used by CRISIL.

Table 10.1 CRISIL debenture rating symbols

High Investment Grades	**Significance**
AAA (pronounced as Triple A)	Highest safety
AA (Double A)	High Safety
Investment Grades	
A	Adequate safety
BBB (Triple B)	Moderate safety
Speculative Grades	
BB (Double B)	Inadequate safety
B	High risk
C	Substantial risk
D	Default likely in payment of interest and principal

Almost the same pattern of symbols is used by CRISIL in the rating of fixed deposits. This is shown in the Table 10.2.

Table 10.2 CRISIL fixed deposit rating symbols

Investment Grades	Significance
FAAA (pronounced as F Triple A)	Highest safety
FAA (F Double A)	High safety
FA	Adequate safety
Speculative Grades	
FB	Inadequate safety
FC	High risk
FD	Default upon maturity

The symbols used by CRISIL for short-term instruments regarding their timely payment are shown in Table 10.3 below.

Table 10.3 CRISIL credit rating for short-term instruments regarding their timely payment

Symbols	Significance
P-1	Very strong safety
P-2	Strong safety
P-3	Adequate safety
P-4	Minimal safety
P-5	Default on maturity

10.13.2 IICRA (Investment Information and Credit Rating Agency of India Limited)

Investment Information and Credit Rating Agency of India Limited (IICRA) was second in the field of credit rating activities in India. It was set up by Industrial Finance Corporation of India (IFCI) on 16 January, 1991, just after 3 years of establishment of CRISIL. IICRA is a public limited company. Its initial paid up capital was ₹35 crore. It has been subscribed by IFCI, UTI, LICI, GICI, SBI and 17 other banks. IICRA started its operation since 15 March, 1991. It primarily rates short-term, medium-term and long-term debt instruments. However, from the middle of 1995, it has been doing equity rating also to a certain extent. The rating of debt instruments is undertaken at the instance of the issuer. The rating of equities is done at the instance of the investor. From Tables 10.4 to 10.6, we have shown the IICRA rating symbols and their significance in the case of different types of credit instruments.

Table 10.4 IICRA rating scale: Long-term instruments including debentures, bonds and preference shares

Symbols	Significance
LAAA (pronounced as L Triple A)	Highest safety
LAA (L double A)	High safety
LA	Adequate safety
LBBB (L Triple B)	Moderate safety
LBB (L Double B)	Inadequate safety
LB	Risk prone
LC	Substantial risk
LD	Default, extremely speculative

Medium-term instruments including fixed deposits

Symbols	Significance
MAAA (pronounced as M Triple A)	Highest safety
MAA (M double A)	High safety
MA	Adequate safety
MB	Inadequate safety
MC	Risk prone
MD	Default

Short-term instruments including commercial papers (CPs)

Symbols	Significance
A-1	Highest safety
A-2	High safety
A-3	Adequate safety
A-4	Risk prone
A-5	Default

Table 10.5 IICRA fixed deposit rating symbols

Symbols	Significance
MAAA	Highest safety
MAA+	
MAA	High safety
MAA−	
MA+	Adequate safety
MA	
MA−	
MB+	
MB	Inadequate safety
MB−	
MC+	High risk
MC	
MC−	
MD	Default on maturity

Table 10.6 IICRA credit assessment symbols

Symbols	Significance
1	Very strong capacity
2	
3	Strong capacity
4	
5	
6	Adequate capacity
7	
8	
9	Inadequate capacity
10	
11	Poor capacity
12	
13	
14	Default

10.13.3 CARE (Credit Analysis and Research in Equity in India Limited)

The CARE was set up in November 1993. It has been set up by the Industrial Development Bank of India (IDBI) in collaboration with some other banks and financial service companies. Since its inception till the end of December 2007, CARE has rated 3,850 debt instruments. They cover a total debt volume of ₹80,716 crore. CARE provides rating services mainly to four types of instruments. They are:

(i) Debentures
(ii) Certificates of deposits (CDs)
(iii) Commercial papers (CPs)
(iv) Fixed deposits

CARE also rates companies for the use of bankers, other lenders and business enterprises.

In the following table (Table 10.7), we have shown the grades given by CARE to different categories of debt instruments.

Table 10.7 Grades used by CARE for different debt instruments

For long-term debt instruments	**Indication**
CARE AAA (pronounced as CARE Triple A)	Highest safety
CARE AA (CARE Double A)	High safety
CARE A	Adequate safety
CARE BB (CARE Double B)	Inadequate safety
CARE B	High risk
For medium-term debt instruments	
CARE AAA (CARE Triple A)	Highest safety
CARE AA (CARE Double A)	High safety
CARE A	Adequate safety
CARE BB (CARE Double B)	Inadequate safety
CARE B	High risk
For short-term debt instruments	
PR-1	Highest safety
PR-2	High safety
PR-3	Adequate safety
PR-4	Inadequate safety
PR-5	High risk

In the recent years, the volume of activities of CARE has considerably increased.

10.13.4 ONICRA (Onida Individual Credit Rating Agency Limited)

ONICRA was launched in November 1993. Its objective is to assess credit worthiness of individuals seeking finance for purchases of consumer durables or for meeting trade deficit. All other major credit rating agencies in India mainly rate the different instruments of corporate houses. They do not rate individual borrowers. Unlike these credit credit rating agencies, ONICRA (now named as ONICRA Ltd.) rates individual borrowers. It has been sponsored by Onida Finance Ltd. In all individual credit transactions like issue of credit cards, house-building loans, hire-purchase agreements, rental agreements and so on, there is some risk of default. Hence, the lenders should know the amount of risk in such credit transactions. They want to know the credit-worthiness of the individuals seeking above-mentioned types of credit. Here comes the credit rating service of ONICRA.

As such, ONICRA does not rate individuals seeking credit. It rates or grades the risk associated with entering into the above-mentioned credit transactions with those individuals at a certain period. ONICRA thus helps the lenders know the amount of risk associated with a credit to be given to an individual. It thus helps the lender financial institution to take proper decisions while making credit transactions with individual borrowers. The credit worthiness of an individual is measured considering various parameters divided in a 100-point scale. These parameters are: age, qualification, nature of job, savings, amount of loan to be taken, arrear loan to any other individual or organisation, past track record of repayment, family size, number of dependent members in the family and so on, in respect of the individual seeking credit. After rating, the individual is issued a certificate on the basis of the above-mentioned 100-point scale. On the basis of this certificate, the individual may obtain a loan credit.

ONICRA rating is gaining popularity day-by-day among financial institutions as it helps the institutions to take proper decisions in issuing credit to individual borrowers.

10.14 CREDIT RATING IN INDIA

The Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) have made credit rating mandatory in respect of all non-government debt instruments where the maturities exceed 18 months or the conversion takes place after 18 months. As a result, the rating activity in India has grown very significantly in recent years in terms of both the number of instruments rated and the amount involved. At present, CRISIL (Credit Rating Information Services of India Limited) and IICRA (Investment Information and Credit Rating Agency of India Limited) are the major players in the rating activities in India. The volume of activities of CARE and ONICRA are also expanding day-by-day. Among the instruments rated by these credit rating agencies, the most important are debentures and fixed deposits. Credit rating in India is gaining popularity very fast among financial institutions, corporate houses and both individual and institutional investors.

In India, credit rating agencies mainly rate or assess bonds/debentures. However, apart from bonds or debentures, a large number of other financial products are also rated by these agencies. Some of these financial products are: commercial papers, bank loans, fixed deposits, mutual fund debt schemes, equity and preference shares (both of primary and secondary markets) and so on. Further, at present, credit rating is not just confined to financial instruments. It also covers country rating, chit funds, rating of banks, rating of real estate builders and developers and so on.

Though credit rating activity is expanding quite fast in India, it suffers from some **limitations**. It has certain weaknesses. We briefly mention them below:

First, credit rating agencies in India do not do unsolicited rating. So, if any company does not request any credit rating agency, people (investors) cannot know about the ratings of financial instruments of that company.

Second, firms which are not satisfied with their ratings, are free not to use them. Then they generally go to other credit rating agency in search for a better rating. About one-third of the ratings done by various agencies in India are not accepted by their client companies. Many think that this has led to a competitive relaxation of rating standards by the rating agencies. If it is so, then the very purpose or objective of credit rating is bound to be defeated.

Third, it has been observed that ratings in India do not often communicate much objective information in financial terms. They only give a general or an overall idea about the credit worthiness of a company. Hence, credit ratings in India display a poor discriminating ability. They fail to help financial institutions to discriminate between 'good' instruments and 'bad' instruments in respect of their credit worthiness. Further, on several occasions, it has been found that credit rating agencies have been awfully wrong in their ratings. They had to revise their ratings substantially. This harms confidence and trust of the investors on credit rating.

The credit rating agencies in India should try to overcome these limitations. In the coming years, ratings are likely to be compulsory for all types of borrowings. Hence, credit rating activity in India may be expected to grow tremendously in the near future. To provide the benefits of credit rating to the investors, these credit rating agencies should try to overcome their deficiencies. They should operate more professionally, efficiently and objectively. Then the benefits of credit rating will reach its users.

10.15 SEBI GUIDELINES REGARDING CREDIT RATING AGENCIES IN INDIA

In India, credit rating agencies are regulated by SEBI. The credit rating agencies are required to maintain some regulations. The relevant regulations stipulated by SEBI may be summarised as follows:

- It is mandatory for credit rating agencies to have registration with SEBI. All credit rating agencies must obtain certificates from SEBI in order to perform credit rating activities.
- To get registration certificate from SEBI, the intending company should comply with the provisions of the SEBI Act, regulations and guidelines of SEBI and instructions issued by it from time to time on credit rating.
- If some information furnished by the company at the time of registration are required to be changed subsequently, that should be immediately communicated to SEBI.
- The certificate of registration is valid for 3 years. After the expiry of registration, it is to be renewed from SEBI.

- SEBI has mentioned the names of organisations which can promote a credit rating agency. Such organisations are as follows:
  - Public financial institution as per Companies Act, 1956
  - Scheduled bank
  - Foreign bank operating in India with RBI approval
  - Foreign credit rating agency having at least an experience in credit rating activities for five years
  - Any company having at least a net worth of ₹100 crore and incorporated under the Companies Act, 1956

SUMMARY

S.1 Concept of Financial Services

Financial services broadly include all activities involved in the transformation of savings into investment.

S.2 Scope/Activities of Financial Services

Activities of financial services can broadly be divided into two categories: traditional activities and modern activities. Traditional activities can again be divided into fund-based activities and non-fund based activities. Fund-based traditional activities include (i) underwriting of or investment in shares, bonds, debentures and so on, (ii) dealing in secondary market activities, (iii) participating in money market instruments, (iv) involving in equipment leasing, hire-purchase, venture capital and so on, and (v) dealing in foreign exchange market activities. Non-fund based traditional activities include (i) management of issue of securities, (ii) arrangement for the placement of capital and debt instruments with investment institutions, (iii) arrangement of funds for customer's project, and (v) assistance in the process of getting all government and other clearances. The main modern activities of financial intermediaries include (i) providing project advisory services, (ii) acting as trustees to the debenture holders, (iii) preparing schemes for sick units, (iv) managing the portfolio of large public sector units and so on.

S.3 New Financial Products and Services

In recent years, many new services and products have emerged in the Indian capital market. Important among them are: (i) Merchant banking, (ii) Loan syndication, (iii) Leasing of equipment, (iv) Mutual funds, (v) Factoring, (vi) Forfaiting, (vii) Supply of venture capital, (viii) Custodial services, (ix) Corporate advisory services, (x) Securitisation, (xi) Derivative security, (xii) Lines of credit.

S.4 Innovative Financial Instruments

A host of innovative financial services/instruments have been introduced in the financial market of India in recent years. Some of such major instruments are:

(i) Floating rate bonds (ii) Zero interest convertible bonds/debentures (iii) Zero coupon bonds or deep discount bonds (iv) Index-linked bonds or indexed bonds (v) Option bonds, (vi) Medium-term debentures, (vii) Variable rate debentures, (viii) Convertible bonds, (ix) Debentures with call and put options, (x) Easy exit bond, (xi) Retirement bond, (xii) Regular income bond, (xiii) Infrastructure bond, (xiv) Convertible bond with a premium put, (xv) Debt with equity warrant, (xvi) Dual currency bonds, (xvii) Samurai bonds, (xviii) Yankee bonds, (xix) Flip-flop bonds/notes, (xx) Floating rate bonds, (xxi) Loyalty coupons, (xxii) Global depository receipts (GDRs), (xxiii) American depository receipts (ADRs), (xxiv) Secured premium notes (SPNs), (xxv) Non-convertible debentures with equity warrants, (xxvi) Carrot and stick bonds, (xxvii) European Currency Unit (ECU) bonds.

S.5 Merchant Banks and Their Functions

Merchant bank refers to a financial institution which covers a wide range of activities. The main functions and services of merchant banks are: (i) corporate counselling, (ii) project counselling, (iii) loan syndication, (iv) issue management, (v) underwriting of public issue, (vi) advisers to the issuer company, (vii) portfolio management, (viii) advisory service relating to mergers and takeovers, (ix) off-shore finance, (x) advisory service to non-resident Indians on their investments.

S.6 Merchant Banking Services in India

Before 1960, merchant banking services were provided in India by managing agency firms. The National Grindlays Bank first started merchant banking in India in 1967 and three years later, the Citibank started it in 1970. Both were foreign banks. The SBI was the first Indian bank to set up merchant banking division in 1972. Gradually, other major Indian banks like Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank and United Commercial Bank started merchant banking. After 1983–84, merchant banking in India has been expanding very fast.

S.7 Distinction between Commercial Banks and Merchant Banks

There are some differences between commercial banks and merchant banks. Important differences are as follows:

(i) Commercial banks basically deal with credit and credit-related finance. On the other hand, merchant banks deal with equity and equity-related finance. (ii) Commercial banks generally avoid risk. However, merchant banks accept risks of business houses. (iii) Commercial banks are financiers of business houses and firms. Merchant banks are, however, not only financiers of business houses and firms but also their advisers and helpers in management.

S.8 SEBI Guidelines in Respect of Merchant Banking

For smooth functioning of merchant banks and for controlling their activities, SEBI, the capital market watchdog, has issued some guidelines in respect of merchant banking. Those guidelines may broadly be divided under the following categories:

(i) Guidelines regarding registration of merchant banks and their capital adequacy norms
(ii) Guidelines in respect of code of conduct of merchant bankers
(iii) Guidelines in respect of maintenance of accounts, records and other documents

Apart from them, SEBI has issued some instructions to the merchant bankers on the appointment of lead merchant bankers. It has also imposed some restrictions on the acquisition of securities of bodies corporate of merchant banks.

S.9 Credit Rating and its Features

Credit rating refers to the act of assessment of the investment quality of a particular credit instrument issued by a company. The main features of credit rating may be summarised as follows:

(i) Credit rating assesses the capacity of a company to honour its obligations. (ii) Ratings are expressed in easy symbols or code numbers. (iii) Credit rating is done by specialised expert and accredited agencies. (iv) Credit rating is generally done for a specific debt instrument. (v) Credit rating is not a one-time evaluation. It is an on-going appraisal process.

S.10 Types of Credit Rating

Credit ratings may be divided into three categories, namely,

(i) Rating of financial products
(ii) Rating of countries or nations
(iii) Rating of various companies/organisations

S.11 Methodology of Credit Rating

Methodology of credit rating involves different types of analysis or evaluation. They are as follows:

(i) Business risk analysis, (ii) Financial analysis, (iii) Management evaluation, (iv) Fundamental analysis, (v) Business environment analysis and (vi) Geographical analysis. After making those analyses, a financial instrument is rated or assessed by a credit rating agency.

S.12 Functions of a Credit Rating Agency

A credit rating agency performs various important functions. Briefly they are as follows:

(i) Credit rating provides an unbiased opinion regarding the capability of a company to serve its debt obligations. (ii) It gives an indication of risk and return of a financial instrument. (iii) It provides information about investment in simplest possible manner. (iv) A credit rating agency provides cheap, standard and dependable information about credit worthiness of a company. (v) It motivates savers to invest in industry. (vi) It helps issuers of debt instruments to price their issues correctly. (vii) Credit rating helps investors to take a quick decision on investment. (viii) It helps in the development of capital market of a country.

S.13 Merits/Benefits of Credit Rating

Various benefits of credit rating may be divided under three heads. They are:

(a) Benefits to investors, (b) Benefits to issuer company, and (c) Benefits to financial intermediaries/capital market. The main benefits of credit rating to investors are:

(i) Superior information, (ii) Information at low costs, (iii) Investors' protection, (iv) Better understanding of investors, (v) Motivation to investors, (vi) Quick decision on investment.

The main benefits of credit rating to the issuer company are: (i) Healthy discipline, (ii) Forewarns risks, (iii) Helpful to foreign collaborators, (iv) Beneficial for the industrial sector, v) Unbiased opinion, (vi) Correct pricing of issues.

The main benefits of credit rating to financial intermediaries or to the capital market as a whole are:

(i) Proper risk-return trade-off, (ii) Expansion of capital market, (iii) Helpful to players in financial markets, (iv) Helpful to market regulators and so on.

S.14 Demerits of Credit Rating

The main demerits of credit rating are as follows:

(i) Perfect credit rating is very difficult. (ii) There is an element of subjectivity in credit rating. (iii) Credit rating sometimes gives misleading conclusions. (iv) Credit rating may be bettered by a company by paying bribes to the credit rating agency. (v) Credit rating of a company is subject to change. (vi) Companies may misuse credit rating assigned to them.

S.15 Credit Rating Agencies in India

There are mainly four credit rating agencies in India. They are:

(a) Credit Rating Information Services of India Limited (CRISIL), now named as CRISIL Ltd.
(b) Investment Information and Credit Rating Agency of India Limited (IICRA)
(c) Credit Analysis and Research in Equity in India Limited (CARE)
(d) Onida Individual Credit Rating Agency of India Limited (ONICRA), now named as ONICRA Ltd.

S.16 Credit Rating In India

In recent years, rating activity in India has significantly increased, in terms of both the number of instruments rated and the amount involved. CRISIL Ltd. and IICRA are the major players in this field. However, credit rating activity in India suffers from two major limitations.

(i) Companies dissatisfied with their ratings may go to other credit rating agency in order to obtain a better rating. (ii) Ratings in India do not often provide much objective information in financial terms. They only give a general or overall idea about the credit worthiness of a company.

EXERCISE

A. Short Answer-Type Questions (1–2 marks each)

1. What do you mean by financial services?
2. What are the two types of activities of financial services?
3. What are the two types of traditional activities of financial services?
4. Mention some fund-based traditional activities of financial services.
5. Mention two non-fund-based activities of financial services.
6. State two modern activities of financial services.
7. What is merchant banking?
8. What is meant by loan syndication?
9. What are mutual funds?
10. What is factoring?
12. What is forfaiting?
13. What is venture capital?
14. What do you mean by custodial services of financial intermediaries?
15. What is meant by securitisation?
16. What is derivative security?
17. What is line of credit?
18. Give the full forms of HUDCO and HIDCO.
19. Write the full forms of HDFC and SHFSs.
20. What is meant by underwriting of shares?
21. What is portfolio? What is portfolio management?
22. What is meant by credit rating?
23. Give the full forms of CRISIL and IICRA.
24. What is the full form of CARE?
25. Give the full forms of ONICRA.
26. Give the names of two major credit rating agencies of India.
27. Mention two benefits of credit rating.
28. Point out two demerits of credit rating.
29. Give the full forms of LOC and KPO.
30. Mention two activities unrelated to credit rating but performed by credit rating agencies.

31. What are the major types of credit rating?
32. What is meant by country or sovereign rating?
33. Give the names of some international credit rating agencies.

B. Medium Answer-Type Questions (4–5 marks)

1. Discuss the traditional activities of financial services.
2. Describe the modern activities of financial services.
3. Analyse any four new financial products introduced in India.
4. Mention any four innovative instruments of Indian capital market.
5. What is merchant bank? Discuss any three functions of a merchant bank in an economy.
6. Write a short note on merchant banking services in India.
7. Distinguish between commercial banks and merchant banks in an economy.
8. What is credit rating? Discuss the main features of credit rating in an economy.
9. Define credit rating. Describe the major functions of a credit rating agency.
10. Briefly mention four major merits of credit rating.
11. Discuss four major demerits of credit rating.
12. Write a short note on Credit Rating Information Services of India Limited (CRISIL).
13. Give a brief description of Investment Information and Credit Rating Agency of India Ltd. (IICRA) and its credit rating symbols.
14. Write a short note on Credit Analysis and Research in Equity in India Limited (CARE).
15. Give a brief description of ONICRA (Onida Individual Credit Rating Agency Limited).

C. Long Answer-Type Questions (10 marks each)

1. Briefly describe the scope or activities of financial services in an economy. **(Section 10.2)**
2. Give an account of new financial products and services in the capital market of India. **(Section 10.3)**
3. Briefly mention the innovative products introduced in the Indian financial market in recent years. **(Section 10.4.3)**
4. Describe the major functions of merchant banks in an economy. **(Section 10.5.3)**
5. Briefly describe SEBI guidelines in respect of merchant banking in India. **(Section 10.6)**
6. What do you mean by credit rating? Discuss the main features of credit rating. **(Sections 10.7 & 10.8)**
7. Explain the concept of credit rating. Briefly describe the methodology involved in credit rating. **(Sections 10.7 & 10.9)**
8. State the major functions of a credit rating agency. **(Section 10.10)**
9. Briefly describe the merits or benefits of credit rating towards investors as well as issuer company. **(Sections 10.10.1 & 10.10.2)**

10. Briefly discuss the demerits or disadvantages of credit rating in India. **(Section 10.12)**
11. Write a note on the problems associated with credit rating in India. **(Section 10.12)**
12. Write short notes on (i) CRISIL, (ii) CARE. **(Sections 10.13.1 & 10.13.3)**
13. Briefly describe the functions of (i) IICRA and (ii) ONICRA. **(Sections 10.13.2 & 10.13.4)**

Appendix to Chapter 2

A1 Comparison between Open Market Operations and Bank Rate

Initially, open market operation was used to re-enforce the bank rate. When the bank rate is raised, commercial banks may not increase their interest rates if they have sufficient excess reserves. In that case, if the Central Bank sells securities in the open market, the excess reserves of the commercial banks will be reduced. Then they can no longer keep their interest rates unchanged. Similarly, with a decrease in the bank rate, the Central Bank can intensify its effect through open market purchases. However, open market operations can also be independently used as a method of credit control. Even if the bank rate is not changed, the open market operations can control the credit-creation capacities of the commercial banks. In fact, OMO is better than bank rate as a tool of credit control on the following two grounds:

1. The bank rate policy controls credit only indirectly. The change in bank rate affects the short-term rate of interest. This will have a secondary effect on long-term interest rates. But, open market operations have direct influence on the reserves of commercial banks and also on the long-term rates of interest. Purchase or sale of long-term securities will have direct effect on their price and hence on long-term rate of interest.
2. The effect of change in bank rate on the volume of commercial bank advances is largely uncertain. This is because commercial banks may continue to borrow from the central bank even if the rate of interest rises. But open market operations, because of their direct impact on the reserves of the commercial banks, will have a definite and certain effect on the volume of bank credit. So, open market operations are superior to bank rate as an instrument of credit control.

However, the two methods should be taken as complementary rather than competitive. They should be combined in a right manner to get the desired result quickly.

A2 Comparison between Open Market Operations (OMO) and Variable Reserve Ratio (VRR)

As instruments of credit control, both OMO and VRR have direct impact on the reserves of commercial banks. When the Central Bank conducts open market sale (purchase) of government securities, commercial banks purchase (sell) those securities, and their credit creating power falls (rises). Alternatively, when the Central Bank raises (lowers) the reserve ratio, more (less) amount of money of commercial banks is locked and they are left with less (more) money. Then also commercial banks' ability to lend money falls (rises). Thus, both the instruments of credit control have a certain and definite effect on the volume of credit.

However, there are some differences between the two methods. OMO can directly influence the rate of interest but VRR has no such direct power. When the Central Bank sells securities in the open market, supply of securities rises and their price ($1/r$) falls. This means that r or the rate of interest rises. In the opposite case of open market purchase, the rate of interest falls. Now, as the rate of interest changes, it will have impact on the level of investment, output, employment and so on. However, the OMO has one important limitation. Its success requires the presence of a developed money market. Hence, it is less effective in an underdeveloped economy. But, VRR may be equally effective in both developed and underdeveloped economies.

The success of OMO requires the fulfilment of some other conditions. They are: the volume of public debt should not be too large; the Central Bank should have a large stock of different types of securities; OMO is more effective to contract credit than to expand credit. Side by side, VRR policy has also some limitations. They are as follows: the method is less effective if commercial banks have large foreign funds; it is highly discriminatory; it is unsuitable for making changes in credit supply in a small area; VRR creates a lot of uncertainty and shock effect among commercial banks; the method is not effective if people assume a non-conformist attitude; the VRR method will be successful only if commercial banks have some legal compulsions to maintain a minimum reserve ratio and so on.

Thus, both OMO and VRR, as instruments of credit control, have some merits and demerits. Still, by making an overall comparison, it appears that VRR is better than OMO. This is because VRR is quicker and more certain than OMO. Unlike OMO, it is well- effective in an unorganised money market. The method can influence the credit-creation power of commercial banks 'at a pen's stroke'. However, it may be admitted that VRR is suitable for making large changes in the supply of bank credit. When small changes are to be made, OMO is better than VRR.

A3 Selective/Qualitative Methods of Credit Control

Selective or qualitative methods of credit control refer to those chosen measures applied by the Central Bank in order to channelise bank credit in the desired direction, and at the same time, to discourage and restrict bank credit in the undesirable sectors. Selective instruments are designed for this purpose and hence, they are called 'selective' methods of credit control.

The quantitative methods regulate only the quantity of credit. It affects all sectors of the economy without any discrimination. It fails to check undesirable expansion or contraction of credit in certain specified channels. To remove this limitation, selective credit control is adopted. It encourages credit for essential purposes and discourages credit for non-essential purposes.

The major objectives of selective control are the following:

- To discriminate against non-essential lines of production and to divert bank credit towards more essential productive uses
- To check only the sensitive spots of the economy, without affecting the economy as a whole
- To discourage excessive consumer demand for certain goods, induced by hire-purchase schemes and the instalment-payment business
- To restore favourable balance of payments position

Types or Instruments of Selective Credit Control

Following instruments of selective credit control are applied by the Central Bank:

1. *Changes in margin requirement:* If the Central Bank wants to reduce credit, it will raise the margin of credit. In the opposite case, it will reduce the margin. This method is applied to prevent excessive use of bank credit in speculative activities.

2. *Regulation of consumer credit:* Today bank credit is widely used to purchase durable consumer goods by paying in instalments or hire-purchase system. To control credit, the Central Bank may raise the amount of minimum down-payment and/or shorten the maximum period of repayment. To expand credit, the Central Bank will follow the opposite course of action.

3. *Rationing of credit:* This is done by two ways.

   (i) Variable portfolio ceiling: Here the Central Bank fixes a ceiling on loans advanced by commercial banks.

   (ii) Variable capital-asset ratio: The Central Bank may vary the capital-asset ratio of the commercial banks as per needs.

4. *Issue of Directives:* Directives are issued by the Central Bank from time to time to the erring commercial banks to follow a policy designed by the Central Bank. Directives may be in the form of oral or written statements, appeals or warnings.

5. *Direct Action:* It includes the following measures:

   - The Central Bank may refuse rediscount facilities to the erring commercial banks
   - The Central Bank may refuse to give any more credit to such commercial banks, or
   - It may charge a penal rate of interest from commercial banks for the credit beyond the prescribed limits

6. *Moral suasion:* Moral suasion is the method of persuasion, of request, of informal suggestion and of advice to commercial banks by the Central Bank to follow the prescribed credit policy.

7. *Publicity:* By this, the Central Bank tries to grow awareness among the public and to exert a moral pressure on commercial banks to follow the policy of Central Bank.

8. Advantages: Selective or qualitative methods of credit control have the following advantages:

- Selective credit control can fulfil the specific demand for a specific area. Quantitative methods of credit control have no such merit.
- Unlike quantitative methods, selective methods of credit control are effective even in unorganised money market of the less developed countries.
- Selective measures can ensure the most effective use of limited funds.
- These measures can encourage investment by restraining consumption.
- In quantitative controls, money supply may not decrease if the velocity of money increases. But selective methods of credit control do not suffer from this limitation.

9. Limitations: Selective/qualitative methods of credit control have some limitations. In short, they are as follows:

- Like general credit controls, selective credit controls have a limited coverage. They are 'generally' applicable to commercial banks and not to non-bank intermediaries.
- Selective credit control methods fail to fulfil specificity function. Bank loans sanctioned for a specific purpose may not be used for that purpose.
- It is sometimes difficult to distinguish between essential and non-essential sectors and between speculative and productive investment to adopt selective measures.
- The selective credit control measures are liable to be ineffective in the case of unscrupulous banks.
- Selective measures of credit control restrict the freedom of borrowers and lenders.
- Selective methods of credit control also discriminate between different types of borrowers and lenders.

10. Conclusion: Selective credit control measures are in fact meant to supplement the quantitative measures. They are regarded only as a 'second' line of instrument. The vital point, as S. K. Basu[1] argues, is not the question of general versus selective credit control, but that of integrating them. Indeed, the co-ordination of general and selective controls of credit appears to have been more effective than the use of any one of them. S. Ganguly[2] has also expressed a similar view.

A4 Bill Market Scheme in India

Bill market is that part of money market where different types of bills can be discounted and cash can be obtained in exchange. Thus, liquidity or money supply in the economy rises. A developed money market should have a developed bill market. In order to develop the Indian money market, the Reserve Bank of India (RBI) introduced bill market scheme on 16 January, 1952. The RBI assured the commercial banks to give cash money against *hundis* for a maximum period of 90 days. However, those *hundis* should be genuine trade bills; they must

1. Basu, S. K., *A Review of Current Banking Theory and Practice*, Macmillan, Bombay, 1971.
2. Ganguly, S., *A Treatise on Banking and International Monetary Management*, Moulik Library, Calcutta, 1970.

have specific maturity periods; those maturity periods should not exceed 90 days and those hundis should be endorsed by at least two—one of them must be an official of a scheduled bank. In later years, there were some changes in the rules. This bill market scheme became very popular. Hence, the RBI announced the new bill market scheme on 1 November, 1970, making some modifications of the earlier scheme. As per this new scheme, the RBI agrees to discount the bills arising out of genuine domestic and foreign trade transactions.

According to the new bill market scheme, the RBI agrees to rediscount several types of bills. Commercial banks can discount and rediscount other bills, but the RBI does not give the opportunity of rediscounting of all types of bills. The conditions of discounting are as follows:

- The bill should be a genuine trade bill.
- In the bill, the nature of transaction should be mentioned.
- The maturity period should not exceed 120 days.
- There should be at least two signatures on the bill—one of them should be of the representative/official of a scheduled bank.

To make rediscounting procedure simple, the RBI brought some changes in the scheme in the bill. The advantages of the bill market scheme of the RBI have been taken by industry, trade and commerce. These sectors have taken credit in order to meet their need for cash in busy seasons. The bill market scheme should penetrate into all major economic activities of the country. It is not desirable that the RBI should finance only temporarily and only in some selected activities. The RBI should ensure that all sectors of the economy get the benefits of bill market scheme.

It is true that through the bill market scheme, the RBI has been able to perform its role as the lender of last resort. But, it does not prove that an active and wide bill market scheme has been established in India. Bill market in India is still underdeveloped and hence Indian money market is also underdeveloped. During the 1970s and 1980s, one committee after another highlighted and lamented the lack of development of the bill market. Some of these committees are Tandon Committee, Chore Committee, Chakraborty Committee and Vaghul Working Group. As a result of their recommendations, the RBI has taken some steps to develop the bill market in India. Important among those measures are as follows:

- The RBI has approached the Government of India for remission of stamp duty on bills of exchange. The Government of India has later accepted this suggestion.
- The RBI has advised banks to impose at least 25% bill discounting in the case of credit monitoring scheme.
- It has simplified the procedures and documentation of discounting of bills.
- Many financial institutions have been permitted to participate in bill rediscounting scheme.
- It has set up, jointly with banks and financial institutions, the Discount and Finance House of India (DFHI) as a major financial institution. Its objectives is to develop the money market including the market for commercial bills.

In spite of these measures, bill market in India has not developed. There are some reasons behind it. In brief, they are stated below.

(i) Development of Banking System: With the development of commercial banking, direct discounting and collection of bills have been easy. Now transfer and remittance of funds have been quick. This has retarded the development of the bill market.

(ii) Small Share in Foreign Trade: Bill markets are mostly useful for financing foreign trade. In India, the share of foreign trade in national income has remained quite small. Further, export and import bills are drawn in foreign currency. This has restricted the scope for negotiation of such bills in the country.

(iii) Structure of Internal Trade: The Government of India has entered into trading activity through Food Corporation of India (FCI), Metals and Minerals Trading Corporation (MMTC) and State Trading Corporation (STC). Now-a-days, the government does not prefer to finance its activities through bills of exchange.

(iv) Alternative Credit System: In India, the systems of cash credit and overdrafts are cheaper and more convenient than bill financing. Further, bills cannot be easily shifted due to want of acceptance facilities from reputed institutions. Hence, both borrowers and banks prefer other forms of advances to bill finance.

(v) Declining Popularity of Hundis as a Credit Instrument: Historically, the bill market in India has been dominated by indigenous bankers who finance internal trade. The main instrument for the transfer of funds is hundis–an indigenous bill of exchange. With the advancement of the financial system, activities of indigenous bankers have greatly declined. Further, since 1965, the SBI has completely stopped the discounting of bills of indigenous bankers. Hundis are now excluded from the rediscounting schemes. This has also retarded the growth and expansion of the bill market in India.

(vi) Other Factors: Some other factors behind the lack of development of the bill market are: complicated procedures of discounting and rediscounting, absence of specialised credit information agencies, and growth of competing money market instruments.

C.U.
Question Papers and Hints to Answers (2005–2016)

2005

Group-A

1. Briefly identify the contributions of the financial system to a country's economic development. **(Section 1.2)**
2. Distinguish between development banks and commercial banks. **(Section 3.4)**
3. Give an outline of the methods of credit control of the Reserve Bank of India. **(Section 2.11)**
4. State the main objectives of the Life Insurance Corporation of India. **(Section 4.6.1)**
5. Explain the concept of mutual fund. **(Section 4.8)**
6. Explain the concept of "differential interest rate". **(Sections 5.4 & 5.5)**
7. What is meant by financial system? Discuss the main components of the Indian financial system. **(Sections 1.5 & 1.8)**
8. Discuss the recent changes in the monetary policy of the Reserve Bank of India. **(Section 2.14.3)**
9. Give a brief account of the rise and fall of the Unit 64 scheme of the UTI. Discuss the recent organisational changes of the Unit Trust of India.

   Ans: The Unit Trust of India (UTI) is the premier mutual fund in India. It was established in February, 1964 as a public sector unit in the financial sector of India. Its main objectives are: to pool the small savings of the lower and middle income groups, and to put the pooled sum in a diversified portfolio to provide safety and liquidity of capital and thus provide funds to the investors. It gives an opportunity to the small savers who cannot have direct access to the stock exchange. To fulfil these objectives, the UTI started selling units to the public from 1 July, 1964. The first scheme was known as Unit-64. For the next 8 years, it was the only scheme of the UTI. The Unit-64 scheme was a grand success and it became very popular among the unit holders (investors) and remained so for the long 31 years starting from 1964 to 1995. We may call this period (1964–95) as the period of rise of Unit Scheme-64 (or US-64, in short). The number of units (of ₹10 each) held by the investors increased from 1.87 lakh in 1965 to 15,277 million in 1995. There were some factors behind this phenomenal success of US-64. In brief, they are as follows:

- Corporate investors and trusts of all kinds purchased a good amount of US-64.
- It was the only unit scheme of the UTI for the first 8 years.
- The US-64 was the flagship scheme of the UTI. Hence, investors considered the scheme with high esteem.
- There was regular payment of dividends to the unit holders.
- The rate of dividend of US-64 from the very beginning was quite high. Naturally, the scheme became very popular among the investors in no time.
- The UTI enjoyed investors' trust and reliance as it was a public sector organisation.
- There were tax concessions on the investment on units as well as tax exemption on the dividends received from US-64.
- The repurchase facility of US-64 provided easy liquidity to the investors.

For all these reasons, US-64 was very popular for a long period of three decades (1964–95) among the investors. However, after 1995, the scheme lost its glory. From 1995–96, the decline of US-64 started. Its market value fell. In the year 1998, it was declared that the reserve of the UTI had become negative. Ultimately, in May, 2003, the scheme of Unit-64 was withdrawn. Thus, the period 1995–2003 may be termed as the period of fall of US-64. There are some reasons behind this fall. In brief, they are as follows:

- There was a prolonged bearish trend in the share market.
- Tax relief on dividend received from US-64 was withdrawn.
- The UTI failed to adjust its policy with the change in market conditions.
- The sale and repurchase price of units of US-64 was not NAV based; it was administered price. Irrespective of actual returns, these prices were increased by the UTI. Such administered pricing was not a problem during bullish conditions in the market. But, in 1990s, under bearish market conditions, such high price was paid out of reserves.
- The UTI was not under the purview of SEBI. Hence, there was no regulator to ensure the soundness of investment decisions made by the UTI.
- There was loss of confidence of the investors on the UTI due to frequent scams in the share market.
- In spite of negative balance in reserve account, sometimes the UTI continued to declare high dividends. Hence, the bubble was to burst someday.
- There was no representation of the unit holders in the Board of Trustees of the UTI and hence they did not get any chance to make their views known to the authorities of the UTI.
- The managerial decisions of the Board of Trustees were faulty. They failed to protect the long-term interests of unit holders.

For restructuring the UTI, the government of India appointed a high-level committee, namely, Deepak Parekh Committee. But the UTI failed to implement its recommendations. Then there was Taropore Committee and, at last, Malegham Committee. Considering the recommendations of all these committees, the government adopted a bail-out package. The main points of this bail-out package are the following:

- The UTI Act was repealed through an issue of ordinance.
- The UTI was bifurcated into two units: a sick UTI segment (UTI-I) and a healthy UTI segment (UTI-II).
- The liabilities of US-64 and assured return scheme were transferred to UTI-I.
- All NAV-based schemes were transferred to UTI-II.
- UTI-I would be run by a government-appointed administrator and a team of advisors.
- A professional team and a Board of Trustees would run UTI-II.
- UTI-II (or, UTI-MF) was brought under the control and regulation of the SEBI. It was subsequently privatised.
- Income from US-64 will be allowed tax reliefs.
- The government spent ₹14,561 crore for the bail-out package.

As a result of these measures, the performance of the UTI has improved to a great extent in recent years. Still, it must be admitted that the UTI could not retrieve its entire past glory. People are still to some extent diffident about the role and performance of the UTI.

Group-B

10. Discuss the nature of India's call money market. **(Sections 7.9.1 & 7.9.3)**

11. Give a brief account of the role of Discount and Finance House of India in the Indian money market. **(Sections 7.13 & 7.13.1)**

12. What is meant by credit rating? **(Sections 10.7 & 10.10)**

13. Discuss the role of brokers in the stock market. **(Section 8.13.1)**

14. Discuss the role of the press in the protection of investors. **(Section 9.8.4)**

15. What is insider trading? **(Section 9.9)**

16. What is money market? Discuss the features and major weaknesses of the Indian money market. **(Sections 7.1, 7.3 & 7.6)**

17. Discuss the role of the Securities and Exchange Board of India (SEBI) in the regulation of India's security market. **(Section 8.16)**

18. (a) Distinguish between the new issue market and stock market. **(Section 8.11)**

(b) Discuss the important functions of merchant bankers.

(Sections 10.5.1 & 10.5.3)

2006

Group-A

1. What roles do regulators play in a financial system?

Ans: Financial markets play a vital role in the process of economic development of a country. If they function properly, they make huge positive contribution towards the progress of the economy. However, sometimes financial markets do not function properly and fairly. Hence their activities are required to be regulated. The organisations/institutions/laws, etc., which exert these regulations on the financial system are called regulators. There are many such regulators in a country. The major regulators are:

(i) The Ministry of Finance and the Parliament of India
(ii) Reserve Bank of India
(iii) Various regulatory bodies like
    (a) SEBI
    (b) IRDA
    (c) Company Law Board
(iv) Various regulatory Acts like
    (a) Companies Act
    (b) MRTP Act
    (c) Securities Contract (Regulation) Act (SCRA)
    (d) Foreign exchange Management Act (FEMA)

We briefly mention the regulations exerted by these regulators of the financial activities.

The Ministry of Finance and the Parliament enact various laws to control the unfair practices of the financial institutions.

Regulation by RBI: See Q.no. 17(b) of 2016 (CU)

Regulation by SEBI: See Q.no. 18 of 2012 (CU)

Regulation by IRDA: See Q.no. 6 of 2007 (CU)

Company Law Board keeps vigilance on the functioning of financial companies. They provide legal advice to these companies and prevent them from doing anything illegal and unethical. Companies Act also performs the similar job.

Securities Contract (Regulation) Act imposes some restrictions on put and call options. It provides some modalities regarding forward contract and futures contract.

The MRTP Act seeks to control monopoly behaviors of any giant firm. It tries to regulate monopolies and restrictive trade practices.

The FEMA intends to stop the misuse of foreign exchange. Its objective is to ensure proper and fruitful use of scarce foreign currencies in our country.

Apart from these functions, the RBI and the government of India regulate the financial activities through the following controlling measures:

- Regulation of money supply and bank credit,
- Control of inflation and thus stabilisation of value of money,
- Stabilisation of exchange rate against foreign currencies,
- Control over the volume exports and imports,
- Control of the activities of banks and other financial institutions
- Control of speculative activities in the economy.

In fact, the government of India, the RBI and the SEBI are major regulators in the financial system of India.

2. Distinguish between Cash Reserve Ratio and Statutory Liquidity Ratio.

(Q. No. 2 of 2009 of WBSU)

3. What is meant by globalisation of financial markets?

Ans: Globalisation means integration of domestic economy with foreign economy. So, globalisation of financial markets refers to the integration of domestic financial markets of an economy with the financial markets of foreign countries. Under this situation, many foreign financial institutions operate in the domestic economy side by side the domestic institutions. Similarly, many domestic financial companies operate in foreign countries. Briefly, when financial operations are not confined to geographical boundary of a country, it is called globalisation of financial markets. Financial markets of different countries are not closed, they are open. In the recent past, globalisation of financial markets has taken place. Some factors have been operative behind this. They are:

- All over the world, economic reforms with globalisation, liberalisation and privatisation have been introduced.
- Many countries have withdrawn restrictions on foreign trade.
- Stock exchanges all over the world have introduced electronic systems.
- e-commerce, e-banking, internet, etc., have been introduced.

The government of India has also adopted the policy of liberalisation, privatisation and globalisation (LPG). As a result, many foreign banks, foreign mutual funds, foreign investment trusts and merchant banks, many foreign insurance companies have been operating in India either independently or as joint ventures with Indian companies. Indian financial sector is now a globalised sector.

4. State the advantages of investing money in mutual funds. **(Sections 4.8 & 4.9.3)**

5. Distinguish between administered and market-determined rate of interest.

Ans: In **sections 5.8.1 and 5.8.2** we have discussed the concepts of administered interest rate and de-regularised or market determined rate of interest. As the names suggest, administered interest rate is fixed by the administration, i.e., by the financial authority. On the other hand, market rate of interest is determined by the forces of market, i.e., by the forces of demand and supply of the factors or variables influencing the rate of interest. While Keynes argues that the rate of interest is determined by the demand for and supply of money, neo-classical economists think that the rate of interest is determined by the demand for and supply of loanable funds. There is still a third opinion given by classical economists that the rate of interest is determined by demand for capital (investment) and supply of capital (savings). Let us formally arrange the differences between the administered and market-determined rate of interest in terms of the following table.

Administered Rate of Interest	Market Rate of Interest
1. It is determined by financial authorities of a country.	1. It is determined by market forces.
2. This is determined by authorities with a view to attain some objectives, say, to check inflation, to regulate money supply, to promote economic growth, etc.	2. The market rate of interest has no such view.
3. The government, the Central Bank and some other financial authorities of a country determine administered rate of interest after some discussion and consideration of various related factors.	3. The market determines this rate of interest. While Keynesians think that it is determined by demand for and supply of money, neo-classicals think that it is determined by demand for and supply of loanable funds.
4. There are differential interest rates for fulfilling different purposes.	4. There will be only one market rate of interest as determined by market forces.
5. Determination of an optimum rate of interest by the financial administration is very complex.	5. It has no such complexity. Here everything is left to the market forces.
6. This rate of interest can be used to attain some macroeconomic goals. The rate of interest is suitably adjusted for the benefit of the economy.	6. Market- determined rate of interest may or may not be suitable for the benefit of the economy.

6. State the functions of State Financial Corporations. **(Sections 3.10.2 & 3.10.3)**

7. Discuss the major changes in the Indian Financial System since the early 1990s.

Ans: The government of India appointed Narasimham Committee to examine all aspects relating to organisation, structure, and functions of the financial system in India. The Committee submitted its report in November 1991. It has recommended minimum restrictions on financial institutions including banks. The government of India has accepted most of the recommendations of the Narasimham Committee and has introduced many reforms in the financial sector. Another part of financial sector reforms includes insurance sector reforms. We shall first consider the reforms adopted following the recommendations of Narasimham Committee and then reforms in the insurance sector.

- Following the suggestion of the Narasimham Committee, both the SLR (Statutory Liquidity Ratio) and CRR (Cash Reserve Ratio) have been reduced. The SLR has been reduced to the recommended level of 25% and CRR to 10%.
- The administered interest rate system in India had become complex over the years. It reduced the ability to promote effective use of credit. The government has gradually reduced interest rate slabs from 20 to 2.
- Most of the interest rates in the economy have been de-regulated. Steps have been taken to move towards market rates on government securities.

- A number of measures have been taken to strengthen commercial banks. The RBI has introduced prudential accounting norms for banks. Accordingly, banks are required to classify their assets and make provision for bad debts. Then the books of accounts of the banks will reflect more accurately their financial position.
- As the government resources are limited, banks have been allowed to mobilise equity resources from the public.
- The SBI Act was amended and the RBI shareholding in the Bank was reduced to 67%. By another amendment in 1994, the government's share in paid up capital of public sector banks had been reduced to 33%.
- Setting up and expansion of private sector banks are being allowed to make banking sector more competitive and customer friendly.

Regarding the effect of these reforms, we may quote Joshi and Little,"The financial health of banks has improved… there is still a long way to go in achieving an efficient banking system."

Let us consider the reforms in the insurance sector. It was argued that in the era of liberalisation, the monopoly of the LICI in life insurance business should be broken and the insurance sector should be made competitive. In this context, the Malhotra Committee was appointed. The Committee (1993) made some recommendations and following those recommendations, some reforms were introduced. The most notable reform in the capital market of India during 1999–2000 was the reform in the insurance sector. In this year, the government passed the Insurance Regulatory and Development Authority (IRDA) bill despite stiff opposition from left parties and trade unions. The IRDA Act has ended the monopoly of government of India in the insurance sector. It invites the private sector including foreign equity capital in the insurance sector. The private sector insurance companies have started functioning in India since November, 2000. With their entry, the insurance sector has become competitive and the customers' range of choice in investment in the insurance sector has increased.

Further, after the adoption of liberalisation policy during 1990s, private share in some public sector development finance institutions (DFIs) has been increased. Again, there has been reorganisation of securities market. The Securities and Exchange Board of India (SEBI) has been given wide range of powers to control the capital market, particularly stock exchanges. Further, during 1990s, some specialized financial institutions like primary dealers and secondary dealers have been formed. Many new financial instruments have been innovated. Those are called new and innovative financial instruments. Again, electronic transactions have been introduced in both money and capital markets. This has made the markets efficient.

All these reforms have made the Indian financial system strong, competitive, efficient and diversified.

8. Give an account of the supervisory and regulatory role of the Reserve Bank of India. **(Section 2.14.5)**
9. Discuss the developmental role of the Industrial Development Bank of India. **(Sections 3.6.5, 3.6.6 & 3.6.7)**

Group-B

10. Distinguish between organised money market and unorganised money market. **(Section 7.2)**
11. Explain the relationship between the new issue market and stock exchange. **(Sections 8.5 & 8.11)**
12. Who are Portfolio Consultants? **(Section 8.13.6)**
13. Distinguish between brokers and sub-brokers operating in the stock exchange. **(Section 8.13.3)**
14. What is meant by investor protection? **(Section 9.1)**
15. Discuss the SEBI regulations regarding registration of merchant bankers. **(Section 10.6.1)**
16. Describe the characteristics of the call money market. Who are the participants in the Indian call money market? What are the drawbacks of the call money market in India? **(Sections 7.9.1 & 7.9.3 and add the following part)**

    Participants of Indian call money market: We know that call money is one of the credit instruments in the money market. Its maturity period is (1–14) days. The main participants in the call money market are banks. Hence, this market is loosely called the inter-bank market. However, there are some other participants in the Indian call money market. In order to operate in this market, the willing organisation has to take approval from the RBI. The main participants in the Indian call money market are:

    (i) The State Bank of India , (ii) all other Scheduled Banks, (iii) Non-scheduled Banks, (iv) Co-operative Banks, (v) Life Insurance Corporation of India, (vi) General Insurance Corporation of India, (vii) Unit Trust of India, (viii) Discount and Finance House of India, (ix) National Bank for Agriculture and Rural Development, (x) foreign banks, (xi) primary dealers, (xii) Securities Trading Corporation of India, etc.
17. What is credit rating? Discuss its importance and limitations. **(Sections 10.7, 10.11 & 10.12)**
18. Discuss the important functions of stock exchange. **(Sections 8.12 & 8.12.3)**

2007

Group-A

1. Give a broad idea of the major components of a financial system. **(Sections 1.1 & 1.3)**

2. Discuss in brief about financial intermediary. **(Section 1.6)**

3. What is mutual fund? **(Section 4.8)**

4. State the principal objectives of a development bank. **(Section 3.1)**

5. How are liquidity and risk related to interest rate? **(Section 5.5)**

6. What are the major functions of Insurance Regulatory and Development Authority (IRDA)?

Ans: For insurance sector reforms, Malhotra Committee was appointed in 1993. Following the recommendations of this Committee, the Insurance Regulatory and Development Authority (IRDA) was set up in 1999. Its objective was to regulate and develop the insurance sector of India. The IRDA was incorporated as a statutory body in April 2000. It seeks to promote competition in insurance business so that customers have greater choice, they have to pay lower premiums and at the same time the financial security of the insurance market is ensured. In order to achieve these objectives, the IRDA has the power to perform the following functions:

- To issue to the applicant company a certificate of registration, renewal or in case, suspension or cancellation of registration.
- To protect the interests of policyholders.
- To promote and enforce standard and fair dealing in insurance business.
- To specify requisite qualifications and code of conduct for insurance intermediaries and agents.
- To specify the code of conduct for surveyors and loss assessors.
- To promote efficiency in insurance business.
- To promote and regulate professional organisations connected with insurance and re-insurance business.
- To levy fee and other charges for carrying out various activities in the insurance sector.
- To ensure speedy settlement of genuine claims.
- To prevent insurance frauds and other malpractices.
- To develop effective grievance redressal machinery.
- To promote fairness, transparency and orderly conduct in insurance business.
- To specify the form and manner in which book of accounts are to be maintained by the insurers.
- To regulate investment of funds by insurance companies.
- To adjudicate any dispute between the insurers and insurance intermediaries.

- To take action where fair, transparent and orderly conduct are not properly maintained.

7. Discuss elaborately the determinants of the general structure of interest rate.

(Section 5.7)

8. Give an account of the development functions of the RBI. **(Section 2.14.4)**

9. Discuss in details how the financial market reaches equilibrium.

Ans: Equilibrium is a term borrowed from physics. In economics, it describes a situation in which economic agents or aggregates of economic agents such as markets have no incentives to change their economic behaviours. When applied to markets, equilibrium denotes a situation in which aggregate demand for a commodity or service is equal to aggregate supply of that commodity or service. Now, we have to discuss the attainment of equilibrium in the financial market. We know that there are two parts of the financial market—money market and capital market. They deal in money, credit and finance. So, a financial market will be in equilibrium where demand for money/ credit/ finance is equal to the supply of money/ credit/ finance. The main factor determining the demand for and supply of finance is the rate of interest. So we have to determine that rate of interest at which the demand for and the supply of finance are equal to each other. There are mainly three theories to explain how the financial market in an economy reaches equilibrium. They are:

(i) Liquidity Preference Theory of Keynes
(ii) Neo-classical/ Loanable Funds Theory
(iii) Hicks–Hansen Theory/ IS-LM curves analysis.

We shall briefly discuss them one by one.

Liquidity Preference Theory of Keynes

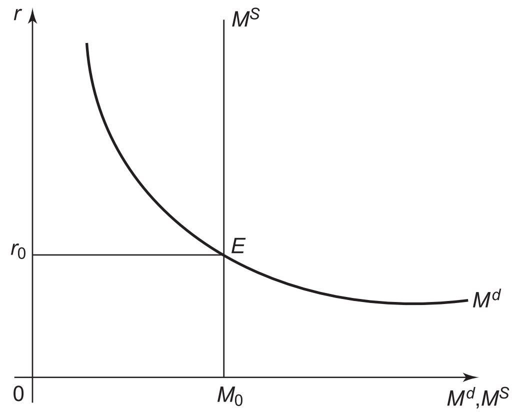
According to Keynes, the rate of interest is purely a monetary phenomenon and it is determined by the demand for and supply of money. In his theory, the supply of money does not depend on the rate of interest. In an economy, the monetary authority determines the supply of money. So, the money supply curve can be represented by a vertical straight line. The demand for money arises from three motives. These are: transaction motive, precautionary motive, and speculative motive.

Transaction motive: Transaction motive is the motive for holding cash money in order to make some transactions. The transaction demand for money, according to Keynes, depends directly on the level of income.

Precautionary motive: Precautionary motive is the motive for holding cash money in order to meet unforeseen contingencies like death, sickness, etc. The precautionary demand for money also depends directly on the level of income. The sum of the transactions balance and the precautionary balance is called the demand for active balance (L_1). It depends directly on the level of income.

Speculative motive: Speculative motive is the motive for holding cash money in order to make speculations (here in the bond market). The amount of money held for speculative purposes is called the speculative demand for money. Keynes calls it demand for idle balance (L_2). It depends inversely on the rate of interest. If the rate of interest rises, the speculative demand for money falls, and vice versa. However, at a very high rate of interest, $L_2 = 0$ and at a very low rate of interest, L_2 is horizontal.

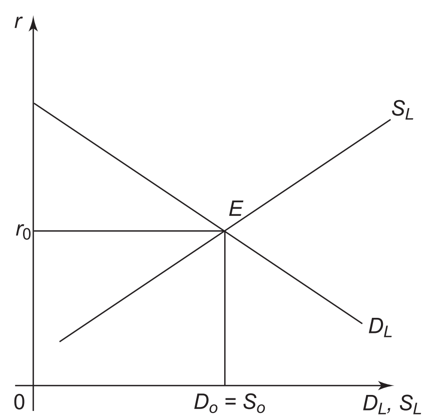
The total demand for money is the sum of demand for active balance and the demand for idle balance ($M^d = L_1 + L_2$). It depends on the rate of interest and the level of income. It is also called the liquidity preference function or curve. If the level of income is assumed to be fixed, the liquidity preference function or the aggregate money demand curve can be drawn as a downward sloping curve (See figure). It means that if the rate of interest falls, the total demand for money rises and *vice versa*. Now, we draw the total money supply curve (M_o) on the same diagram. The two curves intersect at E. Then the equilibrium rate of interest is Or_o, because at this rate of interest, $M^d = M^s$. Thus, in the liquidity preference theory of Keynes, the equilibrium rate of interest is determined by the demand for and supply of money.



This theory has some limitations. **Firstly,** in this theory, the level of income is assumed to be fixed in order to determine the equilibrium rate of interest. **Secondly,** demand for active balance may depend on rate of interest also. **Thirdly,** the role of saving and investment to determine the rate of interest has been ignored. **Fourthly,** the theory considers only two forms of assets, namely, money, and bond. But there may be other forms of assets.

Neo-Classical/Loanable Funds Theory

In the loanable funds theory or neoclassical theory, it is argued that the rate of interest is determined by the demand for and the supply of loanable funds. There are three main sources of loanable funds: (i) present saving, (ii) past saving and (iii) money created by the banks. The aggregate supply of loanable funds (S_L) is an upward rising function of the rate of interest. This means that as the rate of interest rises, the supply of loanable funds also rises. (See figure). The demand for loanable funds comes from three main sources: (i) to meet consumption expenditure by the households, (ii) to meet investment expenditure by the firms, and (iii) to



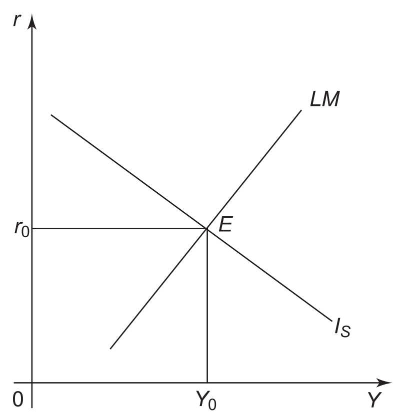
meet budget deficit by the government. The demand for loanable funds (D_L) is a downward sloping function of the rate of interest. This means that as the rate of interest falls, the demand for the loanable funds rises and *vice versa*. (See figure).

The equilibrium rate of interest is determined by the equality of demand for and supply of loanable funds. In our figure this occurs at E. So, E is the equilibrium point and Or_o is the equilibrium rate of interest.

This theory has also some limitations. **Firstly**, it assumes that saving depends on the rate of interest. But saving depends on the level of income also. **Secondly**, at the equilibrium point, there is no guarantee that the level of income will also be in equilibrium. However, many think that this theory is a synthesis of classical and Keynesian theories. It considers the role of saving and investment of the classicals and the role of money demand and money supply of Keynes to determine the equilibrium rate of interest.

Hicks–Hansen Theory or, the IS-LM Theory

The Hicks–Hansen theory is a reconciliation between the classical theory and the Keynesian theory. According to this theory, the equilibrium rate of interest and the equilibrium level of income will be determined where planned saving and planned investment are equal to each other and the money demand and the money supply are also equal to each other. In this theory, it is assumed that saving depends directly on the level of income while investment depends inversely on the rate of interest. In this case, we may get different combination of the rate of interest (r) and the level of income (Y) for which saving is equal to investment.



Plotting these combinations we get a downward sloping curve which is known as IS curve (investment-saving-equality curve). Similarly, we can get different combinations of the rate of interest and the level of income for which the money demand is equal to the money supply. Plotting these combinations we get an LM curve which is normally upward rising. LM curve is the money demand (L) money supply (M) equality curve. At the intersection point of the IS and LM curves the equilibrium rate of interest and the equilibrium level of income are simultaneously determined. In our figure, this occurs at E. Then the equilibrium rate of interest is Or_o and the equilibrium level of income is OY_o.

Group-B

10. What is meant by call money market? **(Section 7.9)**

11. Discuss the importance of credit rating. **(Section 10.10)**

12. Explain the five major points of distinction between capital market and money market. **(Section 8.3)**

13. What do you mean by "over-the-counter exchange of India"? **(Section 8.14.3)**

14. What is meant by foreign direct investment?

Ans: Foreign direct investment (FDI) usually refers to any investment in another country which is carried out by private companies or individuals as opposed to government aid. There are arguments for and against foreign investment in under-developed countries. Those who are against foreign direct investment argue that it constitutes economic colonialism and is an attempt to retain control of ex-colonies. Further, the country becomes dependent on foreign firms. It may delay the setting up of domestic industry or training of experts. In addition, foreign investment often involves the import of totally inappropriate technology, in order that the foreign company can benefit from cheap labour and resources. Those who support foreign direct investment argue that this type of investment became successful in the western world and so will succeed everywhere. Further, there will be spread effects, and local people can be trained in foreign firms. Again, under-developed countries suffer from lack of capital. Foreign direct investment will supplement domestic capital. Further, this type of investment may be desirable to utilise natural resources, to build up economic infrastructure, to import developed technology from abroad, etc. There can be no general solution to this debate since each individual case has to be judged on its own merits.

Coming to the case of India, we see that in the industrial policy of 1991, many concessions have been given to foreign investment. As a result, during the period since 1991, the flow of foreign direct investment to India has considerably increased. This has helped Indian economy in many ways. **Firstly,** it has raised the rate of investment. **Secondly,** it has helped to build up infrastructure. **Thirdly,** foreign investment has supplied machinery and equipment necessary for industrial development. **Fourthly,** foreign direct investment in India has initiated many new ventures. **Fifthly**, it has helped to develop iron and steel industries and also petro-chemicals and electronics industries. **Sixthly,** it has brought improved technologies from developed countries.

However, foreign direct investment in India has created some problems also. **Firstly,** a large share of foreign investment is portfolio investment which is speculative by nature. **Secondly,** it has sent huge money to home country in the form of royalty and profit. **Thirdly,** very often it has brought technologies unsuitable for India. **Fourthly,** foreign direct investment has discouraged domestic producers. **Fifthly,** it has shown interest in the production of luxury consumer goods. Such type of investment is not desirable in India.

Thus, foreign direct investment is not an unmixed blessing. Hence, there should be some judicious restrictions on foreign direct investment in India.

15. What are the differences between commercial bank and merchant bank?

(Section 10.5.5)

16. What do you mean by money market? What are the weaknesses of Indian money market? **(Sections 7.1 & 7.6)**

17. Discuss the constitution and functions of Securities and Exchange Board of India. **(Section 8.16)**

18. Explain the basic functions of the new issue market and state the important methods of new issue of securities. **(Sections 8.10.2 & 8.10.3)**

2008

Group-A

1. What are the differences between development banks and commercial banks? **(Section 3.4)**

2. State the main functions of the Industrial Development of Bank of India (IDBI). **(Sections 3.6.5 & 3.6.6)**

3. Discuss the objectives of the Unit Trust of India (UTI). **(Section 4.9.1)**

4. Explain the advantages of investing money in mutual funds. **(Section 4.8.1)**

5. What do you mean by securitisation?

Ans: Securitisation is a technique by which a financial company converts its illiquid, non-negotiable and high-value financial assets into small-value, tradable and transferrable securities. According to L.M. Bhole, the term "securitisation" is used in financial literature in two senses. First, it refers to a fast growth of direct (primary) financial instruments. Second, securitisation refers to a collateralised financing through the "sale" of existing assets of financial institutions. The term is more generally used in the second sense. When a company takes any loan from an individual or financial institutions, then the loan is to be repaid to the creditor on due date as per specific terms and conditions. Now, if the company is not able to pay the debt, the loan can be converted into securities, such as, equity shares, preference shares, bonds, etc. This is called securitisation. As a result of securitisation, the creditor becomes the security holder. Development banks and financial institutions sometime give loans to companies in such terms that if the company is not able to pay the loan in due time, then such loans will be converted into securities. The terms and conditions of conversion are mentioned at the time of offering the loan. Thus, securitisation refers to the process of converting a loan issued by an individual or a financial institution into securities of the borrowing company if the loan cannot be repaid by the borrower company in due time.

One main part of securitisation is asset-based securitisation (ABS). Let us explain the process of this type of securitisation. In this case, securitisation starts with an originator selling a part of his assets to a body called the **special purpose vehicle (SPV)** and in effect converting the assets into cash. The SPV in turn raises money by floating a debt instrument on the strength of cash flows and the underlying assets, and using the proceeds to pay off the originator. The proceeds collected by the originator on account of a loan made by it, are then passed on to the SPV which in turn pays off the principal and the interest to the final investor.

Asset-based securitisation is mainly of four types:

(i) Mortgage- based securitization,

(ii) Auto loans receivables securitization,

(iii) Credit cards securitisation, and

(iv) Trade receivable securitisation.

In India, the first securitisation took place between Citibank and ICICI in 1990.

6. What is "differential interest rate"? **(Sections 5.4 & 5.5)**

7. (a) Why is Reserve Bank of India (RBI) referred to as 'Banker's Bank'? **(Section 2.10.2)**

(b) Explain the role of RBI in open market operation. **(Section 2.14.3.B)**

8. Discuss briefly the functions of the State Financial Corporations and Life Insurance Corporation of India. **(Sections 3.10.2 & 4.6.4)**

9. Explain the significance of the financial system. **(Sections 1.1 & 1.2)**

Group-B

10. What is a call option?

Ans: An option is an agreement whereby one person grants another the right to buy or sell certain goods or securities at an agreed price at or within a stated future time. Options are of two types: call options (or calls), and put options (or puts). Call option is the option to buy and put option is the option to sell. In the case of call options or calls, the buyer has the right but not the obligation to buy a given quantity of an asset at a given price on or before a given future date. In the case of put options or puts, the buyer has the right, but not the obligation to sell a given quantity of an asset at a given price on before a given date.

We have said that call option is the option to buy shares at a particular price. Hence, an investor will take a call option if he expects market price of shares to be higher than the strike price (i.e., the agreed price). In that case, he will be able to earn the difference in two prices (i.e., market price—agreed/strike price).

In a put option, an investor has a right to sell. So, he will take this option if he expects market price to be lower than the strike price (or agreed price).

11. Briefly discuss the need for stock exchange. **(Section 8.12.3)**

12. Discuss the role of Discount and Finance House of India (DFHI) in Indian money market. **(Section 7.13.1)**

13. Discuss the major functions of merchant banks. **(Sections 10.5.1 & 10.5.3)**

14. Mention five features of financial services.

Ans: Financial services refer to the activities, benefits, and satisfaction rendered by different financial institutions towards savers and investors. These services facilitate the transfer of funds from surplus spending units to deficit spending units. Financial services are provided by various financial institutions like banks, insurance companies, development financial institutions, non-banking financial companies, subsidiaries of financial institutions, leasing companies, mutual funds, merchant banks, etc. These services are regulated by SEBI, RBI, Government of India (GOI), IRDA, and various Acts.

Financial services have some special features which make them distinct from other kinds of services. These are:

- **Intangibility:** Financial services are intangible. They cannot be seen, held, touched, or heard. Their specific qualities are only realised. Like all services, financial services are also invisible.
- **Specificity:** Financial services are customer specific. They try to fulfill the specific requirement of customers. These services are to be generated by financial institutions keeping in mind the prevailing market conditions.
- **Perishability:** Financial services cannot be stored, they are perishable. These services are generated and provided as and when they are required by the customers.
- **Innovativeness:** Financial services are innovative. With the passage of time and with the changing world of business, customer's requirements for financial services also change. To keep pace with them, financial institutions have to innovate new financial products and services.
- **Human-capital intensity:** New and innovative financial services are generated by financial institutions with the help of skilled and experienced personnels, consultancy firms, etc. Thus, financial services are human-capital intensive.

15. Distinguish between brokers and sub-brokers operating in stock exchanges.

(Section 8.13.3)

16. Discuss the features of share market and call market.

Ans: Share market or stock exchange is an organised market where listed securities like shares and debentures of private, public, government, and semi-government companies are regularly traded. This market has a highly competitive condition where a large number of buyers and sellers transact financial securities. Share market (or stock exchange or stock market) has the following features:

- **Company form of Organisation:** Share markets are generally formed as companies. Hence, they have shareholders, bondholders, etc. like other companies.
- **Specific Rules and Regulations:** Share markets are formed as per provisions of law or statute or Company Act. Hence the members have to operate obeying some rules and regulations as contained in the Acts/statutes.
- **Functionaries:** Share market operates through its functionaries like brokers, sub-brokers, jobbers, etc.
- **Management:** A share market has a board of directors. This board supervises the activities of the share market.
- **Types of Transaction:** Securities can be traded on a share market by cash or on credit. Again, there may be spot trading or forward trading. In case of cash transactions, accounts are settled within 3 to 4 days and in case of credit transaction,

accounts are settled within 15 to 30 days. In the case of spot trading, securities are provided within two days after the day of transaction. In the case of forward trading, securities are provided on a future date as per agreement between the buyer and the seller.

- **Nature of Certificate:** In a share market, after transaction of securities, the security certificate may be given in physical form or as an electronic number. The former is known as scrip-based trading and the latter is known as scripless or screen-based trading. The second type of trading is popularly called dematerialisation or demat in short.
- **Speculation:** In a share market, various types of speculative actives are common. There are different types of speculators in a share market, namely, bull, bear, lame duck and stag.
- **Regulation:** As we have mentioned, there are many speculative activities in a share market. Further, the members of a share market may be involved in various types of fraudulent and unfair trade practices. Then the interests of investors in securities are hampered. They also retard the development of securities market. Hence, such fraudulent and unfair trade practices in share market are to be controlled. In order to regulate and control the activities of share market, the Securities and Exchange Board of India (SEBI) has been formed with wide range of powers.

Features of call market **(Sections 7.9.1 & 7.9.3.)**

17. Discuss the role of Securities and Exchange Board of India (SEBI) and the court regarding investor protection. **(Sections 9.8.1 & 9.8.3)**

18. What do you mean by credit rating? Discuss the functions of a credit rating agency. **(Sections 10.7 & 10.10)**

2009

Group–A

1. "Financial System performs co-ordination between saving and investment" – Comment. **(Sections 1.1 & 1.2)**

2. Discuss the importance of LICI in the Indian financial system. **(Sections 4.6.4 & 4.6.5)**

3. Discuss the development role of the state-level development banks in India. **(Sections 3.10.3,3.10.4 & 3.10.3)**

4. What do you mean by "Lender of Last Resort"?

Ans: The Central Bank's function as the lender of last resort refers to its obligation to lend to the commercial banks so long the stability of the financial system is not hampered. The Central Bank lends to commercial banks for short periods and buys approved securities from them. This aid is given at the request of commercial banks. For this role, the Central Bank is called the lender of the last resort.

We give an example. Suppose the non-bank public becomes doubtful of the capacity of the commercial banking system to encash deposits on demand. Then there is a crisis of confidence. The public will then rush to the banks to withdraw their deposits. Thus there will be a "run". We suppose that a commercial bank has a deposit liability of ₹1000 and holds cash of only ₹100. When the public has encashed ₹100, the bank's cash is zero. Deposits however are still ₹900. If the public still wants to encash further deposits, the bank must suspend payments unless the banking system can find additional cash. In this event, the banking system and with this the monetary system will collapse. Deposits will no longer serve as money. In this situation, the Central Bank acts as the lender of last resort. In doing so, the Central bank ensures the liquidity and hence stability of the banking and monetary systems. As long as the crisis of confidence persists, the Central Bank acts as the lender of last resort. When the public sees that it can convert deposit into cash whenever it wishes, it will no longer wish to do so. Then they will deposit cash with the commercial banks. As a result, commercial banks will pay off their loans to the Central Bank. The system will revert to the pre-crisis period.

The above is a classic example of Central Bank acting as the lender of last resort during a financial panic. Such situations are now-a-days rare. At present, the Central Bank acts as a residual lender. This is done even in situations where confidence has not collapsed. Let us explain it.

Let the Central Bank wish to contract the money supply. We assume that it cannot undertake open market sales—and it freezes a part of bank cash ratio below their preferred ratio. So, there will be a secondary contraction of bank credit. But this cannot be carried out instantly, for it will take time to reduce advances. Hence, to maintain their cash ratio, commercial banks borrow from the Central Bank. Then the Central Bank will act as residual lender. It will charge a high lending rate. Such a rate is known as penal rate. Its objective is two-fold:

(i) To compel contraction of bank credit, and
(ii) To raise interest rate. Further, such assistance is given against the deposit of suitable securities. Alternatively, the Central Bank may buy suitable securities from commercial banks.

When commercial banks have to borrow at a (higher) penal rate from the Central Bank, they will also increase the rate of interest. Thus, the Central Bank can directly influence the rate of interest and lending policy of commercial banks as a residual lender without adopting open market operations (OMO).

5. What are the causes of failure of Unit-64 scheme of the Unit Trust of India?

(Q. No. 9 of 2005)

6. What is the difference between administered interest rate and market-determined interest rate? **(Q. No. 5 of 2006)**

7. Discuss the recent changes in the monetary policy of the Reserve Bank of India.

(Q. No. 3 of 2014)

8. Discuss the developmental role of the Industrial Development Bank of India (IDBI). **(Sections 3.6.5, 3.6.6 & 3.6.7)**

9. Analyse the Indian financial system by classifying its components. **(Sections 1.1 &1.3)**

Group-B

10. What is the difference between new issue market and stock market? **(Section 8.11)**

11. Who are "jobbers" in the stock market? **(Sections 8.13.4 & 8.13.5)**

12. Discuss the role of the media in investors' protection. **(Section 9.8.4)**

13. What is "Insider Trading"? **(Section 9.9)**

14. Discuss the usefulness of credit rating to the investors. **(Section 10.11.1)**

15. State the differences between merchant banks and commercial banks. **(Section 10.5.5)**

16. Discuss the major services rendered by merchant banks. **(Sections 10.5.1 & 10.5.3)**

17. Discuss the recent developments in the Indian capital market. **(Section 8. 17)**

18. (a) Discuss the nature of Indian call money market and also state the modes of participation in it. **(Section 7.9)**

(b) Discuss the role of Discount and Finance House of India (DFHI) in the Indian money market. **(Section 7.13.1)**

2010

Group-A

1. Distinguish between organised and unorganised financial institutions in a financial system. **(Section 7.2)**

2. What is the function of RBI as currency authority. **(Section 2.14.2)**

3. What do you mean by "Market Segmentation Theory" of the term-structure of interest rate? **(Section 5.7.3)**

4. What do you mean by fund-based financial services and advisory financial services? **(Sections 10.1 & 10.2)**

5. What do you mean by open market operations?

Ans: The term "open market operations" is used in two senses. In the narrow sense, open market operations (OMO) imply the purchase and sale of government securities by the Central Bank in the open market. In theoretical or broad sense, open market operations imply the purchase and sale by the Central Bank not only of government securities but also of other eligible papers of private concerns.

How it Works *(Modus Operandi)*

When the Central Bank purchases securities from the open market, it makes payments to commercial banks and private individuals. In the case of commercial banks, the payments are made in the form of increasing their reserves with the Central Bank. Then commercial banks are in a position to give more loans. A given increase in the cash reserves of commercial banks will lead to a multiple expansion of credit. This will have an expansionary effect on the level of economic activities.

The opposite process will play in the case of open market sale. When the Central Bank sells securities to commercial banks, commercial banks will have to pay the Central Bank in cash. This will reduce their reserves and so they will create less credit. Money supply will fall and this will have a contractionary effect on the level of income and employment.

Open market operations also influence the rate of interest in the market. For example, open market purchase of securities will cause an increase in money supply and hence a downward movement in interest rates. On the other hand, open market sales of securities will cause a reduction in money supply, and hence an upward pressure on interest rates. Changes in interest rates will again bring about changes in demand, cost, production, and internal price level. Thus, open market operations can expand or contract economic activity by influencing the rate of interest also.

Conditions of Success/Limitations of OMO

For the success of open market operations (OMO), certain conditions must be fulfilled.

- There must exist a broad and well developed market of securities. This condition is not generally fulfilled in underdeveloped countries.
- Commercial banks must maintain a definite cash-reserve ratio. If the reserve ratio is not legally fixed, commercial banks may not reduce their credit even when their reserves fall.
- The volume of public debt should not be too large. Otherwise, even a small sale in a narrow security market will cause a drastic fall in the price of government securities. Then the rate of interest will rise to create an embarrassing situation for the government.
- For the success of open market operations, the purchase and sale of securities should be carried on an extensive scale. Hence, the Central Bank should have a large stock of different types of securities.
- Commercial banks should have no direct access to the Central Bank for financial accommodation. Otherwise, the effect of open market sale of securities will be neutralised.
- Open market operation is more effective in controlling credit than expanding credit. So, it is more effective in controlling inflation rather than curing depression.
- If the borrowers have a non-conformist attitude, i.e., if they are unwilling to take loans, credit cannot be expanded by the Central Bank.

Still, open market operation (OMO) is a useful method of credit control. It is more direct and effective than the bank rate. However, in less developed countries, its effect is somewhat limited for underdeveloped money market.

6. Distinguish between development banks and commercial banks. **(Section 3.4)**

7. (a) Explain the relationship between short-term and long-term interest rate. **(Section 5.5)**

(b) Discuss the determinants of general structure of interest rate. **(Section 5.7)**

8 (a) How does the Reserve Bank of India control credit by changing the reserve ratio?

Ans: Commercial banks are required to keep a part of their deposits in the form of cash with the central bank. This is called cash-reserve ratio (CRR). The Central Bank can vary this reserve ratio. Hence it is also called variable reserve ratio (VRR). This is one the instruments of credit control used by the Central Bank. By changing or varying the reserve ratio, the Central Bank can regulate the volume of bank credit. Hence the method is known as variable reserve ratio (VRR).

How it Works (*Modus Operandi* of VRR)

The theory underlying the method of VRR is that by changing the reserve ratio, cash reserves of the commercial banks can be directly changed. This will affect their ability to create credit.

Let us give an example. Suppose commercial banks have an excess reserve. On the basis of it, they are creating much credit. The Central Bank considers it as undesirable for the economy. So it raises the reserve ratio which commercial banks are required to maintain with the Central Bank. This will automatically sterilise a part of the reserves of the commercial banks and force them to curtail credit. Similarly, when the minimum reserve ratio is lowered, credit will expand. Variable reserve ratio is thus a direct method of controlling the credit operation of commercial banks.

We know that the credit-creation multiplier of commercial banks is inversely related to the cash-reserve ratio (r) of commercial banks, i.e., multiplier = $1/r$. If r is raised by the Central Bank, the size of the multiplier becomes lower. Then commercial banks can create a smaller volume of credit. Conversely, a lower cash-reserve ratio will increase the size of the multiplier and hence credit will rise.

Merits/Advantages of VRR

As an instrument of credit control, the VRR has the following merits:

- The most important merit of the VRR is that it is a direct method and its success does not depend on so many other conditions. In fact, it may be effectively used when the bank rate policy and open market operations fail.
- Unlike bank rate, the success of VRR does not depend on the relation between the bank rate and other rates of interest.
- Unlike open market operations, VRR can be well effective in an unorganised money market. Further, the effectiveness of VRR does not depend on the size of the public debt. Hence, it is an effective method of credit control both in the advanced and backward countries.
- The VRR is a very strong instrument of credit control. It can control the credit-creation power of commercial banks just by a very small change in reserve ratio.

- The method of VRR works very quickly. The Central Bank can reduce the credit-creation power of commercial banks "at a pen's stroke".

Limitations

The method of VRR is subject to some limitations:

- Even if the Central Bank raises the reserve ratio, commercial banks may still be left with ample reserves after satisfying the statutory minimum requirements.
- The VRR also becomes ineffective when commercial banks have large foreign funds. Even if the reserve ratio is raised, commercial banks can expand credit on the basis of foreign fund.
- When small changes are to be made, open market operations are more effective than the variable reserve ratio.
- The VRR is highly discriminatory in nature. It discriminates against smaller commercial banks who have smaller cash reserves. Similarly, it discriminates in favour of non-bank financial intermediaries who are not required to keep reserves with the Central Bank.
- Reserve ratios are fixed for the whole country or at least for a wide geographical area. Hence, it cannot meet the problems of localised stringency or superfluity.
- VRR creates a lot of uncertainty for commercial banks and limits their freedom of lending. Commercial banks are always in constant fear of a sudden rise in reserve ratio. So, they have to keep plenty of reserves with them to meet the requirements of the Central Bank.
- The success of VRR also depends on the demand for credit by the borrowers. If borrowers do not come to the banks to take any loan (non-conformist attitude), credit will not expand even if reserve ratio is lowered
- The VRR can be used only in those countries where commercial banks are under some legal obligations to maintain a minimum reserve ratio.

  Still, VRR is a useful method of credit control. It is specially effective in reducing large reserves of the commercial banks. This method is particularly useful for under-developed countries where the bank rate policy and OMO are not effective due to unorganised money market.

(b) Discuss the role of NABARD in rural development.

(Sections 3.11.4, 3.11.5 & 3.11.6)

9. (a) Discuss the major functions of the Unit Trust of India (UTI).

(Sections 4.9.4, 4.9.5 & 4.9.6)

(b) Give a brief account of organisational changes in the UTI. **(Q. No. 9 of 2005)**

Group-B

10. Distinguish between "call" and "put" option. **(Q. No. 10 of 2008)**

11. Distinguish between Repo and Reverse Repo.

Ans: Repo refers to repurchase agreement. In this case, the seller of a security agrees to repurchase the security at a mutually decided future date and price. In the case of reverse repo, the case is just the opposite. Here, the buyer of a security agrees to sell the security at a mutually decided future date and price. Thus, a repo/ reverse repo is a transaction of financial security in which two parties (buyer and seller) agree to sell and repurchase the same security at a future date and price. From the view point of the seller, the transaction is called a repo. By means of repo, the seller gets funds immediately by selling the securities with an agreement to repurchase the same at a future date. Similarly, from the viewpoint of the buyer, the transaction is called a reverse repo. By means of reverse repo, the buyer buys the securities with an agreement to resell them at a future date. Here, the buyer can utilise his funds for the short period by buying the securities. Thus, by means of repo, the seller gets immediate funds while by means of reverse repo, the buyer can make short-term utilisation of his funds. The repo/ reverse repo is a very important money market instrument to make short-term adjustment in liquidity of financial institutions including banks.

Under the repo system, the RBI purchases securities from commercial banks. It had introduced the system in December 1992. It is applicable for central government bonds. When the RBI purchases government bonds from commercial banks, it pays money to commercial banks and hence liquidity of commercial banks increases. The maturity date varies between 1 to 14 days. In the opposite case of reverse repo, liquidity of commercial banks decreases. The RBI had introduced the system of reverse repo in November, 1996. Under this system, the RBI issues government bonds by auction. If the prevailing short-term interest rate is lower than the interest rate on government bonds, commercial banks will buy those government securities issued by the RBI for earning higher interest rate. Then the amount of cash money at the disposal of commercial banks will fall. So, their liquidity will decrease. Thus, the RBI achieves the function of maintaining short-term liquidity in the money market through repo/reverse repo transactions.

The RBI, commercial banks and primary dealers deal in repo and reverse repo transactions. Non-bank financial institutions can deal only in reverse repo transactions. This means that they are allowed only to lend money through reverse repos to the RBI, commercial banks and primary dealers.

12. What is meant by "Certificate of Deposit"? **(Section 7.7.5)**

13. What do you mean by "credit rating"? Name any two credit rating agencies in India. **(Sections 10.7 & 10.13)**

14. What is Treasury Bill Market? **(Sections 7.10, 7.10.1 & 7.10.2)**

15. What do you mean by portfolio consultants? **(Section 8.13.6)**

16. (a) Discuss the major weaknesses of Indian money market. **(Section 7.6)**

(b) Give an overview of recent changes in this market. **(Section 7.15)**

17. (a) Discuss the functions of the new issue market. **(Sections 8.10.1 & 8.10.2)**

(b) "The share market plays an important role in the Indian economy." Discuss. **(Section 8.12.3)**

18. (a) What do you mean by investors' protection? **(Section 9.1)**

(b) Discuss the role of SEBI in the protection of the interests of the investors.
(Section 9.8.1)

2011

Group-A

1. What is financial system? **(Section 1.1 & 1.2)**
2. What are the different components of Indian financial system? **(Section 1.3)**
3. What is Regional Rural Bank?

   Ans: In the 20-point economic programme announced by the then prime minister, Mrs Indira Gandhi, in July 1975, one point was the liquidation of rural indebtedness and the provision of institutional credit to farmers and village artisans. To fulfil this, the government announced the establishment of Regional Rural Banks. It promulgated Regional Rural Bank Ordinance on 26 September 1975. The ordinance became a law in 1976.

   Initially five regional rural banks were established on 2 October 1975. Each of these banks was sponsored by a commercial bank. The main objective of the regional rural banks is to provide credit facilities particularly to the small and marginal farmers, agricultural labourers, rural artisans and small entrepreneurs. These banks thus seek to develop agriculture, trade, industry and other productive activities in the rural areas. In 2001–02, there were 196 Regional Rural Banks (RRBs) in 23 states with 14,500 branches. They had raised aggregate deposits of ₹43,220 crore and had advanced ₹18,370 crore during 2001–02 to the rural sector. Over 95 per cent of this loan has gone to the weaker sections.

   The share capital of the regional rural bank is subscribed by the central government, the state government concerned and the sponsoring commercial bank in the ratio 50:15:35. The regional rural banks are also basically scheduled commercial banks though there are some differences between commercial banks and regional rural banks.

   The sponsoring banks and the Reserve Bank of India provide many subsidies and concessions to the regional rural banks. These are: lower interest rate on the loans taken by them, managerial and financial assistance, lower cash reserve ratio and lower liquidity ratio for them, etc.

   The regional rural banks are expected to revolutionise rural banking. It was expected that these banks would bring banking facilities to the doorsteps of small and marginal farmers and village artisans. A study of the RBI shows that the RRBs followed the directed path. However, their loan recovery position is highly unsatisfactory. Hence the Khusro Committee has suggested either to wind up them or to merge them with the sponsor banks.

   According to Narasimham Committee, the RRBs have failed to provide a low cost alternative commercial banks mainly for two reasons. **Firstly,** these banks have to operate under many restrictions. **Secondly,** due to rise in wages and salaries of their staff, these banks are no longer low cost banks. Hence, the committee had recommended to waive these restrictions. The Bhandari Committee also made similar suggestions. Hence, the NABARD has taken some steps:

- The RRBs have been permitted to open extension counters.
- They are allowed to give loans in non-priority sectors also.
- They are permitted to relocate their loss making branches.
- They are also free from their service area obligations.

With these steps, RRBs are expected to perform better in future.

4. Mention two differences between commercial banks and co-operative banks.

Ans: Commercial Banks

Commercial Banks collect deposits from the public and lend that money to producers, consumers and businessmen. Among all types of banks, commercial banks are the most important banks in the country. In India, State Bank of India, Canara Bank, Bank of Baroda, Bank of India, Allahabad Bank, United Bank of India, Punjab National Bank, etc., are some of the important commercial banks.

Co-operative Banks

Banks which are organised under the provisions of the law of the co-operative societies of the country are called co-operative banks. In India, co-operative banks were originally set-up to provide credit to the primary agricultural credit societies at lower rate of interest. However, at present, co-operative banks operate in urban areas also and they provide loans not only for agricultural activities but also for a variety of other economic activities.

Some major differences between commercial banks and co-operative banks are noted in the following table.

Commercial Banks	Co-operative Banks
1. These are guided by profit motive.	1. These are guided by welfare motive.
2. Organised under company law.	2. Organised under the law of co-operative societies.
3. Rate of interest charged by them is relatively high.	3. Rate of interest charged by them is relatively low.
4. Size is relatively large.	4. Size is relatively small.
5. They provide a wide range of services.	5. They provide some specific services.
6. They do not get any aid form the government.	6. They get financial aid from the government.

5. Discuss the functions of commercial banks. **(Section 2.7)**

Q.6. Discuss the functions of co-operative banks.

Ans: A co-operative bank is defined as a voluntary agency or a mutual society formed, composed, and governed by working people themselves for encouraging regular savings and granting small loans on easy terms and conditions in respect of interest and repayment. Co-operative banks or co-operative credit societies have the following major objectives:

- To provide loans at concessional rates to needy members.
- To provide loans against any kind of security, or even against personal security.
- To ensure most effective or productive use of loans.

With these three basic objectives, co-operative banks perform some useful functions. Hence their role is important in an economy. In brief, the functions of co-operative banks are as follows:

- Co-operative banks offer loans to farmers so that they can utilise them for raising agricultural production and improving their standard of living.
- Co-operative banks supervise the activities of their borrowers in order to ensure productive use of the loan amount.
- These banks also collect funds outside the society to finance the productive activities of their members.
- Co-operative banks try to develop the spirit of co-operation and understanding among its members.
- Co-operative banks try to supplement the income of farming community by enabling them to engage in dairy farming, sheep rearing, vegetable growing, etc.
- These banks try to develop the saving habit among the rural people so that they may not have to borrow in future.
- Co-operative banks teach the farming community to borrow at the right time, the right amount, for the right purpose and repay the loan in time. In a word, they try to develop a healthy attitude among the rural people.

7. Explain in brief the functions of Indian financial system. **(Sections 1.1 & 1.4)**

8. Discuss the functions of Reserve Bank of India. **(Section 2.14.2)**

9. Discuss the methods of credit control of RBI. **(Section 2.14.3)**

10. Mention two objectives of LICI. **(Section 4.6.1)**

11. Discuss the objectives of GICI. **(Section 4.7.3)**

12. Define development banks. **(Section 3.1)**

13. Write down the names of any two development banks. **(Section 3.3)**

14. Discuss the functions of IDBI. **(Section 3.6.5)**

Group-B

1. What do you understand by money market? **(Sections 7.1 & 7.11)**

2. What is Treasury Bill? **(Section 7.7.2)**

3. What is repo? **(Q. No. 11 of 2010)**

4. What do you mean by term loan?

Ans: Term loan is a loan from a financial institution for a fixed term of years. It is usually for three to five years (middle-term loan) but sometimes longer (long-term loan), at a fixed rate of interest. Term loan is normally repayable by installments spread over a period. A term loan is required by the firm for investment in fixed capital, e.g., on plant and buildings. The borrower has the assurance that so long as regular repayments are made, the loan will not be recalled. Hence this type of loans is particularly suited to the finance of capital expenditures of the business firm. The amount of such loan is generally large and the rate of interest is relatively low. Term loan is sanctioned by the financial institution on the basis of security provided by the borrower in the form of immovable property.

5. Discuss the determinants of money supply. **(Section 2.13)**

6. Discuss the present interest policy of India. **(Sections 5.8, 5.8.1, & 5.8.2)**

7. What is mutual fund? **(Section 4.8)**

8. What do you mean by IRDA? **(Q. No. 6 of 2007)**

9. Can interest be zero? **(Section 5.6)**

10. Discuss the causes of differential interest rate. **(Sections 5.4 & 5.5)**

11. Discuss the structure of Indian money market. **(Section 7.8)**

12. Discuss the objectives and functions of Regional Rural Banks. **(Q. No. 3 of 2011)**

13. What is Bank Rate?

Bank rate or the discount rate is the rate at which the Central Bank rediscounts the first class bills of exchange presented to it by commercial banks or discount houses. The Central Bank tries to control credit through the bank rate policy by influencing both the cost and availability of credit. By raising the bank rate, the Central Bank raises the cost of credit, and by lowering the bank rate, the Central Bank reduces the cost of credit. The bank rate policy also affects the availability of credit by changing the conditions under which the Central Bank grants loan to commercial banks. By changing the eligibility rules of discounting bills, the Central Bank can influence the availability of credit.

Mode of Operation (*Modus Operandi*) of Bank Rate

There are two views on how the bank rate policy works – one put forward by Hawtrey and the other put forward by Keynes.

According to Hawtrey, changes in the bank rate operate through the change in the short-term rate of interest, which, in turn, influences the cost of borrowing. During an inflationary situation, the Central Bank raises the bank rate. Then the cost of bank credit rises and the cost of inventory of goods rises. So the businessmen will reduce their borrowing from commercial banks and will also reduce their orders with manufacturers for finished goods. Then the manufacturers will reduce investment expenditure. So, aggregate demand will fall. This will control the inflationary pressure. In the opposite way, a fall in bank rate will help remove depression.

Hawtrey's analysis is based on two assumptions. **Firstly**, interest charges are a substantial part of the total cost of holding finished goods by businessmen. **Secondly**, traders and businessmen are very sensitive to changes in interest rate. Both these assumptions are unrealistic. Interest charges are only a very small part of total cost of holding goods by businessmen. Further, businessmen and traders are more sensitive to changes in prospective demand rather than to changes in interest rates. If they expect a rise in demand for their goods, they will increase their borrowings from banks even if the rate of interest rises.

Keynes has provided an alternative approach to the working of the bank rate policy. According to him, when the bank rate is increased by the Central Bank, short-term interest rates in the market rise immediately. Then the earnings of long-term securities become relatively low. So people will try to sell away long-term securities and purchase new short-term securities. Then the price of long-term securities will fall and the long-term rate of interest will rise. Then investment will fall and aggregate demand will fall. In the opposite way, a fall in bank rate will stimulate investment through a fall in long-term rate of interest and thereby remove depression.

While Hawtrey emphasises on the effectiveness of short-term interest rate to influence the level of economic activity, Keynes put the emphasis on long-term interest rate.

Conditions of Success/ Limitations of Bank Rate Policy

The success of bank rate policy depends upon the fulfilment of certain conditions. We briefly mention them one by one.

- The bank rate and other rates of interest should move in the same direction. This is the essential condition for the success of bank rate policy. Further, investment expenditure should be highly interest elastic, so that a small change in the rate of interest can bring about a considerable change in investment.
- The second condition for the success of bank rate policy is that commercial banks should not have sufficient excess reserves. If they have sufficient excess reserves, they need not approach the Central Bank for money from rediscounted bills. In that case, even if the bank rate is raised, the market rate of interest will not rise. So, the volume of credit will not fall.
- The existence of an elastic economic structure is necessary for successful working of the bank rate policy. This means that wages, costs, and prices should be sufficiently flexible so that they can adjust themselves quickly to changes in the rate of interest.
- The existence of a well-organised market for short-term funds is another condition for the success of bank rate policy. Such a market helps transmit changes in the bank rate to all the sectors of the economy.
- The bank rate policy is ineffective if borrowers assume a non-conformist attitude. Then investors will not take much loan even if the bank rate is reduced and will take more loan even if the bank rate is raised.
- The bank rate policy is indirect and passive — it works through changes in the rate of interest. It does not impose any restriction on the volume of credit. So the bank rate policy involves uncertainty.

2012

MODULE-I

1. (a) What is financial system? **(Section 1.1)**

(b) Describe the major components of financial system. (**See Section 1.3)**

2. (a) What do you mean by financial intermediary? **(Section 1.6)**

(b) Mention two main types of financial intermediaries.

Ans: In the wide sense, financial intermediary refers to any operator who is engaged in bringing together ultimate providers and ultimate users of finance. There are mainly two types of financial intermediaries. First, there are intermediaries who themselves borrow or take up funds in order to re-lend them. Important examples of such intermediaries are banks, housing societies and companies, insurance companies, etc. Second, there are intermediaries who are engaged as brokers in bringing together borrowers and lenders, or buyers and sellers of securities. The first group can again be divided into two types, namely, banking intermediary institutions and non-banking financial intermediaries. In the sub-category of banking financial institutions we have different kinds of banks, such as, commercial banks, development banks, industrial banks, co-operative banks, agricultural banks, land mortgage banks, exchange banks, Exim banks, etc. In the category of non-bank financial intermediaries, there are insurance companies, housing finance companies, mutual funds, loan companies, investment companies, etc.

(c) Mention five functions of financial intermediaries.

Ans: The main functions of financial intermediaries are as follows:

(i) Collecting savings of surplus spending units by selling different types of financial papers.

(ii) Supplying money/liquidity to the investors or deficit spending units by buying different credit papers from them (indirect finance).

(iii) Innovating new credit instruments.

(iv) Helping investors in asset diversification.

(v) Providing various kinds of merchant banking services, etc.

3. (a) What is Cash Reserve Ratio? **(See 8(a) of 2010)**

(b) Explain the role of Reserve Bank of India in "open market operations".

(Section 2.14.3)

4. (a) What is credit control?

(b) What is its significance?

Ans: (a) Credit control refers to the policy of the central bank of a country to control money supply in the economy in order to stabilise the price level. This is one of the important functions of the central bank of any country. It is monetary policy in narrow sense, and refers to the instruments of credit control at the disposal of the central bank. During inflation, the central bank uses those instruments in such a manner that money supply in the economy falls. Then aggregate demand for goods and services will decrease. This will put a break on the upward trend in price. In the opposite situation of deflation when price level has a downward trend, the central bank will use its instruments in such a manner that the volume of bank credit and money supply rises. This will boost aggregate demand for goods and services and will arrest the downward trend in price level.

(b) The policy of credit control is highly significant in an economy. It is a part of monetary policy and hence a part of macroeconomic policy of a country. The main objectives of credit control policy are as follows:

(i) To stabilise the price level.
(ii) To maintain equilibrium in the balance of payment.
(iii) To control speculative activities,
(iv) To encourage investment in the desired sector on the one hand and to discourage investment in the undesirable sector on the other.
(v) To increase the level of income and employment, and
(vi) To attain a high rate of growth.

From the above objectives of credit control policy, we can easily realise its importance. This policy also raises the effectiveness of fiscal policy and hence should be used as a complimentary to fiscal policy. This again points to the significance of credit control policy.

(c) How does the RBI control credit? **(Section 2.14.3)**

5. (a) What is development bank? **(Section 3.1)**

(b) Explain the need for development bank in industrial and agricultural development of India. **(Sections 3.12.1 & 3.12.2)**

6. (a) Mention two differences between commercial bank and development bank. **(Section 3.4)**

(b) Discuss the functions of EXIM Bank of India. **(Sections 3.8.1 & 3.8.3)**

7 (a) What is IRDA? **(See No. 6 of 2007)**

(b) Discuss the objectives of formation of Life Insurance Corporation of India. **(Section 4.6.1)**

8. (a) Explain the concept of Mutual Fund. (Section 4.8)

(b) Discuss the functions of the Unit Trust of India. **(Sections 4.9.4, 4.9.5 & 4.9.6)**

9. (a) What is differential interest rate? (Section 5.4)

(b) Explain the major determinants of interest rate structure. **(Section 5.5)**

10. (a) What do you mean by “Gross Interest” and “Net Interest”? **(Section 5.2)**

MODULE-II

11. (a) What is financial market? **(Section 6.1)**

(b) Write three types of securities of financial market. **(Section 6.3)**

12. (a) Classify financial market. **(Section 6.2.1)**

(b) Who are the participants of financial market? **(Section 6.3)**

13. (a) What do you mean by money market? **(Section 7.1 & 7.1.1)**

(b) What are the major weaknesses of the Indian money market? **(Section 7.6)**

14.(a) What are the participants of money market? **(Section 7.8)**

(b) What are the main features of Indian money market? **(Sections 7.3 & 7.1)**

15. (a) What do you understand by the term "Capital market"? **(Section 8.1)**

(b) Write the names of market participants. **(Section 8.5)**

(c) Discuss in brief the securities used in the capital market.

(Summary Nos. 7, 8 & 9 of chapter 8.)

16. Write short notes on:

(a) Clearing House of Stock Exchange: This is very much similar to the clearing house of the central bank of a country. In this house, the central bank settles (or clears) the claims and counter-claims of different banks. Similarly, clearing house clears the demand for and supply of various securities made by demanders and suppliers of these securities. One of the main functions of a stock exchange is to clear the shares which have been booked for purchase or sale. The willing buyers and sellers of shares are scattered throughout the country or even throughout the world. When a particular person wants to buy or sell a particular scrip, he does not know who is willing to buy or sell that scrip. Hence, there is a communication gap between demander and supplier (and hence a gap between demand for and supply of that share). The clearing house of the stock exchange removes that gap. It just works as an intermediary between the purchaser and the buyer of a share. Generally a clearing house clears the shares at every 15 days. This is technically known as "session". For example, suppose the investors of Mumbai have booked for 50,000 shares of Tata Motors between 1 May and 15 May 2017 through their brokers. Similarly, some persons have expressed their willingness to sell 40,000 shares of the same company, Tata Motors, during the same time period. In this case, the clearing house of Bombay Stock Exchange will receive the shares from willing sellers and hand over them to the willing purchasers. The deficit of 10,000 shares in this case will be met from its own stock of shares gathered earlier. If the stock exchange does not have previous stock of such shares, the deficit of 10,000 shares of Tata Motors will be met from the next lot in the next clearing session or sessions on priority basis.

(b) Stock broker **(Section 8.13.1)**

(c) Foreign Institutional Investors **(Section 8.13.7)**

17. (a) What is meant by investors' protection? **(Section 9.1.)**

(b) Discuss the role of SEBI in investors' protection. **(Section 9.8.1)**

18. Describe the objectives and functions of SEBI.

Ans: Objectives of SEBI

The main objectives of SEBI are as follows:

(i) To regulate the activities of stock markets and any other security markets.
(ii) To regulate the operations of stockbrokers, sub-brokers, jobbers, merchant bankers and other intermediaries.
(iii) To control and supervise the activities of mutual funds.
(iv) To prohibit unfair trade practices in security markets.
(v) To prohibit insider trading in security markets.
(vi) To regulate and supervise substantial acquisition of shares and takeover of companies, etc.

For Functions of SEBI: **(Section 8.16.3)**

19 (a) What is Credit Rating? **(Section 10.8)**

(b) Describe its objectives. **(Section 10.8.2)**

(c) Mention the drawbacks of credit rating. **(Section 10.12)**

20 (a) Define Merchant Banking. **(Section 10.5.1)**

(b) Discuss the SEBI guidelines for registration of merchant banking. **(Section 10.6)**

2013

MODULE-I

Group-A

1. (a) What is financial system? **(Section 1.1)**

(b) Distinguish between organised and unorganised financial markets in Indian financial system.

Ans. Financial markets have two parts: money market and capital market. So, we have to distinguish between organised money market and unorganised money market and between organised capital market and unorganised capital market.

(Now See Section 6.2.2)

(c) Distinguish between development banks and commercial banks. **(Section 3.4)**

(d) What are the major objectives of Industrial Development Bank of India? **(Section 3.6.1)**

(e) What are the differences between Industrial Finance Corporation of India (IFCI) and the State Financial Corporations (SFCs)?

Ans: There are some differences between IFCI and SFCs. We summarize them in the following table.

IFCI	SFCs
1. The decision of setting up IFCI was taken in 1948.	1. Later, various states decide to set up such organisations. They were established in 1951 onwards.
2. It is an all-India level organisation. Its activity is spread all over India.	2. It is a state-level organisation. Its activity is limited within the respective state.
3. Its main objective is to provide finance to large industrial units.	3. The objective of SFC is to provide finance to small and medium size industries.
4. It gives mainly long-term loans.	4. SFCs provide middle-term and long-term loans.
5. Share capital is quite large compared to an individual SFC.	5. Share capital of each SFC is quite small compared to that of the IFCI.
6. It extends loan mainly to public limited company.	6. It extends loan mainly to private limited company, partnership firm and sole proprietorship unit.
7. It can sanction relatively large amount of loans, generally, up to ₹1 crore.	7. It can sanction relatively small amount of loan, generally up to ₹10 lakhs.

Group-B

2. (a) Discuss the objectives of Life Insurance Corporation of India. **(Section 4.6.1)**

(b) Indicate the objectives of the Unit Trust of India. **(Section 4.9.1)**

(c) Discuss the determinants of the interest rate. **(Sections 5.4 & 5.5)**

Group-C

3. (a) Discuss the importance of commercial banks in India. **(Section 2.8)**

(b) Explain the various functions of the Reserve Bank of India. **(Section 2.14.2)**

MODULE-II

Group-A

4. (a) What is meant by "financial markets"? **(Section 1.3)**

(b) Distinguish between Capital market and money market. **(Section 8.3)**

(c) What is Treasury Bill Market? **(Section 7.10)**

(d) Distinguish between "repo" and "reverse repo". **(Q. No. 11 of 2010)**

Group-B

5. (a) Discuss the importance of investors' protection. **(Section 9.2)**

(b) Evaluate the role of SEBI in the protection of the interest of the investors. **(See Section 9.8.1)**

(c) Discuss the objectives and functions of credit rating. **(Sections 10.8.1, 10.8.2 and 10.10)**

Group-C

6 (a) Discuss the functions of the new issue market. **(Section 10.8.2)**

(b) "The share market plays an important role in the Indian economy." Discuss. **(Section 8.12.3)**

(c) Indicate the recent changes in the capital market in India. **(Section 8.17)**

2014

MODULE-I

Group-A

1. (a) Write a brief note on the financial system of a country. **(Summary Nos. 1–4 of Chapter 1)**

(b) Briefly discuss the role of financial system in the economic development of a country. **(Sections 1.1 & 1.2)**

(c) Write a note on SIDBI. **(Section 3.9)**

(d) What are the major objectives of NABARD? **(Sections 3.11 & 3.11.3)**

(e) Discuss the role of development banks in industrial development of a country. **(See Sections 3.6.6, 3.6.7 & 3.6.8)**

Group-B

2. (a)(i) Write a note on the Unit Trust of India. **(Summary No. 8 of Chapter 4)**

(ii) Make a distinction between life insurance and general insurance.

Ans: Insurance is of two types: insurance on human life called life insurance and insurance on any asset other than human life called general insurance. There are some basic differences between life insurance and general insurance. This is shown in the table below:

Life insurance	General insurance
1. This type of policy is done on human life.	1. This type of policy is done on any asset other than human life.
2. Compensation is given to the nominee on the occurrence of death of the insured person.	2. Compensation is given for the loss/damage of the insured property against theft, fire, etc.
3. It involves payment of a certain sum after certain period or after death.	3. Amount of payment is not certain. It depends on actual damage.
4. Nomination can be done.	4. Nomination cannot be done.
5. Amount of loss due to death cannot be measured.	5. Amount of loss/ damage can always be measured.
6. The policy holder can get loan against policy documents.	6. There is no loan facility against policy document
7. It is usually long-term insurance.	7. It is usually short-term insurance.

(iii) Discuss the objectives and functions of General Insurance Corporation of India. **(Sections 4.6.1 & 4.6.4)**

(b) Distinguish between

(i) Gross interest rate and net interest rate. **(Section 5.2)**

(ii) Nominal interest rate and real interest rate. **(Section 5.3)**

Group-C

3. (a) Discuss the various methods of credit control as is followed by the RBI. **(See Section 2.14.3)**

(b) Examine the recent changes in the monetary policy as is followed by the RBI.

Ans: Some recent changes in the monetary policy of the RBI are as follows:

1. Both the cash reserve ratio (CRR) and the Statutory Liquidity Ratio (SLR) have been reduced.
2. The RBI has given more stress to increase rural finance through the Self-Help Group (SHG) in order to help the small and marginal farmers, village artisans, petty businessmen in rural areas, etc.
3. After 1991, the monetary policy of the RBI has been dissociated from the fiscal policy of the government of India.
4. Restrictions on interest rates have been largely removed. Interest rate is now market-determined in most cases.
5. In accordance with the policy of liberalisation, various restrictions on imports and foreign capital have been removed.
6. Banking sector has been given more autonomy and operational flexibility.
7. More initiatives have been taken by the RBI to integrate various segments of financial markets.

MODULE-II

Group-A

4. (a) Write the important functions of financial market. **(Section 1.4)**

(b) Distinguish between organised and unorganised financial market. **(Section 6.2.6)**

(c) Briefly discuss the major weaknesses of Indian money market. **(Section 7.6)**

(d) Discuss the functions of Discount and Finance House of India (DFHI). **(Section 7.13.1)**

(e) What are the functions of money market? **(Section 7.5)**

5. (a) Discuss the functions of Grievance Redressal Cell. **(Section 9.7)**

(b) Discuss the role of court in investors' protection. **(Section 9.8.3)**

(c) Discuss the importance of and services rendered by merchant bankers in India. **(See Sections 10.5.1 &10.5.3)**

Group-C

6 (a) Discuss the role of brokers and sub-brokers in the stock exchange.

(Sections 8.13.1 & 8.13.2)

Q.7 (a) Who are portfolio consultants? **(Section 8.13.6)**

(b) Discuss the services rendered by stock exchanges in the Indian capital market.

(Section 8.12.3)

2015

Group-A

1. Briefly state the role of financial intermediaries in an economy. **(Section 1.7)**
2. Give an overview of the structure of Indian financial system. **(Section 1.8)**
3. Discuss the importance of LICI in the Indian financial system.

   (Sections 4.6.4 & 4.6.5)
4. State the advantages of investing money in mutual funds. **(Sections 4.8 & 4.9.3)**
5. Give an overview of recent changes in the UTI. **(Q. No. 9 of 2005)**
6. Discuss the importance of financial markets. **(Sections 6.4 and 6.6)**
7. Write short notes on:

   (a) Foreign exchange market

   Ans: Foreign exchange means foreign currency. The market in which foreign exchange is bought and sold is known as foreign exchange market. In this market, currencies of different countries are exchanged against each other, and bonds and securities are exchanged against currencies. It is an over-the-counter market. It operates round the clock. Important locations of foreign exchange market are London, Paris, Zurich, New York, Tokyo, Hong Kong, Singapore, etc. The principal function of foreign exchange market is to convert one currency into another and to transfer funds from one country to another. In the case of international transaction, the currency of one country is generally not acceptable to other countries as medium of exchange. Hence when a country earns foreign currency through exports, that currency will have to be converted into domestic currency. Similarly, if a country imports commodities from other countries, the country will have to pay for these imports in foreign currency and for this domestic currency will have to be converted into foreign currency. Foreign exchange market is the place where such conversions take place.

   In the foreign exchange market, the main players are the banks. Apart from banks, there are travel agents, money changers and others who are given restricted licenses to deal in foreign exchanges. Other participants in the foreign exchange market are individuals, firms, governments and occasionally the international agencies. The foreign exchange market has some features which make it a near-perfect market. Various credit instruments used to transfer funds by banks are demand drafts, travellers' cheques, bills of exchange, international credit cards, international money orders, etc.

(b) Debt market **(Q. No. 6 of WBSU on paper of 2015)**

8. Discuss the objectives of credit rating. **(Section 10.8.2)**

9. State the limitations of credit rating. **(Section 10.12)**

10. Discuss the SEBI regulations regarding the registration of merchant banking. **(Section 10.6.1)**

Group-B

11. Discuss the objectives and functions of State Financial Corporations. **(Section 3.10)**

12. Explain the causes of variation in interest rate. **(Sections 5.4 & 5.5)**

13. Discuss the recent changes in interest rate structure in India. **(Section 5.8.3)**

14. Write a note on the call money market. **(Section 7.9)**

15. What do you mean by investors' protection? Discuss the role of media in investors' protection. **(Sections 9.1 & 9.8.4)**

16. Discuss the role of SEBI in investors' protection. **(Sections 9.6 & 9.8.1)**

Group-C

17. (a) Explain the significance of high powered money,

Ans: According to Milton Friedman, high powered money (H) is the sum of hand to hand currency with the non-bank public (C) and cash reserves with the commercial banks (R), i.e., H = C+R. This high powered money determines the volume of money supply in the economy. Friedman has shown that the volume of money supply in an economy is a multiple of the amount of high powered money. This is known as money multiplier doctrine or H-theory of money supply. So, the amount of money supply in the economy can be regulated by regulating the amount of high powered money. Then the rate of interest, the rate of inflation, etc., can be influenced. Here lies the importance or significance of high powered money.

(b) Write short notes on:

(i) Money multiplier **(Section 2.13)**

(ii) Bank rate policy **(Q. No. 13 of 2011)**

18. Explain the process of credit creation of commercial banks. State the limitations of the process. **(Sections 2.9 & 2.9.1)**

19. (a) Who are institutional investors? Discuss the role of institutional investors in Indian capital market. **(Section 8.13.7)**

(b) Write a note on Book-Building Method. **(Section 8.10.3.E)**

20. (a) Explain the relationship between the new issue market and secondary market. **(Section 6.2.3)**

(b) Give an overview of recent changes in Indian capital market. **(Section 8.17)**

2016

Group-A

1. Briefly discuss the role of financial system in economic development of a country. **(Sections 1.1 & 1.2)**

2. Write a note on indirect finance. **(Sections 1.5 & 1.5.3)**

3. State the functions of NABARD. **(Sections 3.11.3, 3.11.4 & 3.11.5)**

4. Briefly discuss the objectives of SIDBI. **(Sections 3.9, 3.9.1 & 3.9.5)**

5. State the importance of development banks in industrial development of a country. **(Sections 3.12.1 & 3.12.2)**

6. Distinguish between organised and unorganised financial markets. **(Sections 6.1 & 6.2.3)**

7. Give a brief overview of the components of Indian financial markets. **(Section 6.3)**

8. Briefly discuss the functions of Grievance Redressal cell of stock exchange in India.

9. Discuss in brief the role of SEBI in investors' protection. **(Section 9.8.1)**

10. State the role of court in investors' protection. **(Section 9.8.3)**

Group-B

11. (a) Explain the concept of mutual fund. **(Section 4.8)**

(b) Discuss the functions of General Insurance Corporation of India. **(Sections 4.7.5 & 4.7.6)**

12. (a) State the objectives of LIC of India. **(Section 4.6.1)**

(b) Write a note on Insurance Regulatory and Development Authority of India (IRDAI). **(Q. No. 6 of 2007)**

13. (a) Distinguish between real interest rate and nominal interest rate. **(Section 5.3)**

(b) Explain the relationship between short-term and long-term interest rate. **(Section 5.5)**

14. (a) State the features of treasury bill market in India. **(Section 7.10)**

(b) Distinguish between certificate of deposit and commercial paper. **(Sections 7.7.4 &7.7.5)**

15. Discuss the important functions or services rendered by merchant bankers. **(Sections 10.5.1 & 10.5.3)**

16. (a) What is credit rating? **(Section 10.7)**

(b) Discuss the SEBI guidelines regarding credit rating agencies in India. **(Section 10.15)**

17. (a) Discuss the alternative measures of money supply in India. **(Section 2.4)**

(b) Give a brief account of supervisory role of the Reserve Bank of India.

Ans: The Reserve Bank of India is the undisputed leader in the financial market of India. In order to develop a strong and sound monetary system in the country, the RBI has been given a wide range of powers to regulate and control the activities of financial institutions including commercial and co-operative banks. The supervisory role of the RBI may be summarised in the following manner:

- The RBI regulates the volume of credit given by commercial banks. It does so by using the quantitative and qualitative instruments and also by issuing circulars, notifications, etc.
- To establish a new bank in the country or to open a new branch of an existing bank, permission or license from the RBI is necessary.
- The RBI determines the minimum amount of cash and other liquid assets to be maintained by commercial banks.
- If banks are involved in any fraudulent and unfair activity, the RBI can investigate the matter. If the allegations are proved, it can take penal measures against the erring bank.
- The RBI supervises the activities of the banks so that banks do not invest imprudently or without proper security. Otherwise, banks will fall into financial crisis in future.
- The RBI supervises various activities of domestic as well as foreign banks. Such activities of banks include collection of deposits, expansion of business, opening of branches, human resource management, investment, profit planning, organisational activities, etc.
- The RBI can regulate and control the activities of chit funds, unit trusts, merchant banks and various investment banks.
- The RBI can appoint and terminate the office of the chairman and executive officers of all private banks.
- The RBI can regulate the external value of rupee against major foreign currencies by adopting some suitable measures.
- The RBI can adopt some export promotion and import substitution measures in order to maintain equilibrium in the balance of trade.

18. (a) Discuss the various methods of credit control as followed by the Reserve Bank of India. **(Section 2.14.3)**

(b) Give an outline of the developmental functions of the Reserve Bank of India. **(Section 2.14.4)**

19. (a) "Stock market plays an important role in Indian economy." Discuss. **(Sections 8.12 & 8.12.3)**

(b) Discuss the role of brokers and portfolio consultants in the stock markets. **(Sections 8.13.1 & 8.13.6)**

20. (a) Discuss the methods of raising funds through the primary market in India. **(Sections 8.10.1 & 8.10.4 & 8.10.5)**

(b) What do you mean by insider trading? **(Section 9.9)**

W.B.S.U Question Papers and Hints to Answers (2009–2011 and 2014–2016)

2009

Group-A

1. What are the objectives of Small Industries Development Bank of India (SIDBI)? **(Sections 3.9 & 3.9.1)**
2. Distinguish between cash reserve ratio and statutory liquidity ratio.

   Ans:

   Cash Reserve Ratio (CRR): All commercial banks are required to keep a certain percentage (i.e., ratio) of their deposits in the form of cash with the RBI. This ratio or percentage is called the cash reserve ratio (CRR). In India, the CRR is legally fixed between 3–15%. This is an important instrument of the RBI to control the volume of bank credit. During inflationary situation, the RBI raises CRR and hence a large portion of deposit is to be held by them in cash. Then, the credit-creating capacity of commercial banks falls. Secondly, this ratio(CRR) ensures that a portion of bank deposits is totally risk-free as it is not lent out and is held by banks in cash.

   Statutory Liquidity Ratio (SLR): Banks in India are required to maintain 25–40% of their demand and time deposits in government securities, gold, and certain approved securities. This is known as statutory liquidity ratio (SLR). In 1991, SLR was 38% and in 1992 it has been reduced to 30%. One objective of the statutory liquidity ratio is to force the commercial banks to hold government securities.

   Following the suggestion of Narasimham Committee, both SLR and CRR have been reduced. The SLR has been reduced to 25% and the CRR to 10%.
3. Briefly discuss the functions and powers of Insurance Regulatory Development Authority. **(C.U. Q. No. 6 of 2007)**
4. What roles do regulators play in a financial system? **(C.U. Q. No. 1 of 2006)**
5. **(a)** State the advantages of investing money in mutual funds. **(Sections 4.8 & 4.9.3)**

   (b) Discuss the functions of Unit Trust of India. **(Sections 4.9.4, 4.9.5 & 4.9.6)**
6. **(a)** Discuss the differences between nominal interest and real interest. **(Sections 5.3)**

   (b) Explain the major determinants of interest rate structure. **(Sections 5.4 & 5.5)**

7. Discuss the recent changes in the monetary policy of Reserve Bank of India. **(Section 2.14.3. Also see C.U. Question Paper 2014, Q. No. 3(b) of Group C)**

8. Discuss the role of Development Banks in the context of Indian economy. **(Sections 3.1, 3.12.1 & 3.12.2)**

Group-B

9. Define call option and put option. **(C.U. Q. No. 10 of 2008)**

10. Discuss in brief the importance of credit rating. **(Section 10.10)**

11. Discuss the role of institutional investors in the capital market. **(Section 8.13.7)**

12. What are the differences between money market and capital market? **(Section 8.3)**

13. **(a)** Discuss the role of Press in the protection of investors. **(Section 9.8.4)**

(b) Discuss the role of brokers in the stock market. **(Section 8.13.1)**

14. **(a)** Briefly state the main functions of Merchant Bankers. **(Sections 10.5 & 10.5.3)**

(b) Discuss the SEBI guidelines for registration of Merchant Banking. **(Section 10.6.1)**

15. **(a)** What is meant by call money market? Discuss the features of call money market. **(Sections 7.9 & 7.9.1)**

(b) Discuss the role of Acceptance House in money market. **(Section 7.12)**

16. **(a)** Give an account of the importance of Stock Exchange Clearing House. **(Q. No. 16(a) of C.U. Question Paper 2012)**

(b) Explain the basic functions of new issue market. **(Section 8.10.2)**

2010

Group-A

1. Discuss the objectives of Unit Trust of India. **(Sections 4.9 & 4.9.1)**

2. What are the differences between Commercial Bank and Development Bank? **(Section 3.4)**

3. Discuss the functions of EXIM Bank of India. **(Sections 3.8 & 3.8.3)**

4. State the objectives of Industrial Development Bank of India. **(Sections 3.6 & 3.6.1)**

5. What do you mean by net asset value? Give an example.

Ans:

NAV and its Calculation: NAV or Net Asset Value is the actual value of the investments made by the mutual fund for each unit issued by it. The value of the mutual fund varies with the value of the portfolio, as the prices of the securities included in the portfolio fluctuate from day to day. As the intrinsic value of the security, the NAV represents the fair value of a unit in a mutual fund. As the market prices of individual securities change, NAV also changes accordingly.

NAV = Value of investment + Receivables + Accrued income + Other current assets – Liabilities – Accrued expenses/Number of outstanding units

We know that there are two categories of mutual funds: close-ended schemes and open-ended schemes. NAV is more meaningful for the close-ended schemes. These schemes, which are normally tradable in the market, have two sets of prices: NAV (declared by the company) and price at which they are traded. These two prices need not be equal. The units may sell at the current NAV per share (par value) or for more (at a premium) or for less (at a discount). Normally, NAVs of the schemes of any mutual fund institution are declared by the institution in the economic dailies at any suitable time. For the open-ended schemes, NAV is not so important. Such schemes have two prices: (i) sales price or public offering price (POP), i.e., the price at which these schemes are sold, and (ii) re-purchase price or buy-back price by the institution. The difference between the NAV and the public offering price (POP) is the sales charge recovered by the institution or its asset management company from the scheme to cover costs of raising funds on a continuous basis. Public offering price (POP) is generally calculated as follows:

POP = NAV/(1 – Sales charge)

Illustration: From the following data of a mutual fund, calculate NAV. If the maximum sales charge is 2% on the NAV, calculate POP at that level. (All figures are in ₹ Lakhs).

Value of investments = 50.00

Receivables = 1.00

Accrued income = 0.80

Other current assets = 4.00

Liabilities = 3.50

Accrued expenses = 0.50

Number of outstanding units = 1,00,000.

Solution:

NAV = (Value of investment + Receivables + Accrued income + Other current assets – Liabilities – Accrued expenses)/Number of outstanding units
= ₹(50.00 + 1.00 + 0.80 + 4.00 – 3.50 – 0.50) lakhs/1,00,000
= ₹(55.80 – 4.00)
= ₹51.80

POP = NAV/(1–Sales charge)
= ₹51.80/(1 – 0.02)
= ₹51.80 × 100/98
= ₹52.86

6. What is differential interest rate? Explain with an example. **(Sections 5.4 & 5.5)**

7. **(a)** Briefly identify the contributions of financial system to a country's economic development **(Sections 1.1 & 1.2)**

   (b) Describe the components of Indian financial system. **(Section 1.3)**

8. Discuss the central banking functions of the Reserve Bank of India. **(Section 2.14.2)**
9. Discuss the objectives and functions of National Bank for Agriculture and Rural Development (NABARD). **(Sections 3.11, 3.11.4 & 3.11.5)**
10. Discuss the functions of Employees' State Insurance Corporation. **(Not included in syllabus)**
11. Give an outline of the structure of the Indian financial market. **(Section 6.3)**
12. State the guidelines formulated by SEBI relating to credit rating. **(Section 10.15)**
13. Discuss the role of call money market. **(Sections 7.9 & 7.9.1)**
14. Discuss the main functions of Grievance Cell of Stock Exchange. **(Section 9.7)**
15. Explain the term "swap" with an example.

    Ans: In common conversation, the word "swap" means to exchange. It is an arrangement between two companies to exchange cash flow in future according to a pre-arranged formula. This technique is found in case of change in the rate of interest, in case of exchange rate of indigenous currency with foreign currency and foreign exchange market. There are different kinds of swap contracts. Important among them are interest rate swap, foreign currency swap, and debt equity swap.

    Originally, swap arrangement, which is a method of improving liquidity arrangement, was developed in the 1960s by swapping currencies. For example, under this arrangement, the central banks of two countries would credit each other with an equivalent amount of the other's currency such that either government could draw on this extra foreign exchange reserve if necessary. It is usually for a specified period of time. After that period, transactions would be reversed at the original rate of exchange.
16. State the functions of credit rating agencies. **(Section 10.10)**

17.(a) Explain the causes of price fluctuations in a stock exchange.

Ans: Price of any commodity or service depends basically on two forces, namely, demand and supply. The price of a share or stock is not an exception. It is determined by demand for and supply of the share. So, the price of a share will fluctuate due to changes in factors working behind demand and supply. We may briefly mention some of those factors as follows:

- **Demand and supply position:** If the demand for a share rises, *ceteris paribus*, its price will rise. In the opposite case, its price will fall. Similarly, if the supply of the share rises, *ceteris paribus*, its price will fall. In the opposite case, its price will rise.
- **Financial position of the company:** If the financial position of the company under consideration is strong, if it earns higher profit for the last few years and pays larger dividend, then its share price will certainly rise. In the opposite case, its share price will fall.
- **Business condition:** General business condition or economic atmosphere is also an important factor working behind share price. If the general business environment is favourable or good, the share price of any industrial unit is likely to be high. In the opposite case, it will be low.

- **Political situation:** If there is political instability or, say, fear of war with neighbouring countries, then share price is likely to fall. If there is political stability at home and abroad, the price of shares is likely to go up.
- **Competition faced by the company:** If the company enjoys a monopoly position in the production of its output, its share prices will go up. If the company faces stiff competition from its rival firms, then its share prices will fall.
- **Government policy and control:** If the government gives concession and subsidy for the expansion and diversification plan of firms, then share prices will move up.
- **Trade cycle:** During upswing of a trade cycle, share prices will go up. During downswing, share prices will go down. Thus, during inflation, share prices rise. During deflation share prices fall.
- **Company's goodwill:** If the company has a goodwill and reputation among the public, then its share prices will be high. In the opposite case, share prices will be low.
- **People's psychology:** The price of shares sometimes fluctuates without any valid reason and due to purely psychological factors. If people think that a particular share of a company will not be able to fulfil their expectations, they will leave that company by selling that share. In that case, price of that share will fall. In the opposite case of positive expectation regarding the returns of the share, its price will rise.
- **Condition of the stock exchange:** If the stock exchange is dominated by bull speculators, share prices will rise. If the stock market is dominated by bear speculators, stock prices will decline.

(b) Who are the speculators in a stock exchange? **(Section 8.13.9)**

2011

Group-A

1. What is the role of financial system in economic development? **(Sections 1.1 & 1.2)**

2. Explain in brief the instruments used in money market. **(Section 7.7)**

3. What are the major objectives of Industrial Development Bank of India? **(Sections 3.6 & 3.6.1)**

4. What are the advantages of saving through LICI? **(Sections 4.1 & 4.2)**

5. Show the difference between nominal interest and real interest. **(Section 5.3)**

6. State the advantages of mutual fund. **(Sections 4.8)**

7. Discuss the structure of Indian financial system. **(Sections 1.1 & 1.3)**

8. **(a)** Discuss the role of RBI in economic development of India. **(Section 2.14.4)**

(b) Distinguish between "bank rate" and "open market operation". **(Appendix A1)**

9. **(a)** Describe the objectives of Life Insurance Corporation of India (LICI). **(Sections 4.6 & 4.6.1)**

   (b) Discuss the functions of Insurance Regulatory and Development Authority (IRDA). **(C.U. Question Paper Q. No. 6 of 2007)**

10. **(a)** Define interest. What are the causes of differential interest rates? **(Sections 5.1, 5.4 & 5.5)**

    (b) What are the reasons of regulations of interest rates in India? **(Sections 5.8.1 & 5.8.2)**

Group-B

11. State the major features of Indian money market. **(Section 7.6)**
12. Mention the reasons of listing of securities. **(Sections 8.12.2A & 8.12.2)**
13. Define "call option" and "put option". **(Q. No. 10 of C.U. Question paper 2000)**
14. What are the objectives of formation of SEBI? **(Sections 8.16 & 8.16.1)**
15. What are the limitations of credit rating? **(Section 10.2)**
16. What are the functions of portfolio consultants? **(Section 8.13.6)**
17. **(a)** Discuss the features of call money market. **(Sections 7.9 & 7.9.1)**

    (b) What are the drawbacks of call money market in India? **(Section 7.9.3)**
18. **(a)** Discuss the regulatory system of share market in India. **(Section 8.15 & 8.15.2)**

    (b) Describe briefly about the participants of share market. **(Section 8.13)**
19. Discuss the functions of merchant banking. Mention the rules regarding registration of merchant banks. **(Sections 10.5.1, 10.5.3 & 10.6.1)**
20. What is meant by investors' protection? Discuss the role of SEBI in investor's protection. **(Sections 9.1 & 9.8.1)**

2014

Module-I

1. What do you mean by financial system? Discuss the main components of Indian Financial system. **(Sections 1.1 & 1.3)**

   Or,

   What do you mean by globalisation of financial market? Distinguish between organised and unorganised financial institutions in a financial system.

   (See C.U. Question Paper 2006, Q. No. 3 & Section 6.2.2)
2. What do you mean by credit creation? Discuss the role of Reserve Bank of India in respect of credit creation in India. **(Section 2.14.3)**
3. What is meant by Development Bank? What are the needs of Development Bank in Indian financial system? **(Sections 3.1, 3.12.1 & 3.12.2)**

   Or,

Mention two differences between commercial bank and development bank. Discuss the functions of EXIM Bank of India. **(Sections 3.4, 3.8 & 3.8.3)**

4. What is IRDA? Discuss the objectives of Life Insurance Corporation of India. **(Sections 4.6.7, 4.6.1 & 4.6.8)**

Or,

Explain the concept of Mutual Fund. What are the objectives of Unit Trust of India? **(Sections 4.8, 4.9.1 & 4.9.6)**

5. Define nominal rate of interest. Explain liquidity preference theory of interest. **(Section 5.3 & Q. No. 9 of C.U. Question Paper of 2007)**

Or,

Distinguish between administered interest rate and market determined interest rate. How are liquidity and risk related to interest rate?

(Q. No. 5 of C.U. Question paper of 2006 & Section 5.5: points 1 & 2)

Module-II

6. Distinguish between call option and put option. **(See No. 10 of C.U. Question paper of 2008)**

Or,

Distinguish between futures contract and forward contract.

Ans: A forward contract is a customised contract between two parties. Here, settlement takes place on a specific future date at today's pre-agreed price. In other words, forward contract is a final contract requiring the buyer to buy and the seller to sell a given asset at a pre-determined price and date in the future. Futures contract is an agreement or contract between two entities to buy or sell an asset at a particular period of time in the future at a certain price. They are standardised exchange-traded contracts. Hence, futures contracts are special types of forward contracts. The main differences between the two types of contracts are as follows:

First, forward contract has no liquidity while futures contract is highly liquid. **Secondly**, forward contracts are not traded on a stock exchange while futures contracts are exchange trade. **Thirdly**, in the case of forward contract, margin is not required, while in futures contract, margin is to be paid by both buyers and sellers.

7. Define clearing house. Discuss the significance of clearing house in Stock Exchange. **(Q.No 16 of C.U. Question paper of 2012)**

Or,

Define call money market. Discuss the weakness of call money market in India. **(Sections 7.9 & 7.9.3)**

8. Describe the features of Indian capital market. "New issue market and secondary market are interdependent". Discuss. **(Sections 8.6 & 8.11)**

Or,

Write short notes on the following:

(a) Bulls and Bears **(Section 8.13.9)**

(b) Share index

Ans: A stock index or share index is the simple or weighted average of prices of some selected shares listed on a stock exchange. It captures the overall behaviour of the stock market. A rise in share index or stock index indicates a bullish situation in the market. On the other hand, a fall in stock index signifies an overall bearish condition in the market. Share index thus serves as a barrometer for a given stock market or for the industry. It helps prospective investors to take decisions regarding investment in stock market. It is also very important in case of hedging and speculation. Some regularly quoted global stock indices are American S&P 500, the Japanese Nikkei 225, the Russian RTSI, the SENSEX of India, etc. Most of the publicly quoted stock indices are weighted averages, not simple averages. In India, two important stock indices are SENSEX and NIFTY.

SENSEX is the weighted average of equity share prices of thirty companies listed on the Bombay Stock Exchange. While constructing the index, it takes the financial year 1978–79 as the base year. SENSEX is the short form of Sensitive Index.

NIFTY (also called NIFTY fifty or CNX NIFTY) is the share price index of National Stock Exchange. It is the weighted average of share prices of fifty companies listed on National Stock Exchange (NSE). Its base year is 3 November 1995, the date on which the NSE completed exactly one year.

(c) Insider trading **(Sections 9.9 & 9.10)**

9. What do you mean by investors' protection? Discuss the role of SEBI in relation to investors' protection. **(Sections 9.1 & 9.8.1)**

Or,

Discuss the role of media for investors' protection. What are the objectives of SEBI? **(Sections 8.16.1 & 9.8.4)**

10. Define Merchant Bank. Discuss the SEBI guidelines for registration of a merchant bank. **(Sections 10.5.1 & 10.6.1)**

Or,

Describe the objectives of credit rating. Mention the drawbacks of credit rating. **(Sections 10.7, 10.8.2 & 10.12)**

Group-B

11. Define 'Call option' and 'Put option'. **(Q. No. 10 of C.U. Question Paper of 2008)**

12. State at least four features of money market. **(Sections 7.3 & 7.6)**

13. Describe the functions of capital market. **(Section 8.4)**

14. Write a note on investors' protection. **(Section 9.1)**

15. Discuss the main functions of Grievance Cell of Stock Exchange. **(Section 9.7)**

16. Write at least four differences between money market and capital market. **(Section 8.3)**

17. Give an overview of financial markets in India. **(Summary of Chapter 6)**

18. What do you mean by stock exchange? Mention at least four stock exchanges in India. Describe the role of stock exchange in the development of an economy.

(Sections 8.12, 8.12.3 & 8.14)

19. "Recently investors' protection in India is in danger". Do you agree? What measures are to be taken to protect the interest of investors as per your opinion?

(Sections 9.1, 9.4 & 9.3)

20. Write short notes on:

(a) Clearing House **(Q. No. 16 of C.U. Question Paper of 2012)**

(b) OTCEI (Over-the-Counter Exchange of India) **(Section 8.14.3)**

(c) Asset Management Company

Ans: Asset management refers to the management of the financial assets of a corporate body or of an individual in order to maximise the returns on investment and minimise the risk involved. The company doing this job of asset management is called asset management company. The company does this job against a fee. So, it is a fee-based job. Generally mutual funds appoint asset management company in order to have suggestions and directions on asset diversification. Various merchant banks do this job of asset management for financial institutions. The asset management company performs the following kinds of activities:

(i) portfolio management services,

(ii) management and advisory services to offshore funds,

(iii) management and advisory services in relation to pension funds, provident funds, venture capital funds, and insurance funds.

(iv) financial consultancy, etc.

The asset management company cannot generally invest in any of the schemes for which it has been appointed.

(d) SEBI **(Summary No. 22 of chapter 8)**

(e) Jobbers **(Section 8.13.4)**

2015

1. Discuss briefly the contribution of the financial system to the development of a country. Write the names of regulatory bodies of Indian financial system.

(Sections 1.1 & 1.2 + C.U. Q. No. 1 of 2006)

Or,

Discuss the structure of Indian financial system. **(Sections 1.1 & 1.3)**

2. What is M_3 measure of money supply? What are the instruments of monetary control used by RBI? What is Repo rate? **(Sections 2.4, 2.14.3 & C.U. Q. No. 11 of 2010)**

Or,

What is commercial bank? Discuss the functions of commercial bank in India. **(Sections 2.5 & 2.7)**

3. What do you mean by development bank? Write down the four important functions of IDBI. Give two major objectives of IDBI. **(Sections 3.1, 3.6.1 & 3.6.5)**

   Or,

   What is the full form of NABARD? Discuss the objectives and functions of NABARD. **(Sections 3.11, 3.11.4 & 3.11.5)**

4. Distinguish between insurance and assurance. What are the objectives of LICI? Write two major functions of LICI.

   Ans: Insurance is an agreement between one person or firm and another that the second party will make good (i.e., compensate for) the loss incurred by the first party in specified circumstances against the payment of insurance premium by the first party. Examples of insurances are life insurance or insurance against the damage or loss of a property due to fire, theft, riot, ship-wreckage, etc. Assurance is a type of insurance relating to a situation where the cover is against an inevitable event. The example is life insurance. In this case, the contract is related to paying the specified amount on a particular date or on the death of the assured. **(Also see Sections 4.6, 4.6.1 & 4.6.4)**

   or,

   Explain the concept of mutual fund. State the advantages of investing through mutual fund. What is NAV? **(Sections 4.8, 4.9.3 & Q. No. 5 of WBSU Question Paper of 2010)**

5. Distinguish between nominal interest and real interest. What are the causes of variation in interest rate? **(Sections 5.3, 5.4 & 5.5)**

   Or,

   What do you mean by Gross and Net Interest? Discuss the recent trend in interest structure in Indian economy. **(Sections 5.2 & 5.8.3)**

6. Distinguish between money market and capital market. **(Section 8.3)**

   Or,

   What do you mean by Financial Market? Define Debt Market. **(Sections 6.1 & 6.2)**

   Ans:

   Debt market: Debt is an obligation or liability arising from the borrowing of finance or the taking of goods or services on credit, i.e., against an obligation to pay later. There are various kinds of debt instruments specifying terms and conditions of debt. The market in which such debt instruments (i.e., bonds and debentures) are traded is called debt market. It includes both money market and capital market comprising new issue market and secondary market.

7. Define Treasury bill. What is the importance of the "Acceptance Houses" in Indian money Market? **(Sections 7.7.2 & 7.12)**

   Or,

   What is call money market? Discuss the features of call money market. **(Sections 7.9 & 7.9.1)**

8. What is the importance of institutional investors in India? How does secondary market (share market) support new issue market? Explain the features of share market.

(Sections 8.6, 8.11 & 8.13.7)

Or,

Write short notes on

(i) Share index **(Q. No. 8 (b) of WBSU Question Paper of 2014)**

(ii) Portfolio consultant **(Section 8.13.6)**

(iii) Jobbers **(Section 8.13.4)**

(iv) Brokers **(Section 8.13.1)**

2016

Module-I

1. What is Financial System? Explain the significance of Financial System.

Or, **(Sections 1.1, & 1.2)**

What do you mean by non-banking financial intermediaries? Discuss the functions of intermediary financial institutions in a modern economy.

Ans: The institutions which accept deposits from the public and give loans from these deposits but whose deposits are not withdrawable by cheques, are called pure financial intermediaries or non-banking financial intermediaries. The LICI or the UTI are examples of such pure financial intermediaries. Like commercial banks, these financial institutions act as intermediaries between surplus spending units and deficit spending units. But there are some differences between commercial banks and non-bank financial institutions. Hence, the latter are called non-banking financial institutions. The most important difference between the two is that commercial banks can make multiple expansion of credit. Non-banking financial intermediaries have no such power. Secondly, depositors can issue cheques against their banks deposits. But cheques on deposits with non-banking intermediaries cannot be issued.

Functions of intermediary financial institutions (NBFIs): NBFIs perform some important functions and thus play a vital role in an economy. Briefly they are as follows:

1. **Reduce hoarding**: NBFIs bring the ultimate lenders (savers) and ultimate borrowers together. They thus reduce hoarding of cash by the people.
2. **Help the household sector**: NBFIs help the household sector in making profitable use of its surplus funds.
3. **Help the business sector**: NBFIs also help the non-financial business sector by financing it through loans, mortgages, purchase of bonds, and shares, etc.
4. **Help the state and local government**: NBFIs help the State and local bodies financially by purchasing their bonds.

5. **Provide liquidity**: NBFIs provide liquidity when they convert an asset easily and quickly. For economic development of a country, regular and smooth supply of liquidity is very important.
6. **Help in lowering interest rates**: Competition among NBFIs leads to the lowering of interest rate. This promotes investment and reduces cost of production. This, in turn, reduces the price level.
7. **Brokers of loanable funds**: NBFIs act as brokers of loanable funds. They act as intermediaries between ultimate savers and ultimate investors.
8. **Mobilise savings**: NBFIs help in mobilising savings. In less developed countries, saving is low and this is one major cause of underdevelopment. Further, saving is scattered all over the country. NBFIs help in mobilising saving. They then channelize the mobilised savings into productive investment. They thus help in capital formation of a country.
9. **Promote investment**: NBFIs encourage investors to invest through their various counselling and helpful activities. In a word, NBFIs help in capital formation and economic development of a country.

2. Explain the concept of alternative measures of money supply in India. Discuss the functions of Reserve Bank of India. **(Sections 2.4, 2.14 & 2.14.2)**

Or,

Write short notes on:

(a) Credit creation **(Section 2.9 & 2.9.1)**
(b) Cash Reserve Ratio **(Q. No. 2 of WBSU Question Paper of 2009)**
(c) Lender of the last resort **(Q. No. 3 of C.U. Question Paper of 2009)**

3. Discuss the role of Development Bank in Indian economy. What are the objectives of formation of Industrial Finance Corporation of India Ltd?

(Sections 3.12.1, 3.12.2, 3.5 & 3.5.1)

Or,

What is the full form of SIDBI? Discuss the functions of EXIM Bank of India.

Ans: The full form of SIDBI is Small Industries Development Bank of India.

(For second part, see Sections 3.8 and 3.8.3)

4. Discuss the investment pattern and policy of Life Insurance Corporation of India. Briefly state the concept of mutual fund. **(Sections 4.6, 4.6.4 & 4.8)**

Or,

Discuss the functions of the Unit Trust of India. Distinguish between life insurance and general insurance. **(Sections 4.9, 4.9.5 & Q. No. 2a (ii) of C.U. Question Paper of 2014)**

5. Can rate of interest be zero? Explain the relation between interest rate and economic progress. **(Section 5.6)**

Or,

State the difference between Administered Rate of Interest and Market Determined Rate of Interest. What do you mean by Default Risk and Call Risk?

(For first part, see Q. No. 5 of C.U. Question Paper of 2006)

Call risk: Call money is the money lent for a very short period (1–14 days). The borrower has to pay back the sum on demand (at call). Now there may be a risk that the borrower cannot respond to the call of repayment. This risk is known as call risk.

Default risk: The creditor lends money to the borrower who agrees to repay the interest and principal sum in due time. Now, there is always a risk that the borrower does not or cannot repay the sum in time or cannot repay at all. This risk of non-payment of a loan is called default risk.

Module-II

6. Define Financial Market. Indicate the names of participants in the financial market. **(Sections 6.1 & 6.3)**

Or, what do you mean by "option" and "swap"?

(Q. No. 10 of C.U. Question Paper of 2008 and Q. No. 15 of C.U. Question Paper of 2010)

7. What is money market? Discuss the features and major weaknesses of the Indian money market. **(Sections 7.1 & 7.6)**

Or,

Discuss the functions of Treasury Bill Market. Evaluate the role of the government towards the development of the active Treasury Bill Market in India.

(Sections 7.10, 7.10.1 & 7.10.2)

8. Discuss the functions of Indian Stock Market. Discuss the steps and methods of trading securities in the stock market. **(Sections 8.12, 8.12.3 & 8.12.2 B)**

Or,

Write short notes on

- **(a)** Clearing House of Stock Exchange **(Q. No. 16 of C.U. Question Paper of 2012)**
- **(b)** Sub-broker **(Section 8.13.2)**
- **(c)** Insider trading **(Section 9.9)**
- **(d)** Foreign Institutional Investors **(Section 8.13.7)**

9. Discuss the constitutions and organisation of SEBI. What are the roles of SEBI for investors' protection? **(Sections 8.16, 8.16.2 & 9.8.1)**

10. Discuss the origin of Merchant Banking. State the code of conduct or responsibilities and duties of the Merchant Banker. **(Sections 10.5.1, 10.5.2 & 10.6.2)**

Or,

Define Credit Rating. Discuss the functions of credit rating agencies in India.

(Sections 10.7 & 10.10)

MODEL QUESTIONS

A. Short Answer-Type Questions **(1–2 marks each)**

1. Define Financial System.
2. What are the components of financial system?
3. What is direct finance?
4. What is meant by indirect finance?
5. What are financial intermediaries?
6. Mention two functions of money.
7. What is a bank?
8. What is the basic difference between a bank and a non-bank financial intermediary?
9. What is central bank?
10. Mention two objectives of central bank.
11. What is the expression of credit creation multiplier?
12. What do you mean by scheduled commercial banks?
13. What is high-powered money?
14. Distinguish between qualitative and quantitative methods of credit control.
15. What is development bank?
16. Mention two objectives of IFCI.
17. What are the two major objectives of IDBI?
18. What is EXIM Bank?
19. What is the full form of SIDBI? What is its major objective?
20. Give the full form of NABARD. What is its objective?
21. Define insurance.
22. Mention two objectives of LICI.
23. What is IRDA?
24. Mention two objectives of GICI.
25. What are mutual funds?
26. Mention two objectives of UTI.
27. Define interest rate.

28. What do you mean by the term, "structure of interest rates"?
29. Define financial markets.
30. What is money market and what is capital market?
31. What is primary market and what is secondary market?
32. What do you mean by unregulated credit market?
33. What is call money?
34. What do you mean by treasury bill?
35. Define commercial bill.
36. What are commercial papers?
37. What do you mean by certificate of deposits?
38. What is the full form of DFHI?
39. What is a security market?
40. What are bonds/debentures?
41. What is a depository?
42. What is IPO?
43. What is stock exchange?
44. What do you mean by listing?
45. Who are brokers in a stock exchange?
46. Define jobbers.
47. What do you mean by portfolio consultant?
48. Who are sub-brokers?
49. Who is a bull and who is a bear in stock exchange?
50. Who is called a lame duck?
51. Who is a stag?
52. Give the names of four major stock exchanges in India.
53. Mention two objectives of SEBI.
54. What do you mean by investors' protection?
55. What is credit rating?
56. Define merchant bank.
57. Give the names of two credit rating agencies in India.
58. Give the full forms of CRISIL and IICRA.

B. Medium Answer-Type Questions (4–5 marks each)

1. Distinguish between direct and indirect finance.
2. Briefly describe the major functions of money.
3. What are the differences between a central bank and a commercial bank?
4. Discuss the developmental activities of the RBI.
5. Distinguish between commercial banks and development banks.
6. What are the benefits of investing in a mutual fund?

7. Distinguish between gross interest and net interest.
8. Differentiate between nominal interest rate and real interest rate.
9. Mention the causes of variations in interest rates.
10. Distinguish between administered and market determined interest rates.
11. What are the differences between money market and capital market?
12. Distinguish between organised and unorganised financial markets.
13. Distinguish between primary market and secondary market.
14. State the deficiencies of Indian money market.
15. What are the features of call money market in India?
16. Mention the limitations of call money market.
17. Write a short note on commercial bill market.
18. Briefly describe the treasury bill market in India.
19. Write a short note on acceptance houses.
20. State the features of Indian capital market.
21. Describe the major types of shares.
22. What are the major types of bonds/debentures?
23. Discuss the role of brokers in a stock exchange.
24. State the functions of sub-brokers in a share market.
25. Distinguish between a broker and a sub-broker.
26. Describe the functions of jobbers in a stock exchange.
27. What are the differences between a broker and a jobber?
28. Write a short note on Bombay Stock Exchange.
29. Briefly describe the functions of National Stock Exchange.
30. Briefly state the objectives of SEBI.
31. What is the need for investors' protection?
32. State the objectives of credit rating.
33. Briefly describe the functions of a credit rating agency.
34. Write a short note on credit rating in India.
35. Mention SEBI guidelines regarding credit rating agencies in India.
36. Distinguish between merchant bank and commercial bank.
37. What do you mean by insider trading?
38. Discuss the functions of grievance cells.
39. Write a short note on CRISIL.
40. State the problems associated with credit rating.
41. Discuss the importance of investors' protection.
42. Analyse the role of SEBI in removing insider trading.
43. Discuss the role of court in investors' protection.
44. Describe the role of media in redressal of investors' grievances.

C. Long Answer-Type Questions (10 marks each)

1. Define financial system. Explain the significance or importance of financial system in an economy.
2. Discuss the components/structure of financial system of India.
3. Carefully explain the functions of financial system in an economy like India.
4. What are financial intermediaries? Discuss the role of financial intermediaries in economic development of a country.
5. What are commercial banks? Discuss the structure of scheduled commercial banks in India.
6. Analyse the role of commercial banks in economic development of a country.
7. How do commercial banks make a multiple expansion of credit? What are the limitations of this credit creation process?
8. What is a central bank? Discuss the major functions of Reserve Bank of India.
9. Critically examine the credit control policy of the RBI.
10. What are the objectives of IFCI? Discuss the major functions of IFCI.
11. Briefly describe the functions of IDBI and make a brief evaluation of those functions.
12. What are the objectives of ICICI? Make a critical assessment of the performance of ICICI in the light of those objectives.
13. Write a note on the actual performance of EXIM bank of India.
14. What are the objectives of SIDBI? Discuss the functions and the actual performance of SIDBI.
15. Describe the lending operations of State Financial Corporations. How far are they satisfactory?
16. Briefly analyse the functions of NABARD. Make a critical evaluation of its actual performance.
17. Evaluate the role of development banks in promoting economic growth of India.
18. What are the main objectives of LICI? Discuss the functions and investment policy of LICI.
19. What is IRDA? What are its major powers to rectify the insurance sector of India?
20. Mention the major objectives of GICI? Evaluate the functions performed by GICI in recent years.
21. What are the benefits of investing in UTI? Make a brief evaluation of the performance of UTI.
22. Explain the liquidity premium theory of term structure of interest rates.
23. Write an essay on features and trends of interest rates in India.
24. What are financial markets? Describe the structure of Indian financial market.
25. What are the functions of financial markets? Discuss the major reforms in financial markets of India in recent years.
26. Examine the role of financial markets in economic development of a country.

27. What is money market? Discuss the important functions of money market.
28. Briefly mention the reforms in Indian money market in recent years.
29. What is capital market? Discuss the role of capital market in economic development of a country.
30. Briefly describe the structure of Indian capital market.
31. What is new issue market? Discuss the functions of new issue market.
32. Describe the issue mechanism of an IPO.
33. Discuss the Book Building Method or Tender Method of issuing an IPO.
34. Discuss the merits and demerits of listing securities on a stock exchange.
35. What are the objectives of SEBI? Describe the major functions of SEBI.
36. What is a merchant bank? Discuss the functions/services of merchant banking.
37. Discuss SEBI guidelines in respect of code of conduct of merchant banks.
38. Describe the merits and demerits of credit rating.
39. Evaluate the role of SEBI in investors' protection.
40. Discuss the functions of grievance cells in stock exchange.
41. Discuss the roles of court (Law) and media in protecting the investors in a stock exchange.

Glossary

Acceptance House: A financial institution including merchant banks and other financial institutions, functioning primarily for negotiation of bills of exchange either by accepting them or guaranteeing them.

Accounting Money: Money used only in the books of account. Also known as **notional money**. The SDR (Special Drawing Rights) introduced by the International Monetary Fund (IMF) is the best example of accounting/notional money.

Acquisition: Purchase of one company by another. Also called **takeover**.

Actual Money: Money in circulation or money having physical existence.

***Ad hocs/Ad hoc* Treasury Bills:** Treasury bills issued by the Government of India only in favour of the RBI in order to raise finance for particular purpose, i.e., on *ad hoc* basis.

Administered Interest Rates: Interest rates not determined by market forces but by some authority.

ADRs: See **American Depository Receipts**.

Amalgamation: Coming together by arrangement of two or more companies in order to increase mutual benefit. Also called **merger**.

American Depository Receipt (ADR): A certificate of ownership issued by a US bank as a convenience to investors in lieu of the underlying foreign corporate shares it holds in custody.

Amortisation:

(i) Repayment of loan in instalments over a period of time.

(ii) Write-off of an expenditure (like issue cost of shares) over a period of time.

Annuity: A fixed amount of cash to be received/paid every year for a given period of time.

Application Money: The amount of money an investor has to pay with the application for purchasing securities which are newly issued. It is usually less than the full value of the security at which it is issued.

Appreciation: Increase in value of an asset. Opposite is **depreciation**.

Arbitrage: Buying or selling of the same share, commodity, derivatives, etc., in different markets at the same time with a view to benefit from price differentials between different markets. In other words, arbitrage is the business of taking advantage of differences in price of a security or commodity traded in two or more markets.

Arbitrageur: One who is involved in arbitrage. An arbitrageur buys a security or a commodity in the market with lower price and immediately or simultaneously sells in the market with higher price in order to earn a profit.

Ask Price: The price at which a person or an institution offers to sell shares or any other asset. Also see **Bid Price**.

Asset: Anything owned by a person or a corporate body, the value of which can be expressed in monetary terms.

Asset Diversification: Holding of different types of securities in order to minimize risk without a corresponding reduction in returns. Sometimes simply referred to as **diversification.** See **Systematic Risk** and **Unsystematic Risk**.

Asset Management: Management of the financial assets of a corporate body or of an individual in order to maximize the returns on investments and minimise the risk involved.

Asset Management Company: The company involved in the management of assets held by an individual or organisation or a corporate body.

At a Discount: Sale of a security at a price lower than its face value or par value. Opposite is **at a premium**.

At a Premium: Sale of a security at a price higher than its face value or par value. Opposite is **at a discount**.

At Par: Par value or face value. When the face value of a security is equal to the price at which it is sold or bought, it is said to be sold or bought at par.

Authorised Capital: The amount of capital that a company is authorised to raise by the Registrar of Companies and is stated in the Memorandum of Association of the company.

Bad Debt: Debt which is due to a person or organisation appears irrecoverable, or where the estimated cost of recovery seems to be greater than the value of the debt.

Bad Debt Fund: Fund or reserve for the provision of bad debt. Also called reserve for bad debt.

Badla: Carrying forward of transactions from one settlement period to another without effective delivery of a good or security.

***Badla* Charge**: Interest or fee paid to the seller by the buyer for carrying over a transaction from one settlement period to another. Also called **contango.**

Balance Sheet: A statement prepared by an organisation showing the financial position of that organisation at a particular date.

Bank Note: A piece of paper purporting to pay the bearer on demand a specified sum of money.

Bank Rate: The rate of discount applied by the central bank on the bills of exchange presented to it by commercial banks. In effect, it is the rate at which the central bank of a country lends money to commercial banks. See **Repo Rate**.

Barter System: A system of exchange of goods for goods.

Bear: A speculator who sells shares forward, anticipating that their prices will fall in future. Opposite is **bull**.

Bearer Bonds/Bearer Securities: Bonds/securities for which their possession is the prime evidence of their ownership. Such bonds or securities do not require registration of the name of the owner in the books of the company. Both the interest (or dividend) and the principal whenever they become due, are paid to anyone having possession of the bonds or securities. No endorsement is required for changing the ownership of such bonds or securities.

Bear Market: A weak or falling market characterised by the dominance of sellers. In other words, it is a market dominated by operators who have a pessimistic view of the future of the market. Also means a period of time during which indicators of the stock market decline.

Bid/Bid Price: The price that a dealer is willing to pay to purchase shares or any other assets. Also see **Ask Price**.

Bid-Ask (Offer) Spread: The difference between bid price and ask price is called bid-ask spread, or simply, **spread**. It is also called **Bid-offer spread** or **Jobbing spread.** Sometimes, it is also called **impact cost**.

Bill/Bill of Exchange: An unconditional order in writing to pay on demand or on a future date a sum to a person or to the bearer of the written order.

Bill Rate: The rate at which the future value of a bill is discounted to get its present value. Also called **discount rate** or the **rate of discount**.

Blue chips: The most attractive shares with the highest status. It refers to first class equities having a very low risk of depreciation of earnings. Blue chips are determined on the basis of rate of return, safety, liquidity, etc. of the shares. Opposite is **cats and dogs**.

Bond/Debenture: Fixed interest security issued by government or local bodies and corporate houses. Also means a document by which a company or an organisation acknowledges a loan.

It is simply an "I owe you" (IOY/IOU) statement issued by a borrower to a lender. The terms bonds and debentures are generally used interchangeably.

Bond Market: Any place where any kind of bond is transacted, the obvious example being the stock exchange or the stock market.

Bonus Shares: Shares issued to existing shareholders as a result of capitalisation of reserves.

Book Building Method: A mechanism through which a demand for a security proposed to be issued by the company, is deduced and built-up and the price for such a security is assessed in order to determine the quantum of the security to be issued. Also called **Tender method**.

Book Debts: A book-keeping term meaning amounts due to the trader.

Book Value: The asset-backing value or intrinsic value of an asset. In other words, it is the cost price of an asset less accumulated depreciation.

Boom: The expansionary phase of the trade cycle. Opposite is **slump**.

Break: A rapid and sharp decline in a security or index.

Broad Money: It refers to M_3 in monetary aggregates in India. (See **M_1, M_2 and M_3**.)

Broker/Stock Broker: A functionary in a stock exchange acting as an agent for the buyer and/or the seller (client). Strictly speaking, a broker is an intermediary who brings buyers and sellers together, or who, acting as an agent for one or the other, carries through a sale or a purchase transaction, receiving for the service a commission or brokerage charge.

Brokerage: A charge made by a broker for carrying through a sale or purchase on behalf of a client. It may be a fixed charge or a percentage of the value of the transaction. Also called **brokerage fee**.

Bubble: A speculative sharp rise in share prices which like the bubble is expected to burst suddenly.

Bull: A speculator who buys shares forward, anticipating that their prices will rise in future. Opposite is **bear**.

Bull Market: A rising market with abundance of buyers and relatively few sellers. It is a market dominated by bull speculators who expect a rise in share prices in future and hence buy shares. Also means a period of time during which indicators of stock market show a rising trend.

Buoyancy: A rising trend in share prices. The market is called buoyant market.

Buy Back: The redemption (repurchase) by a company of its securities.

Call Money: Loaned funds among banks that are repayable upon the request of the either party within very short notice, normally within 1–14 days.

Call Option: An option that gives the holder of an asset the right to buy the asset at a fixed price during a certain period. Opposite is **put option**.

Capital:

1. In the theory of production in Economics, a word used to refer to a factor of production produced by the economic system. Capital goods are produced goods which are used as factor inputs for further production. Bohm Bowark described capital as "produced means of production".
2. In financial analysis, the word "capital" is also used as a term for financial assets. There, capital refers to the value contributed by the proprietors to an organisation to enable it to function. Thus, share capital is the amount collected by selling shares and the loan capital is the amount collected by selling bonds or debentures. The capital of the shareholders (proprietors) of companies also consists of retained profit. It occurs to the holders of ordinary shares. Retained profit is also called reserve capital.

Capital Adequacy: The ability of a bank to meet the needs of their depositors and other creditors in terms of available funds. The Bank of International Settlements requires, as per the Basel Agreement, banks to maintain 8% of their risk-adjusted assets as capital.

Capital Adequacy Norms: A model or a set of criteria to maintain capital adequacy by a financial institution.

Capital Gain: The positive difference between the price originally paid for a security and cash proceeds at the time of maturity (face value of the security) or at the time of sale (selling price of the security). Opposite is **capital loss**.

Capital Gains Yield: Capital gain as a percentage of the value of a security at the beginning of the time period.

Capital Loss: The negative difference between the price originally paid for a security and cash proceeds at the time of maturity (face value of the security) or at the time of sale (selling price of the security).

Capitalisation: The conversion of the reserves of a company into capital by means of issuing security certificates (scrips).

Capital Market: The segment of financial market where long term capital funds (one year or above) are issued and traded. It is a market in which financial instruments with maturities equal to or greater than one year are bought and sold.

Cash Reserve Ratio (CRR): Ratio of reserves to deposits with the commercial banks.

Cats and Dogs: Securities which are not attractive among the investors. Its opposite is **Blue chip**.

CD: See **Certificate of Deposit**.

Central Bank: The apex institution in the financial market, which conducts the monetary policy of the government, advises the government on financial matters, controls the activities of banks and other financial institutions of the country. The main functions of the central bank are: (i) to issue notes, (ii) to act as banker of the government, (iii) to act as banker of commercial banks, (iv) to control the volume of bank credit in the economy, (v) to manage public debt, (vi) to manage government's accounts, (vii) to manage the external value of home currency, (viii) to hold the reserves of gold and foreign currency of the country, (ix) to represent the government in dealings with other central banks, IMF and the World Bank, (x) to act as the lender of last resort to the banking system, (xi) to conduct the clearing house, (xii) to manage the accounts of the government, etc. All countries have a central bank in order to conduct the monetary policy of the government. The Reserve Bank of India is the central bank of India just as the Bank of England is the central Bank of UK.

Certificate of Deposit (CD): A negotiable financial instrument issued by a bank, documenting a deposit, with principal and interest repayable to the bearer at a specified date.

Cheap Money Policy: The policy of monetary authority of a country to increase money supply with a view to reduce rate of interest and thus encourage investment by reducing the cost of capital or borrowed fund. It is followed during recession. Opposite is **Dear (or Tight) money policy**.

Cheque: An unconditional order, drawn on a specified banker or financial institution, signed by the drawer, directing the banker to pay on demand a specified sum of money only to a certain person or to his order or to the bearer of the instrument. It is the most common and popular instrument used for making payment of different kinds.

Circulating Capital: Funds flowing through different sections of a business enabling it to carry out its usual or running operations. Also known as **working capital** or **floating capital**. Also see **Fixed Capital**.

Clearing House: A department of central bank for settling inter-bank claims and counter-claims.

Close-ended Fund/Scheme: Fund or scheme of a mutual fund or any other security which has a pre-specified maturity period. Opposite is **open-ended fund or scheme**.

Collateral: An asset which serves as security of a loan. Hence known as **collateral security** also.

Commercial Banks: Financial institutions which accept deposits from the public, withdrawable by cheques and which lend that money to individuals including producers and businessmen.

Commercial Paper (CP): A short-term unsecured promissory note, issued by corporates, mostly on discount basis.

Company: A corporate body registered with the Registrar of Companies and whose regulation is governed by the provisions of Company Law existing in the country concerned. In the eye of law, a company is a legal person who can sue and be sued.

Compound Interest: Interest payable (receivable) on interest.

Compounding: The process of determining the terminal value of an amount when compound interest rate applies. It can be on a continuous basis or at fixed time intervals. Opposite is **Discounting**.

Consols: Government securities paying interest but having no maturity (redemption) date.

Consortium: A group of companies or firms formed to fulfil a particular purpose. Also called **syndicate**.

Consumer Credit: Short term loans to the public by financial institutions for the purchase of goods. Examples of such credit are credit at retail stores, personal loans from banks and other financial institutions, hire-purchase and credit card. By means of consumer credit, people buying goods can delay payment and so spread the cost. Purchasing in this way generally requires a deposit and carries a charge in the form of interest.

Contango: See **Badla Charge**.

Conversion Price: The price at which a convertible security is converted into shares of the company.

Convertible Bonds/Debentures: Bonds/debentures which give an option to the instrument holder to convert them into equity shares of the company at a fixed conversion price or as per a pre-determined pricing formula.

Convertible Security: Bond or preferred stock which is convertible into equity shares generally at the option of the holder.

Corporate Advisory Services/Corporate Counselling: Suggestions and advices given by merchant banks to their client corporates on various financial matters.

Cost of Capital: The return, expressed in terms of an interest rate or dividend that an organisation is required to pay for the capital used in financing its activities. The true cost of capital is its opportunity cost, i.e., the maximum return that can be obtained by lending surplus funds in the open market.

Coupon: A detachable ticket entitling the holder to obtain something.

Coupon Rate: The stated interest rate on a bond. It is the rate of interest paid by a fixed interest-bearing bond.

CP: See **Commercial paper**.

Credit: A sum of money which a person or trader or company allows a customer before requiring payment. It also refers to the ability of any member of the public to purchase goods and services with money borrowed from banks or any other financial institution or a private money lender. Credit arises as soon as anybody acquires goods or services without paying for them at once or paying for them with somebody else's money.

Credit Card: A plastic or metallic card issued by a bank or financial institution to enable its holder to obtain goods and services on credit in shops, hotels, restaurants, petrol pumps, etc. The retailer or the trader receives monthly payment from the credit card issuer company. Customers also receive monthly statements from the card issuer company. The company later realises the money together with interest and some service charge from the card holders. There are various types of credit cards, such as, Visa Card, Master Card, Gold Card, etc. They have different terms and conditions.

Credit Creation by Commercial Banks: Refers to the multiple expansion of credit by commercial banking system as a whole.

Credit Crunch: A situation when supply of credit is less than its demand.

Credit Rating: Assessment of the credit-worthiness of an individual buyer or a buyer-firm of credit paper.

Credit Rating Agency: Organisation involved in the activity of credit rating. Some of such organisations in India are CRISIL, IICRA, CARE, ONICRA, etc.

Creditworthiness: Ability of a person or business organisation to pay for goods purchased or services received. It is assessed in the form of credit rating by a credit rating agency.

CRR: See **Cash Reserve Ratio**.

Current ratio: The ratio of current assets of a business organisation to its current liabilities. It is used as a test of liquidity of the business organisation. Also known as **working capital ratio**.

Custodian: A financial organisation that holds the securities and other assets of mutual funds and other institutional investors.

Custodial Services: Services provided by financial intermediaries to their clients, particularly to foreign investors, for a fee. Custodial services include keeping of shares and debentures of the clients, collection of interest, and dividend on behalf of them, reporting of corporate developments to the clients, etc.

Darshani Hundi: Darshani hundis are like sight bills. They are paid immediately on presentation, sight or demand. There are generally three parties to a darshani hundi, viz., a drawing party, a paying party and a payee. See **Muddati Hundi**.

Dear Money Policy: The policy of monetary authority of a country to decrease money supply with a view to increase the rate of interest and thus discourage investment and thereby control inflationary pressure. Opposite is **cheap money policy**.

Debenture/Bond: A financial instrument for raising long term debt. Also see **Bond**.

Debenture with call and put options: In the case of debentures with call option, the issuing company, i.e., the seller has the option to redeem the debentures at a certain price before maturity. In the case of debentures with put option, the investor, i.e., the buyer has the option to sell the debentures before maturity.

Debt: A sum owed by one person to another.

Debt Instrument: Any credit instrument used to raise loan. It includes promissory note, bill of exchange, or any type of bond issued by government or financial institutions or corporate houses.

Debt Market: A market in which debt instruments (mainly bonds) are bought and sold.

Debt with Equity Warrant: Bonds issued with warrants for the purchase of shares. A warrant is a corporate-created option to purchase a stated number of shares at a specified price within a specified time.

Deep Discount Bonds: Bonds sold at a large discount on their nominal/face value. In the case of such bonds, there will be no interest payment. Also known as **zero coupon bonds**.

Deep Market: The market in which there are always insufficient orders for buying and selling at both below and above the market price. Opposite is **thin market**.

Deficit Spending Unit: An economic entity whose expenditure in a given period exceeds its income. Opposite is **surplus spending unit**.

Delivery: Presentation of securities with transfer deeds in fulfillment of a transaction.

Demand Bills: Bills which are to be paid immediately on presentation, sight or demand. Also called **Sight bills**.

Demand Deposits: Deposits that can be withdrawn without serving a notice. See **Time Deposits**.

De-mat/De-materialisation: A trading system in which securities cease to exist in physical form and exist only in electronic number. Also called **scripless trading** or **screen-based trading**. Also see **Re-materialisation**.

Depository: A system of organisation which keeps records of securities deposited by its depositors. The records may be physical or electronic.

Depository Participant (DP): An agent of the depository through which it interfaces with the investors. A DP can offer depository services only after it gets proper registration from SEBI.

Depreciation: Reduction in the value of assets, generally arising from wear and tear. Also called **consumption of capital**. Opposite is **appreciation**.

Deregulation of Interest Rate: A system in which the determination of interest rate is left to the market forces of demand for and supply of funds.

Derivatives: The most modern financial instruments in capital market in hedging risks. Derivatives are some assets whose values are determined from the values of some underlying assets. The underlying asset may be equity share, commodity, or currency. As the financial products commonly traded in the derivatives market are themselves not the basic securities like equity share or debenture, but can be used to change the risk characteristics of the underlying asset, they are referred to as derivative financial instruments or, simply, derivatives. These derivatives have no intrinsic value of their own and they derive their value from the underlying instrument. Hence, they are called derivatives. Futures, options, etc., are some commonly used derivatives. See **Futures**, **Options** and **Hedging**.

Derivative Deposit: A deposit for a customer of a bank created at the initiative of the bank. It is known as active transaction as the bank takes the active role in this transaction. Also see **Primary Deposit**.

Derivatives Market: Trading of derivatives takes place on standardised contracts involving futures, options, etc. An imaginary segment of the securities market where such trading of derivatives takes place is known as derivatives market.

Derivative Security: A security whose value depends upon the values of other basic assets backing the security.

Development Banks: Special financial institutions, usually promoted, sponsored and financed by governments, which provide finance for development purposes, often on preferential terms, i.e., at concessional rates of interest. Examples of such banks are IFCI, NIDC, IIBI, SIDBI (at all-India level), SFCs (at state levels), etc. Also called **Development Financial Institutions** or **DFIs**.

Development Financial Institutions (DFIs): See **Development Banks**.

DFIs: See **Development Banks**.

Differential Term Structure of Interest Rates: Different rates of interest on loans having different lengths of maturity. See **Term Structure of Interest Rates**.

Direct Finance: Financial transactions between lenders and borrowers without any financial intermediary. Opposite is **Indirect Finance**.

Discount: When a security is quoted at a price below its nominal or face value, it is said to be at a discount.

Discounting: The process of finding the present value of a future cash flow or a series of future cash flows. Opposite is **compounding**.

Discount House: A financial intermediary in the money market acquiring short-term assets with money repayable at short notice. The assets while acquired are discounted by these intermediaries and hence the name discount house.

Discount Market: The market in which short term bills, mainly treasury and commercial bills, are traded. The main players in this market are discount houses.

Discount Pricing: Setting the price of a financial instrument at the face value less the amount of interest that will have to be paid till the maturity of the asset.

Discount Rate: See **Bill Rate**.

Distribution:
1. Return to investors of the accumulated income of a trust or mutual fund and capital gains.
2. Function of selling an IPO or a new issue to ultimate investors. The distribution service is performed by brokers and agents in the security market. Various methods used to distribute securities in the new issue market are: public issues through prospectus, offer for sale, placement or private placement, rights issue, book building method, etc.

Diversifiable Risk: The portion of a security's risk that can be eliminated by diversification.

Diversification/Asset Diversification: Investment in more than one risky asset with the primary objective of risk reduction. However, only the unsystematic risk can be diversified away, not the systematic risk. See **Portfolio, Systematic Risk, Unsystematic Risk** and **Diversifiable Risk**.

Dividend: Periodic payments to the owners of corporate shares. It is the payment to shareholders, usually once or twice a year out of a company's profit after tax, called net profit. The entire net profit is not generally distributed as dividend payments. A part (sometimes, a substantial part) of which is held back as reserves for the company's expansion or modernisation. Dividend is declared on the face value or par value of a share, and not on its market price.

DP: See **Depository Participant**.

Dual Currency Bonds: Bonds which are denominated and pay interest in one currency and are redeemable in another currency. Such bonds facilitate interest rate arbitrage between two markets.

Dumping:
1. In financial analysis, the offering of large amount of stock in the security market without any regard for the effect on prices in the market.
2. In international trade, the selling of goods overseas below cost to dispose of a surplus or to get a competitive edge over the foreign firms.

Easy Exit Bond: Bond allowing the investor to encash it after a certain period. Also called **exit bond**.

Efficient Portfolio: A portfolio which has the largest expected return for a given level of risk or the smallest risk for a given level of expected return. See **Portfolio**.

Eligible Paper: Treasury bills, short-dated gilt-edged securities, and any first class security, accepted by commercial banks or acceptance houses and thus acceptable by the central bank for rediscounting, or as security for loans to discount houses.

Equities: Otherwise known as ordinary shares, these are shares in the issued capital of a company. Equities or ordinary shares are held on terms that make the holder a member of the company, entitled to vote at annual meetings and elect directors, and to participate through dividends in the profits of the company. The holders of the ordinary shares carry the residual risk of the business. They rank after debenture holders and preference shareholders for the payment of dividends. They are also liable for losses, although in a limited liability company this liability is limited to the value of the shares themselves plus any uncalled liability on them. If the company is a public company and has a stock exchange listing, its shares may be traded on the stock exchange. See **Preference Share**.

Equity Capital: Ordinary share capital. It is the part of the issued capital of a company owned by ordinary shareholders. See **Equities**.

Equity Premium: The difference between the expected return from holding stocks or shares and from holding riskless bonds.

Exchange: Regulated market place where capital market products are bought and sold through intermediaries. Ordinarily referred to as **stock exchange**.

Exchange Rate: The rate at which one currency may be exchanged for another.

Exit Bond: See **Easy Exit Bond**.

Expectations Theory of Interest Rate: The theory that the long-term rate of interest is equal to an average of the short-term rates that are expected to prevail over the long-term period.

Export Promotion: The policy of developing those industries whose main markets are overseas. See **Import Substitution**.

Face Value: Value written on a financial asset. Face value is the value that appears on the face of a financial asset. Also called **nominal value** or **par value** or **at par**.

Factor: Generally means: 1. An input used to produce outputs. 2. In financial analysis, it means the financial intermediary which takes the entire responsibility of collecting the book debts of a company for a fee.

Factoring: An arrangement under which a financial intermediary takes the credit risk in the collection of book debts for its clients for a fee.

Fiat Money: Non-convertible paper money. Fiat means something enforced by an authority. Hence, paper money which is a legal tender, is a fiat money.

Fiduciary:
1. Of a trust or trustee.
2. Held or given or issued on trust.

Finance: The term used broadly in three different senses:

1. The practice of managing and manipulating money.

2. The amount of capital involved in a project.

3. A loan of money or a credit amount for a particular purpose.

Finance Bill: An exchange bill or, simply, a bill used for raising short-term credit.

Finance Brokers: Middlemen between borrowers and lenders in an unorganised credit market.

Financial Asset: A piece of paper representing claim on real assets.

Financial Crisis: Sharp, short term deterioration of all or most of a group of financial indicators, such as, short-term interest rates, prices of assets like stock, real estate, land, etc.

Financial Institution: Any organisation, such as a bank, housing finance company, insurance company, unit trust, or finance house that collects funds from surplus spending units and lends them to deficit spending units or invests them in any activity.

Financial Intermediaries: Financial institutions making intermediation between savers and investors.

Financial Intermediation: The process of facilitating the flow of funds from surplus spending units to deficit spending units through financial intermediaries.

Financial Investment: Investments in shares, bonds, or in any other financial instrument.

Financial Product: A good or service provided by a bank, investment company, or any other financial institution. Financial product includes share/stock, bond/debentures, loan, mortgage, insurance policy, etc.

Financial Risk: The risk that arises from the use of debt capital.

Financial System: A set of complex and interlinked institutions, agents, practices, transactions, claims and liabilities dealing in money, credit, and finance of an economy.

Fixed Asset: Items of long-term function or activity that can be used repeatedly, e.g., land, building, equipment, machinery, plants, etc. Such assets are not only useful in running the firm but can also be used as collateral for securing additional loan capital.

Fixed Capital: The amount of capital tied up in the capital assets of an organisation, such as, land, machinery, building, plant, etc. Also see **Fixed Asset**.

Fixed Income Securities: Securities with specified payment dates and amounts, primarily bonds, and preferred stocks.

Flip-Flop Bonds: A kind of debt instrument which permits the investors to switch over from one type of bond to another type of bond.

Floating Capital: See **Circulating Capital**.

Floating Rate Bond: Bond whose interest rate varies with changes in market interest rates.

Floor: Trading hall of the stock exchange where transactions in securities take place. It is the trading ring where members of stock exchange and their assistants or agents assemble with their order book for executing the order of their clients.

Floor Price: The minimum offer price below which bids cannot be entered. The issuer company in consultation with the lead book runner fixes the floor price.

Floor Trader: A member of a stock exchange who is permitted to enter the dealing room (floor) of the exchange and deals with other traders, brokers, underwriters, etc. Now-a-days, dealing through computers and other electronic devices is replacing face-to-face floor trading.

Forfaiting: A service which enables exporters to convert their credit sales into cash sales, discounting their receivables with any agency called "forfaiter".

Forward Contract: The contract in forward trading of a security on the future date of delivery and the price of the security.

Forward Dealing: Dealing or trading in securities for delivery at some future date at a price agreed at the time of contract (called a forward contract). Also called **forward trading**.

Forward Price: The agreed price at which a given amount of a financial instrument to be delivered on a fixed future date agreed at the time of contract (called forward contract).

Futures: Forward sales or forward purchases of securities by the speculators. This is one kind of derivative instrument. All contracts covering the purchase and sale of physical commodities or financial instruments for future delivery on a commodity exchange or stock exchange at a fixed rate are generally termed as futures. See **Futures Contract**.

Futures Contract: An agreement to exchange a fixed quantity of an asset on a specified date in the future at a predetermined price.

Futures Market: A market where futures are traded, i.e., contracts for future delivery of commodities and certain financial instruments on agreed dates and prices, are traded.

GDR: See **Global Depository Receipts**.

Gilt-Edged Market: The market for government securities.

Gilt-Edged Securities: Generally stocks and bonds issued by Union and State governments.

Global Depository Receipts(GDRs): A dollar-denominated instrument traded on a stock exchange in Europe or the USA or both. It represents a certain number of equity shares issued by a company to an intermediary called depository. The shares are registered in favour of the depository which subsequently issues the GDRs to the investors.

Goodwill: The part of value of a business organisation which is based on good customer relations, high employee morale, good quality of products, and such other desirable factors.

Government Securities: Fixed interest securities issued by the government. Such securities may be in the nature of bonds or other types and may or may not be redeemable.

Gross Interest: The additional amount of money collected by the lender from the borrower over and above the principal sum.

Growth Fund: The fund whose portfolio consists of investments which have potential for securing income at regular intervals. The primary emphasis is on regular return.

Hedge: One investment purchased against another investment in order to counter any loss made by either.

Hedging: Hedgers try to minimise risk or to protect themselves by buying (i.e., holding) different types or kinds of shares and/or other assets and selling them so that they are able to offset their losses with gains. Hedging is meant to minimise losses, or investment risk, not to maximise profits. This is achieved because while one kind of shares or assets may fall in prices, others may rise in prices.

High Powered Money: Sum of currency with the non-bank public and reserves with the commercial banks.

Holding Company: A company holding a controlling interest in one or more other companies which are referred to as subsidiaries.

Housing Finance Companies: Companies providing finance for house building. Finance for housing is generally provided in the form of mortgage loans, i.e., against the security of immovable property of land and buildings. In India, important housing finance organisations are HDFC, HIDCO, LICI, GICI, National Housing Bank (NHB), etc.

Hundi: A credit instrument used by indigenous bankers in India in their monetary transactions. It is an indigenous bill of exchange and of various types, the most important being **Darshani Hundis** and **Muddati Hundis**.

Hypothecation: Pledging assets against a loan. The ownership of the asset or the income from the asset is not transferred so long there is no default of repayment of the loan. In the event of default, the asset may be sold to realise the loan.

IDA: See **International Development Association**

Impact Cost: Difference between bid price and ask price (offer price). Also called **bid-ask spread**.

Import: A good or service consumed in one country which has been brought from another country. A visible import is a good, while an invisible import is a service.

Import Substitution: Policy of producing import goods domestically and thereby reducing dependence on foreign countries.

Income Bonds: Bonds on which interest is payable only if earned.

Index Bonds/Index-Linked Bonds: Bonds on which payments are linked to a price index.

Indigenous Bankers: Private firms or individuals who receive deposits and give loans in unorganised money market of India. Their activities are beyond the control of the Reserve Bank of India.

Indirect Finance: Financial transaction between lenders and borrowers through financial intermediaries. In this process of financing, deficit spending units obtain funds from financial intermediaries who in turn, obtain them from ultimate surplus spending units. See **Direct Finance**.

Infrastructure Bonds: Bonds issued to raise funds for the development of infrastructure. It provides tax-relief to the investors.

Initial Public Offer (IPO): Securities offered to the public for the first time. The market where such new issues are traded, is called **New issue market** or **Primary market**.

Insider: Any person who is or was connected with a company and has or had access to vital information related to the company.

Insider Trading: Illegal and unethical trading by company's insiders like directors, higher officers, promoters, brokers, and jobbers by using some secret information about the company.

Institutional Investors: Organisations that invest in real or financial sector. In financial sector, such organizations are banks, mutual funds, insurance companies, pension funds, investment companies, investment banks, etc.

Insurance: An agreement between one person or firm and another that the second party will make good the loss incurred by the first party in specified circumstances against the payment of insurance premium by the first party.

Insurance Premium: A sum of money which the insured agrees to pay the insurer after specified time intervals. In exchange, the insurer agrees to make good the loss suffered by the insured in specified circumstances.

Intangible Assets: Assets which have no physical form, examples being the value of a patent, a firm's goodwill, etc.

Interest/Interest Rate: Interest is the price paid for borrowed funds. It is generally expressed as a rate per cent per period of time. It is then called the rate of interest, or simply, interest rate. Usually the period is taken as one year.

Interest Rate Structure: A structure or framework showing different rates of interest in different segments of the loan market of a country.

Interlocking (of Markets): The operation of the same person or of an economic agent in a number of markets. As a result of the interlocking, all the markets are controlled by a few individuals. So they can continue exploitation in different markets. In India, this is found in unorganised credit market where money lenders appear either as a buyer or as a seller in land lease market, labour market, crop market, and credit market and exploit their borrowers.

Intermediary: Any person or organisation making connection between two parties in any transaction of physical or financial products.

Intermediation: The act of making connection between two parties in any transaction of physical or financial product.

International Development Association (IDA): An affiliate of World Bank. It is a soft loan window of the World Bank.

Investment:
1. Physical investment refers to the purchase of capital goods, such as plant and machinery in a factory in order to produce goods and services for future use.
2. Financial investment refers to the purchase of financial assets, such as securities, bank deposits, post office deposits, bonds, shares, etc., for getting financial return in the form of income (interest or dividend) or capital gain.

Investment Banks: Banks which fulfill many of the functions of a merchant bank. Such banks give advice on mergers and acquisitions and provides finance to the industrial sector.

Investment Portfolio: See **Portfolio**.

IPO: See **Initial Public Offer**.

Issued Capital: The part of authorised capital of any company which has been issued (sold) to the individual and institutional investors or to the buyers of the shares of the company.

Issue Management: Marketing of corporate securities. Merchant banks perform various jobs related to the new issue (share or bond) floated by the customer company.

Jobbers: One type of stock market functionaries. A jobber is an independent dealer in securities who deals in securities in his own account.

Jobber's Spread/Jobbing Spread: Difference between bid price and ask (offer) price, i.e., bid-ask (offer) spread.

Joint Sector: A business activity in which both public and private sectors work together.

Joint Venture: A business arrangement in which two companies invest in a project over which both have partial control. It is a common way for companies to collaborate without engaging in full scale merger.

Junk Bonds: Bonds that carry low ratings with correspondingly higher yields. This junk bond market is referred to as the 'high-yield debt market'.

Leasing: A contractual arrangement whereby one party (the lessor) grants the other party (the lessee) the right to use an asset in return for periodic rental payments.

Leasing Companies: Financial companies which lease out capital equipment to business firms which want to avoid the capital cost involved in owning it or due to high rate of depreciation of the capital equipment.

Legal Tender: The money that must be accepted in discharge of a debt. Some currency notes of small denominations are limited legal tender. These are to be accepted, as per law, only up to specified limits. Notes of large denominations are unlimited legal tender. These are acceptable in settlement of debts of any amount.

Lender of Last Resort: The central bank of a country which lends money to commercial banks and other financial institutions at the ultimate stage or at the hour of financial crisis.

Letter of Credit: A formal document issued by a bank on behalf of a customer, stating the conditions under which the bank will honour the commitments of the customer.

Liability: Any claim, actual or potential, on an individual or institution.

Line of Credit (LOC): A pre-approved credit facility (usually for one year) enabling a bank customer to borrow up to the specified maximum amount at any time during the relevant time period.

Liquidation: The process of converting stocks into cash. Also means the dissolution of a company.

Liquidity (of an Asset): The extent to which or the ease with which an asset may quickly be converted into cash with the least transaction cost.

Liquidity Premium:
1. Additional return for investing in a security that cannot easily be turned into cash.
2. Difference between the forward interest rate and the expected spot interest rate.
3. Additional return for investing in a long-term security.

Liquidity Premium Theory: A theory of term structure of interest rate. It highlights the preference for liquidity and the desire to minimise the sum of income risk and capital risk as additional factors determining the term structure of interest rates.

Listed Company: A company whose shares or other securities are admitted for trading on a recognised stock exchange. Also referred to as **quoted company**.

Listed Securities: Securities which are admitted for trading on a recognised stock exchange. Also called **quoted securities.**

Listing: Admission of securities to dealing on a recognised stock exchange.

Loan Syndication: Forming of a syndicate or consortium by some merchant banks in order to provide a large volume of loan to a customer, generally a government organization or a big corporate house.

LOC: See **Line of credit**.

$\mathbf{M_1}$ = currency + demand deposits + other deposits.

M_1 is called **narrow money** by the RBI as there are other liquid or monetary resources with the public.

$\mathbf{M_2}$ = M_1 + time liability portion of savings deposits with banks + certificates of deposits issued by banks + short term deposits maturing within one year.

$\mathbf{M_3}$ = M_2 + term deposits over one year maturity + call/short term borrowings of banks. M_3 is referred to as **broad money** by the RBI as it includes not only narrow money (i.e., currency plus bank money held by the people) but also other liquid or monetary resources with the public.

Managing Agency System: The system of management of companies developed during the 19th and early 20th centuries in India. The companies gave the responsibilities of management to the managing agents for a remuneration. This system is referred to as the managing agency system in the analysis of Indian economic history.

Margin: That part of a transaction or borrowing which a borrower must pay to initiate transaction, with the other part being borrowed from the lender financial institution. There are two types of margin: initial margin, and maintenance margin. In another context, margin means that part of the value of collateral security which is not given as a loan by the bank or any other financial instuition.

Market Risk: See **Systematic Risk**

Market Segmentation Theory: A theory of term structure of interest rate. The theory states that interest rates on securities with different maturities are effectively determined by the conditions that prevail in the different maturity segments of the market.

Market Value: Value determined by the market, that is, value determined by the forces of demand and supply.

Marketable Security: A security (stock, share, bond, etc.) that can be traded on a stock exchange.

Maturity (Date): The date on which a loan, bond, or debenture becomes due for payment.

Maturity Value: The amount an investor receives when a security is redeemed at maturity, not including any periodic interest payment.

Medium Term Debentures: Debentures having a medium term maturity (normally, 1 to 3 years). These are secured and negotiable and hence highly liquid.

Merchant Bank: A financial organisation that serves many needs of business enterprises, such as giving advice on financial alternatives, corporate mergers, underwriting new issues, loan syndication, etc.

Merger: Friendly or mutually agreed combining of two or more business concerns into one unit in order to increase the overall efficiency or mutual benefit. Also called **amalgamation**.

MMMFs: See **Money Market Mutual Funds**.

MNCs: See **Multinational Corporations**.

Monetary Control: Central bank's control of bank credit by using its quantitative and qualitative instruments, such as bank rate, open market operations, variable reserve ratio, selective methods of credit control, etc. Also known as **credit control**.

Monetary Policy: Deliberate and conscious action undertaken by the monetary authority to change the quantity, availability and cost (i.e., interest rate) of money and thereby to influence the level of economic activity.

Monetary System: A system used by a country to provide the public with money as the medium of exchange and to control the exchange of its currency with foreign currencies.

Money: Anything which acts as a medium of exchange or means of payment.

Money at Call: Money repayable on demand.

Money at Short Notice: Money repayable within a notice period up to 14 days.

Money market: A market in which financial instruments with maturities of less than one year are bought and sold.

Money Market Mutual Funds (MMMFs): An investment company whose assets consist primarily of treasury bills, negotiable certificates of deposit, commercial paper, banker's acceptances, etc.

Money Multiplier: The numerical coefficient which is to be multiplied with the amount of high powered money (i.e., currency plus reserves with banks) in order to get the amount of money supply in an economy.

Money Supply: Generally the sum of currency with the non-bank public and deposits with commercial banks.

Mortgage: Long-term liability collateralized by real property.

Mortgage Bond: Bond secured against physical asset such as plant and equipment.

Muddati Hundi: A financial instrument in unorganised credit market. Muddati hundi is like a usance (time) bill. It becomes payable after a stipulated period from the date of the hundi or after sight. The usance of these hundis is normally 30, 60, 90 or 120 days. However, the 90-day usance is the most popular.

Multinational Corporations (MNCs): A large enterprise having a home base in one country but operating through wholly or partially owned subsidiaries in other countries. Such corporations expand on an international scale to take the advantage of vertical and horizontal economies of scale as well as benefits from enjoying near monopoly status. Also known as **trans-national corporations**.

Mutual Fund: A trustee company which pools the resources of small savers (called unitholders) by selling units of small denominations and invests the pooled sum in a variety of instruments with the objective of giving the unitholders the maximum possible financial gain. Also called **unit trust**.

Narrow Money: Currency *plus* deposits with banks and other financial institutions. See $\mathbf{M_1}$.

NASDAQ: US over-the-counter market. Full name is National Association of Securities Dealers Automated Quotations system. It provides a computerized information network covering a wide range of security trading.

National Income: Money value of all final goods and services produced by the earning units of an economy during a financial year.

National Stock Exchange (NSE): Established in November1992 in Mumbai, NSE is a fully automated screen-based system of security trading.

NAV: See **Net Asset Value**.

NDS: See **Negotiated Dealing System**.

NEFT: A system of electronic fund transfer. Full form is National Electronic Fund Transfer.

Negotiable Instrument: Transferable instrument

Negotiated Dealing System (NDS): An electronic system facilitating dealing in Government securities and money market instruments, introduced by the RBI.

Net Asset Value(NAV): Actual value of the investments made by the mutual fund for each unit issued by it. It is calculated by taking the mutual fund's total assets, securities, cash and accrued earnings, deducting liabilities and accrued expenses, and dividing the remainder by the number of outstanding units.

Net Dividend: Dividend after deduction of tax payable from gross dividend.

Net Interest: The extra amount to be paid only for the use of money capital.

Net Liquid Assets: Cash and readily marketable securities *minus* current liabilities of a company. It measures the ability of a company to meet its current debt obligations.

Net Working Capital: The excess of current assets over current liabilities.

Net Worth: Difference between total assets and total liabilities.

New Issue: Shares of a company offered to the public, through a public issue, for the first time. Also called Initial Public Offer (IPO).

New Issue Market: See **Primary Market** and **Secondary Market**.

NIFTY: Share price index of National Stock Exchange. It is the weighted average of share prices of fifty companies listed on National Stock Exchange (NSE). Thus, NIFTY is the national index constructed from fifty share prices. Also called **NIFTY Fifty** or **CNX NIFTY.** Its base-year is 3 November 1995, the date on which the NSE completed exactly one year.

Nominal Interest Rate: Money interest rate on a fixed interest security calculated as a percentage of its par value or face value rather than its market price. It is the percentage return on deposit, loan or bond. Sometimes it is called **money interest rate**. Nominal or money interest rate does not take into account the effects of inflation.

Nominal Value: The face value of a share of a company. Also called **par value** or **at par** or **redemption value**.

Non-Diversifiable Risk: See **Systematic Risk.**

Non-Performing Assets (NPAs): Assets which are not performing, i.e., from which no income is being earned for a considerable period of time are called non performing assets.

Not negotiable: Not transferable.

Notional Money: See **Accounting Money**.

NPAs: See **Non-Performing Assets**.

NSE: See **National Stock Exchange**.

Offer for Sale: An offer of securities of a company to the public for subscription, through an offer document.

Off-Shore Finance: Financial help made by merchant banks to their off-shore clients in the areas involving foreign currency.

Ombudsman: Originated in Sweden, an independent person appointed to hear and act upon citizen's complaint about government services. Similar to that line, the RBI has arranged to appoint ombudsmen to attend to the various complaints arising in financial transactions. If any party is not satisfied with ombudsman's (free) service, he has the full right to take legal action.

OMO: See **Open Market Operations**.

Open-Ended Fund/Scheme: Fund or scheme available for subscription on repurchase on a continuous basis, i.e., all through the year. Opposite is **close-ended fund/scheme**.

Open Market Operations: Purchase and sale of government securities by central bank on its own initiative.

Option: An agreement whereby one person grants another the right to buy or sell certain goods or securities at an agreed price at or within a stated future time.

Option Bonds: Cumulative or non-cumulative bonds as per option of the buyer at the time of investment. In the case of cumulative bonds, interest is paid on maturity. In the case of non-cumulative bonds, interest is paid periodically.

Option Contract: An agreement that confers the right to buy or sell an asset at a set price at some future date. The right is exercisable at the discretion of the option buyer.

Ordinary Shares: See **Equities**.

Origination: Investigation, analysis, and processing of new project proposals by the new issue market. It starts before a new issue is actually offered in the market for sale.

OTCEI: See **Over-the-Counter Exchange of India**.

Over-capitalisation: A situation in which a company has more capital than its need. Then interest charge will be high and dividend will be low. Over-capitalisation may be reduced by: (i) repaying long-term debts and/or (ii) buying back own shares.

Over-Capitalised: A company or business which has more capital than it can profitably use, i.e., suffering from the problem of over-capitalisation.

Over-Draft: Drawing more money than has actually been deposited by an account-holder in his bank account.

Overpricing: Issue of securities above their face values. Also called **at a premium.** Opposite is u**nderpricing** or **at a discount**.

Oversubscribed: Securities are said to be oversubscribed when more have applied for than are being offered for sale.

Over-the-Counter Exchange of India (OTCEI): An exchange set up in October 1990 with the prime objectives of offering small and medium companies an access to a worldwide security market and developing a computerized scripless stock exchange of international standard at lower cost. The OTCEI offers a trading system equipped with electronic or computer network. Through this network, domestic as well as foreign buyers and sellers can trade in securities more efficiently and economically.

Paid-Up Capital: That part of the issued capital of a company which the subscribers have been required to pay. When issuing securities, the issuer may require only part payment of the issue price. The remainder is the uncalled capital, and may be called at any time as the financial needs of the company dictate. The difference between the called-up capital and paid-up capital represents calls-in-arrear.

Para-banking Lenders: Unregulated non-bank financial intermediaries in unorganised credit market of India. They include loan or finance companies, chit funds, and *nidhis* (mutual benefit funds).

Par Value: The value of a security when it is issued. For bond and preferred stock, par value is equivalent to face value. Variously termed as **nominal value** or **face value** or **at par**.

Partnership: A form of business enterprise with two or more persons involved in the ownership and control of that business.

Payee: A person or organisation who is to be paid.

Payer: A person or organisation who makes a payment.

Players: A diverse range of intermediaries, lenders and borrowers active in the capital market.

Placement: A method of distribution of new issues among the buyers. Under this method, issue houses or brokers buy the securities outright from the issuing company and sell them afterwards to the public. The difference between the selling price and the buying price is the profit per unit of the issue. Also called **private placement**.

Pledge: Any article (house, machine, car, deed, etc.) given by the borrower (pledger) to a lender (pledgee) as a security for a debt. The article remains in the ownership of the pledger although it is in the possession of the pledgee until the debt is repaid.

Portfolio: A set or group or combination of financial assets held by an investor. Also called **investment portfolio**.

Portfolio Investment: Investment which goes into the financial sector in the form of various financial assets. It involves neither control of operations of a business, nor ownership of physical asset.

Portfolio Management: Determining proper combination of securities in a portfolio so that it gives maximum return with minimum risk.

Precautionary Balance: The amount of cash held for precautionary motive, i.e., to meet unforeseen contingencies like death, sickness, etc.

Preference Share/Preferred Stock: Shares offering some preference or benefit over other types of shares. Such shares enjoy two types of preference over equity shares. First, payment of dividend should first be made to the preference shareholders. Second, at the time of liquidation or winding up, the company has to pay off first the preference shareholders. Also called **preferred stock**.

Premium: The difference between the face value of a security and the price at which it is actually sold (issued).

Primary Deposit: Deposit with a bank created at the initiative of the depositor. It is also known as passive transaction as the bank's role in this transaction is passive. Also see **Derivative Deposit**.

Primary Market: A market in which securities are issued for the first time. Also called **New Issue Market** or **Initial Public Offer (IPO)**. See **Secondary Market.**

Primary Rate: Rate at which banks lend to their most favoured or most credit-worthy customers.

Private Placement: See **Placement**.

Project Counselling: Counselling by merchant banks to corporates on their projects. It includes preparation of project reports, project finance and project approval.

Promissory Note: A negotiable instrument containing a promise to pay a certain sum of money to a person or to that person's order, or to the bearer of the note at a specified time in the future. It must be unconditional, signed by the issuer and delivered to the payee or bearer.

Prospectus: The document containing necessary and relevant information about a company prepared and made available when the company wants to raise fresh capital on the new issue market.

Public Issue: An invitation by a company to public to subscribe to the securities offered for sale in the security market.

Public Issue through Prospectus: An invitation by a company to public to subscribe to its new issue offered through prospectus.

Put Option: An option that gives the asset-holder the right to sell the asset at a fixed price during a certain period. Opposite is **Call option**.

Quoted Company: See **Listed Company**.

Quoted Securities: See **Listed Securities**.

Rate of Discount: See **Discount Rate**.

Real Interest Rate: Interest rate expressed in terms of real goods, i.e., nominal interest rate adjusted for inflation. It is the nominal interest rate minus the rate of inflation.

Real Time Gross Settlement (RTGS): Transactions settled across accounts held at the central bank on a continuous gross basis. The settlement is immediate, final and irrevocable.

Redemption: Buy back or repurchase by a company of its securities.

Redemption Price: The price at which a security is redeemed. Also means the price per unit which the unitholder receives when the scheme is liquidated.

Redemption Value: See **Nominal Value** or **Face Value**.

Regular Income Bond: Bond paying interest at regular intervals with the facility of early redemption.

Reinsurance: The passing of all or part of an insurance risk that has been covered by an insurer to another insurer in exchange for a premium.

Re-mat/Rematerialisation: The process of converting a scrip or security certificate existing only in electronic number into physical securities. Also see **Dematerialisation/De-mat**.

Repo: Repurchase agreement. It is an agreement between the buyer and the seller in the sale of securities to reverse the transaction in the future at a specified date and price.

Repo Rate: In India's finance market, repo rate simply means the rate at which the RBI lends money to commercial banks. See **Reverse Repo rate**.

Repurchase Agreement: See **Repo**.

Repurchase Price: Another name for redemption price. It is the price or net asset value (NAV) at which the issuer of an open-ended scheme purchases or redeems its units from the unit holders. It may include exit load, if applicable. Also see **Redemption Price**.

Reservation Price: The minimum price a security holder must get in order to sell the security.

Reserve Requirement: Minimum reserve assets which by law a depository financial institution must maintain. Reserve requirements are expressed in terms of a percentage of relevant deposits.

Retained Earnings: The part of company's net profits after tax which is not distributed among shareholders as dividends and is kept with the company presumably for its growth and expansion. Also called **undistributed profits** or **undistributed reserves**.

Retirement Bond: The bond which gives the investor an assured monthly income for a fixed period after the expiry of the "wait period" chosen by the bond holder.

Revaluation: An increase in the foreign value of home currency. Opposite is **devaluation**.

Reverse Repo: The purchase of securities with an agreement to resell them at a higher price at a specific future date. Also called reverse repurchase agreement. See **Repo**.

Reverse Repo Rate: In the Indian context, it is the rate at which commercial banks lend money to the RBI. See **Repo Rate**.

Rights Issue: Issue of securities to existing shareholders/bond holders on a pre-emptive or priority basis. Shares thus obtained/issued are called **rights shares**.

Rights Share: See **Rights Issue**

Risk: Variability of return or gain from a financial asset on a portfolio. It is generally measured by standard deviation or beta co-efficient of returns.

Risk Aversion: Attitude that less risk is preferred to more risk, all other things being the same.

Risk Capital: Another name of venture capital. It is the capital invested in a risky project, particularly in a new venture. Risk capital is invested in the equity of a company. It is not a loan. See **Venture Capital**.

Rolling Settlement: A settlement of trade or transaction in which tradings executed during a day are settled on a daily basis.

RTGS: See **Real Time Gross Settlement**

Ruling Price: The current market price of a good or a security.

Samurai Bonds: Foreign bonds offered in the Japanese bond market.

Savings Banks: Banks established to encourage thrift by providing a secure depository, with some interest incentive, for the savings of people of limited means.

SCC: See **Selective Credit Control**.

Scheduled Banks: Banks which are entered in the Second Schedule of the RBI Act, 1934. Such banks are those which have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakh and which satisfy the RBI that their affairs are carried out in the interests of their depositors.

Screen-based Trading: Security trading through computers. Now-a-days, all the stock exchanges have transformed their trading into a computerised system. Under this system, bidding and bargaining in security prices take place not verbally but in an on-line process. This is called screen-based trading. This is possible if security certificates exist only in electronic number, i.e., in de-mat form. See **Dematerialisation/De-mat**. Also called **scripless trading**.

Scrip: A document or certificate which shows that the holder has subscribed money to a company and which entitles him to receive dividends (return or income).

Scripless Trading: Trading without any scrip or certificate of a security. Under dematerialisation or de-mat, scrips or share certificates cease to exit. They only exist in electronic numbers. Trading in financial securities on on-line basis and without any certificate in paper form or physical form is called scripless trading. Also called **screen-based trading**. See **De-mat/ Dematerialisation.**

SDR: See **Special Drawing Rights**.

SEBI: See **Securities and Exchange Board of India**.

Secondary Market: Market in which already existing or issued or outstanding securities are traded. Also called **exchange** or **stock market**. See **Primary Market**.

Secondary Security: A financial claim issued by a financial intermediary. See **Indirect Finance**.

Securities and Exchange Board of India (SEBI): The watchdog of Indian capital market. It is a statutory body authorised to regulate and supervise the working of financial intermediaries and institutions and to oversee the activities of stock exchanges in India.

Securitisation: A technique by which a financial company converts its illiquid, non-negotiable and high-value financial assets into small-value, tradable and transferable securities.

Security: A wide range of financial assets, equities and debentures. Short term assets like bills are sometimes included, but the word generally tends to refer to longer term assets. Thus, in general sense, security means any financial paper or instrument.

Security Market: The market which deals in securities. The term security embraces both short term and long term financial instruments. Hence, security market includes those markets which trade in both short-term and long-term financial instruments. In other words, security market includes both money market and capital market.

Seed capital: Term loan for the purchase of fixed assets and some amount towards working capital provided by the financial institutions to the industrial units.

Selective Credit Control (SCC): Refers to some measures used by the central bank of a country to regulate the volume of credit going to certain selected sectors of the country. It may have different forms, such as regulation of consumer credit, variation in margin requirement, differential rates of interest, etc.

SENSEX: See **Sensitive Index**.

Sensitive Index (SENSEX): The weighted average of equity share prices of thirty companies listed on Bombay Stock Exchange. While constructing the index, it takes the financial year 1978–79 as the base year.

Shares: See **Equities**. Also see **Stocks**.

Share Capital: The total of shares issued, or authorized to be issued, by a company.

Share Market: Market where old and existing shares of registered and enlisted companies are traded. Also called stock market or stock exchange. See **Primary Market** and **Secondary Market**.

Sick Unit: An industrial unit which fails to produce profitably or fails to repay its debt. For a sick unit, the ratio of current assets to current liabilities is less than one, i.e., current assets are less than current liabilities.

Sight Bills: See **Demand Bills**.

Simple Interest: Interest calculated only on the initial investment. See **Compound Interest**.

Slump: A severe downturn phase or recession in the trade cycle. Its opposite is **boom**.

Soft Loans: Loans on liberal terms and conditions.

Special Drawing Rights(SDR): A new form of international reserve asset created by the IMF in 1967. The value of SDR is based on a portfolio of widely used currencies. SDR is a **notional money** or **accounting money** of IMF.

Speculation: When the investor trades in security on the basis of anticipated or expected price changes of the security, he is said to be engaged in speculation.

Speculative Demand for Money: Amount of cash held for speculative purposes, i.e., for practising speculation.

Spot Delivery: Actual delivery of securities and the payment of price on the same date of trade or on the next day.

Spot Rate: Price of a security which applies to the spot delivery of the security. See **Spot Delivery**.

Spot Trading: Trading of securities on the spot. However, the security will be delivered on the same date of trade or on the next day. See **Spot Delivery**.

Spread: See **Bid-Ask Spread**.

Stag: Share market investors who frequently buy and sell shares for speedy encashment of profit.

Stagflation: Stagnation coupled with inflation. A very common situation in less developed countries suffering from lack of capital.

Stakeholder: Person or persons having an interest in a firm or organisation, such as its shareholders, bond holders, workers, consumers, suppliers, local people and so on.

Stamp Duty: The *ad valorem* (as per value) duty payable by buyer for transfer of shares or any other security in his name. Also payable on contracts issued by a stockbroker.

Standard Money: Money whose metallic value is equal to its value as the medium of exchange. See **Token Money**.

Start-up Capital: Initial capital to start a business.

Stock: The issued capital of a company or a particular issue of securities (e.g., by a government), which is in a consolidated form so that it can be held or transferred in any amounts.

Stockbroker: A broker specialised in dealing in stocks and shares. Also see **Broker**.

Stock Exchange: A market where existing stocks, shares and debentures are bought and sold under a code of rules and regulations. Also known as **stock market** or **share market** or **secondary market**. See **Primary Market**.

Stock Market: See **Stock Exchange**.

Store of Value: One of the functions of money. Unlike a barter situation, money enables wealth or value to be stored. An individual can sell a good or service and store the money until he needs something, and can then use the money to purchase what he needs. Money thus acts as a store of value. To be useful as a store of value or wealth, money must have a stable value. If the price level changes considerably, the purchasing power of money will greatly change. Money will not then be considered to be useful for storing value as it would not be reliable in terms of future purchasing power.

Sub-broker: An agent of broker on the stock exchange. A sub-broker acts on behalf of a stock-broker as an agent and helps the investors in buying, selling, or dealing in securities on the stock exchange through such stock-brokers.

Surplus Spending Unit: An economic entity whose income in a given period exceeds its expenditure. Opposite is **deficit spending units**.

Syndicate: See **Consortium**.

Systematic Risk: Risk that cannot be avoided through diversification of the portfolio. It is also referred to as **market risk** or **non-diversifiable risk**. See **Unsystematic Risk**.

Takeover: See **Acquisition**.

Tangible Asset: Physical asset such as plant, machinery, factories and offices. Opposite is **intangible asset**.

T-bill: Short form of **treasury bill**.

Tender method: See **Book Building Method**.

Term Loan: A loan which is generally repayable in more than one year.

Term structure of Interest Rates: The relationship between the length of maturity of loans and interest rates on them.

Thin Market: The market in which there are few buyers and sellers for a security. Opposite is **deep market**.

Third World: Underdeveloped or less developed countries (LDCs) of the world, the first world being the advanced capitalist countries and the second world being the erstwhile socialist countries.

Tight Money Policy: An alternative name of **dear money policy**. It is a monetary policy of reducing money supply or bank credit by the central bank or monetary authority of an economy. Under tight money policy, loans are difficult to obtain and only available at high rates of interest. This type of monetary policy is adopted to control inflation when there is excess demand in the economy. See **Dear Money Policy**. Opposite is **cheap money policy**.

Time Deposit: A deposit of money in an interest-bearing account for a specified period. Such deposit can be withdrawn by giving a short notice. Also see **Demand Deposits**.

Time Value of Money: The concept that cash received earlier (today) is worth more than a similar sum received later (tomorrow).

Token Money: Money whose face value or value as the medium of exchange exceeds its intrinsic or metallic value. See **Standard Money**.

Transaction Balance: Amount of cash held for transaction motive i.e., to make regular transactions of goods and services.

Trans-national Corporations: See **Multinational Corporations**.

Treasury Bills/T-bills: Short term government bonds that are available only in large denominations. In India, it refers to short term money market instrument issued by the RBI on behalf of the central government. Its maturity periods are generally 91 days, 182 days or 364 days. Thus, treasury bills are repayable within few months.

Treasury Bill Rate: The rate of interest obtainable by buying a treasury bill or T-Bill at a discount and selling it at its redemption value (face value). Treasury bills bear no interest directly, the yield being the difference between the purchase price and the redemption price.

Trustee: One to whom the management of property or money on behalf of another is committed.

Unauthorized or Unregulated Credit Organisations: Those credit organisations which are not recognised by the Reserve Bank of India.

Underpricing: Issue of securities below their market values. Also called **at a discount**. Opposite is **overpricing** or **at a premium**.

Underwriter: One who does underwriting. It is a financial institution which commits to subscribe the whole or a part of unsold securities issued by a company.

Underwriting: The arrangement in which financial institutions provide guarantee to purchase the whole or a part of unsold securities issued by a company.

Undistributed Profit: See **Retained Earnings**.

Unit Trusts: See **Mutual Fund**.

Universal Bank: A bank or financial institution that has the legal authority to offer all kinds of financial services. Thus, a universal bank may be engaged in security trading, insurance, underwriting, all merchant banking services and full range of conventional banking services. In India, ICICI is the universal bank.

Universal Banking: Banking that includes not only traditional services of taking deposits and making loans but also merchant banking services relating to investments in companies. It is an amalgam of commercial banking, merchant banking and development banking. In India ICICI is doing universal banking.

Unorganised Credit/Money Market: The informal and often usurious credit system existing in most less developed countries, particularly in rural areas. This market is beyond the control of the monetary authority of a country. Here, small and medium farmers and firms with little collateral are forced to borrow from moneylenders at a very high rate of interest (called "usury" in economics).

Unsystematic Risk: Variously called as non-diversifiable risk, residual risk, or company-specific risk. It is the risk which is unique to a company, such as strike, the outcome of unfavourable litigation, etc. It is also referred to as unique risk, specific risk, etc. Opposite is **systematic risk**.

Variable Rate Debentures: Debt instruments carrying a compound rate of interest which varies from time to time according to some pre-determined formula.

Velocity: The speed with which money circulates in the economy. It is defined as the ratio of income to the money supply.

Venture Capital: Initial funds for risky operations of a firm.

Venture Capital Fund: A fund, registered under SEBI and raised under specific regulations, used for investments in venture capital undertaking in accordance with some regulations.

Volatility: Fluctuations in return or price of a security or portfolio.

Voting Rights: The entitlement of a shareholder to exercise vote in the general meeting of a company.

Warrant: A corporate-created option to purchase a stated number of ordinary shares at a specified price within a specified time.

Window Dressing: A manoeuvre or manipulation in accounts by companies, banks and financial institutions in order to impress shareholders and customers.

Working Capital: The amount of current assets which is financed from short-term sources of finance. Its size is an indicator of the liquidity and solvency of a company. See **Circulating Capital** and **Fixed Capital**.

Working Capital Ratio: See **Current Ratio**.

Yankee Bonds: Bonds issued in US domestic market by a non-US entity.

Yield: Used to mean various types of returns: 1) The return from investment in shares or stocks, called dividend yield. 2) Interest obtained from a security, expressed as a percentage of its par value or face value. It is then called nominal yield. 3) The capital gain or loss on redemption of a stock is called the redemption yield.

Yield to Maturity (YTM): The average annual rate of return from a security at the time of its maturity.

YTM: See **Yield to Maturity**.

Zero Coupon Bond: Bond sold at a discount and without any coupon rate written on it. The return to the investors is the difference between the acquisition value and the redemption value.

Abbreviations

ABS	Asset Backed Security
ADB	Asian Development Bank
ADRs	American Depository Receipts
AGM	Annual General Meeting
ARC	Agricultural Refinance Corporation (India)
ARDC	Agricultural Refinance and Development Corporation (India)
AMC	Asset Management Company
BoA	Basis of Allotment (of securities)
BOI	Bank of India
BOLT	BSE on-line Trading
BSE	Bombay Stock Exchange
CARE	Credit Analysis and Research on Equities Limited
CCI	Controller of Capital Issues
CCIL	Clearing Corporation of India Limited
CDs	Certificate of Deposits
CDSL	Central Depository Services Limited
CHSE	Clearing House of Stock Exchange
CLB	Company Law Board
CMA	Credit Monitoring Arrangement
CPs	Commercial Papers
CPF	Customers' Protection Fund
CRA	Credit Rating Agency
CRISIL	Credit Rating Information Services of India Limited
CRR	Cash Reserve Ratio
CSE	Calcutta Stock Exchange Limited
DAC	Disciplinary Action Committee
DC	Defaulter Committee
DCA	Department of Company Affairs

DFHI	Discount and Finance House of India Limited
DFIs	Development Financial Institutions
DPs	Depository Participants
ECU	European Currency Unit
EXIM Bank	Export-Import Bank of India
FCDs	Fully Convertible Debentures
FCI	Food Corporation of India
FEMA	Foreign Exchange Management Act
FIIs	Foreign Institutional Investors
GDRs	Global Depository Receipts
GIC HFL	GIC Housing Finance Limited
GICI	General Insurance Corporation of India Limited
GOI	Government of India
HDFC	Housing Development Finance Corporation Limited
HIDCO	Housing and Infrastructure Development Corporation Limited
HUDCO	Housing and Urban Development Corporation Limited
IBP	Inter-bank Participation
IBRD	International Bank for Reconstruction and Development (World Bank)
ICF	Investors' Compensation Fund
ICICI	Industrial Credit and Investment Corporation of India Limited
ICICI HFC	ICICI Home Finance Company Limited
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India Limited
IGRC	Investors' Grievance Redressal Committee
IGC	Investors' Grievance Cell
IIBI	Industrial Investment Bank of India
IICRA	Investment Information and Credit Rating Agency of India Limited
IMF	International Monetary Fund
IOU	I owe you
IPF	Investor Protection Fund
IPO	Initial Public Offering
IRA	Insurance Regulatory Authority
IRBI	Industrial Reconstruction Bank of India
IRCI	Industrial Reconstruction Corporation of India
IRDAI	Insurance Regulatory and Development Authority of India
ISC	Investors' Services Cell
JCR	Japan Credit Rating Agency Limited
KPO	Knowledge Process Outsourcing

LAF	Liquidity Adjustment Facility
LBS	Lead Bank Scheme
LDBs	Land Development Banks
LDCs	Less Developed Countries
LIC HFL	LIC Housing Finance Limited
LICI	Life Insurance Corporation of India Limited
LPG	Liberalisation, Privatisation and Globalisation
M&A	Merger and Acquisition
MFAL	Marginal Farmers and Agricultural Labourers
MMMFs	Money Market Mutual Funds
MMTC	Metals and Minerals Trading Corporation of India
MoA	Memorandum of Association
MoU	Memorandum of Understanding
MSME	Micro, Small and Medium Enterprises
NABARD	National Bank for Agriculture and Rural Development
NASDAQ	National Association of Securities Dealers Automated Quotations
NAV	Net Asset Value
NBFIs	Non-bank Financial Intermediaries
NCLT	National Company Law Tribunal
NDS	Negotiated Dealing System (in securities)
NEAT	National Exchange for Automated Trading
NEP	New Economic Policy
NHB	National Housing Bank, National Housing Board
NIDC	National Industrial Development Corporation of India
NPA	Non-performing Asset
NRIs	Non-resident Indians
NSDL	National Securities Depository Limited
NSE	National Stock Exchange
NSIC	National Small Industries Corporation Limited
OMO	Open Market Operations
ONICRA	Onida Individual Credit Rating Agency of India Limited
OTCEI	Over-the-Counter Exchange of India
PNB	Punjab National Bank
POP	Public Offering Price
PPP	Public–Private Partnership
RBI	Reserve Bank of India
R&I	Rating and Investment Information Inc.
RoC	Registrar of Companies

RTGS	Real Time Gross Settlement
SAT	Securities Appellate Tribunal
SBI	State Bank of India
SBI HFL	SBI Home Finance Limited
SCRA	Securities Contract Regulation Act
SDRs	Special Drawing Rights
SEBI	Securities and Exchange Board of India
SFDA	Small Farmers Development Agency
SHFSs	The State Housing Finance Societies
SIDBI	Small Industries Development Bank of India
SIDCs	State Industrial Development Corporations
SLR	Statutory Liquidity Ratio
SPN	Secured Premium Note
SPV	Special Purpose Vehicle
SRO	Self-Regulatory Organisation
STC	State Trading Corporation of India Limited
STCI	Securities Trading Corporation of India Limited
TBs	Treasury Bills
TDICI	Technology Development and Information Company of India Limited
UBI	United Bank of India
UCO	United Commercial Bank
UK	United Kingdom
USA	United States of America
UTI	Unit Trust of India
UTI MF	UTI Mutual Fund
VRR	Variable Reserve Ratio
WDM	Wholesale Debt Market
YTM	Yield to Maturity

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